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MANAGING RISKS FOR MACROECONOMIC STABILITY

LAO PDR ECONOMIC MONITOR
January 2014

Sector Focus

School Based Management in Lao PDR:
Current Conditions and Recommendations for the Future

THE WORLD BANK

The World Bank

Lao PDR Economic Monitor – January 2014 was prepared by the World Bank country team under the guidance of the Sector Manager and Lead Economist for South-East Asia Region, Mathew Verghis and Senior Country Economists, Alain W. D'Hoore and Richard Record. The team comprises of Keomanivone Phimmahasay, Alain W. D'Hoore and Somneuk Davading (recent economic developments and overall report), Saysanith Vongviengkham and Leah April (public finance), Ratchada Anantavrasilpa (financial sector), Konesawang Nghardsaysone and Richard Record (private sector and trade facilitation) and Lucrecia Santibanez from RAND and Omporn Regel (school based management). The team would like to express its gratitude to the Government of Lao PDR (especially BOL, MOF, MPI/LSB, MEM, MOIC, MoICT, MAF and other ministries) and the Lao National Chamber of Commerce and Industry and its members for providing essential inputs. We would like to also thank our World Bank colleagues: Vattana Singharaj, Meriem Gray and Toomkham Luanglath, for administrative support and dissemination of the Monitor.

"THE WORLD BANK TEAM APPRECIATES FEEDBACK ON STRUCTURE AND CONTENT OF THE MONITOR"

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EXECUTIVE SUMMARY

Recent Macroeconomic Update

The Lao economy is estimated to grow at 8.1 percent in 2013, fueled by a vibrant resource sector, continued FDI-financed investment in hydropower, and accommodative macro economic policies. The hydropower sector (both completed projects in operation and projects in the construction/development phase), construction, food processing and services sectors remain the major contributors to this growth. This is aided in part by accommodative macroeconomic policies. Domestic credit growth has remained high at about 31 percent (year-on-year) in September 2013 driven by private sector credit. In addition, public spending has also expanded through a substantial base wages increase and the provision of monthly benefits of 760,000 kip per person to all public employees.

Growth is projected to moderate to 7.2 percent in 2014, reflecting a small projected slowdown in some real sectors, mainly mining and construction. Key growth drivers are expected to come from services (wholesale and retail, transportation and telecommunication), and food processing and beverages, supported by continued strong domestic demand and construction and construction-related industry. The resource sector is expected to provide a smaller direct contribution to growth in 2014 as new commercial operations of major power projects are not expected and the halt in Sepone's gold production is likely to offset some gains in expected higher copper production.

Inflationary pressures, mainly through food prices, are not showing signs of dissipating by end 2013. The headline inflation reached about 7 percent in November 2013. With fast growing meat prices earlier in the year first, and lately a pick-up in rice prices, food price inflation has driven the inflation process through most of 2013.

In FY12/13, the fiscal deficit widened markedly due to a combination of a large increase in public sector wages and benefits, and a decline in grants and mining revenues. Total expenditure is estimated to have risen fast in FY12/13 driven by the more-than-two folds rise in the wage bill, including salaries and benefits. This large increase reflected three main factors: a 40 percent increase in the base wage; a large 760,000 kip monthly allowance to all public employees; and about 10 percent increase in new public recruitments. This total wage and benefits increase was equivalent to almost 5 percent of GDP compared to FY11/12, which was the major contributor to a higher fiscal deficit, followed by lower mining revenues and grants. As a result, the fiscal deficit is estimated to have widened sharply to 5.8 percent of GDP, from 1.3 percent in FY11/12 and non-mining fiscal balance to 8.6 from 4.6 percent in the same period. The rapid widening in the deficit appears to have strained the cash position of the government in recent months, leading to payment delays (or arrears) on wages and non-wage items to be carried on to the next fiscal year.

The FY13/14 budget plan indicates a narrower fiscal deficit of about 4.3 percent. Overall spending remains high because a combination of a further 40 percent increase in wage index and new recruitment despite the cut in benefits to civil servants and some capital spending. However, the deficit (cash basis) could be higher of up to about 6 percent of GDP if arrears such as payments for

EXECUTIVE SUMMARY

wages arrears from FY12/13 were included. On the revenue side, the focus has been placed on strengthening revenue administration. However, mining revenue contribution remains uncertain due to projected lower commodity prices and expected lower total gold production in 2013-2014 that will partly offset the expected copper output increase in the same period. Therefore, the path of the fiscal deficit in FY13/14 will critically depends on the authorities' ability to achieve an unusually strong performance in revenue collection and to maintain tight control over spending across categories.

The risk of debt distress remains moderate, according to the recent Joint IMF-World Bank Debt Sustainability Analysis (DSA) 2013. Although all external debt distress indicators remain below the policy dependent indicative thresholds during the projection period under the baseline scenario, the thresholds are breached under certain shocks. The ratios of external public and publically guaranteed debt and its net present value to GDP have risen in 2012, particularly from an increase from bilateral sources. Non-concessional borrowing has also risen, from a low base, due to SOEs and the government to finance equity stake in hydropower projects. This commercial borrowing also includes the first bond issuance on the Thai bond market in May 2013 in an amount of US$50 million (about 0.5 percent of 2013 GDP) to finance the general public investment program. Debt service ratios remain within the policy-dependent indicative thresholds mainly due to the high level of concessionality of official borrowing, although the share of concessional loans is expected to decline in the future. Therefore, strengthening fiscal and debt management capacity is of crucial importance.

While the Bank of Lao PDR maintains nominal exchange rate stability of the Lao kip against major currencies, foreign exchange policy should probably give more consideration to reserve management and competitiveness. In nominal terms, the kip depreciated only slightly against USD during January-November 2013 while it appreciated against the Thai Baht by about 3.8 percent in the same period, as Baht has weakened against USD in the wake of political turmoil Thailand. The effective exchange rate appreciated by 2 percent in nominal terms and by 5.5 percent in real terms during January-November 2013. The continued real appreciation of the exchange rate implies a deterioration of competitiveness for Lao PDR's tradeables exports, which exacerbates the pressure on the external balance.

Foreign exchange reserves and net foreign assets continued to fall in the third quarter of 2013. Reserves are expected to reach about $600 million by end 2013 which would make the level lowest in a decade with only 1.3 months of goods and services imports. This trend has been fueled by a widening current account deficit. While a significant portion of the current account deficit is accounted for by increased investment in the resource sector, strong domestic demand, fueled in part by accommodative fiscal and monetary policies and a continued real appreciation of the exchange rate have contributed to the pressures on the overall external balance and foreign reserves. The declining reserve buffers raise concerns over the country's resilience in absorbing any adverse shock. In response, the Bank of Lao PDR recently issued an instruction to discourage lending in foreign currencies to businesses that have insufficient foreign currencies earnings and to limit cash withdrawals from foreign currency accounts. Although the effect of these measures has yet to be fully realized, such a step signals the move by the monetary authority to addressing more forcefully the issue of low foreign reserves.

Sector Focus

School Based Management in Lao PDR

Lao PDR's education system faces challenges in meeting its goals of providing all students with access to education and improving learning outcomes. The government has increased spending on education aiming to improve student outcomes. Nevertheless, it has faced challenges, for example, non-wage, public recurrent expenditure, which serves to pay for school materials, equipment, teacher training, etc., is still relatively low. Private household financial contribution has remained a contributing part of funding for schooling. The lack of resources constitutes a constraint learning resources and quality of facilities.

The study presents a framework explaining how school based management can help improve education quality. In order to help address challenges on education quality, in 2011 the government instituted a School Block Grant (SBG) program, which is a form of School Based Management (SBM), that provides financial contribution for schools as non-wage expenditure per student and gives provinces, districts and schools greater administrative control with a view to improve effective educational administration and schooling quality. As this initiative is at its early stage, challenges encountered include, among others, the limited local capacity. The study then provides possible suggestions in areas such as local capacity building, improving of timeliness of fund delivery, and improving accountability mechanisms. The summary section provides further details.

ACRONYMS AND ABBREVIATIONS

ASEM	Asia-Europe Meeting
BOL	Bank of Lao PDR
BOP	Balance of Payment
CB	Commercial Bank
COD	Commercial Operation Date
CPI	Consumer Price Index
DEBs	District Education Bureaus
EAP	East Asia & Pacific
EQS	Education Quality Standards
ESDF	Education Sector Development Framework
EU	European Union
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GOL	Government of Lao PDR
IMF	International Monetary Fund
IPP	Independent Power Producers
LDC	Least Developed Country
LNCCI	Lao National Chamber of Commerce and Industry
LSB	Lao Statistics Bureau
LSX	Lao Securities Exchange
LXML	Lane Xang Mineral's Limited
MAF	Ministry of Agriculture and Forestry
MDG	Millennium Development Goals
MEM	Ministry of Energy and Mines
MOES	Ministry of Education and Sports
MOF	Ministry of Finance
MOIC	Ministry of Industry and Commerce
MPI	Ministry of Planning and Investment
NA	National Assembly
NEER	Nominal Term Effective Exchange Rate
NFA	Net Foreign Assets
NPL	Non-Performing Loan
NSEDP	National Socio-Economic Development Plan
PBM	Phu Bia Mining
PPG	Public and Public Guaranteed Debt
QOQ	Quarter on Quarter
REER	Real Effective Exchange Rate
RO	Right Offering
SBG	School Block Grants
SBM	School Based Management
SOCBs	State-Owned Commercial Banks
SOE	State-Owned Enterprise
UHC	Universal Health Coverage
VAT	Value Added Tax
WB	World Bank
WEO	World Economic Outlook
YOY	Year on Year

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PART I
RECENT ECONOMIC DEVELOPMENTS

RECENT ECONOMIC DEVELOPMENTS

GROWTH AND INFLATION

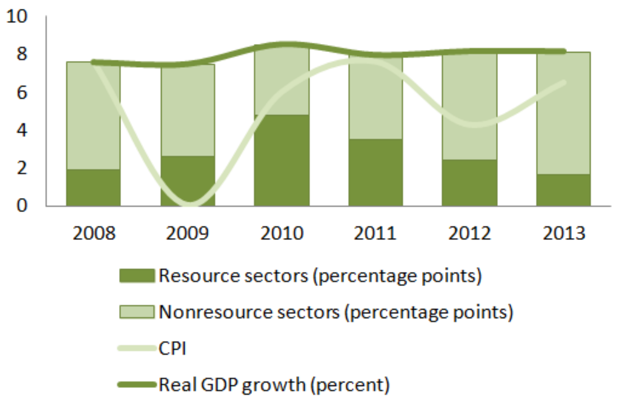
The Lao economy is estimated to grow at 8.1 percent in 2013, fueled by a vibrant resource sector, continued FDI-financed investment in hydropower, and accommodative macroeconomic policies. The hydropower sector (both completed projects in operation and projects in the construction/development phase), construction, food processing and services sectors remain the major contributors to this growth. Furthermore, the hydropower contribution to GDP will benefit from the completion[1] and development of several large hydropower projects including Hongsa Lignite, Sayaboury, Nam Ou, and Xepian Xe Namnoi projects, with large spillovers to the construction, food and services sectors. Growth in the services sector is strong across main sub-sectors, in wholesale and retail trade, tourism, transportation and telecommunication, and banking. The growth was also supported in part by accommodative monetary and fiscal policies. Domestic credit growth has remained high at about 31 percent (year-on-year) in September 2013 driven by private sector credit. In addition, public spending also expanded through a substantial base wages increase and provision of monthly benefits of 760,000 kip per person to all public employees.

For 2014, growth is projected to moderate to 7.2 percent, reflecting a small projected slowdown in some real sectors, mainly mining and construction. The forecast does not assume that macroeconomic policy will be markedly less expansionary. Fiscal policy, in particular, will only be moderately less so, since the authorities decided to retain a large wage increase even as allowances were canceled for the current fiscal year, saving an estimated 2 percent of GDP. On the supply side, key growth drivers are expected to come from services (wholesale and retail, transportation and telecommunication), and food processing and beverages, supported by continued strong domestic demand. Construction and construction-related industry are expected to still grow fast, albeit at a slower pace compared to the high base in recent years. The resource sector is expected to provide a smaller direct contribution to growth in 2014. On the hydropower side, the sector's output will be broadly flat, as new commercial operations of major power projects are not expected to come on stream in 2014. The contribution from the mining sector will benefit from increased copper production, which will compensate for the halt in Sepone's gold production from end 2013[2].

1 Completed projects expected to commence full operations in 2013 include Nam Ngum 5 and the Theun Hinboun expansion project.

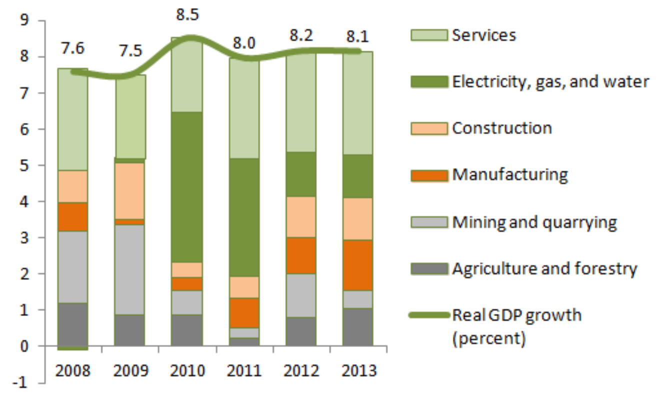
2 In November 2013, MMG Limited (Sepone mine) announced a decision to cease gold operations at its Sepon mine in Laos effective December 2013 due to depleting ore reserves and lower margins. See more detail at http://www.mmg.com/en/Investors-and-Media/News/2013/11/18/Sepon-to-cease-gold-production.aspx

Figure 1. Growth and Inflation (percent change)



Source: Government, LNCCI data and staff estimates and projections

Figure 2. Real GDP Growth (at factor cost): Contribution by Sector (percentage points)

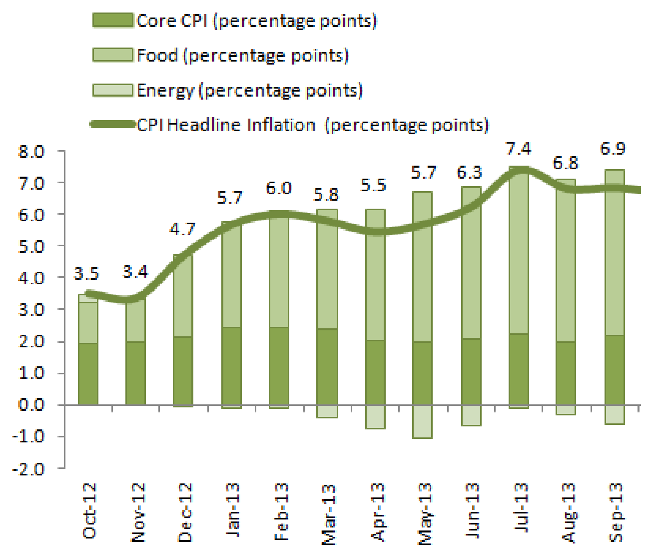


Source: Government, LNCCI data and staff estimates and projections

INFLATION

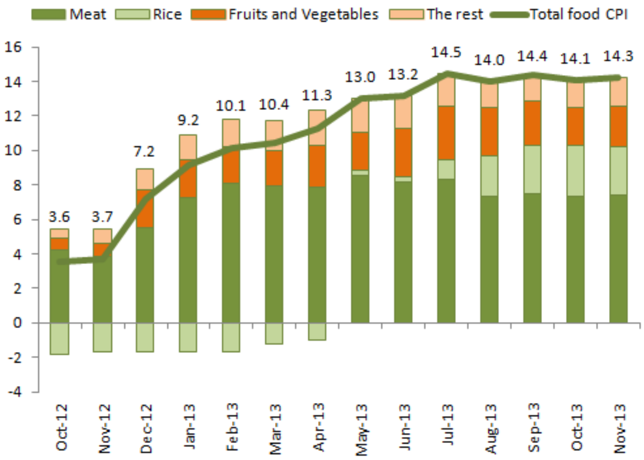
Inflationary pressures, mainly through food prices, are not showing signs of dissipating by end 2013. With fast growing meat prices earlier in the year first, and lately a pick-up in rice prices, food price inflation has driven the inflation process in Laos through most of 2013. Overall inflation has doubled since early 2013, and the headline inflation is projected at 6.5 percent for 2013, compared to 4.3 percent in 2012. Overall inflation accelerated from 3.5 percent YOY in late 2012, to 5.5 percent YOY by April 2013, and almost 7 percent in November, off only somewhat from its peak in July (at 7.4 percent) (Figure 3). Headline inflation has since leveled off at around 7 percent in the past few months. Food price inflation has decelerated slightly since July but remained above 14 percent (Figure 4). The increase in meat and vegetable prices that drove sharply higher food price inflation earlier in the year has slowed down somewhat but remains high, while rice consumer prices have accelerated in the last three months, registering around 17 percent increase, broadly in line with a recent strengthening of glutinous rice prices in Thailand (Figure 5). This said, accommodative macroeconomic policies are also a factor behind the continued momentum in inflation, and they raise the risk that higher inflation expectations could become entrenched even if supply/demand factors dissipate.

Figure 3. Monthly Inflation (YOY percent change)



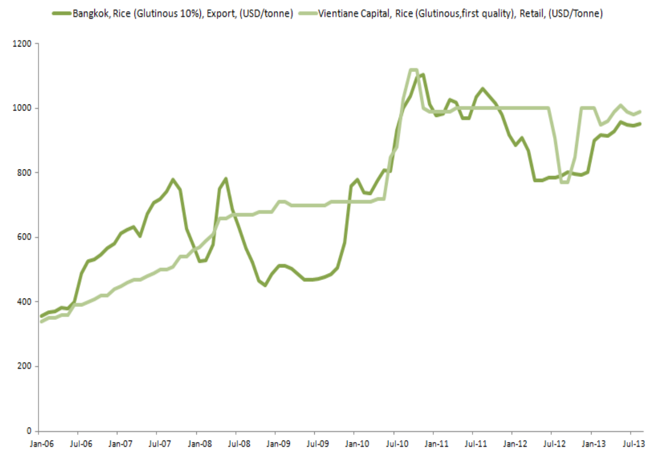
Source: MPI (LSB) and staff calculations

Figure 4. Contributions to Food Inflation



Source: MPI (LSB) and staff calculations

Figure 5. Thai and Lao glutineous rice price (USD/Tonne)



Source: www.fao.org

GOVERNMENT'S REVENUE AND EXPENDITURE

In FY12/13, the fiscal deficit widened markedly due to a combination of a large increase in public sector wages and benefits, and a decline in grants and mining revenues. Total revenues and grants declined from 19.7 percent of GDP in FY11/12 to about 19.1 percent in FY12/13 due mainly to lower grants (Figure 7). Overall domestic revenues eased to 17.1 percent of GDP in FY12/13, from 17.2 the previous year, as strong non-resource tax performance almost offset lower mining revenue. Mining revenues fell by 4 percent, as a fall in copper prices and higher mining production costs that partly offset the volume and gold price gains in 2012—as a share of total revenues, mining revenues dropped from their high of 19 percent in 2012, to 16 percent in 2013 (hydro revenues remained at 5.5 percent of total domestic revenue). At the same time, non-resource taxes, particularly VAT and excise taxes, registered a strong performance, growing by 21 percent in nominal terms, and from 11.8 percent of GDP in 2012 to 12.3 percent of GDP in 2013 (Figure 7).

Total public expenditure for FY12/13 rose sharply, mainly as a result of a large increase in the wage bill. Total expenditure is estimated to have risen by 37 percent in FY12/13 driven by the more-than-doubling (125 percent increase) in the wage bill, including salaries and benefits. The ratio of the wage bill to GDP rose from about 5 percent in FY11/12 to 9.5 percent in FY12/13 (Figure 9). This large increase reflected three main factors: a 40 percent increase in the base wage (in the same proportion for all wages) (Figure 8); a large 760,000 kip monthly allowance to all public employees—estimated to cost about 2 percent of GDP; and new recruitments, adding an estimated 10 percent to the numbers of employees.

Wages in FY12/13 accounted for about 70 percent of the non-resource domestic revenue—one measure of stable sources of revenue on which to fund stable, hard-to-compress spending (Table 1). The vulnerability of budget execution to negative shocks on the revenue side is heightened. As a result also, the share of domestic revenue that financed non-wage recurrent spending (including equipment, operations and maintenance, and important material, such as textbooks in public schools and medication in public health centers) decreased to its smaller share in recent years.

Further fiscal pressure has also emanated from a growing trend of local government reported encouragement of private pre-financing and execution of public infrastructure projects. These projects are pre-financed by private contractors citing development priorities of concerned regional authorities despite limited prior budget allocations, with related risks of creating contingent liabilities and intensifying pressure on the budget and the fiscal stance. While the current number and size of active and planned pre-financing arrangements remains unclear, the authorities will need to develop clear regulations and policies to manage these projects.

Overall, with lower revenues and sharply higher total spending, the fiscal deficit is estimated to have widened sharply to 5.8 percent of GDP, from 1.3 percent in FY11/12 (Figure 6). The overall non-resource fiscal deficit is estimated at 9.5 percent in FY12/13 (from 5.5 percent in FY11/12) while the non-mining fiscal deficit is estimated at 8.6 percent, from 4.6 percent in the previous year. The increased deficit was mainly due to the wage and benefits increase (equivalent to almost 5 percent of GDP increase compared to FY11/12), followed by lower mining revenues and grants. The rapid widening in the deficit appears to have strained the cash position of the government in recent months, leading to payment delays ("arrears") on both wages and non-wage items. It also encouraged the authorities to take corrective measures on short-term spending as the new fiscal year started.

The path of the fiscal deficit in FY13/14 will critically depends on the authorities' ability to achieve an unusually strong performance in revenue collection and to maintain tight control over spending across categories. On current plans, the fiscal deficit on a commitment basis—that is, based on current year's authorized spending plans—is projected to narrow to about 4.3 percent of GDP this fiscal year, with slightly higher revenues to GDP, broadly stable (relative to GDP) current spending, including on wages, and a decline in capital spending. At the same time, the fiscal deficit on a cash basis— that is, including the full payment of FY12/13's budget items in arrears—should widen to about 6 percent of GDP (cash basis), well above the level reached last year.

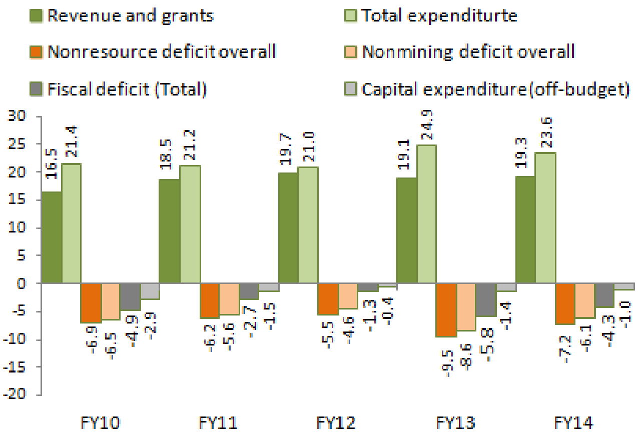
Overall spending will remain high, despite the cut in benefits to civil servants. This cut, however, is almost fully offset by a substantial rise in the wage index by about 40 percent, with the index value increasing from 4800 to 6700) (Figure 8), as well as continued recruitment, including the full-year effect this year of last year's recruitment[3]. An even larger concern is the continuation of the wage increase policy into next fiscal year (FY14/15). On current trends, the pursuit of this policy implies a further sizeable increase in the wage bill (in absolute and relative terms), unlikely to be offset by new revenue measures, or spending cuts in other categories. A rapid revision of civil service wage policy appears to have become a new priority for Lao PDR.

On the revenue side, the focus has been placed on strengthening revenue administration particularly related to the valuation of equipment and vehicles imports. However, mining revenue contribution remains uncertain due to projected lower commodity prices and expected lower total gold production in 2013-2014, despite expected copper output increase in the same period. Achieving the needed 20 percent increase in nominal revenues in the non-resource sectors will

3 For example, new staff that has been recruited at mid-year in FY13/14 only impacted the budget for half a year, while they will affect the budget for all 12 months this year. Since recruitment levels exceed 10 percent per year, this financial effect of recruitments is large, as it implies a 5 percent growth in the wage bill next year even if there are no new recruitments or no wage increases.

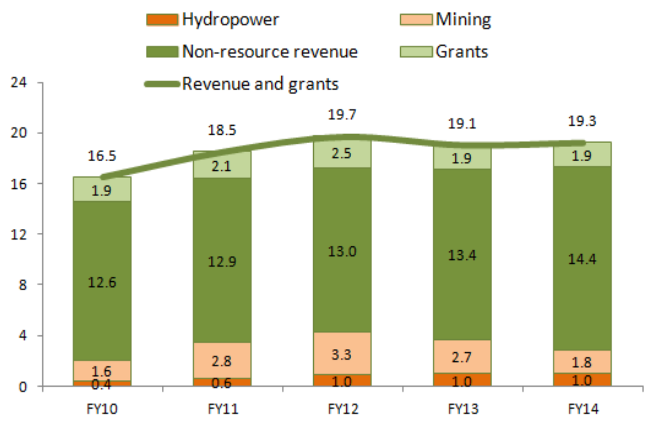
be a significant challenge, even as the revenue base expands with nominal GDP by about 11 percent over the year. The large outlays on wages, to be paid every month over the year, should also be expected to put continued strain on the government's cash position, and require careful monitoring and control of all expenditure, across government levels and agencies.

Figure 6. Government's Fiscal Performance (percent of GDP)



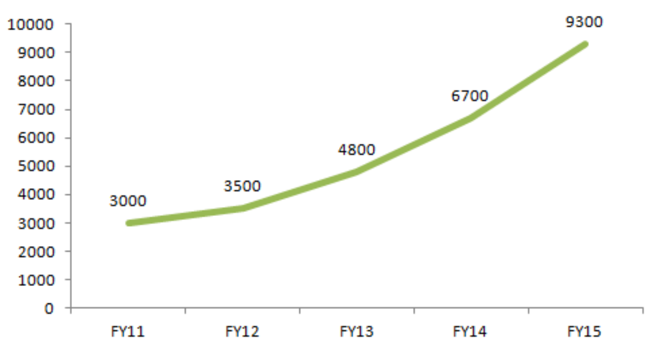
Source: MOF and staff estimate and projection

Figure 7. Government Revenues (percent of GDP)



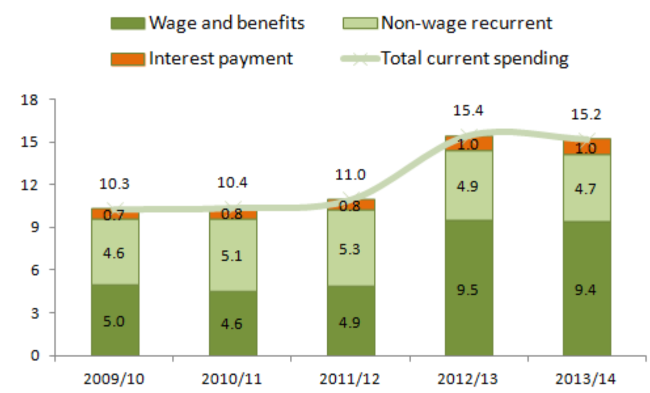
Source: MOF and staff estimate and projection

Figure 8. Wage Index Increase



Source: MOF and staff estimate and projection

Figure 9. Government Expenditures (percent of GDP)



Source: MOF and staff estimate and projection

Table 1: Ratios of Wages and Benefits to other fiscal variables (percent)				
	FY11/12	**FY12/13**	**FY13/14**	**FY14/15**
		Est.	Proj.	Proj.
Wage and benefits as % of total expenditure	23.2	38.1	39.8	48.2
Wage and benefits as % of total recurrent	44.5	61.5	61.9	68.3
Wage and benefits as % of domestic revenue	28.3	55.4	54.2	66.6
Wage and benefits as % of non-resource domestic revenue	37.6	70.6	65.0	78.5
Wages, benefits and compensations as % of non-resource domestic revenue	49.3	80.1	73.7	86.6

Source: MOF and staff estimate and projection

PUBLIC DEBT[4]

The recent Joint IMF-World Bank Debt Sustainability Analysis (DSA) 2013 concluded that Lao PDR's risk of debt distress remains moderate. Although all external debt distress indicators remain below the policy dependent indicative thresholds during the projection period under the baseline scenario, the thresholds are breached under certain shocks.

The DSA 2013 showed that the present value of external debt to GDP ratio is moving closer to the thresholds in the near term due to higher projected new borrowing to support projected fiscal expenditure. This trend of the net present value indicates a smaller room for adjusting in case of any adverse shocks.

Table 2: Lao PDR: External Public Debt, Indicative Thresholds and End-2012 Outcomes		
	Indicative thresholds	**End 2012**
Present value of debt, as % of		
GDP	40	32.5
Exports	150	73.8
Revenue	250	184.9
Debt Service, as % of		
Exports	20	4.1
Revenue	20	10.1

Source: Lao authorities; IMF and WB Debt Sustainability Analysis 2013

Table 3: Lao PDR: Stock of external PPG at end 2012			
	Billion USD	**Indicative thresholds**	**End 2012**
Total	4.2	100	46.0
Multilateral	1.9v	45.9	21.1
Bilateral	2.0	47.3	21.8
Commercial 1/	0.3	6.7	3.1

Source: Lao authorities; IMF and WB Debt Sustainability Analysis 2013

1/ Includes direct borrowing by state-owned enterprises on non-concessional terms

4 Lao PDR Debt Sustainability Analysis and Article IV Consultation 2013 prepared by IMF and World Bank staff in consultation with Lao PDR authorities.

The external public and publicly-guaranteed debt (PPG) level has been increasing in 2012. The nominal stock of external PPG debt rose from US$ 3.7 billion in 2011 to US$ 4.2 billion in 2012, mainly due to rapid increase in borrowing from China and Thailand. As a result, the ratio of PPG external debt to GDP increased from 44.8 percent to 46.1 percent in 2012 while the net present value of PPG rose from 29.8 percent of GDP to 32.5 percent in the same period (Table 2, 3). Debt service ratios remain within the policy-dependent indicative thresholds mainly due to the high level of concessionality of official borrowing, although the share of concessional loans is expected to decline in the future. The share of bilateral creditors has been increasing, mainly from China, India, Japan, Korea, Malaysia, Russia and Thailand. Commercial borrowing share has also risen due to higher borrowing by SOEs and the government to finance the equity stakes hydro projects. This commercial borrowing also includes the first bond issuance on the Thai bond market in May 2013 in an amount of US$50 million (about 0.5 percent of 2013 GDP) to finance the general public investment program. This initiative contributed to create a market in Lao sovereign bonds, part of the country's efforts to prepare for an eventual exit from eligibility for concessional sources of finance. This trend also underscores the importance of strengthening debt management framework and capacity.

Higher debt to GDP ratio underscores the need to strengthen debt management capacity. Considering debt sustainability would be one key criterion before new debt creation. Additional external borrowing to finance mega infrastructure projects could jeopardize debt sustainability by bringing the debt-to-GDP ratios well above the indicative debt distress thresholds. For example, an illustrative scenario of a high speed railway project could push the overall external PPG debt to the peak at around 80 percent of GDP in 2022 and the ratio of debt service to revenue could exceed the 20 percent threshold in 2021. The risk to debt sustainability could be dependent on the return in the medium to long run from resource projects that have been partly financed by external PPG borrowing. Cautious assessment and monitoring of large scale projects and private external debt will be essential to mitigate risks on external and public debt sustainability, particularly if some projects are financed from commercial borrowing such as bonds backed by future revenue.

Recorded domestic public debt also rose notably. Recorded domestic public debt to GDP rose to 15.8 percent in 2012 from 8.9 percent in 2011 half of which comes from continued disbursements from BOL to local government off-budget infrastructure projects. The remaining includes government bonds to recapitalize state-owned banks (SOCBs). Total domestic and external PPG debt was recorded climbed to 61.8 percent of GDP in 2012 from 56.2 percent in 2011 as a result of expansionary fiscal policy in 2012.

EXTERNAL SECTOR

The external current account deficit has continued to widen, rising from 15 percent of GDP in 2012 to about 21 percent this year (Figure 10). Much of the widening reflects strong import growth particularly associated with capital imports to support the construction of large resource projects, such as the Hongsa Lignite, Nam Ou, and Sayaboury power projects. In addition, mining export earnings came out lower than projected (Figure 12), and they are expected to fall further due to lower prices despite higher output. With loose fiscal and monetary policies, and a sustained appreciation of the real exchange rate in recent years (which makes imports relatively cheaper and exports more expensive and thus harder to sell), non-resource imports growth has likely outpaced the non-resource exports increase.

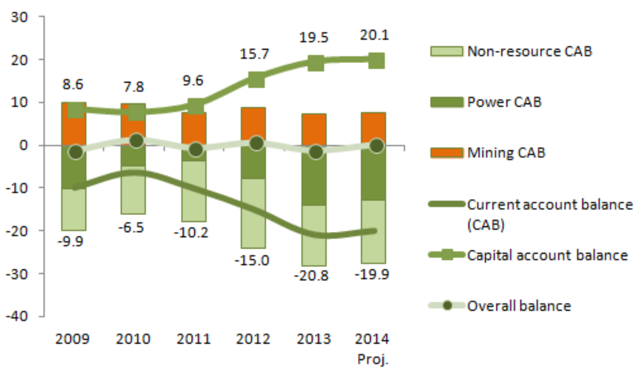
The overall balance of payments is projected to come out in a small deficit in 2013 as the widening current account deficit is partly offset by higher investment inflows. The capital account surplus, that mostly finances capital imports, is estimated to have risen from about 15.7 percent to 19.5 percent of GDP, mainly driven by investment in hydropower projects, while that in the non-resource sector is estimated to slow in 2013 after a robust acceleration in 2012.

Reflecting this overall balance, foreign exchange reserves are projected to decline in 2013. Foreign exchange reserves and net foreign assets continued to fall in the third quarter of 2013 (Figure 14). Reserves were recorded at $580 million[5] in September and are expected to reach about $600 million by end 2013 which would make the level lowest in a decade with only 1.3 months of goods and services imports. The ratio of reserve to foreign currency deposits fell progressively from about 60 percent two years ago to around 27 percent in September 2013 (Figure 15). This trend of dwindling buffers raises concerns over the country's resilience in absorbing any adverse shock. In an attempt to address the issue, the BOL recently issued an instruction to commercial banks to tighten foreign currency lending to businesses that have insufficient foreign currencies earnings and to limit cash withdrawals from foreign currency accounts. Commercial banks also have to exercise their due diligence in knowing their customers. Although the effect of these measures has yet to be fully realized, such a step signals the move by the monetary authority to addressing more forcefully the issue of low foreign reserves. Pursuing this policy, as well as embarking on a gradual reconstitution of their gross reserves position by outright sterilized purchases if needed, is clearly an important undertaking for policy makers, even if entails some modest temporary pressure on bilateral exchange rates.

The outlook for 2014 calls for a slight improvement in the overall balance of payment as strong capital inflows are expected to continue to compensate the current account deficit. The current account deficit is expected to remain high due in part to the large need for capital goods imports supporting the on-going construction of large scale hydropower projects. Additionally, non-resource imports growth is likely to continue outpacing non-resource exports growth. At the same time, the uncertainty in the global economy and possible moderation of growth in some emerging markets could have further implications for Laos, including through lower FDI and lower mining export prices, with a possible negative impact on Lao export earnings and government revenues.

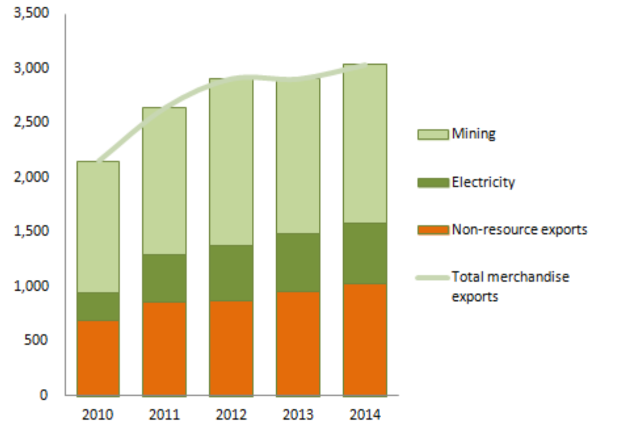
5 The stock of foreign reserves in September was roughly equivalent to the projected debt repayments (interest and principal) due over two years, 2014-15 (of US$490 million).

Figure 10. Balance of Payments (percent of GDP), 2009-14



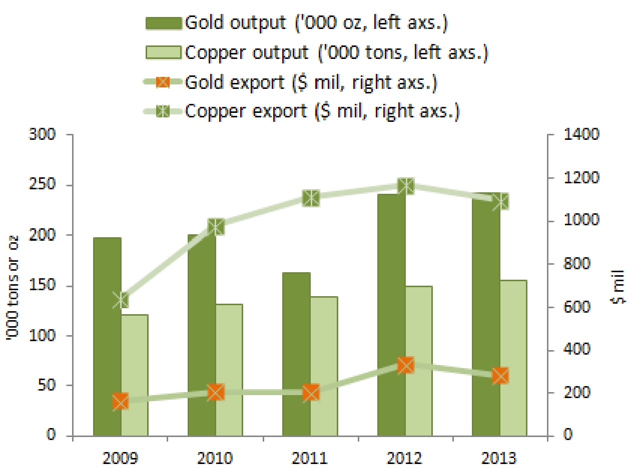
Source: BOL and staff estimates and projections

Figure 11. Merchandise Exports (US$ million)



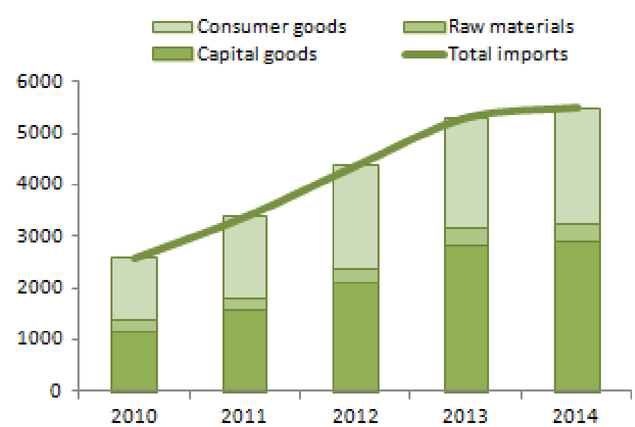
Source: Staff estimates and projections based on data from MOIC, LNCCI and partner countries

Figure 12. Gold and Copper exports



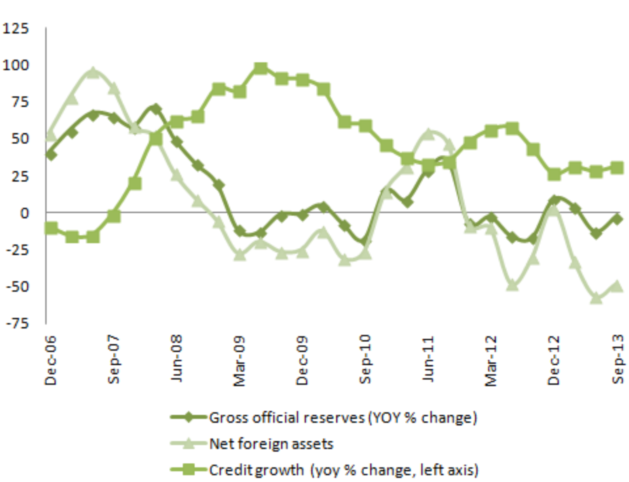
Source: Lane Xang Minerals Limited and Phu Bia Mining Companies, 2012 and staff calculations

Figure 13. Merchandise Imports (US$ million)



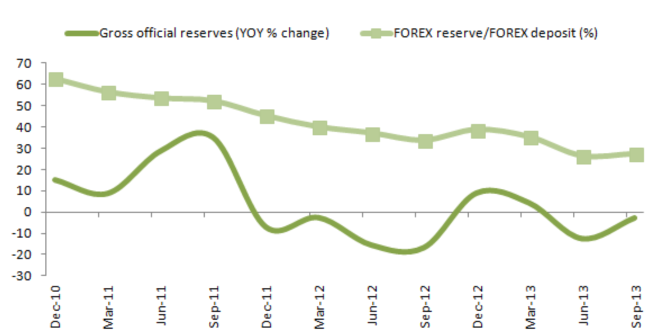
Source: Staff estimates and projections based on data from MOIC, LNCCI and partner countries

Figure 14. NFA and International Reserves



Source: BOL and staff estimates

Figure 15. Reserves Coverage (percent of total FOREX deposits)

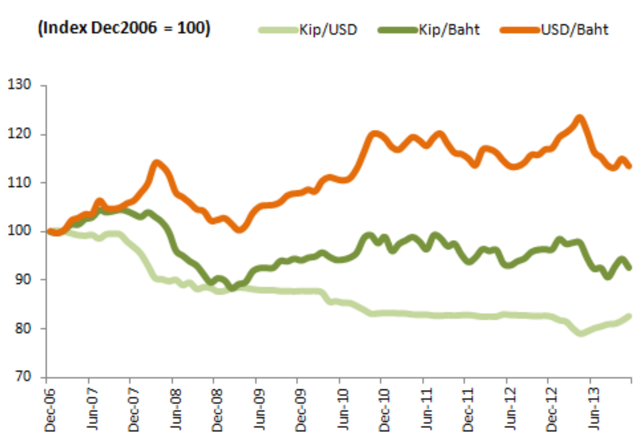


Source: BOL and staff estimates

EXCHANGE RATE

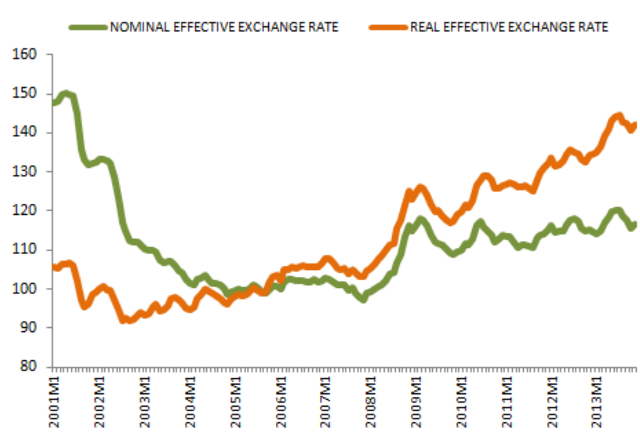
While the Bank of Lao PDR maintains nominal exchange rate stability of the Lao kip against major currencies, the onus of foreign exchange policy should probably shift toward giving more weight to reserve management and competitiveness. In nominal terms, the kip depreciated only slightly against USD during January-November 2013 while it appreciated against the Thai Baht by about 3.8 percent in the same period, as Baht has weakened against USD in the wake of political turmoil Thailand (Figure 16). With inflation well in excess of the rates in partner countries, real exchange rates continued to appreciate steadily for the fourth continuous year. The effective exchange rate appreciated by 2 percent in nominal terms and by 5.5 percent in real terms during January-November 2013 (Figure 17). The continued real appreciation of the exchange rate implies a loss of competitiveness for Lao PDR's tradeables (discouraging exports and encouraging imports that compete with locally-produced goods), which exacerbates the impact of the continued increase in domestic labor costs. In addition, better balancing the goal of nominal exchange rate stability and the need for reserves is also important.

Figure 16. Kip Exchange Rate (Index Dec-2006 =100)



Source: BOL and Bank of Thailand and staff calculations

Figure 17. Nominal and Real Effective Exchange Rates



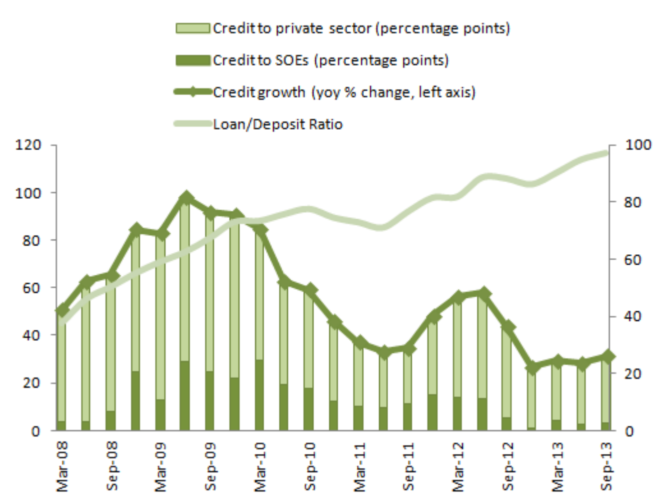
Source: IMF

MONETARY DEVELOPMENTS[6]

Domestic banking credit growth has slowed down but remained high in September 2013 (Figure 18). This growth was driven mainly by private sector credit, which grew by about 37 percent YOY at end-September 2013. This trend has primarily come about from broadly accommodative policy—both monetary and structural banking policy—in the face of buoyant credit demand growth in the construction, commerce and service sectors. Credit to state-owned enterprises (also including BOL direct lending to local infrastructure projects) still grew at 13 percent YOY in that same period despite the fall QOQ in recent quarters. The BOL has reportedly committed to cease lending to finance new government projects (off-budget) outside the approval from the National Assembly. In addition, the BOL recently issued a notice to discourage commercial banks from lending to businesses with inadequate foreign currency earnings and do not allow withdrawals of foreign currencies intended for transaction settlement with foreign suppliers. Broad money growth was slightly slower at 23 percent YOY in September 2013 compared to about 26 percent in March due to slower growth in the money and quasi-money in the same period.

As the banking sector expands and credit growth is strong, the authorities should continue efforts to strengthen supervision and enforcement of prudential norms. In the context of a rapidly growing banking sector and growing bank lending, the BOL continues to strengthen enforcement of compliance with prudential obligations of commercial banks to publish their financial reports. However, some banks are still facing difficulties in complying in a timely manner. In terms of financial soundness, BOL issued a regulation for commercial banks to increase their registered capital which is to be completed by 2014. Most banks have met the minimum capital to asset (CAR) ratio requirement while some state-owned banks still face difficulties in that respect. Non-performing loans have reportedly remained below 4 percent by end 2012 partly on the account of growing credits. The growth of banking also reflects physical expansion and improvement in availability of, and access to, financial services, with an expanded network of branches and services units (from 340 units in 2011 to 383 units across the country in 2012) while the number of ATMs has increased by 22 percent from 442 units to 540 units in the same period. An important on-going effort is the improvement of the Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT) draft law. In this context, strengthening bank supervision capacity is also crucial to oversee and support implementation and enforcement of the regulations.

Figure 18: Contribution to Bank Credit Growth (percent and percentage points)



Source: BOL and staff estimates

6 The most recent monetary data after September to enable an assessment of the government's recent monetary policy stance is not yet available.

PART II
SECTOR FOCUS

SCHOOL BASED MANAGEMENT IN LAO PDR: CURRENT CONDITIONS AND RECOMMENDATIONS FOR THE FUTURE

SCHOOL BASED MANAGEMENT IN LAO PDR: CURRENT CONDITIONS AND RECOMMENDATIONS FOR THE FUTURE[7]

Despite sustained economic growth since the mid-1980s, Lao PDR's education system faces challenges in meeting its goals of providing all students with access to education and improving learning outcomes. To further the country's economic development, the Government of Lao PDR (GoL) has placed a priority on improving its education sector. However, as of 2012, Lao PDR was not on track to achieve its Millennium Development Goal (MDG) of universal primary education. There are concerns about education quality as well, particularly whether students are completing primary school with sufficient mathematics and literacy skills. To help address these challenges, the GoL instituted in 2011 a School Block Grant (SBG) program that gives provinces, districts and schools greater administrative control than they have ever had. The program is a form of School Based Management (SBM) that was designed to make educational administration more effective and improve the quality of schooling.

The report presents a framework that explains how SBGs can improve education quality. The framework draws lessons from international experience that may be particularly useful for the GoL, and identify challenges and potential risks to successful implementation of the program. It uses information from published data and reports, as well as a baseline survey that was administered during the first year of the SBG program operation by a local survey firm to a sample of schools. This was carried out as part of the SBG impact evaluation effort. The discussion is also informed by qualitative data gathered by RAND in October 2012 from six schools in the Southern region of the country. Our findings provide a framework for policy makers in Lao PDR to consider strengths, weaknesses, and other challenges that they might face as they continue to introduce SBM in Lao PDR.

Overview of Education Sector and Outcomes in Lao PDR

Recent measures by the GoL to increase spending on education and thereby improve student outcomes have faced challenges, but are beginning to produce modest results. To formalize its commitment to improving education, the GoL developed the Education Sector Development Framework (ESDF), which documents the education policy objectives in Lao PDR. It called for increasing public expenditures on education from 11 percent in 2010/11 to around 18 percent by 2015. According to data from the Ministry of Finance, educational expenditure as a percent of total government spending was 13 percent in 2011-2012. However, non-wage recurrent expenditure in education in the country remains low (Ministry of Finance, 2012). Non-wage, public recurrent expenditure is that which serves to pay for school materials, equipment, teacher training, etc. It currently represents about 20 percent of recurrent expenditure, but only between three and seven percent of total education expenditure over the past four years. As a result, households have to pay non-mandatory fees for schooling in order to make up for the shortfalls, and this could negatively affect access to education for children from poor families. Low levels of non-wage public spending on education also limit learning resources and quality of facilities in classrooms and schools. Although learning outcomes have improved in recent years, only about half of fifth grade students can demonstrate Lao language skills beyond the basic level. In mathematics, learning outcomes are particularly poor, and results from 2006 and 2009 suggest a declining trend. Repetition and dropout rates are high in first, and to a lesser extent second grade, but improve thereafter.

7 Santibanez, Lucrecia. 2014. School based management in Lao P.D.R. : current conditions and recommendations for the future. Washington DC ; World Bank Group. http://documents.worldbank.org/curated/en/2014/01/18745470/school-based-management-lao-pdr-current-conditions-recommendations-future

The "School Operating Cost" or Government SBG Program

The SBGs seek to increase school enrollment, reduce education costs for parents, address pressing quality issues and involve the broader community in school-based management and oversight. The SBG program introduced a guaranteed, predictable stream of funding for all schools to help them meet their most pressing operational needs. This is a key feature of the SBG program and novel in the Lao PDR context. In the program's first year (2011), the SBG amounted to 20,000 LAK per student, which was roughly equal to the non-wage expenditure per student (Ministry of Finance data). In addition, provincial and district level authorities received some initial training on SBGs from the Ministry of Education and Sports (MoES). A SBG manual was also produced and distributed among provincial and district level authorities for training purposes. The year 2012-13 was the second year of the program, and the GoL plans to keep the program in place for 2013-14, with a few modifications that could include increasing the amount of the block grant.

SBM in Lao PDR: Foundations to build from

The report finds that, although still in its early stages, the GoL's SBG program appears to be a solid step toward establishing School Based Management efforts in the country. Lao PDR already has some of the institutional foundations to build from.

- VEDCs have been established in most schools, and school decision-making is already highly decentralized. In fact, principals report already having high degrees of influence over most school matters.

- Although after SBG program was implemented most schools no longer collect non-mandatory school fees from parents, many parents continue to make voluntary financial and in-kind contributions to schools. This signals that they are invested and committed to improving their children's education.

- Lastly, there have been efforts in Lao PDR, by EFA-FTI and CIED, to develop and disseminate training materials to help schools craft a School Development Plan and to train them on the Education Quality Standards (EQS) framework. These efforts can help principals and school committees make effective spending decisions. However, dissemination of these materials has been limited and only a few hundred schools have received training on their usage.

Challenges and risks to successful implementation of SBM programs in Lao PDR

The "School Operating Cost" program, also referred in this report as the Government's SBG program, was launched for the first time in 2011-2012 at a national scale. The massive size of the reform effort probably contributed to limitations in some features of implementation. Our review identified several challenges and risks to a successful implementation of the SBG program in Lao PDR.

- Schools are not always receiving the grants on time, which makes it difficult for them to plan effectively. This is to be expected given that the program is just getting started, but it is important that education officials should pay close attention to in the coming years.

- SBM implementation is hindered by insufficient local capacity and limited support and monitoring efforts; for example, some local school staffs are not receiving training, and student record keeping is faulty in some schools. Although the MoES has initiated training efforts, a larger-scale effort is needed to build local capacity and provide adequate monitoring and support for SBG implementation.

- Although most schools continue to solicit voluntary contributions from parents to make up for resource shortfalls, the SBG program could lead some parents to reduce their financial contributions to schools. Evidence from grant programs in other countries suggests households reduce their own spending on education when schools receive grants that pay, among other things, for school supplies. If this were to happen, it would lower the amount of total resources schools receive and make schools worse-off financially. Moreover, beyond making financial contributions to schools and having some influence on construction of school facilities, parents do not perceive to have an influence over most school decisions. This could hamper the SBG's program ability to engage a wider base of parents and community members in schoolwide decision making.

- In the first year of the program, reporting on the use of funds has been erratic. Part of this is the result of the GoL releasing the first tranche of the funds unconditionally. However, reporting on the second tranche was still uneven across districts. This might have been due to the absence of training given to district officials as well as principals and VEDC members on reporting and general management of the SBG. Erratic reporting could hamper monitoring efforts by officials at districts and provinces. Thus, in the future, closer attention should be paid to the issue of reporting. Another potential issue that could increase the risk of misuse or waste of the SBG funds is related to improper safeguarding of these funds—such as school treasurers keeping the funds in unlocked containers at home. This could be the result of lack of banking facilities in the villages or high transaction costs, but should also be addressed by education officials in the coming years.

Recommendations

As the Government SBG program evolves and education officials gain better knowledge and experience with its implementation, more time and resources can be devoted to ensuring that key program implementation elements are adequately addressed. If properly implemented, better school administration and higher community involvement could have long-term impact. Based on this review of documents and survey data, and limited information gathered from interviews with principals, teachers, parents and other school actors, the following is recommended.

1. Deliver funds on time. Since 2011-12 was the first year of the SBG program, it is understandable that there were issues with timely delivery of the funds to schools. However, in future editions of the program, concerted efforts should be placed on ensuring that funds are delivered on time, so that schools can effectively plan. If possible, schools should receive the whole SBG at once, to allow for the purchase of bigger-ticket items that might be needed earlier in the year (i.e., classroom equipment, teacher training).

2. Train school leaders and community members. Training of principals, VEDCs and even District Education Bureaus (DEBs) during this first year of implementation was limited. To effectively participate in school affairs, principals and VEDC members should receive training that increases their ability to understand the purpose of SBG, and their role in the program. Principals in particular need to be given basic leadership and management training on how to conduct meetings, develop a school vision, and engage in participatory planning and budgeting. Parents should be trained and supported so they can be better informed about how to promote higher student learning and how to make better use of school funds. As the SBG program continues into the future, the goal of principal and VDEC training should be to enhance their management and planning capacity thus systematic training is needed on an ongoing basis. The SBG program can reap the benefits of the financial and administrative empowerment it confers to schools, only if all school actors have the capacity to take full advantage of the resources, collaboration and planning processes the SBG is intended to offer.

3. Increase parent empowerment through targeted training and mechanisms for school participation that encourage wide representation from the community might be needed. Principals report having a lot of influence over most school matters, but the influence of parents appears to be more limited. SBM programs can confer both financial and administrative empowerment. However, to reap the full benefit of both, parents must be well-informed, engaged and capable of making decisions that best address school needs. In addition, SBM requires strong parental participation and oversight to counter the diminished role of central authorities. Thus, to increase parent empowerment, targeted efforts and investments in training and other mechanisms might be needed. Parents should receive training that allows them to engage and participate in school decision making.

4. Establish a system to collect and use school data for decision making. Principals and VEDC members should have the required information to set learning and other school quality targets. This includes keeping accurate attendance records so they can receive the right amount of the SBG. Lao PDR does not have a national, standardized student assessment system. Principals do have access to student-level data on repetition rates and enrollment for their own schools. The MoES publishes reports of these and other school data for all schools, and aggregated by province and district. Principals and VEDCs could be trained to use those indicators to set student outcome targets and gauge progress. In addition, there are the EDQ standards which can also be used to set targets.

5. Train school leaders on how to manage SBG funds. Training for school leaders should also address the importance of adequate reporting and safeguarding of SBG funds. In an environment where the authorities delegate autonomy over spending decisions to schools, adequate reporting is important to prevent misuse of funds and to ensure that resources are spent as effectively as possible. The review also identified issues related to adequate safeguarding of leftover SBG funds. Many villages in Lao PDR lack adequate banking facilities. In villages with banks, transaction and other costs might become too high for schools to bear. Nevertheless, some attention could be paid to devise mechanisms or provide resources to adequately safeguard funds that are not immediately spent.

6. Provide more implementation support and consider making funding formula more progressive. Some funds should be earmarked for provinces and districts to provide needed support for SBG implementation. Consider soliciting technical assistance services and funds from donors to enhance local capacity, and infrastructure (including IT infrastructure) and in turn, aid monitoring and support efforts. District Education Bureaus (DEBs) should receive additional human and financial resources to enable them to fulfill their tasks under the SBG program. The funding formula could also be made to be more progressive. First, to compensate small and remote districts for the added cost associated with collecting the grant. And second, to consider that it could cost more to deliver comparable quality education services in some area, and that some schools face greater challenges improving student outcomes and thus might need additional support.

7. Leverage existing resources. Training manuals and materials developed for other initiatives (i.e. the Community Initiatives for Primary Education Development project (CIED), EQS, etc.) should be adapted for this program where relevant. These previous efforts could be useful inputs to design training that is intended to support effective planning and school management.

8. Establish financial accountability. The GoL should take additional steps to ensure accountability from schools, districts and provinces in the use of SBG funds. Since 2011-12 was the first year of operation of the SBG, the first tranche of the funds was delivered to schools unconditionally. In addition, training of principals and district officials on reporting and other SBG management has been limited. As the SBG program evolves, schools should be required to report to DEBs in a timely fashion on the use of the SBG, and to submit their school development plans. DEBs should report back to provincial education authorities and provincial authorities to the MoES on the implementation of the SBG. District and provincial reports should detail when and how funds were transferred to the schools, use of funds at the school level (expenditure analysis), the work of the VEDCs, supervision (inspector visits, etc.), and trainings delivered.

9. Encourage parents to continue to donate funds to schools. Parents should be encouraged to continue to contribute to their school to the extent that they are able to. Schools in Lao are in need of more resources for infrastructure, classroom materials and equipment, teacher training and other items. Parents can be encouraged to see the SBG as a complementary, sustained funding stream that provides certainty over some expenditures over the long run. But unforeseeable expenditures will continue to arise. Parents might also be encouraged to make in-kind contributions. Schools should register the reception of these funds and integrate them within their school budgets so they can better plan for their use.

10. Take further steps to strengthen school autonomy and accountability and signal stronger policy intent in this area. While the country has made important progress and demonstrated strong policy intent in one indicator of school autonomy and accountability (school autonomy in budget planning and approval), the SABER study rated all other indicators as only “emerging.” There is still more work to be done on the other indicators, such as personnel management, school and student assessment and school accountability to stakeholders to move further toward greater accountability and school autonomy.

ANNEX 1 – LAO PDR AT A GLANCE

			Est.	Prel. Est.	Proj.
Growth and Inflation	**2010**	**2011**	**2012**	**2013**	**2014**
Real GDP	8.5	8.0	8.2	8.1	7.2
Resource contribution	4.8	3.6	2.4	1.7	1.2
Non-resource contribution	3.7	4.4	5.8	6.5	6.0
Inflation (annual average)	6.0	7.6	4.3	6.5	6.5
GNI per capita (Atlas method, US$)	980	1100	1260	..	..
Public Finance (FY, % of GDP)					
Total revenue (including grants)	16.4	18.6	19.7	19.1	19.3
Domestic Revenue	14.5	16.5	17.2	17.1	17.3
Mining	1.6	2.8	3.3	2.7	1.8
Hydro	0.4	0.6	1.0	1.0	1.0
Grants	1.9	2.1	2.5	1.9	1.9
Total Expenditure	21.3	21.3	21.0	24.9	23.6
Current expenditure	10.3	10.4	11.0	15.4	15.2
Capital expenditure and on-lending	9.8	9.3	9.2	8.9	7.6
Overall surplus/deficit	-4.9	-2.7	-1.3	-5.8	-4.3
non-resource overall balance	-6.9	-6.2	-5.5	-9.5	-7.2
non-mining overall balance	-6.5	-5.6	-4.6	-8.6	-6.1
Balance of Payments (% of GDP, unless otherwise specified)					
Current account balance	-6.2	-10.2	-15.0	-20.8	-19.9
Resource current account balance	5.0	4.2	1.2	-6.4	-5.2
Non-resource current account balance	-11.3	-14.3	-16.2	-14.4	-14.7
Capital account balance	7.8	9.6	15.7	19.5	20.1
Overall balance	1.4	-0.6	0.6	-1.3	0.2
External Public Debt (% of GDP, unless otherwise specified)					
Total external debt	88.1	84.1	89.9	109.1	125.7
Total Public Debt	60.4	56.2	61.8	63.5	64.1
Total external public debt (% of GDP)	50.3	44.8	46.1	47.4	49.1
Total public debt service (% of exports)	4.4	2.7	4.1	5.4	5.5
Total public debt service (% of revenue)	11.0	7.5	10.1	12.6	12.0
Monetary Sector					
Reserves, excl. gold ($ million)	730	679	739	598	621
Months of imports of goods and services	3.2	2.3	1.9	1.3	1.3
Credit growth	46.0	48.1	26.6	24.3	23.2

Real Effective Exchange rate	122.3	127.2	133.7	141.1*	..
Memorandum items					
Nominal GDP (billion kip)	59,098	65,979	75,168	87,422	95,873
Nominal GDP (US$ millions)	7,156	8,194	9,418	11,120	11,984
Exchange rate (period average, kip/ US$)	8259	8052	7982	7862	8000

Source: Lao PDR Authorities, IMF-WB DSA 2013, WB staff estimates and projections.
*Note: * for January-November 2013*

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