



# Lao People's Democratic Republic

*The Lao People's Democratic Republic (Lao PDR) continued its steady growth of the 1990s through 1997. The crisis in Thailand, however, affected Lao PDR's trade and currency. Membership in the Association of Southeast Asian Nations (ASEAN) is expected to increase trade liberalization and facilitate foreign investment, as is the promise of Most Favored Nation (MFN) trading status from the United States.*

## RECENT TRENDS AND PROSPECTS

**F**looding in 1996 took its toll on GDP growth, which slipped to 6.9 percent. In 1997 more favorable weather conditions and increased government incentives to farmers resulted in improved agricultural performance, which contributed to GDP growth of 7.2 percent. Agriculture continues to account for more than half of GDP, but slow growth in agriculture has meant that manufacturing, construction, and services (including tourism) have been the driving forces behind the strong growth of the 1990s. Industry accounts for about 22 percent of GDP and services for 26 percent.

As a landlocked country heavily dependent on trade with its neighbors, particularly with Thailand, Lao PDR has not escaped the effects of the Southeast Asian currency turmoil. Thailand has been the largest investor in Lao PDR, accounting for more than a third of foreign direct investment through August 1997. Information on domestic savings and investment is not available, but they are believed to amount to relatively small shares of GDP. The economic dominance of subsistence agriculture and a correspondingly low level of monetization buffered the real economy from the regional crisis to some extent, but inflationary pressures remain a significant danger, both from the floods' effects on agricultural prices and from events in Thailand.

Following the rapid depreciation of the Thai baht, uncertainty spread to the Lao kip. The kip continued to depreciate, especially in the second half of 1997, to a level roughly 50 percent lower than at the beginning of the year, relative to the US dollar. The financial system remains fragmented, and the interbank market for kip is small. With the baht's status as the principal currency for cross-border trade between Lao PDR and Thailand, inflation has been largely imported. This has resulted both from the baht's depreciation and the August increase in the Thai value-added tax, which appears to have been passed on to Lao consumers. Estimates indicate that inflation reached more than 19 percent during 1997.

Widespread use of the Thai baht and the US dollar hampers the central bank's implementation of effective monetary policy. Foreign currency deposits account for roughly 40 percent of broad money and one third of loans to the private sector. As the kip depreciated, the authorities restricted the use of foreign currency for imports. The resulting monetary expansion was somewhat erratic, as consumers tended to hoard dollars and release them only gradually to the banking system. The foreign currency restrictions thus had the perverse effect of decreasing the amount of dollars available to the banking system and further undermined public confidence in the government and banks. At the same time, the restrictions had a limited effect on reducing

imports because of the porous nature of the country's long border. They did, however, restrict imports of goods that earn high import duties, thereby affecting government revenues negatively. They also restricted imports of materials and equipment crucial for export production. At present, wood products remain the largest source of export earnings, followed by electricity sales. Expansion of hydroelectric projects has resulted in increased logging, contributing to export receipts, and future electricity sales should eventually reduce reliance on foreign aid.

Despite some improvements in tax collection, particularly in timber royalties and income taxes, the tax base needs to be broadened further to reduce reliance on customs revenues. The ratio of fiscal revenues to GDP remains low, but limits on expenditures in 1997 led to current fiscal surpluses and a declining trend in the overall fiscal deficit. Capital spending is widely financed by external assistance, and domestic debt has been reduced. Substantial foreign assistance and investment has strengthened the capital account and reserve position.

The 1996/97 budget increased current expenditure allocations on social sectors by 10 percent in an effort to raise the level of human resources in the country, and future increases are planned. The budget for 1997/98 aims to increase revenues and

decrease expenditures (as a percentage of GDP) further, thereby raising the current surplus and reducing the overall deficit. Inflation is expected to remain in double digits in 1998, and the large trade deficit is likely to exert continued downward pressure on the kip. Growth is expected to pick up somewhat in 1998.

## **POLICY AND DEVELOPMENT ISSUES**

As a relatively small, low-income, landlocked country, Lao PDR is heavily dependent on other countries for opportunities and resources for its development. In recent years the government has taken major steps to expand such links, which has increased both risks and opportunities.

In 1997 Lao PDR became a member of ASEAN. Membership will result in further trade liberalization in preparation for the ASEAN Free Trade Area. The scheduled lowering of tariffs will also motivate fiscal reform, because currently some 20 percent of revenue is derived from tariffs. The regular schedule of numerous ASEAN meetings, however, is likely to tax the country's limited English-speaking human resources severely, and substantial capacity building efforts are required. ASEAN membership also confirms the shift in external relations in recent years to broader commercial ties in

hopes of stimulating trade and investment. While Thailand remains the principal source of imports by a large margin, since 1994 Viet Nam has been the leading destination for Lao PDR's exports.

The United States has promised to grant Lao PDR a MFN status in the near future. As a requirement for MFN status, Lao PDR has adopted a legal framework that should also facilitate accession to the World Trade Organization. In addition, MFN status will increase the attractiveness of Lao PDR for foreign investors who wish to produce for export. Capitalizing on this potential will require the authorities to reduce bureaucratic delays in customs procedures, increase transparency in granting licenses, and address infrastructure inadequacies.

Access to the outside world is increasing: Japan has agreed to fund a second bridge across the Mekong River and has donated an international direct dialing system, agreement was reached on new Thai-Lao border passes, and renovation of the

Vientiane airport has begun. However, as Thailand is the main source of Lao PDR's imports and foreign direct investment and a principal destination of exports, the slowdown in the Thai economy may temper the expansion of foreign trade and investment. Thailand's agreement with the International Monetary Fund may require Thailand to reopen talks with Japan on the planned 50-50 financing of the proposed third Mekong River bridge.

Before the regional currency turmoil, Lao PDR manufacturing workers were generally considered to be less productive, but to be paid more, than competitors in Cambodia, PRC, or Viet Nam. To the extent that the kip has now depreciated further than the currencies of these other countries and foreign currency restrictions have eased, Lao PDR's export prospects may improve. Cross-border infrastructure and trade links are expanding, which should help, but recovery in Thailand would have the biggest effect.