



Lao People's Democratic Republic

In 1999, the economy experienced moderate expansion accompanied by high monetary growth, rapid inflation, and volatile exchange rates. The outlook is for relatively stable economic growth over the medium term.

RECENT TRENDS AND PROSPECTS

Several factors contributed to sustain economic growth in 1999 at the same rate as 1998. While industry and services grew slowly, agriculture performed well, benefitting from a major government irrigation program. Production of garments, one of the largest export earners, rebounded because of increased penetration in European markets.

The gross investment rate fell as both public and private investment rates weakened. Construction slumped as work wound down on the nearly completed 60-megawatt Nam Leuk and 150-megawatt Huoy Ho hydropower projects. However, an increase in tourist arrivals boosted the service sector, although this was partially offset by weakness in the banking sector.

Fiscal performance improved in 1999 as the drop in public investment reduced the overall fiscal deficit, excluding grants, to 9.3 percent of GDP from nearly 14 percent in the previous year. In contrast to 1998 when bank financing of the budget deficit was required, net bank credit to the government declined in 1999. Revenues recovered from 9.8 percent of GDP

in 1998 to about 11.3 percent because of improvements in both tax and nontax revenue collections. At the same time, the government further compressed current expenditures to 5.5 percent of GDP in 1999, down from 7.1 percent in 1998.

In 1999, rapid money supply growth of approximately 86 percent resulted in an estimated inflation rate of about 87 percent and significant exchange rate depreciation of 40 percent. Although still high, these rates were all lower than the previous year, as the government gradually moved to reduce credit expansion. The government alternated between tightening and easing credit conditions throughout 1999 before settling into a tight monetary stance in the final quarter, which stabilized prices and the exchange rate at the end of the year.

However, because of monetary policy inconsistency, the year was characterized by volatility in the foreign exchange market. Furthermore, because of the government's reluctance to adjust the official exchange rate rapidly in response to changing market conditions, the unofficial exchange rate ranged from more than 40 percent in February and March 1999 to less than

3 percent above the official rate in June 1999. Overall, confidence in the kip weakened, so banking and other transactions were increasingly carried out in foreign currencies, which put more pressure on the exchange rate.

The current account balance as a percent of GDP improved modestly in 1999. The trade balance significantly improved, more than offsetting deterioration in net factor income and private transfers. Foreign direct investment and official development assistance disbursements increased slightly in 1999 relative to 1998. Gross official reserves increased from \$112.8 million to \$115.9 million.

Prospects are for modest improvement in economic growth in 2000 and 2001. Agriculture should continue to enjoy moderate growth, helped by continued investment in irrigation. If normal trading relations with the United States are established, this would translate into improved growth in manufacturing in the near to medium term. Hydropower export earnings are projected to grow by more than 30 percent in 2000 with the start of operations at the

Nam Leuk and Huoy Ho sites. However, foreign direct investment likely will stagnate and construction continue to slump in the medium term, partly because of the delay in new hydropower projects resulting from a slowdown in Thai electricity demand.

ISSUES IN ECONOMIC MANAGEMENT

Macroeconomic conditions are intertwined intimately with fiscal management. Figure 2.8 shows the evolution of fiscal revenues and expenditures since 1995. In late 1997, total revenues dropped as the regional crisis lowered trade tax revenues. Furthermore, external financing of the budget decreased because aid flows diminished when donor countries saw the reform effort faltering, particularly in the financial sector. Nevertheless, the government expanded public investment with central bank financing, especially for its irrigation projects.

Using outdated and overvalued exchange rates to calculate import tariffs—thus reducing the tax liability in kip terms—resulted in revenue shortfalls.

Table 2.9 Major Economic Indicators, Lao People's Democratic Republic, 1997-2001 (percent)

Item	1997	1998	1999	2000	2001
GDP growth	6.9	4.0	4.0	4.5	5.0
Gross domestic investment/GDP	26.2	26.1	23.7	24.0	25.0
Gross savings/GDP	9.4	15.5	13.4	13.0	13.0
Inflation rate (consumer price index) ^a	26.6	142.0	86.7	30.0	10.0
Money supply (M2) growth	65.8	113.3	86.3	50.0	30.0
Fiscal balance/GDP ^b	-8.8	-13.9	-9.3	-8.5	-8.0
Merchandise exports growth	-1.2	7.7	2.9	5.0	6.0
Merchandise imports growth	-6.0	-14.7	-2.9	7.0	6.5
Current account balance/GDP ^c	-16.8	-10.6	-10.3	-11.0	-12.0
Debt service/exports	9.0	11.1	12.0	12.5	12.0

Note: Figures for 1999 are preliminary estimates.

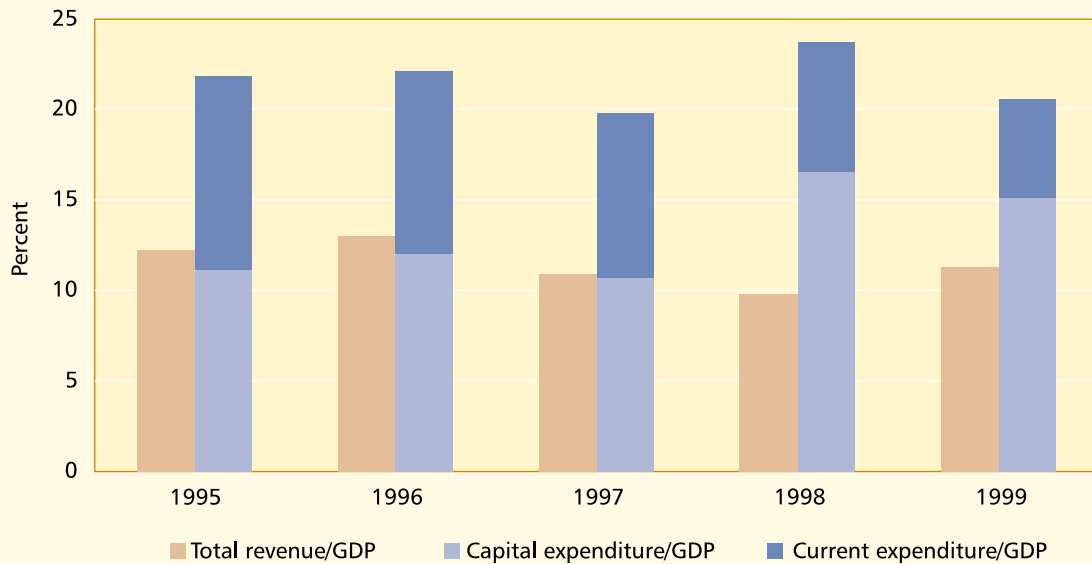
a. End of period.

b. On a fiscal year basis ending 30 September; excludes official transfers.

c. Excludes official transfers.

Sources: Bank of Lao PDR; IMF; Ministry of Finance; National Statistical Centre; staff estimates.

**Figure 2.8 Fiscal Performance,
Lao People's Democratic Republic, 1995-1999**



Sources: Ministry of Finance; IMF data.

The government has since adjusted the exchange rate used for import valuation. Another problem arising from high inflation was erosion in the real value of nominal lump sum commercial income tax payments during the year, although their levels had been fixed at the beginning of the year. As a result of the high inflation and exchange rate depreciation, weaknesses in tax administration were exposed. On the expenditure side, imperfect management often resulted in public investments that were higher than intended. Facing shortfalls in revenues and foreign funding, the government economized on current expenditures, which in 1995 were as high as 10.8 percent of GDP. These have been squeezed over the past several years and continue to be compressed despite recent success in curtailing capital expenditures.

In particular, wages and salaries of government workers have fallen significantly, both as a percentage of GDP (from 5.2 in 1995 to 2.2 in 1999) and in real terms, because nominal wage increases have not kept

pace with high inflation during the last two years. In addition, even as public investment accelerated to nearly 17 percent of GDP in 1998, spending on materials and supplies fell from more than 3 percent of GDP in 1995 to less than 2 percent in 1999. These trends can cause problems such as increased absenteeism among government workers, incentives for corruption, and inadequate spending on maintenance, all of which can impair public sector efficiency.

POLICY AND DEVELOPMENT ISSUES

About 40 percent of the population lives below the national poverty line, less than the estimated 45 percent in 1992-1993. The highest incidence of poverty occurs in the north region, although poverty levels in the south and central regions are also significant. Most of the rural poor are subsistence farmers with low productivity and poor market access. Pervasive poverty is also indicated by a low per capita income of \$330 in

1998. However, among income groups there is relative equality, as evidenced by a low Gini coefficient (a measure of income inequality) of 0.38.

Wide disparities exist between the richest and poorest quintiles with respect to access to and the quality of public services used. For education, net primary enrollments for the richest quintile are 78 percent compared with 44 percent for the poorest quintile. At secondary levels, the inequities are even greater: net enrollments are 28 percent for the richest and 4 percent for the poorest. Availability of textbooks and access to better-qualified teachers mirror these differences. Student performance rates are lower in the poorest provinces, accompanied by higher dropout rates and lower enrollment rates. Consequently, children from poorer families have little access to skills training and other income-generating opportunities.

Patterns for health care access and quality are similar. Only 8 percent of the poorest quintile use modern health care services, compared with 22 percent of the richest quintile. Similarly, only 8 percent of the poorest quintile as compared with 33 percent of the richest quintile have access to safe water and sanitation, causing more waterborne diseases among the poorest. The cumulative impact of poor access to health care and inadequate sanitation and water services implies a large quality gap in health care between the richest and poorest quintiles.

To address poverty, greater efforts must be made to enhance opportunities for the poor through policies to promote rural economic activities, especially in agriculture. In addition, greater spending on social services by the government is needed to achieve broader coverage and reduce the gap in the utilization of the social services.