

Lao People's Democratic Republic

Expansion of mining, hydropower, and services maintained robust economic growth in 2008, in a context where inflation accelerated initially, but slowed later in the year. The global economic slowdown is expected to reduce growth in 2009 through its impact on trade, tourism, and foreign investment. An immediate need is to ensure macroeconomic stability and safeguard progress achieved in recent years, including reductions in poverty. The gradual improvements in trade and investment conditions, prompted by the preparations to join the World Trade Organization, should help in that regard.

Economic performance

Solid economic growth of 7.2% in 2008—similar to the average of the previous 5 years—was based on continuing expansion of industry (especially mining and hydropower), and services. Industrial production grew by 10.2%, with increases in copper and gold mining output, power generation, and construction. Production of copper rose by 42% to about 89,000 metric tons and of gold by 4.1% to about 4.3 metric tons (Figure 3.25.1). Output of both was boosted in April 2008 when the Phu Kham copper and gold mine started production. Hydropower output rose by 5.7%, mainly a result of higher rainfall in water-collecting areas.

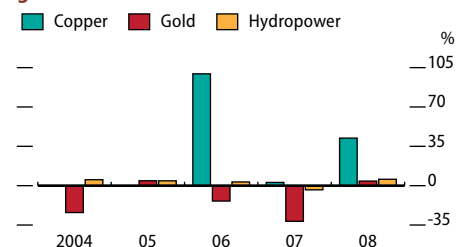
Services expanded by 9.7% and contributed more than half of total GDP growth (Figure 3.25.2). Subsectors to grow included finance, with the opening of four new commercial banks and expansion of two others, wholesale and retail trade, government services, and transportation and communications. However, tourist arrivals rose by just 1%, damped by the global economic slowdown and political instability in neighboring Thailand.

Agriculture, which employs over 70% of the labor force, was hit by severe floods in late August that damaged 10% of the arable area and curtailed production of rice and vegetables. Production increased, though, of tree crops (including coffee), livestock, and fish farming, lifting total agricultural output by 2.0%.

Early in the year, higher global prices for food, oil, and fertilizer spurred inflation, which peaked at 10.3% year on year in May 2008 (Figure 3.25.3). The Government took steps to cushion the impact of higher imported inflation. It froze the price at which it levies duties and other taxes on petroleum products at April 2008 levels; imposed a ban on exports of glutinous rice, the staple rice (partly relaxed in November); and regulated prices of some other consumption goods.

The Bank of the Lao PDR let the kip gradually appreciate against the US dollar (by 10.3% in 2008) and the Thai baht (by 15.2%; about 70% of the country's imports are from Thailand). Inflation decelerated later in 2008 when global oil and food prices eased, leaving the year-average rate at 7.6%, well up from 2007 but below the average for 2003–2007.

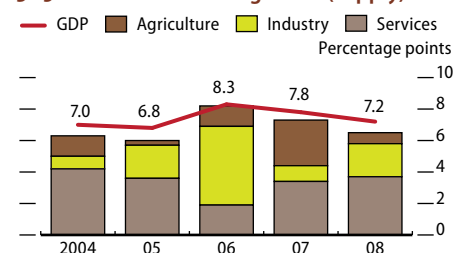
3.25.1 Energy and mineral production growth



Sources: Ministry of Energy and Mines, Lao PDR; US Geological Survey, available: <http://minerals.usgs.gov>; CEIC Data Company Ltd., both downloaded 13 March 2009; Oxiana Ltd., various annual and quarterly reports, available: <http://www.oxminerals.com>; Pan Australian Resources Ltd., various annual and quarterly reports, available: <http://www.panaust.com.au>.

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3.25.2 Contributions to growth (supply)



Sources: Asian Development Outlook database; Department of Statistics of the Lao PDR.

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The fiscal deficit (excluding grants) widened to an estimated 5.8% of GDP in FY2008 (ended 30 September 2008) (Figure 3.25.4). Expenditures rose to the equivalent of 20.5% of GDP. Revenue rose to 14.7% of GDP, from 14.0% in FY2007, exceeding the target for a second consecutive year. A recentralization of tax collection to the central Government from the provinces has helped revenue efforts over the past couple of years, as has improved tax enforcement and an increase in tax and royalty collections from mining (about one third of all government revenue).

A debt-sustainability analysis conducted by development institutions in June 2008 noted that external public debt declined to about \$2.4 billion at end-2007, for a still-high 59.5% of GDP, from 77% of GDP 2 years earlier. Most of the debt is to multilateral development banks and the Russian Federation, and is on concessional terms.

Merchandise exports are dominated by copper and gold, followed by clothing, power, and coffee. Increased exports of these two metals drove an estimated 21.2% rise in total merchandise exports in 2008, despite weakness in the fourth quarter as a result of the slump in global copper prices (Figure 3.25.5). Clothing exports rose by 15% in 2008. Merchandise imports climbed by an estimated 11.9%, the higher cost of imported fuel being a major factor. The current account deficit widened to 18.9% of GDP. After inflows of foreign direct investment and grants, the overall balance of payments was in surplus for the first 3 quarters (the latest available data). Gross international reserves rose by almost 19% to \$622 million, sufficient to cover 5 months of non-resource-related imports.

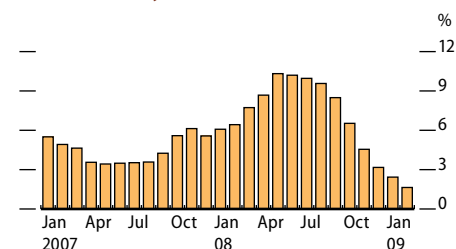
Banking, while still underdeveloped, has expanded since the Government approved a commercial banking law in 2006. In addition to three state-owned commercial banks, there are now two public-private banks, two domestic private commercial banks, and nine foreign bank branches. The state-owned commercial banks account for 59% of total banking assets, although their share is declining. Lending to the private sector more than doubled in 2008 to the equivalent of 15% of GDP. The central bank lowered its policy interest rate in three steps, from 12% to 7%, to stimulate borrowing.

Although the ratio of nonperforming loans to total loans has come down from high levels over recent years, loan quality is expected to deteriorate as the economy slows. Further progress is needed to recapitalize the state-owned commercial banks (their capital-asset ratio was 0.42% last year, compared with 15.6% for private banks) and to strengthen bank risk assessment and supervision.

Preparations to join the World Trade Organization (WTO) in 2010 were stepped up last year, with the formation of a new body to coordinate the effort and to oversee associated trade-related reforms. Laws and regulations are being changed to meet WTO requirements. The Government added an offer on market access to services to its offer on market access to goods that it submitted in 2007.

The private sector continued to develop gradually. Laws to promote business and investment that were passed some time ago are being implemented. A special economic zone is being trialed in Savannakhet province, aimed at promoting foreign and domestic investment, attracting technology and skills, and generating jobs. Faster private sector growth is retarded by poor infrastructure, cumbersome regulations, limited

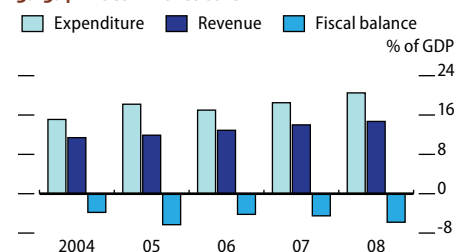
3.25.3 Monthly inflation



Source: Bank of the Lao PDR, available: www/bol.gov.la, downloaded 13 March 2009.

[Click here for figure data](#)

3.25.4 Fiscal indicators



Sources: Asian Development Outlook database; Ministry of Finance, Lao PDR.

[Click here for figure data](#)

3.25.5 Growth of merchandise trade



Sources: CEIC Data Company Ltd., downloaded 13 March 2009; staff estimates.

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availability of skilled labor and finance, and inadequate land security. Boosting private activity will need a switch from the system of business licensing to one of business registration. Similarly, there is a need to enhance transparency, simplify, and define tax procedures. Another hindrance to firms is business customers' high power tariffs. In finance, the banks could assist development of small and microenterprise startups that have solid business proposals by simplifying lending procedures and clarifying which assets can be used as collateral.

Economic prospects

Growth will slow in 2009 and 2010 as the global economic downturn hits exports of clothing and copper, as well as tourism. Orders for clothing exports in early 2009 were down by 15–20%. Foreign direct investment is expected to diminish in the face of weaker prices for metals (particularly copper) and tighter international funding. Several planned projects have been delayed, including expansion of a copper and gold mine and work on three new hydropower stations. Slower export growth will curtail incomes and consumption spending, and weigh on business confidence and investment.

On the positive side, government spending on facilities for some special events will contribute to growth. The Southeast Asian Games are scheduled to be held in Vientiane late this year and the 450th anniversary celebrations for Vientiane as the capital will be held in January next year. Assuming reasonable weather, agricultural production is forecast to expand faster this year than last, when floods damaged crops. Irrigation systems are gradually improving and additional bank credit is being made available to bolster farm output. The 1,082 megawatt Nam Theun 2 hydropower project, the country's biggest, comes into full commercial operation late in 2009.

Furthermore, the Government is preparing measures to cushion the economy from the impact of the global slowdown. These include provision of credit and other support for small and medium-sized enterprises and temporary reductions in power tariffs for mining companies that face cash-flow difficulties. It is also considering suspending a 10% value-added tax that came into effect on 1 January this year. On the monetary side, the central bank is prepared to support credit for farmers and small firms.

On these factors, GDP growth is expected to decelerate to 5.5% in 2009 and stay close to that rate in 2010 (Figure 3.25.6). Year-average inflation is projected to ease to 5.0–6.0% in the forecast period (Figure 3.25.7). Lower average global oil and food prices this year will put downward pressure on inflation, though this impact is expected to be partly offset by other influences, notably the value-added tax (unless it is suspended). The current account deficit is forecast to be around 16% of GDP (Figure 3.25.8). International reserves will likely decline further as foreign direct investment and remittance inflows wane.

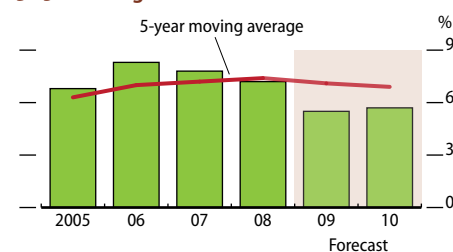
The Government plans to lift spending in FY2009 by about 10%. However, its revenue will slip by at least that rate as a result of the slump in global copper prices as well as the likely suppression of tax revenue caused by slower economic activity. The fiscal deficit is expected

3.24.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	5.7
Inflation	5.0	6.0
Current account balance (share of GDP)	-15.9	-16.0

Source: Staff estimates.

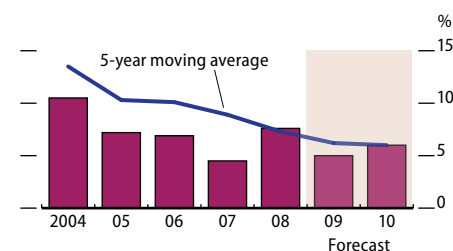
3.25.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

3.25.7 Inflation



Sources: National Statistics Center, Lao PDR; Bank of the Lao PDR, available at: <http://www.bol.gov.la>, downloaded 18 March 2008; staff estimates.

[Click here for figure data](#)

to widen to about 5% in 2009. The authorities are therefore looking at ways to reprioritize spending so as to put more emphasis on supporting growth. In this situation, it may divert planned spending on social development, such as health and education. Fiscal strains are likely to intensify in FY2010, given the weakness in revenue and the likely need to support growth.

Risks to the above forecasts include cutbacks in mining production and the related possibility of more serious erosion than expected in government receipts. Expansion of credit by state-owned commercial banks last year, coupled with the slowing economy in 2009, raises the risk of higher nonperforming loans, which in turn could lead banks to be more cautious in their lending.

Development challenges

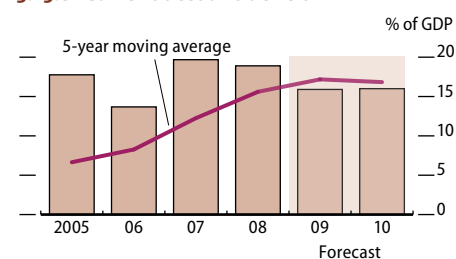
The immediate priority is to ensure macroeconomic and financial stability, and to prevent the global economic fallout from unraveling past achievements. Poverty incidence, for example, has declined, from 33% in 2002 to around 28% in 2008. At a time when the economy is slowing and vulnerable groups need to be protected, changes in budget priorities put at risk funding for social development and poverty reduction.

Other achievements that need to be upheld include the increased momentum in economic growth (averaging 7.5% over 5 years), suppression of formerly double-digit inflation, and the strengthened fiscal position. Monitoring the impact of the slowdown on the economy to enable sound policy making will require improvements in the timeliness and reliability of economic and financial data.

Closer commercial links with neighboring countries in recent years provide greater opportunities for the country to access outside markets, technology, and capital. Indeed, investment and trade have surged, mainly involving natural resources (mining, hydropower, and agriculture). It is now important to ensure that development of natural resources is environmentally sustainable.

A more diversified economy would generate more employment than is possible through mining and power generation, and would reduce vulnerability to volatile global commodity prices. In this regard, improving the environment for private sector development is key. That requires addressing constraints referred to above. Shortages of skilled labor indicate that education and training should be high on the list of priorities for investing the public revenue from minerals and hydropower. Related to skill shortages is weakness in public services because, although the Government has rolled out reforming policies, it has very limited capacity to carry them through, in particular at the local level.

3.25.8 Current account deficit



Sources: Asian Development Outlook database; staff estimates.

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