



Lao People's Democratic Republic

Despite flooding which had an adverse effect on agricultural output, overall economic growth remained strong in the Lao PDR in 1995, led by continued good performance of the industry and services sectors. There was, however, a slackening of fiscal and monetary discipline which resulted in an acceleration of inflation and weakening of the currency. These developments underscore the need to make further progress in macroeconomic management, particularly in prudent fiscal policy and control of monetary aggregates. These measures must be coupled with continued deepening of the financial system, development of instruments of monetary control, comprehensive tax reform, and liberalization of regulations so that the export base can expand and diversify.

Recent Trends and Prospects

Growth, Investment, and Employment. Growth of real GDP in 1995 at 7.1 percent was somewhat lower than in 1994, when GDP increased by over 8 percent. Nevertheless, the outturn was commendable in view of the poor performance by the agriculture sector, which was adversely affected by severe flooding resulting in output growing by only 4.9 percent in 1995 compared with 8.3 percent in 1994.

The transition from a centrally planned to a market economy has been very slow in the agriculture sector. Poor and limited transport infrastructure, undeveloped market systems, and declining fertility of soils in the uplands are serious constraints on development. In addition, the lack of a skilled work force and of a national research and extension system,

together with the underdeveloped rural savings and credit systems, are constraints that have to be overcome before a transition to an efficient market system in agriculture can be achieved.

Industrial output grew at a double-digit rate for the third year in a row. The mining and construction sectors performed particularly well, with construction output increasing by 22 percent in 1995 following growth of over 11 percent in 1994. However, the larger manufacturing sector, including the nascent garment industry, small vehicle assembly, and other light industrial enterprises, was hampered by infrastructure bottlenecks and slow progress in privatization, and grew by only 7 percent in 1995, the same as in 1994. Limited infrastructure, which has permitted growing competition from imports in most regions accessible to border markets, and cautious private sector investment are some of the factors responsible for lower growth in manufacturing. During the past three years, progress in privatizing the remaining public enterprises has slowed, and divestiture has most frequently been limited to fixed-term lease contracts for operations only, without the sale of state assets. This practice has not encouraged confidence in the permanence of the privatization policy. Growth, even in the more dynamic manufacturing industries, has also to some degree been impeded by such factors as the high cost of imported inputs, high cost of transport, relatively higher taxes levied on import/export companies, and cumbersome customs procedures.

Services sector growth picked up to 8.5 percent in 1995 from 5.5 percent in 1994. Growth in hotel and restaurant services was particularly

strong; financial services output also improved on that in 1994. Growth in wholesale and retail trade, which claims the largest share of the services sector and accounts for over 8 percent of GDP, increased to 8.9 percent in 1995 from 7.9 percent in 1994. Public services, as indicated by the public sector wage bill, continued to decline, which reflects the Government's policy to reduce the size of government and shift services to the private sector.

Structural weaknesses in the economy are highlighted by the large imbalances between saving and investment. Estimates indicate that gross domestic saving has risen from 4 percent of GDP in 1990 to as much as 7 percent in 1995, reflecting some strengthening of confidence in the economy and the financial sector. Nevertheless, the resource gap remains wide, with the investment rate remaining at about 21 percent of GDP. Foreign resources continue to be relied upon to finance this gap.

While real per capita income has been growing at a fairly high average rate of 3.8 percent over the past six years, there has been less progress in rural areas where the economy is largely nonmonetized and rice deficiencies are common during years of poor harvests. As a result, there has been only limited progress in reducing poverty

and increasing employment. Some unemployment is now appearing in the urban areas; this has affected young men in particular as many of the new firms in manufacturing preferred to recruit women. Concern has also arisen over the enforcement of labor standards as firms seek to reduce costs and extend hours.

Growth prospects for 1996 and 1997 will continue to depend on weather conditions since productivity increases in the nonagriculture sectors are not expected to be significant in the short term. GDP should continue to expand at 7-7.5 percent, and the share of agriculture will continue to decline slowly. Acceleration of industry and services sectors growth can be expected if financial sector reforms are not delayed, and if regulation of the private sector is further streamlined.

Budget, Money, and Prices. In the early 1990s, the Lao PDR improved its fiscal management, and the recurrent account deficit was reduced through tax reform measures and limitations on expenditure growth. While government revenue remains low compared with that in other developing economies in the Asian region, there were improvements in the revenue to GDP ratio - from under

Table 2.9 Major Economic Indicators: Lao PDR

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	5.9	8.1	7.1	7.5	7.0
Agriculture	% change	2.7	8.3	4.9	5.4	4.2
Industry	% change	10.3	10.7	11.4	11.0	11.3
Services	% change	7.7	5.5	8.5	9.0	9.0
Inflation Rate	% change in CPI	6.3	6.7	19.4	13.8	5.8
Money Supply Growth	% change	64.6	31.9	16.6	16.6	16.6
Merchandise Exports	\$ million	240.5	300.4	347.9	385.0	419.0
	% change	81.3	24.9	15.8	10.6	8.9
Merchandise Imports	\$ million	431.9	564.1	589.2	678.0	737.0
	% change	62.7	30.6	4.1	15.5	8.7
Current Account Balance ^a	\$ million	-146.1	-231.0	-201.0	-256.0	-278.0
	% of GDP	-11.0	-15.0	-11.4	-13.9	-13.3
External Debt Outstanding ^b	\$ million	495.3	579.6	677.6	802.0	039.0
Debt Service Ratio	% of exports	4.2	3.4	4.8	5.4	7.0

^a Excluding official transfers.

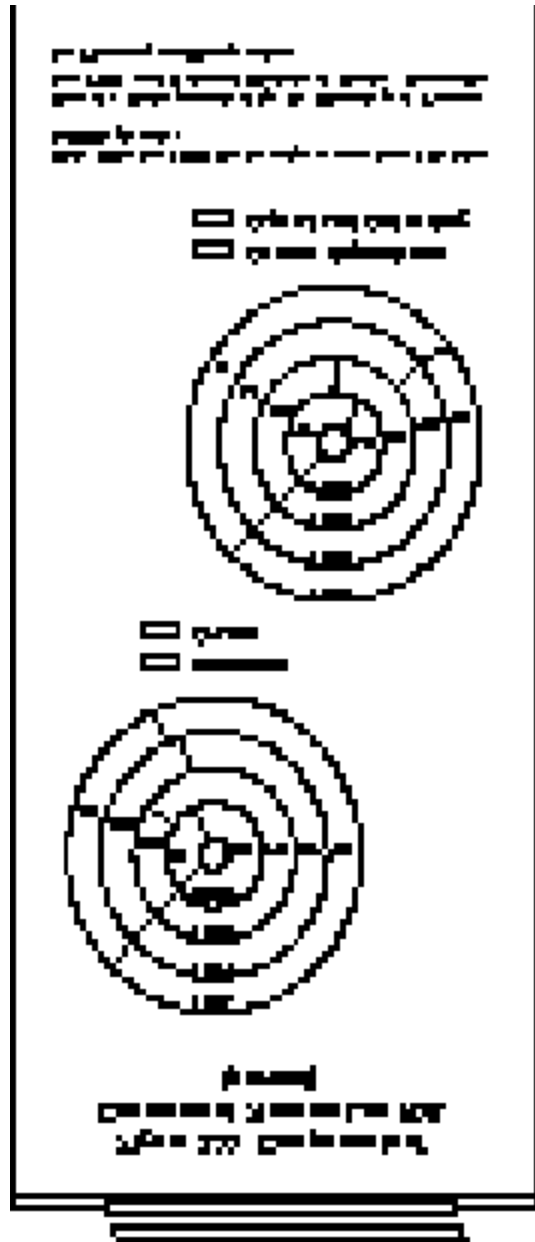
^b Refers to debt to the convertible area only. Data may differ from the series contained in the Statistical Appendix.

Sources: Data provided by the Government of the Lao People's Democratic Republic; and staff estimates.

10 percent in 1990 to over 12 percent in 1995 – due to improved tax administration procedures. Revenue began covering current expenditures in 1993 (Figure 2.11). However, capital spending, which is still financed primarily by external grants or borrowing, increased from 7 percent of GDP in 1993 to over 11 percent of GDP in 1995 as the need to improve the physical and human resource infrastructure led to an expansion in the public investment program.

Over the past few years, the money supply has grown rapidly as the monetization of the economy deepened. There has been rapid growth in private sector credit and a large increase in net foreign assets. Deposits in commercial banks have swelled enormously, from kip (KN) 25.8 billion in 1990 to over KN140.0 billion in 1995, reflecting increasing confidence in the banking and financial system. However, to some extent, the increase in the money supply also reflected inadequacies in monetary policy, particularly the inability to offset foreign capital inflows through open market operations and to control the growth of credit to the private sector. The relatively more expansive monetary and fiscal policies played a role in the 1995 inflation, as prices rose sharply compared with experience in previous years. As inflation accelerated, real interest rates fell and bank deposit levels declined. The Central Bank experienced considerable difficulty in influencing the market because of limited linkages between Treasury bills, the commercial banks' liquidity management, and interest rates. Ultimately, it resorted to direct credit controls to reduce the rate of money supply growth.

To improve the effectiveness of monetary policy, a number of new monetary instruments have recently been put in place. Starting in March 1994, open market instruments in the form of Treasury bills have been issued and made negotiable, with auctions held each month. Government bonds of various maturities have also been issued. A discount window replaced the credit window in 1994, and the Central Bank is now using penalty discount rates, which will help to build up the interbank market. Despite the introduction of these instruments, secondary market activity is still rudimentary; banks have only recently begun to trade these instruments, while at the same time there are not enough instruments to make a robust market.



Measured by the consumer price index in Vientiane, inflation increased sharply from 6.7 percent in 1994 to 19.4 percent in 1995. The rate of monetary expansion exceeded the demand for liquidity. Shortages in construction materials and services, combined with supply shocks in the food sector following the floods and higher import prices as a result of currency depreciation, also contributed to inflationary pressure.

The budget for 1996 proposes to curb fiscal expansion by reducing the overall deficit to within 9 percent of GDP. Revenue improvements are expected to increase the revenue/GDP ratio by a further 2.5 percent

of GDP. Improvements in the instruments of monetary control should enable money supply to be maintained at its 1995 level of 16.6 percent, thereby enabling the rate of inflation to be contained to 13.8 percent in 1996 and further to 5.8 percent in 1997.

External Trade and Payments. Although the balance-of-payments position initially strengthened in the early 1990s, there was a deterioration in 1994. In response to trade liberalization measures and other structural reforms, merchandise exports increased between 1990 and 1993 by an average annual rate of about 40 percent. However, export growth slowed down to 25 percent in 1994; and further to 15.8 percent in 1995 mainly because exports of forest products, which in the recent past have comprised about 30 percent of total exports, declined. Exports of motorcycles also declined. Exports of garments increased in 1995 at a faster pace than in 1994; while manufactures and especially coffee showed strong gains. Import growth in 1994 at 30.6 percent was half its 1993 level; it contracted even further to 4.1 percent in 1995. Imports of consumption goods slowed down to only 3 percent in 1995 while imports of investment goods rose by some 29.5 percent. With exports increasing more than imports, the trade deficit improved from 17 percent of GDP in 1994 to 13.6 percent in 1995. With a positive balance on the services account in both years, especially for travel, transportation, and embassy expenditures, the current account deficit (excluding official transfers) was 11.4 percent of GDP in 1995 compared with 15 percent in 1994. Official transfers and capital movements resulted in an overall balance-of-payments surplus of 0.8 percent of GDP in 1995 compared with a deficit of 0.8 percent in the previous year. Gross foreign reserves increased to almost four months of import cover in 1995 from over three-and-a-quarter months in 1994.

The country's medium- and long-term external hard currency debt was \$677.6 million or 37.5 percent of GDP by the end of 1994 and was projected at \$635 million at the end of 1995. As most debt is at concessional rates, the debt-service ratio is low, at about 4.8 percent of exports of goods and services in 1995.

Improvement in the regulatory environment will affect export potential, fostering more rapid expansion of light manufacturing

and commercial agriculture which, in turn, will generate employment in some urban areas. Urban economic activity will continue to fuel imports of consumer and investment goods. With import growth expected to exceed the expansion of export capability, the current account deficit is expected to widen to 13.9 percent of GDP in 1996 but to fall slightly to 13.3 percent in 1997. However, as most of this will be financed by concessional lending, debt service can be expected to remain below 4 percent of exports of goods and services.

Policy and Development Issues

While substantial achievements have been made over the past decade, much remains to be done. Improvements made in the fiscal area need to be consolidated through comprehensive tax reforms. Public saving must be increased to allow a higher share of the budget to go to physical infrastructure and human resource development and, at the same time, public sector investment must become more efficient. The restructuring of the industry sector remains a reform challenge, requiring further privatization of the remaining state-owned enterprises. More rapid industrial expansion hinges on a renewed commitment to allow the private sector to grow without arbitrary restrictions. Further liberalization of regulations to expand and diversify the export base is also needed. Factor markets need to be reformed to improve efficiency. This is particularly true in agriculture, where product markets would also benefit from fuller decontrol paired with infrastructure support. A comprehensive reform program for agriculture is needed to speed up the present slow economic development outside the urban areas. In the financial sector, measures already taken should be developed further to improve the working of the market so that the Government can conduct its monetary policy through open-market operations. Strengthening of the financial system will also help to improve domestic resource mobilization, and elaboration of the legal system will promote confidence among investors as well as consumers. Much of the weakness in the economy reflects the weak human resource base and lack of institutions; efforts must continue to build the management skills and institutions required to increase absorptive capacity.