

Lao People's Democratic Republic

Growth accelerated in 2005 as investment in mining and hydropower projects maintained the industry sector's double-digit expansion, while agriculture and services also grew. An increase in imports of capital equipment for these projects has deepened trade and current account deficits. Fiscal concerns are the major risk factor, given a weak revenue base. Solid economic growth is expected into the medium term, assuming further progress on fiscal reforms.

Economic performance

Gross domestic product (GDP) grew by an estimated 7.2% in 2005, edging higher for a third year in a row. (It had risen at just under 6% annually in 2000–2003.) Per capita GDP increased from \$322 to \$491 between 2001 and 2005. Until a few years ago, agriculture accounted for more than 50% of GDP, but double-digit growth in industry since 2001 has raised that sector's share to about 30% and lowered agriculture's to about 45%. Industry—driven by gold and copper mining—grew at a robust 13.0% in 2005 and contributed 3.5 percentage points of GDP growth, or about half of the total (Figure 2.23.1). Indeed, industry has been the main source of growth for the past 5 years. Construction activity at the large Nam Theun 2 hydropower project also provided a fillip to growth in 2005.

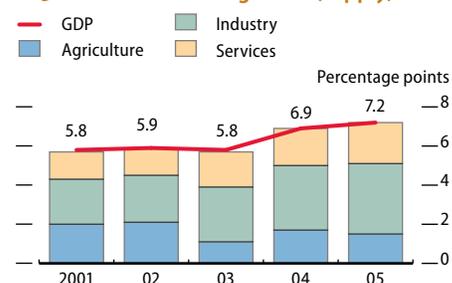
Agriculture, mainly rice production, has recorded steady but modest average growth of 3–4% in the past 5 years, slipping to the lower end of this growth range in 2005. The services sector has generally expanded by 5–7% in the period, reflecting steady improvements in tourism and trade, though sector growth picked up to 8.0% last year.

Inflation was contained at 7.2% in 2005, decelerating from the 10–15% range recorded in 2002–2004 and the lowest inflation rate for many years. Growth of broad money (M2) was reined in to an estimated 8%, from above 20% in most recent years. The central bank's monetary policy is based on open-market operations, although it is constrained by the widespread use of the United States (US) dollar in the economy.

Data for 2005 on trade and financial flows remain scant, which limits an analysis of the external sector. The merchandise trade deficit has widened sharply to around \$350 million for the past 2 years, from about \$150 million in the previous 3 years, largely because of high oil prices and imports of capital equipment for mining and hydropower projects (Figure 2.23.2). Exports, which comprise primarily coffee, electricity, clothing, minerals, and wood, performed well in 2005, surging by nearly 50%. Clothing exports increased slightly. The widening trade gap in the past 2 years has pushed the current account deficit to around 8% of GDP. Mining and hydropower projects have attracted foreign direct investment, which rose from an estimated \$17 million in 2004 to \$27 million in 2005. The exchange rate has remained broadly stable over the past 3 years.

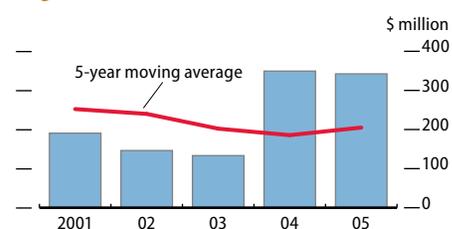
Public and publicly guaranteed external debt was estimated at

2.23.1 Contributions to growth (supply)



Sources: Asian Development Outlook database; staff estimates.

2.23.2 Trade deficit



Sources: Asian Development Outlook database; staff estimates.

\$2.2 billion at end-2005. The country is in fact eligible for debt relief under the debt initiative for heavily indebted poor countries, but the Government has not requested such assistance. It is, though, seeking further concessions on debt owed to the Russian Federation, following an initial agreement in 2003 on a net present value reduction of about 20% in outstanding debt to \$387 million. Gross international reserves rose slightly to \$238 million (Figure 2.23.3).

Robust economic growth and some improvement in revenue collection, which is a chronic weakness in the budget, kept the overall budget deficit (including grants) to about 4% of GDP in FY2005 (ended 30 September) (Figure 2.23.4). After several years of pursuing a program of fiscal reforms, basic fiscal discipline is in place, although policy instruments require further development. Tax revenue comes mainly from turnover tax, excise tax, and import duties; income tax is narrowly based and has many exemptions, but the Government is making efforts to broaden the tax base. Various tax measures, including changes to the administration of the turnover tax and excise tax were passed by the National Assembly in FY2005. The challenge now is to implement them.

Provinces and districts have received more autonomy on budget management issues in recent years, but without a sound institutional framework or adequate technical training. Problems have therefore emerged, including wide variations among provinces in per capita spending on key sectors and delays in revenue transfers from tax-surplus provinces to the national treasury.

The Government is implementing a 5-year public expenditure management program to address these concerns. In terms of outlays, an expanding wages bill is a major concern, caused in part by provincial governments raising staff levels after they obtained greater autonomy in hiring. The Government has made serious efforts to align annual budgets with its poverty reduction strategy, and created 157 village development funds in 47 districts to promote household income generation. However, budget processes are not yet completely aligned with the strategy.

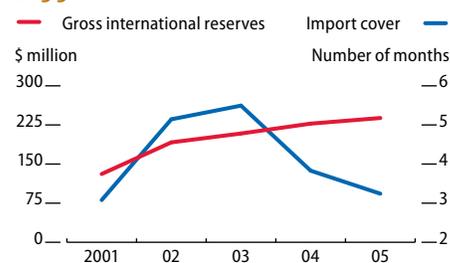
Economic outlook

The following forecasts assume that the Government will continue with the fiscal reforms needed to maintain economic growth and macroeconomic stability. The fiscal reform agenda is expected to meet major economic benchmarks agreed with the donor community, though some delays may occur. On the monetary front, the authorities are seen as keeping to prudent monetary management.

Prospects for 2006 and 2007

Growth will likely stay solid over the next 2 years, supported by investments associated with construction of the Nam Theun 2 hydropower project and mining projects. These projects, and enhanced opportunities for intraregional trade from closer integration with the rest of the subregion (Box 2.23.1), have the potential to maintain industry's double-digit growth. The performance of agriculture is expected to be satisfactory during a gradual transition from subsistence to commercial activities and contract farming. The services sector should

2.23.3 Gross international reserves



Source: International Monetary Fund, *International Financial Statistics* online database, available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>, downloaded 3 March 2006.

2.23.4 Budget deficit



Sources: Asian Development Outlook database; staff estimates.

2.23.1 Selected economic indicators

	2006	2007
GDP growth	7.3	6.5
Inflation	9.0	9.0
Current account balance (% of GDP)	-10.0	-10.0

Source: Staff estimates.

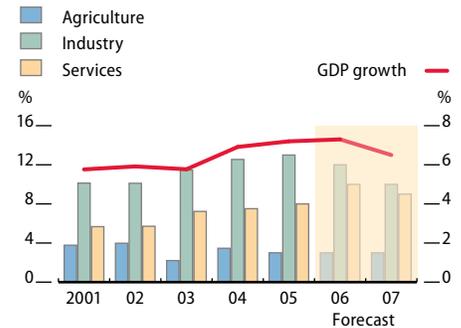
be underpinned by forecast annual growth of 11–12% in tourist arrivals. These are predicted to exceed 1.7 million by 2010, when income from tourism may well reach \$200 million–\$300 million a year. GDP growth is projected to average about 7% over 2006–2007 (Figure 2.23.5). Inflation will stay relatively high at around 9% (Figure 2.23.6)

The trade deficit is likely to widen further, given the need for imports of capital goods for the hydropower and mining projects and continued high global oil prices (Figure 2.23.7). Furthermore, clothing exports will face stiffer competition in international markets. The current account will remain in deficit, though capital inflows, including foreign direct investment, are likely to offset the gap. International reserves are projected to increase gradually, maintaining a level equivalent to 3–4 months of imports. The kip is expected to depreciate slightly in nominal terms against the US dollar.

Medium-term outlook

The economy is forecast to grow by 6–7% in 2006–2010, supported by construction of, and then exports from, Nam Theun 2 (scheduled for completion in 2009); new mineral production; and the increasing commercialization of agriculture. The main challenge is likely to be fiscal and debt management. Targets identified in the fiscal reform program need to be met and reform accelerated to address weaknesses in revenue collection and to strengthen public expenditure management. Under the draft Sixth National Socio-Economic Development Plan (2006–2010), the Government envisages a significant rise in spending and an increase

2.23.5 GDP growth by sector



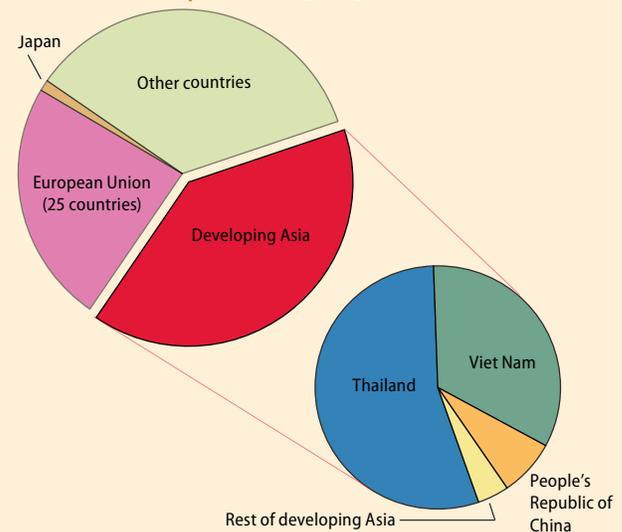
Sources: Asian Development Outlook database; staff estimates.

2.23.1 Focus on increasing trade

The Government is keen to increase trade as a way of promoting economic growth. Its 2006–2010 development plan states that the country intends to implement bilateral and multilateral commitments. It is reducing tariffs in line with its commitments under the Association of Southeast Asian Nations (ASEAN) Free Trade Area (it is scheduled to lower tariffs on eligible ASEAN imports to 0–5% by 2008) and pursuing membership of the World Trade Organization. Nontariff barriers are no longer commonly used, import quotas have been abolished, and import licensing is required only for cement, fuel, motor vehicles, and steel.

Cooperation and integration with neighboring countries are particularly important for this landlocked country. More than one third of its trade is with these countries and others in Asia (box figure). Under the Greater Mekong Subregion cooperation program, the Government supports measures to facilitate trade and transport, including cross-border agreements. The implementation of one such agreement, with Viet Nam, began at the Dansavanh-Lao Bao border crossing in June 2005. The Government signed a similar agreement with Thailand in July for the Savannakhet-Mukdahan border crossing.

Distribution of exports, Q1–Q3 2005



Source: International Monetary Fund, *Direction of Trade Statistics*, February 2006.

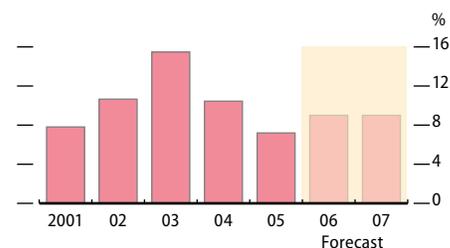
in revenue. The fiscal balance is projected to remain in deficit over the medium term.

In relation to debt management, the ratio of external debt to GDP is forecast to stay high, in the 80–90% range. Because of the mostly concessional nature of this debt, the debt service burden of about 9% of exports is manageable, if economic reforms stay on track and exports rise substantially as expected. The export growth rate, reflecting commissioning of Nam Theun 2, is projected to rise to nearly 30% by 2010. Additional debt and interest costs arising from the Government's financial participation in Nam Theun 2 are expected to be outweighed by the forecast increase in GDP and exports, so this financing should not undermine the overall debt position.

The 2006–2010 plan assumes a high level of official development assistance and increased domestic and foreign investment. The commitment and disbursement of official aid will largely depend on the maintenance of prudent fiscal and debt management, while private investment flows require progress in improving the business environment.

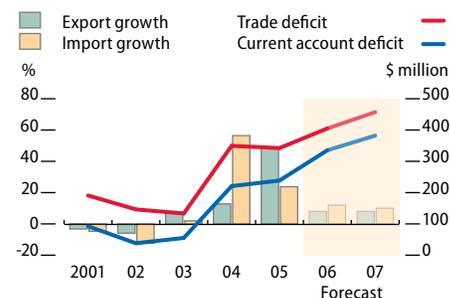
The main domestic risk to the outlook is incomplete implementation of fiscal reforms. If there is slippage in this area, and the economy is hit by an external shock, the fiscal deficit could widen to an extent that jeopardizes macroeconomic stability and the poverty reduction strategy. Consolidation of public expenditure, especially wages, is required to avoid further expansion of the debt and to allow for funding of priority areas. The risks raised by decentralization of fiscal management could be addressed by more effective planning and implementation to avoid both inconsistency between central and local budgets and delays in revenue transfers to the central Government.

2.23.6 Inflation



Sources: Asian Development Outlook database; staff estimates.

2.23.7 Trade indicators and current account deficit



Sources: Asian Development Outlook database; staff estimates.