MACROECONOMIC DEVELOPMENTS OF THE LAO PEOPLE’S DEMOCRATIC REPUBLIC

I. Overview

1. The Lao People’s Democratic Republic (Lao PDR) has enjoyed strong gross domestic product (GDP) growth, which averaged 7.3% during 2013–2017. Poverty has declined from 27.6% in 2008 to 23.2% in 2013. However, income disparity widened with Gini coefficient deteriorated from 0.31 in 2003 to 0.36 in 2013. The main economic driver has been power and mining sectors, which accounted for almost 17% of GDP and more than half of total exports, while these two sectors employed only 1% of the labor force and has limited linkages to the rest of the economy. With 70% of the labor force work in agriculture sector and most of them are subsistence farmers, productivity increase in agriculture sector and economic diversification are necessary to shift the labor force from agriculture to other sectors and achieve inclusive and sustainable economic growth. The government aims to graduate from the least-developed country status in 2024 and its progress is on track.¹

2. As for the macroeconomic management, the country has been facing with large current account deficit mostly backed by foreign direct investment, low level of foreign reserves, large fiscal deficit, rising public debts, and dollarization in the banking system. The country is exposed to external risks which include slower growth in major trading partners and the impact of the escalating trade disputes between the United States (US)-People’s Republic of China (PRC) and domestic risks which involve the slow progress in public finance management reform and the recurrence of natural disasters which could erode the progress made in poverty reduction.

II. Growth and Inflation

3. After the sustaining strong growth during the past several years, GDP growth eased from 6.9% in 2017 to 6.3% in 2018 due to severe flooding affecting agricultural outputs and contraction in the mining sector, coupled with slower growth of construction activities. The economy is forecast to further slow down to 6.2% in 2019 due to softer growth in industry and services sectors. Growth in industry sector is pulled down by decelerated increase in electricity exports due to the delay in the commercial operation of a few large power plants. Growth in tourist arrivals, a proxy for the services sector, fell from 6.1% in the first 6 months of 2018 to 5% in the same period of 2019 (Figure 1). Meanwhile agricultural production continues to be affected by weather such as severe flooding in September 2019 and an anticipated El Niño induced drought toward year end.

4. Inflation remains modest but has risen moderately since mid-2018. Inflation reached 3.3% in August 2019, the highest in 8 months. The rise in inflation was driven by higher food prices and local currency depreciation. The average annualized inflation rate was 2.0% for 2018 and is forecast to 2.3% for 2019.

¹ The Lao PDR met two out of the three United Nations (UN) eligibility criteria, i.e. per capita Gross National Income and Human Asset Index, for graduation from Least Developed Country (LDC) status for the first time in 2018. If the Lao PDR sustains development outcomes and meets the criteria again in 2021, the country will formally graduate from the LDC status in 2024.
III. External Sector Development

5. **External position remains fragile.** The country’s external position remains weak from large current account deficit which is mostly backed by foreign direct investment, low foreign reserves and high external debt. The current account deficit is likely to decline from 9.2% in 2018 to 8.9% in 2019 as lower growth and weakening domestic consumption cause imports to contract. Imports decreased by 4.7% in the first five months of 2019, compared to the same period of 2018, and trade deficit is estimated to shrink from $671 million in 2018 to $549 million in 2019. International reserves remained low at $884 million at end of March 2019, equivalent to 1.3 months of imports. However, since major part of imports are related with large-scale infrastructure investment which are backed by foreign direct investment, after deducting such imports from the total, the reserves to the months of imports ratio was maintained to 3.2 months of imports in 2018.

6. **Monetary and exchange rate policy.** Although overall inflation remains at modest levels, monetary policy will have little room to maneuver as the country’s exchange rate regime remains under a managed float system. From January to September 2019, the Lao Kip has depreciated by 2.9% against the US dollar and 8.7% against the Thai Baht in regulated commercial banks’ rate, and 5.6% for the US dollar and 10% for the Thai Baht in the parallel market. The low level of international reserves and high debt render the economy vulnerable to external shocks. However, dollarization of the economy has been partly mitigating the pressure to the local currency depreciation.

IV. Fiscal Operations

7. **Fiscal situation improved somewhat, but fiscal challenges remain.** The fiscal deficit declined to 4.4% in 2018 from 5.6% in 2017, in line with the government’s fiscal consolidation efforts (Figure 2). Measures to rationalize expenditures such as reducing the number of civil service intakes, directing public investment to priority projects, and redirecting public expenditures...
to government priorities resulted in lower recurrent and capital expenditures.\(^2\) Fiscal deficit is projected to remain at 4.4% of GDP in 2019 as expenditure rationalization continues. The data from the Ministry of Finance suggested that up to June 2019, revenue collection reached 47% of the plan, while expenditure achieved 34% of the plan, of which capital expenditure reached only 22%, reflecting continued fiscal consolidation. As assessed in the 2019 IMF Article IV Consultation, concerns rest with the deteriorating tax revenue performance. This could place increasing pressure on government to achieve fiscal consolidation at the expense of cutting back on much needed spending on social sectors. Spending on education and health is lower than those of the Association of Southeast Asian Nations and lower income developing countries.\(^3\) Tax revenue to GDP ratio declined from 12.7% in 2016 to 11.2% in 2018 and is estimated at 11.4% in 2019 due in part to the impact of natural disasters. Expanding the available fiscal space will need to target improved revenue collection to yield benefits over the medium- to long-term. In the short- to medium-term, the government has been making effort to: (i) implement the reforms as guided by the Public Finance Development Strategy to 2025; (ii) increase natural disaster resilience by prioritizing expenditures to prepare for post disaster recovery and rehabilitation; and (iii) ad hoc expenditure cuts in social sector spending to improve fiscal situation.

\[\text{Figure 2: Fiscal Indicators}\]

<table>
<thead>
<tr>
<th>Year</th>
<th>% of GDP</th>
<th>% of GDP</th>
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<tbody>
<tr>
<td>2014</td>
<td>60</td>
<td>-7</td>
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<tr>
<td>2015</td>
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<td>0</td>
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<tr>
<td>2016</td>
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<td>5</td>
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<tr>
<td>2017</td>
<td>45</td>
<td>10</td>
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<tr>
<td>2018</td>
<td>40</td>
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V. Public and Publicly Guaranteed Debts

8. Public and publicly guaranteed (PPG) debts are large and largely borrowed from external sources. Total PPG debt stood at $10.4 billion, or 57.2% of GDP in 2018 (footnote 3). Of which, external PPG debt amounted to $9.3 billion and rose to 51.4% of GDP in 2018 from 49.6% in 2017 (Figure 2). Multilateral debt accounts for $1.6 billion, or 15.1% of total PPG debt.\(^4\)

\(^2\) Current expenditures declined from 15.4% of GDP in 2015 to 12.5% of GDP in 2018, in which wage bill (accounted for 50% of the current expenditures) dropped from 7.7% of GDP in 2015 to 6.6% of GDP in 2018. Capital expenditures declined from 10.8% of GDP in 2015 to 7.5% of GDP in 2018.
\(^3\) International Monetary Fund. 2019. Lao People’s Democratic Republic: 2019 Article IV Consultation Staff Report. Washington, D.C.
\(^4\) The debt to ADB accounted for 7.7% of the total PPG debt.
Bilateral debt amounted to $6.2 billion; of which, $4.4 billion, or 43% of total PPG debt, was to a single lender. Majority of external PPG debts are concessional (65%) and denominated in US dollar (55%).

9. **Debt sustainability assessment.** The debt sustainability analysis (DSA) of the International Monetary Fund (IMF) 2019 Article IV Consultation classified Lao PDR’s public and external debt positions at the same category as in its 2018 report: *high* risk of debt distress. (footnote 3) However, the 2019 analysis notes that large electricity export revenues under long-term power purchasing agreements with neighboring countries, primarily Thailand, and growing electricity export markets help mitigate risks and keep debt sustainability outlook sustainable. The government intends to manage public debt in accordance with the newly enacted public debt management law. The IMF advised that “rebuilding the fiscal space, strengthening policy guidelines for sovereign debt issuance and guarantees, managing risks from contingent liabilities, improving overall debt management are immediate priorities, and prioritizing infrastructure projects with high growth and social returns and financing these with concessional financing would further benefit debt sustainability”. (footnote 3)

10. **Contingent liabilities pose a significant risk but the government has track record to manage it, especially in power sector.** The Lao PDR remains an outlier globally in terms of its total capital stock associated with public-private-partnerships (PPP) which stands at 85% of GDP. Based on the IMF estimates, in 2018, total contingent liabilities amounted to $7.0 billion or 39% of GDP, of which PPP-related contingent liabilities accounted for 29% of GDP or $5.2 billion. Around one-third of total PPG debts, or approximately $3.5 billion, were on-lent to State Owned Enterprises as of December 2018. This is due to the significant and sustained large scale investments in the power sector. The power-purchase agreements with take-or-pay clauses signed between IPPs and Electricite du Laos (EDL) have potentially negative impact on EDL’s financial positions and could incur future social cost, if EDL cannot find export markets and domestic demand. IMF considered that the Lao PDR could manage the contingent liability issue given that the country has track record to find export markets and growing electricity demand in its neighboring countries with some of which the government signed memorandum of understanding on power sales. The government also took a proactive measure by imposing a 2-year moratorium in March 2019 to suspend or postpone new power generation projects for which EDL cannot find markets.

11. In summary, growth prospects for the economy are threatened both by external and domestic factors. Despite the headwinds, the growth is projected to remain robust and rise to 6.5% - 7% over the medium term boosted by private sector investment, electricity exports, increasing regional economic integration and supply chains upon the completion of Kunming-Vientiane railway and expressways. Inflation is forecast to remain moderate. Foreign-direct-investment related imports would sustain large current account deficit. The government continues to make progress in fiscal consolidation by optimizing expenditures and improving revenue collection through tax administration reform and modernization. The government has embarked on modernizing legal frameworks with a view to strengthen the economic governance and aim to contain fiscal deficit at below 3% of GDP and public debt at around 50% of GDP by 2025.