Lao People's Democratic Republic

Rising production of copper, gold, and silver coupled with stimulative government policies helped the economy maintain solid growth in 2009. The pace of growth is forecast to step up in both 2010 and 2011, underpinned by expansion in the mining and hydropower industries. Inflation, curtailed in 2009, will pick up this year. Rapid increases in credit have raised macroeconomic and banking system risks. Longer-term challenges involve diversifying sources of growth and generating more employment.

Economic performance

Given limited financial links with industrial countries and firm demand from neighbors for its main exports, the economy was relatively unscathed by the global slump, posting GDP growth of 6.5% in 2009. This outturn, a little below 7.5% average growth of the previous 5 years, was supported by significant increases in mineral production, a recovery in the price of copper in the second half of the year, and expansionary government policies.

Industrial production surged by about 17% and contributed most of the growth in GDP (Figure 3.25.1). This jump stemmed from mining, construction, hydropower, and, to a lesser degree, the small manufacturing subsector. Several mining and power projects continued the expansion works that had already been planned for the year, although a few other projects that depended on foreign investment were postponed when global financial flows dried up. Hydropower output rose by 2%.

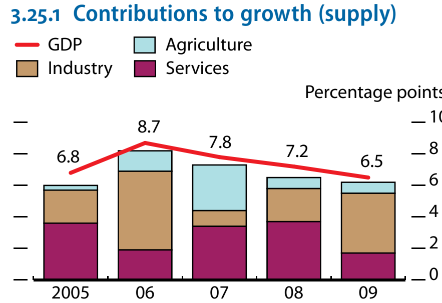
Output of copper from the country's two main mines rose by about 40% to 121,560 tons in 2009 from 2008's level, gold output rose by about 39% to 161,800 ounces, and silver production more than doubled to 496,000 ounces. It was the first full year of production from the Phu Kham copper and gold mine, which started operating in April 2008. The recovery of global copper prices in the second half also stimulated mine production.

Construction was spurred by the building of roads, sports facilities, and hotels for the Southeast Asian Games held in Vientiane in December 2009 and for the 450th anniversary of Vientiane as the capital, which is being celebrated during 2010.

Agriculture, which accounts for a third of GDP but employs more than 70% of the workforce, expanded by 2.3%, reflecting better crop yields from improved rice varieties, growth in fisheries and livestock, and expansion of plantations (for tree crops such as coffee and natural rubber) and contract farming (especially of corn and cassava).

Growth in the services sector was moderate at 4.4%. The Southeast Asian Games attracted visitors from neighboring countries late in the year, but tourism from industrial economies was damped by recession in Europe, Japan, and the United States. Growth of service industries such

3.25.1 Contributions to growth (supply)

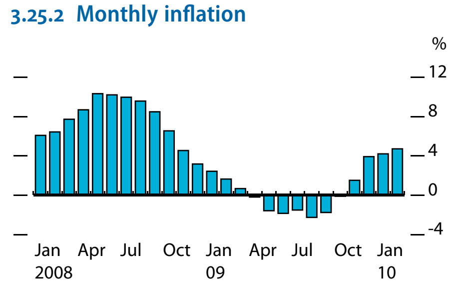


Note: Contributions to growth based on GDP at constant basic prices.

Source: Asian Development Outlook database.

Click here for figure data

3.25.2 Monthly inflation



Source: CEIC Data Company (accessed 15 March 2010).

Click here for figure data

This chapter was written by Christopher Hnanguie and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

as retailing, hotels, and restaurants decelerated, although the expansion of banking and finance services continued at a robust pace.

The government stepped up spending in 2009, to cushion the economy from the impact of the global recession and to build facilities for the Southeast Asian Games. Total spending grew to the equivalent of just over 21% of GDP in FY2009 (ended 30 September 2009). A previously approved hike in public sector wages contributed to the increase. Revenue was dented by the drop in copper prices in the first half of the fiscal year, but recovered in the second half as copper prices turned up. The government moved to offset the loss in copper revenue by raising excise taxes on luxury items, cigarettes, and alcohol. Excluding grants, the budget deficit widened to 5.9% of GDP in 2009 from 5.0% in 2008.

In addition to higher expenditure from the budget, the Bank of the Lao PDR, the central bank, funded significant off-budget direct lending for public infrastructure projects.

Inflation was curtailed by lower global oil and food prices, and was zero in 2009, compared with 7.3% over the previous 5 years. For the first 7 months of 2009, the consumer price index fell before turning up in the last 2 months and rising by 3.9% year on year in December (Figure 3.25.2). The kip depreciated by 2.5% against the Thai baht (Thailand is the Lao PDR's biggest trading partner).

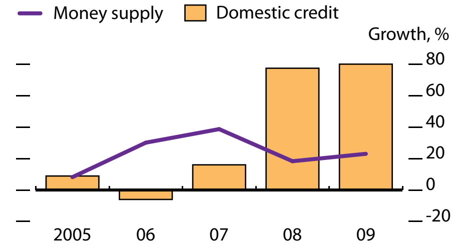
Rapid growth in credit—at a pace of about 80% in both 2008 and 2009 (Figure 3.25.3)—raised concerns that it could fuel inflation and lead to a rise in nonperforming loans at banks. Contributory factors included the central bank's lending for infrastructure projects and increasing monetization of the economy, while during 2009, the central bank lowered its policy interest rate from 7.0% to 4.0%. Growth in money supply (M2) picked up to about 23.0% in 2009.

Lower prices for export commodities, notably copper, coffee, and corn, trimmed the value of total merchandise exports by an estimated 10.0% in dollar terms in 2009. Clothing exports fell by about 13% because of weak demand in industrial countries. Merchandise imports declined by an estimated 13.0%, mainly a result of lower international oil and food prices and a fall in imports of machinery. With imports declining faster than exports, the trade deficit shrank and the current account deficit narrowed to 11.8% of GDP. Gross international reserves edged up to $644 million (Figure 3.25.4), sufficient for about 4 months of nonresource import cover.

Progress was achieved in some policy reforms in 2009. The recentralization of treasury, customs, and tax functions to the central government from the provinces was completed and other public finance management reforms made advances. Implementation of a value-added tax law promulgated in January 2009 was delayed to this year because of the global recession.

In changes that should improve the investment climate, business registration procedures were simplified and the government continued to implement trade-related reforms in its efforts to join the World Trade Organization. The National Assembly approved a new unified investment promotion law that will abolish cumbersome licensing procedures and harmonize investment incentives for domestic and foreign investors. However, implementation of this law, and other reforms, is slow.

3.25.3 Monetary indicators



Source: Asian Development Outlook database.

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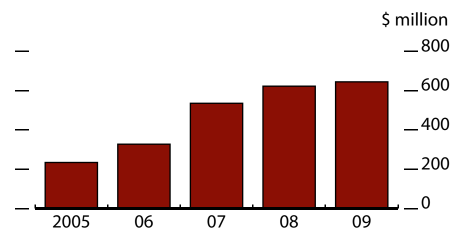
3.25.4 International reserves



Source: Asian Development Outlook database.

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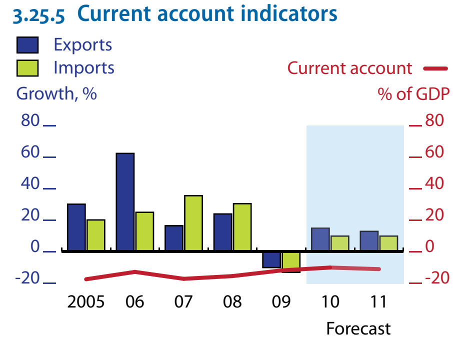
3.25.5 Current account indicators



Source: Asian Development Outlook database.

Click here for figure data

3.25.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.0	7.5
Inflation	5.6	6.0
Current account balance (share of GDP)	-10.0	-11.0

Source: ADB estimates.

Economic prospects

Growth is projected to pick up in the forecast period, underpinned by increases in investment and buoyant prices for export commodities, particularly copper and gold. The two major mining companies plan substantial investment, some hydropower projects delayed last year are being revived, and several other substantial mining and power projects are under consideration.

The country's biggest hydropower project, the 1,088 megawatt Nam Theun 2 plant, ramped up production in March 2010, a move that will more than double the country's power exports to more than $300 million in 2010. The Lao PDR exports about 80% of its electricity to Thailand. Clothing shipments are expected to recover this year as markets in Europe and the United States pick up.

Moderate growth is forecast in the services sector, supported by an increase in tourist arrivals as recession recedes in industrial countries and by an expected rise in visitors from neighboring countries as a carryover from the national capital's celebrations. Agriculture is envisaged to record slight growth, with some concerns for 2010 over a lack of rain in the north early in the year.

The government has budgeted a substantial increase in spending in FY2010, much of it directed at capital works. Revenue should rise quite strongly, too, supported by buoyant prices for copper and gold exports, rising income from hydropower exports, and the new value-added tax. The fiscal deficit is forecast to widen.

However, a firmer stance is expected on monetary policy, in the context of a rebound in imported inflation. The central bank aims to curb M2 money supply growth to 10% in 2010 and the government has committed to reining in the rapid growth in credit. Furthermore, the central bank has phased out direct lending for off-budget infrastructure.

On the balance of these factors, GDP growth is forecast to rise to 7.0% in 2010, quickening to 7.5% in 2011 as construction starts on several more power plants.

Inflation is seen accelerating to average 5%–6% in the forecast period, owing to upward pressure from higher global oil and food prices, recent rapid growth in credit, the depreciation of the kip against the baht, and, for 2010, the value-added tax. In the first 2 months of 2010 inflation averaged 4.5%.

Merchandise exports are forecast to rise by about 15.0% in 2010 (Figure 3.25.5), underpinned by buoyant copper and gold prices and rising exports of hydropower, in particular from Nam Theun 2. Exports will get a fillip from rebounding growth in the Thai economy, which contracted in 2009. Imports are projected to increase at a slower rate than exports, and the current account deficit should narrow slightly.

External public debt declined to 52% of GDP at end-2009 from 81% at end-2004, but is projected to rise slightly in the medium term as the government borrows to fund its equity stakes in some large projects. Although the stock of debt remains high, debt service is manageable, given that most is on concessional terms.

Aiming to broaden funding sources for the public and private sectors, the government plans to launch a small stock exchange at the end of this year, with assistance from other Asian exchanges.

3.25.1 Development challenges

The near-term challenge is to maintain low inflation, a stable exchange rate, and adequate foreign reserves at a time that very high rates of credit growth and generally expansionary policies have raised the level of risk to these achievements.

Now that inflation has turned up again, rapid rates of credit growth would likely fuel price pressures. Expansionary policies, if continued in 2010 as the economy picks up pace, could spur imports to an extent that depletes foreign reserves and jolts the exchange rate.

Excessive growth of credit, or an abrupt credit slowdown, would undermine the quality of bank loan portfolios, particularly as new private banks enter the market. The banking system remains vulnerable: state-owned commercial banks, which have a 60% share of banking assets, need to further strengthen capital positions and improve banking practices, including risk management. Central bank oversight capacity should be reinforced, especially in the context of the increasing number of banks.

Diversifying the economy's sources of growth and generating jobs to absorb the growing labor force remain major longer-term challenges. Mining and hydropower boost growth but offer few jobs. Reliance on mining puts economic growth and public revenue at the mercy of downswings in global metal prices.

Hence it will be important to build a fiscal framework that channels revenue from hydropower and mining into projects that expand the productive capacity of the economy, and into reducing poverty.

The private sector has the potential to generate more employment, if the government steps up efforts to ameliorate the business environment. The country has slipped in the World Bank's *Doing Business 2010* ranking to 167 of 183 countries, and in Transparency International's 2009 Corruption Perceptions Index to 158 of 180 countries.