Lao People's Democratic Republic

Foreign investment in hydropower and mining, together with rising exports of minerals in 2006, continued to drive double-digit growth in industry, the major contributor to GDP growth. Inflation slowed to levels not seen since 1994. However, progress was slow on reforming fiscal management and on improving the climate for private investment. Economic growth is projected to decelerate moderately this year.

Economic performance

Growth accelerated to 7.3% in 2006, to average 6.5% over the past 5 years. Robust growth over the period is largely attributable to industry, particularly the development of hydropower projects and gold and copper mining. Industry registered double-digit growth over the period (13% last year), expanding to account for 31% of the economy (up 10 percentage points in a decade). It was the largest contributor to total GDP growth in 2006 (Figure 2.23.1). Services grew by 5.5% and agriculture by 3.3%. Actual gross foreign direct investment (FDI) increased by 30% to $650 million, driven by large investments in the Nam Theun 2, Nam Ngum 2, and Xe Kaman 3 hydropower projects and in mining.

While growth picked up, average inflation eased to 6.8% in 2006, the lowest rate in 12 years (Figure 2.23.2). Rice output recovered after being hit by floods—and this helped slow inflation.

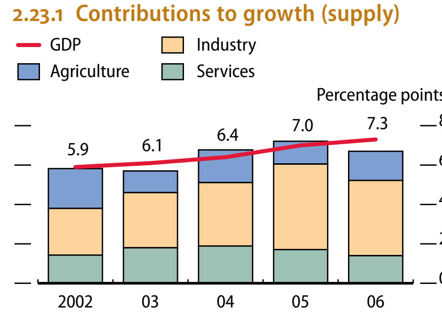
The kip appreciated against the US dollar by 5.2% using average exchange rates for 2005 and 2006, but the currency weakened slightly against the Thai baht (Figure 2.23.3). The Bank of the Lao People's Democratic Republic (Lao PDR) could be expected to take steps if needed to prevent any sharp decline against the baht, owing to the importance of Thailand as a supplier to the country.

Merchandise exports in nominal terms soared by an estimated 51% in 2006 as a result of both higher prices and export volumes of minerals. Over the past 5 years, exports have averaged 23% growth. Imports have been boosted by foreign inputs for hydropower and mining projects. In 2006, imports grew by 13.5% and are expected to accelerate further this year. The current account deficit widened to 14.0% of GDP. External reserves, at about $300 million, were buoyed by higher mining exports and FDI. Reserves equal 3.3 months of imports of goods and services.

The overall fiscal deficit (excluding grants) narrowed to about 5.7% of GDP in FY2006 (ended 30 September 2006) from 6.0% in FY2005 (Figure 2.23.4). Revenue collection (chronically a weak link in the budget) increased partly because tax collection functions were moved back to the central Government from the provinces. Also, a new tax law that came into effect in 2005 widened the tax base and increased receipts from large projects and tourism.

However, revenues are still hampered by tax exemptions and by lackluster collection of nontax items. Overall, the fiscal position remains

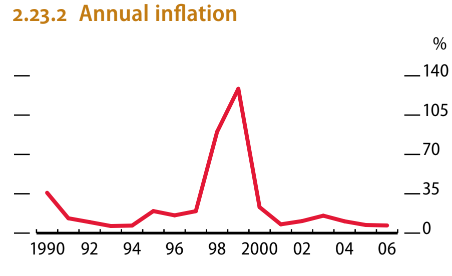
2.23.1 Contributions to growth (supply)



Sources: National Statistics Centre, available: www.nsc.gov.la, downloaded 21 February 2007; staff estimates.

Click here for figure data

2.23.2 Annual inflation



Source: National Statistics Centre, available: www.nsc.gov.la, downloaded 21 February 2007.

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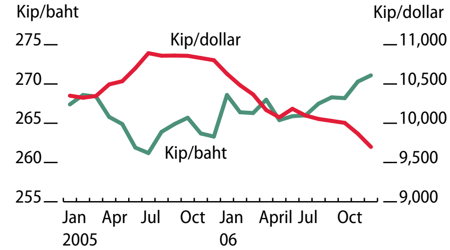
fragile. Expenditures were generally below allocations in FY2006, especially on the capital side. Overambitious revenue projections compelled the Ministry of Finance to maintain strict cash management of actual budget allocations. This approach has enabled the Government to rein in the overall budget deficit to levels required to maintain macroeconomic stability, but it may well delay planned expenditure. External public debt was estimated at $1.6 billion (46% of GDP) at end-2006. Much of the debt is owed to multilateral development banks and the Russian Federation on concessional terms.

Efforts were maintained to improve the performance of state-owned enterprises (SOEs). Restructuring of large SOEs continued in 2006 with draft external audits done on four of them. Restructuring plans were prepared on another five. The aim is to promote their commercial viability so as to reduce the funding burden on the budget and on state-owned banks. While SOEs are now less important in terms of their contribution to the economy and employment than a decade ago, they still generate a large share of nonperforming loans (NPLs), which risks the stability of the banking system.

On the fiscal reform front, the National Assembly passed several tax enhancements and a value-added tax is scheduled to come into effect in late 2007. More needs to be done, though, to implement these measures and to more broadly lift efforts to raise revenues (now equivalent to 12.5% of GDP) and reform state-owned banks.

The Government approved the Sixth Socioeconomic Development Plan 2006–2010 in July 2006. It aims to achieve annual average GDP growth of 7.5–8% over the 5 years with agriculture and forestry increasing by 3–3.4%, industry by 13–14% and services by 7.5–8%. GDP per capita is targeted to increase to $700–750. Inflation is envisaged to average 6–6.5% a year.

2.23.3 Exchange rates



Sources: International Monetary Fund, *International Financial Statistics* online database; Bloomberg; both downloaded 7 February 2007; staff estimates.

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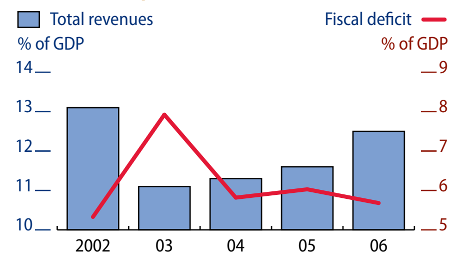
2.23.4 Fiscal performance



Sources: International Monetary Fund, *Lao People's Democratic Republic: Selected Issues and Statistical Appendix*, November 2006; staff estimates.

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Economic prospects

Projections for 2007 and 2008 assume that the Government will accelerate structural reforms and meet targets of the Development Plan. As it pursues membership of the World Trade Organization, the Government is expected to improve the climate for investment and trade. The outlook also assumes further economic integration into the subregion—driven by the ASEAN Free Trade Area (AFTA) and other regional initiatives—which should lead to improved transportation links, facilitate trade and investment, and promote tourism with neighboring countries. FDI inflows are projected to remain buoyant, with new investment in rubber plantations, contract farming, and in tourism.

On the downside, global prices of gold and copper are likely to stabilize after sharp gains over recent years. Economic growth is projected to slow in most of the Lao PDR's export markets, including the People's Republic of China, European Union, Thailand, and the United States. Taking into account these influences, GDP growth is projected to slow by a half percentage point to 6.8% this year. Projected lower year-average global prices of fuel and food will bring down inflation to about 5%.

Exports of clothing to the US are increasing, but this industry is constrained by Lao PDR's high transportation costs and need to import much of its raw materials for clothing. While total exports will

2.23.1 Selected economic indicators

	2007	2008
GDP growth	6.8	6.5
Inflation	5.0	5.2
Current account balance (% of GDP)	-15.3	-13.1

Source: Staff estimates.

remain strong, the merchandise trade deficit is projected to widen as a consequence of increased imports required for mining and hydropower projects. Imports of consumer items are also expected to increase as a result of reductions in tariffs required by AFTA commitments. In services, tourist arrivals rose by 15% to an estimated 1.3 million in 2006 and are projected to reach 1.6 million in 2008 (Figure 2.23.5).

The current account deficit will remain substantial in the forecast period. Inflows of grants and FDI should cover the external financing requirement.

Domestic risks to the projections include a possible resurgence of avian flu, which could undermine growth in tourism and agriculture, and put an additional strain on the budget. The slow pace of reforms also puts the economy at risk. Unless improvements continue in the trade and investment climate, the growth outlook will weaken. The main risk on the fiscal side is that revenues from natural resources may be seen as a substitute for undertaking difficult reforms to mobilize nonresource revenues, limiting the improvement in the overall revenue effort and making fiscal consolidation more difficult.

Development challenges

Solid rates of economic growth have reduced income poverty, though more attention is needed to ensure that growth generates the Development Plan's target of reducing the number of poor households to below 15%, and creating 652,000 additional productive jobs during 2006–2010. Exploiting hydropower (Box 2.23.1), minerals, and forestry resources can maintain GDP growth, but these activities have limited capacity to generate employment.

The population is relatively young and is expected to grow at about 2% annually. Thus, development of commercial agriculture and labor-intensive services should be a high priority if new entrants are to be absorbed into the labor force. Agriculture, which employs about 80% of the population, remains vital to development that lifts more people out of poverty. An improved climate for small and medium enterprises would diversify income sources, add value to agriculture production, and provide steady employment.

The country looks likely to meet its Millennium Development Goals in income poverty reduction. However, some nonincome targets related to basic education, maternal health, child nutrition, and access to clean drinking water may be beyond reach. Although coverage of basic services is improving, service quality and affordability are problems, and several regions are underserved.

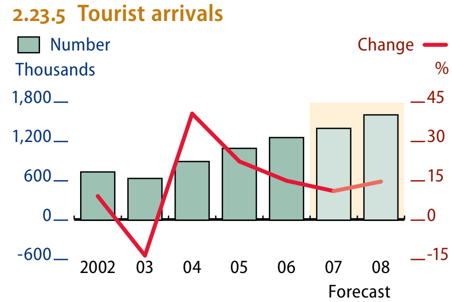
Fiscally, financial management and reporting systems require further strengthening. Government efforts to mobilize revenues have yet to reach expectations and tax administration requires strengthening. Development of much-needed private sector activity requires greater legal enforcement, more efficient business license requirements, and clarity on property rights. Much work remains to be done on restructuring SOEs and state-owned commercial banks.

2.23.1 Power and growth

Growth will continue to be supported by construction of the big 1,070-megawatt (MW) Nam Theun 2 hydroelectric project—which began in 2005 and is expected to be completed in 2009—and further expansion of gold and copper production. An energy cooperation agreement signed with Cambodia in 2006 looks likely to lead to a purchase agreement.

Thailand, the main consumer of Lao PDR–generated electricity, is preparing to sign new purchase agreements for power. Additional purchase agreements are expected because the 250 MW Xe Kaman 3, the 70 MW Xe Set 2, and the Nam Ngum 2 hydropower projects are scheduled to start production during 2009–2012. New mines are also due to get under way in the medium term.

2.23.5 Tourist arrivals



Source: Lao National Tourism Administration, *Statistical Report on Tourism in Laos*, 2004, 2005.

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