Lao People’s Democratic Republic

Expansionary fiscal and monetary policies supported economic growth in 2013. They also put stability at risk as inflation accelerated, fiscal and external deficits widened, and international reserves shrank. The government responded by cancelling some fiscal expenditure, which will take a toll on GDP growth in 2014. The key to maintaining economic stability and robust economic growth is to restore a sustainable fiscal position.

Economic performance

GDP grew by 7.6% in 2013, slightly below the pace of the previous 2 years (Figure 3.25.1). Growth in services gathered momentum, but industry and agriculture slowed.

Services expanded by 9.0% last year. Robust consumer spending, backed by a very large rise in incomes for the civil service, drove increases in wholesale and retail trade, while strong growth in credit boosted financial services. A 12% increase in tourist arrivals to 3.7 million in 2013 benefited hotels, restaurants, and transportation. Double-digit growth in telecommunications stemmed from the extension of mobile phone and internet services.

As for industry, copper production from the two main mines increased by 3.5% to 154,920 tons, slowing from the expansion rates of previous years. Growth in gold production also decelerated, with output rising by 6.6% to 219,880 ounces. Silver production jumped by 54.9% to 955,360 ounces. After 3 years of sharply rising electricity generation, the rate of increase slowed to 3.6% in 2013 (Figure 3.25.2). Several new hydropower plants were under construction. About 70% of hydropower is exported.

Construction slowed, with the completion in the previous year of public projects in the capital city and delays in 2013 on some foreign-invested property developments owing to economic slowdowns in the past 2 years in the People's Republic of China (PRC), Thailand, and Viet Nam, which provide much of the country’s foreign investment. Growth in industry as a whole slowed to 7.2% in 2013.

Agriculture was hit by floods in the third quarter, but production still grew by 2.7% for the year.

Economic growth was supported by expansionary fiscal and monetary policies. The government raised base wages for the civil service by 37% and approved large cost-of-living allowances for its employees, decisions that were estimated to double the government’s wage bill in FY2013 (ended 30 September 2013). At the same time, revenue fell short of the target.
These developments sharply widened the fiscal deficit (including grants but excluding off-budget spending) to an estimated 5.8% of GDP in FY2013 (Figure 3.25.3). The strain on the government’s cash position became evident when it fell into arrears in payments for wages and utilities that were estimated at 2.5% of GDP.

Moving to stanch the deteriorating fiscal position, the government in October 2013 cancelled the cost-of-living allowance for the public sector and postponed a large number of public investment projects, including roads and government buildings.

On the monetary side, growth in the M2 money supply expanded by 22.7% and growth in credit was a rapid 36.1% (Figure 3.25.4). Concerned about the expansion of credit and about dwindling international reserves, the central bank in June 2013 directed commercial banks to curb lending in foreign currencies and in August it restricted sales of foreign currencies to the public.

The Lao kip started to soften against the US dollar after the central bank restricted sales of foreign currencies. However, reflecting relatively high domestic inflation, the kip has appreciated in real effective terms over recent years, hurting export competitiveness and contributing to the current account deficit.

Robust domestic demand drove up imports of both consumer goods and capital equipment last year, while weakening global commodity prices curbed growth in export earnings. A larger trade deficit contributed to a wider current account deficit, estimated at 29.5% of GDP. A deficit in the balance of payments reduced gross international reserves to $666 million, providing limited cover estimated at 1.2 months of imports of goods and services.

Strong consumer spending also added inflationary pressure. Higher food prices, particularly for meat and vegetables, drove inflation up to a 2013 peak of 7.4% in July (Figure 3.25.5). Year-average inflation accelerated to 6.4% in 2013 from 4.3% in 2012.

**Economic prospects**

Domestic demand is expected to moderate in 2014, trimming GDP growth to 7.3%. Government investment will slow as it postpones 254 public projects and cuts off-budget spending. Reduced government investment and delayed government payments to suppliers and employees will hurt business activity and confidence. Slowdowns in large and influential neighbors, the PRC and Thailand, also cloud the outlook, particularly for investment.

The government aims to gradually rein in its fiscal deficit through tighter controls on spending and by strengthening revenue administration. That said, the authorities have again raised wages for the civil service in FY2014 by nearly 40% and hired additional public employees. Moreover, civil service wages are scheduled to rise for a third year in FY2015. Deficit reduction is complicated as well by arrears carried forward from last year and uncertain prospects for mining revenue in light of soft global commodity prices.
Monetary policy aims to slow growth in credit and maintain restrictions on lending in foreign currencies in 2014. But the extent of fiscal and monetary tightening this year is uncertain.

Nevertheless, private consumption will remain buoyant, and foreign direct investment approvals are strong. Construction is continuing on eight new hydropower projects, including the $3.5 billion Xayaburi project, and four more plants are expected to start construction in 2014. Work is well advanced on the large Hongsa lignite coal power project, due to be finished in 2016. Several new mines are under construction.

Against this, the Sepon mine stopped gold production in December 2013 in response to lower global gold prices.

Services are likely to maintain solid growth, particularly tourism-related services, telecommunications, and wholesale and retail trade. Agriculture is projected to expand at about the same rate as last year.

Next year, GDP growth is forecast to pick up to 7.5% as more export-oriented projects come into production, Thailand recovers, and exports gain momentum with the brightening global outlook (Figure 3.25.6).

Inflation averaged 5.8% in the first 2 months of 2014 and is forecast at 5.5% for the year, down slightly from 2013. Improved supplies of meat and moderation in domestic demand are expected to ease upward pressure on prices. The kip is projected to depreciate slightly against the US dollar, which will support exports and help rebuild foreign reserves. In 2015, inflation is seen escalating as the economy picks up.

The government has started to scrutinize the import valuation of vehicles and fuel to close loopholes that have caused revenue losses. That tighter control, together with restrictions on access to foreign currencies and reduced government capital outlays, should dampen growth in imports. The large current account deficit is seen narrowing only slightly over the forecast period (Figure 3.25.7).

**Policy challenge—a sustainable fiscal position**

The sharp widening of the fiscal deficit last year raised serious concerns for the government, which is wrestling with persistent arrears in its payment of wages and resorting to postponing public projects and cancelling cost-of-living allowances for the civil service. Addressing the fiscal deficit in a sustainable manner is key to maintaining economic stability and future growth, even if it means accepting lower growth in the short to medium term.

The three major reasons for the large fiscal deficit have been overly optimistic revenue projections, large wage increases and allowances awarded without due regard for their impact on the country’s fiscal and external positions, and development projects financed off budget. In response to the emerging fiscal crisis, the government doubled its efforts to collect revenue and cancelled or postponed some expenditure. It is also preparing a new fiscal strategy.

The main challenge is to reduce expenditure to drive the fiscal deficit down to a sustainable 3% of GDP. Assuming real economic growth of 7.5% and nominal growth of 13.0%, slowing expenditure growth in real terms to 2%–3% over the next 3 years would bring the budget deficit down to a sustainable level. Also, off-budget spending needs to be reined in.