

Lao People's Democratic Republic

Mining and hydropower kept the economy growing at a rapid rate last year and the outlook is for further growth at a more moderate pace in 2008–2009. Inflation decelerated to its lowest level in years, although it picked up in late 2007. The Government is improving trade and investment conditions in an effort to join the World Trade Organization by 2010. But more needs to be done to spur development of the private sector, as well as agriculture, to boost employment and reduce poverty.

Economic performance

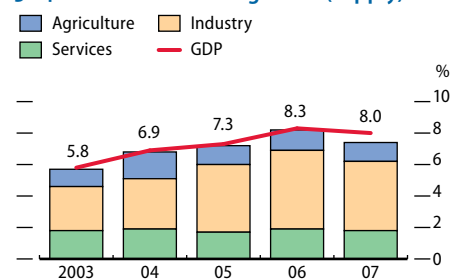
The economy grew by 8.0% in 2007, above the 6.8% average of 2002–2006. For a seventh consecutive year, industry recorded double-digit growth (14.0% in 2007), as output from hydropower plants and mining continued to expand. Industry has grown to account for nearly one third of the economy, a result of strong external demand for the country's hydropower and minerals (mainly gold and copper). Services grew by 7.2% in 2007 (Figure 3.24.1). Tourist arrivals rose by about 15% to an estimated 1.4 million, and tourism attracted significant investment in accommodation and other facilities. Agriculture and forestry, which supports more than four fifths of the population and is still the biggest sector, grew by 2.7%, hurt by drought in some provinces last year.

The expansion of hydropower and mining is underpinned by increasing inflows of foreign direct investment (FDI). Rubber plantations, small-scale manufacturing, and tourism also attracted such inflows. In 2007, gross FDI increased by nearly 20% to \$770 million.

Merchandise exports in nominal terms rose by an estimated 50.6% in 2007, reflecting buoyant exports of copper and gold, which account for about 60% of total exports. Other exports are clothing, electricity, and agricultural products. Imports fell by 1.7% as a result of reduced purchases of heavy machinery as a major hydropower project neared completion, and the closure of some clothing factories, which rely heavily on imported raw materials. A small trade surplus and rising tourism earnings helped narrow the current account deficit to 15.0% of GDP. After inflows of FDI and grants, the overall balance of payments recorded a surplus. External reserves increased by \$203 million to \$530 million by December 2007 (Figure 3.24.2), equal to almost 6 months of nonresource imports.

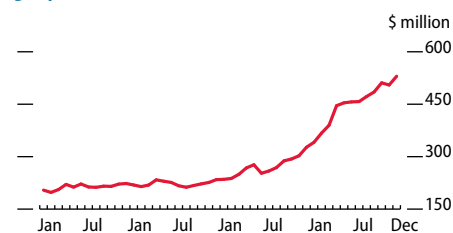
Despite robust economic growth, inflation slowed to a multiyear low, averaging 4.5% in 2007. Prices started to pick up in the fourth quarter, though (Figure 3.24.3). The decline in inflation partly reflects government subsidies for paddy production and greater efforts at land reform, which have stimulated supply of rice. Broad money supply (M2) growth

3.24.1 Contributions to growth (supply)



Sources: Asian Development Outlook database; staff estimates.

3.24.2 Gross international reserves



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 25 March 2008.

accelerated from about 25% in January 2007 to 44% in August, reflecting the buildup in international reserves and a directive by the central bank for retailers to quote prices in the local currency, the kip, rather than in United States (US) dollars or Thai baht. The kip appreciated by 1.0% against the dollar in 2007, but depreciated by 4.0% against the baht (Thailand is a major trading partner).

Government revenues, a perennial weakness in fiscal management, have picked up in recent years, partly because hydropower and mining provide expanding sources of taxes and other income. Total revenues, excluding grants, rose to 14.0% of GDP in FY2007 (ended 30 September 2007), marking an increase of some 3 percentage points since 2003 (Figure 3.24.4). Implementation of a revised tax and customs law helped in this regard, as did the recentralization 2 years ago of tax collection functions from the provinces. Government spending in 2007 increased slightly as efforts were made to concentrate on priority areas and to trim costs. The fiscal deficit narrowed to 3.1% of GDP in FY2007, about half the level of the 2 previous years.

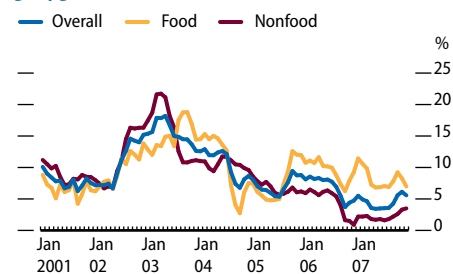
The International Monetary Fund projected that external public debt would fall to 63% in 2007, still high but declining, from 69% in 2006 and 89% in 2003. Most of the debt is to multilateral development banks and the Russian Federation, and is on concessional terms. Debt service payments consume about a tenth of total government revenues. One focus of fiscal policy is to maintain the effort to mobilize revenues so that spending on social and economic programs can be increased while the borrowing requirement can be reduced. Fiscal policy generally is consistent with macroeconomic stability, but there are slippages reflected in government borrowing from banks, accumulating arrears, and taking on quasi-fiscal liabilities through state-owned enterprises.

In an effort to join the World Trade Organization (WTO) by 2010, the Government is formulating policies to improve the environment for trade and investment. Reforms introduced for WTO accession, and to meet the country's commitments under the ASEAN Free Trade Area and Greater Mekong Subregion initiatives, have improved customs clearance procedures with the establishment of computerized systems and the piloting of one-stop customs clearance at selected border posts, an important step in view of the fact that several major trading partners are neighbors.

Private sector participation in the economy is gradually expanding, with the number of registered firms growing by about 12% in aggregate over the past 3 years. The Enterprise Law and Investment Law, both approved in recent years and aimed at enhancing the business climate, are being implemented. A business registry office was established in 2007 to issue business licenses, and it reduced the time and costs associated with business registration. Also last year, the National Assembly approved the implementation decree for a development strategy for small and medium enterprises.

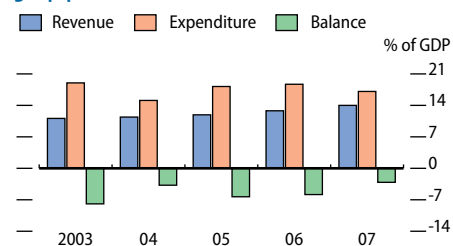
Still, private sector development remains constrained by poor infrastructure (especially reliability and cost of electricity); cumbersome regulations; deficiencies in the legal and tax frameworks; lack of skilled labor; and problems in access to land for business. On this last point, it takes on average 4 months to register a property. A provincial land

3.24.3 Inflation rates



Source: National Statistics Center, Lao PDR; Bank of Lao PDR, available at <http://www.bol.gov.la>, downloaded 18 March 2008.

3.24.4 Fiscal indicators



Sources: Asian Development Outlook database; staff estimates.

management authority has been established under the Prime Minister's Office to enforce the implementation of the land laws, but this has had limited impact so far.

Reforms of state-owned commercial banks are making slow progress. Three of these banks dominate the banking sector, and had nonperforming loans estimated at 70% of their total loan portfolio in 2006. The three banks made provisions in early 2007 for such loans in accordance with international accounting standards. An audit report last year found the banks to be operating profitably, with no government transfers foreseen. Further action is required to expedite the recapitalization of the banks and to strengthen bank supervision. A privately owned bank agreed to take an international bank as a strategic partner and shareholder in 2007.

Economic prospects

Projections are based on the assumptions that the Government will maintain efforts to meet targets of the Sixth Socioeconomic Development Plan 2006–2010, which aims to achieve annual average GDP growth of 7.5–8.0% over the 5 years. The plan prioritizes development of agriculture, infrastructure, education, and health care, and calls for accelerating reforms in key areas including governance, private sector development, and natural resources management.

Robust economic growth expected in neighboring trading partners such as the People's Republic of China (PRC) and Thailand should support demand for the country's main exports. The 1,080-megawatt Nam Theun 2 hydropower project is scheduled to be completed in 2009, and construction is under way on several other power projects due to start production between 2011 and 2015. A forecast weakening in global prices for metals is expected to dent export income, but new mining projects, notably the Phu Kham copper and gold mine, are scheduled to start production this year and will contribute to exports. Imports are forecast to rise significantly this year as demand increases for construction materials to build new hydropower and mining projects, and imports of consumer goods increase as a result of reductions in tariffs under ASEAN Free Trade Area commitments.

The clothing industry has been in decline since the phasing out of quotas in the European Union market in 2004. It is also hurt by rising transportation costs for imported raw materials. Several factories were closed in 2007 and the outlook for the industry is grim. Tourism, though, is expected to maintain solid growth (Figure 3.24.5). The performance of agriculture, as usual, depends largely on the weather.

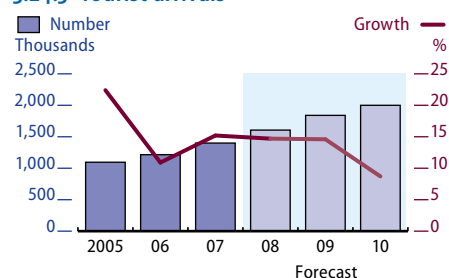
On this basis, GDP growth is projected to edge down to just below 8% in 2008–2009 (Figure 3.24.6). The current account deficit is forecast to remain over \$500 million, although that would represent a declining percentage of the rising GDP. Inflows of grants and FDI should cover the external financing requirement. Inflation is expected to accelerate to 5–6% in the forecast period (Figure 3.24.7) because of rising prices for imported goods, including fuel, and the rapid growth in money supply. A value-added tax approved in 2006 is expected to be put into effect next year. This will expand the tax base and further help build government

3.24.1 Selected economic indicators

	2008	2009
GDP growth	7.7	7.8
Inflation	5.0	6.0
Current account balance (% of GDP)	-12.2	-11.4

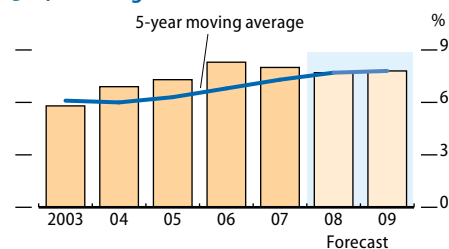
Source: Staff estimates.

3.24.5 Tourist arrivals



Source: Lao National Tourism Administration, Annual Report 2006.

3.24.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

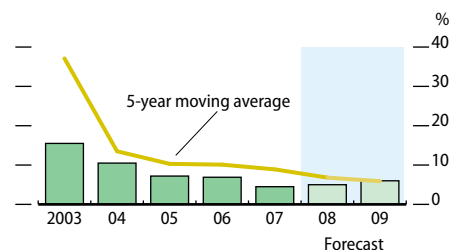
revenues. However, tax administration still requires substantial strengthening.

A sharp fall in global metal prices is a risk for the forecast period. In the medium term, there is a risk of slippage in the reform agenda, particularly fiscal reforms, which could jeopardize macroeconomic stability. The increase in revenues from natural resources could undermine the will to undertake reforms for mobilizing nonresource revenues. The Government's policy to take equity stakes in some resource projects raises a potential financial risk in the longer term.

Development challenges

Diversifying sources of growth and generating employment remain major challenges. Since hydropower and mining have only a limited capacity to create employment, an expansion of agriculture remains the key to raising incomes and employment. In this regard one issue that needs more focused attention is access to land and land titling. A 2007 poverty assessment noted that one major cause of poverty in the country is diminishing access to cultivated land. The private sector has the potential to generate significant employment, but more needs to be done to improve the business environment for small and medium enterprises. The clothing industry, a significant source of jobs in the formal sector employing about 28,000 people, as noted, has been in decline. The civil service employs about 100,000 people but its salary range of \$50–90 a month is below that required to afford many basic necessities.

3.24.7 Inflation



Sources: National Statistics Center, Lao PDR; Bank of Lao PDR, available: <http://www.bol.gov.la>, downloaded 18 March 2008; staff estimates.