Laos's Economic Prospects and Challenges[1]

4-23-10

Laos performed relatively well in 2009 compared to its neighbors. The fall of the growth rate from 7-8% in 2008 to an estimated 6-6.5% in 2009 made Laos one of the best performers in the region. Demand for Laos's main exports (copper, gold, timber and garments) from its main trading partners (Thailand, Vietnam and China) decreased. However, starting in mid-2009 commodity prices rose, the economies of Laos's trading partners began to recover and activity in the mining sector picked up. Additionally, government spending was high and Laos hosted the South East Asian (SEA) games in the capital Vientiane, which drew more than 10,000 tourists and stimulated the retail trade, construction and service industries. Combined with the country's relatively low integration into world markets, these demand-generating factors limited the fall of the GDP growth rate in 2009.

Growth rates should rise in 2010 and 2011. The Economist Intelligence Unit (EUI) currently predicts that the economy will expand by 7% in 2010 and 7.5% in 2011. Commodity prices are expected to remain high during 2010-2011, which, along with persistent demand for natural resources and an improving investment climate, is expected to attract significant foreign investment. Higher mineral prices have already reignited foreign interest in the mining sector, especially from China and Vietnam. Hydropower project activity should pick up in 2010. Investment from Thailand in the Nam Theun 1 and Nam Ou projects will resume after interruption at the end of 2008, and the Nam Theun 2 hydropower plant should open during the year. Strong activity in the hydropower sector should raise electricity exports substantially, with some observers considering that they will double in 2010. Finally, higher productivity and prices in the agricultural sector, and strong expected performance in the services sector will support overall growth.

The government intends to alter the structure of the Laotian economy along two main axes, but it might face an uphill battle. The first change aims at shifting the source of growth away from the natural resource base in order to conserve natural resources and diversify the economy. The government and the private sector have agreed on tax incentives and preferential access to government services for companies exporting products that are not based on natural resources. The second seeks to add more value to Laotian exports by encouraging more processing of export products. Proposals for increases in export duties on non-processed and semi-processed minerals and timber (to 10-20% and 30%, respectively) were made in February. Conversely, the government proposed to decrease tariffs on exports of livestock and fish products. Both axes of intervention are likely to encounter problems: the first due to general skills and training

[1] Thibaut Muzart, Management Systems International, under ME/TS's Alliances, Analyses, and Program Support (AAPS) buy-in to EGAT's Business Growth Initiative. The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

shortages, and the second due to resistance from exporters of minerals and timber, which are currently largely exported as raw materials.

Agriculture and forestry are key to the economy. Agriculture and forestry account for 40-50% of Laos's GDP and agricultural production has grown by an estimated 3% in 2009. In 2006 (latest estimate), timber exports accounted for about 16% of total exports, surpassed only by copper and gold. Productivity increases and continued high commodity prices in 2010-2011 should support the sector, which is projected to grow by 4% and 5% respectively in 2010 and 2011. In addition, foreign interest in land has been rising, with companies from Japan and Singapore looking to grow and export minimally processed agricultural goods.

However, the contribution of agriculture and natural resources to poverty reduction seems limited. More than 80% of Laotians are engaged in mostly low-productivity agriculture, including a large proportion in subsistence agriculture. Most communities in rural areas (about 70% of the population is rural) obtain food and supplement their income through forest products (timber and non-timber). Rural areas also have the highest incidence of poverty. At the national level, it is estimated that 27-30% of the population lives under $1/day, and that approximately 73% of the population lives under $2/day. However, although agriculture and forestry could contribute more to poverty reduction, the reality is different. Arable land is scarce[2] and the moratorium on the award of new land concessions to foreign-owned agricultural companies that began in 2007 is no longer in effect, driving smallholders off their land to make way for large investments. Overall, the government's stance on agriculture seems to favor contract farming and large operations rather than encouraging positive changes in smallholder agriculture. Additionally, growing environmental degradation (chiefly, deforestation and deteriorating soil quality) is likely to alter the incomes of forest-dependent households by depriving them of essential resources[3].

The trade deficit decreased in 2009 and will widen in 2010 and 2011. Higher mineral prices and economic growth in importing countries will increase Laotian exports in both nominal and real terms. Increased investment in 2010 will raise the demand for imported capital goods, and along with lower import tariffs and the poor competitiveness of local products this will raise imports significantly in 2010 and 2011. Imports are significant relative to exports in real and nominal terms, and as such are a key determinant of the trade balance: Larger decreases in imports due to lower shipments and construction materials reduced the 2009 trade deficit to US$204m from US$222m in 2008 in spite of the fall in exports. In 2010 and 2011, the trade deficit is expected to widen, again in spite of the recovery in exports.

2 Approximately 4% of the total land area in Laos is arable, most of it used in rice cultivation.
3 A large amount of unexploded ordnance (UXO) from the second Indochina war further limits the availability of land.

Current account deficits will persist in 2010 and 2011. The income account should continue to be in deficit owing to the expected repatriation of profits by foreign companies in 2010. This, combined with the merchandise trade deficit, will cause the current account deficit to widen in 2010, to 0.6% of GDP equivalent from 0.4% in 2009. In 2011, the current account deficit should benefit from the projected increases in services exports (mainly from tourism) and from higher official development assistance, and should shrink to 0.2% of GDP.

The recent expansion of the banking sector seems to be attracting government attention. Loans and deposits have risen, existing banks are expanding, and foreign banks are opening branches in the capital. However, the government declared that an increase in the working capital required to open a bank (from US$10m to US$33.5m) would be in effect within the next five years, and the central bank has set up a fund guaranteeing deposits.

The central bank is expected to raise interest rates in 2010. The central bank is likely to raise interest rates in 2010 after lowering them to 5% in 2009. Overall credit growth almost doubled in 2009, with almost 30% being central bank loans to local infrastructure projects. This raises concerns for macroeconomic and financial stability. Recently, Non-Performing-Loans (NPLs) have been estimated to amount to 4% of total loans, largely due to the suspension of agricultural exports to Thailand during the global crisis and to late or suspended payments by the Laotian government to contractors.

Although the 2009 rise of the Kip against the dollar will endure in 2010, larger external deficits should weaken the exchange rate in 2011. The central bank usually aims to moderate fluctuations between the Thai Baht and the Kip, since Thailand is Laos's largest export market. Since the second quarter of 2009, the Baht has gained ground against the Dollar and as a result, the Kip has followed in the same direction by an average of 2.7% in 2009. The Kip is expected strengthen further in 2010, before persistent external deficits weaken the exchange rate in 2011.

Consumer prices are estimated to have remained stable on average in 2009 but will rise in 2010-2011. On average prices did not change in 2009, but there were upward and downward fluctuations: In April 2009, prices actually fell before rising year-on-year in November (by approximately 1.5%) on the back of the recovery in commodity prices. Inflation is expected to climb to 6.2% in 2010 and 7.1% in 2011.

Budget deficits will persist in 2010-2011, but the declining trend observed since fiscal year 2008/2009 (October-September) will continue as well. From 4.5% of GDP equivalent in FY2008/2009 the deficit is expected to average 3.3% of GDP equivalent in FY2009/2010 and 2.8% in FY2010/2011. To compensate for revenue lost from tariffs due to its participation in the Asian Free Trade Agreement (AFTA), the government reintroduced the VAT in January 2010 (after suspending it in March 2009), introduced a tax on luxury goods, and liberalized the leasing

and sale of state-owned buildings. On the external side, significant revenues from higher metal prices (especially copper) should also accrue to the government, and renewed electricity exports to Thailand from the Nam Theun and Nam Ou projects should bring in taxes, royalties and dividends in 2010. Finally, the government plans to issue K200bn (US$24m) in government bonds and to borrow K1.5trn from abroad (around US$176m).

Laos's Ease of Doing Business ranking is low, but the government seems willing to undertake private sector oriented reforms. Laos scores poorly (number 167 out of 183 economies[4]) on the World Bank's 2010 *Doing Business* report. The Prime Minister (Bouasone Bouphavanh) has promised that his government will include the private sector in the formulation of policies concerning the conduct of business in the future. The government plans to bring private investment up to 30% of GDP equivalent in fiscal year 2009/10. The Laos National Chamber of Commerce and Industry has requested that state-owned banks make more loans to the private sector, and also to allow business entities to invest in and operate state-owned enterprises.

4 The lower the score, the better the performance.

References

AusAID. *Laos Country Page*. Available online at http://www.ausaid.gov.au/country/country.cfm?CountryID=35&Region=EastAsia

Economist Intelligence Unit. December 2009. *Laos Country Report.*

Economist Intelligence Unit. March 2010. *Laos Country Report.*

Coordination Team of the UN System High-Level Task Force on the Global Food Security Crisis (HLTF). September 2009. *Laos Full Country Visit Report – 14 – 15 May 2009.*

United Nations and the Government of the Lao PDR. 2008. *Millennium Development Goals Progress Report 2008 – Lao PDR.*

World Bank. December 2009. *Lao PDR Economic Monitor End of Year Update*. Issue # 14.

World Bank. 2009. *Doing Business 2010*. Available online at http://www.doingbusiness.org/ExploreEconomies/?economyid=107

World Bank and Science Technology and Environment Agency. 2006. *Lao PDR Environment Monitor.*