Lao PDR Economic Monitor

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Vientiane Capital, Lao PDR

The Lao PDR Economic Monitor - Mid-Year Update 2010 is issued in Lao and English by the World Bank Office in Lao PDR. This update reports mainly on recent economic developments and medium-term outlook for the country. The paper was prepared by Somneuk Davading (Country Economist) and Keomanivone Phimmahasay (Research Analyst) under the overall supervision of Genevieve Boyreau (Senior Country Economist) and Mathew Verghis (Lead Economist). We are grateful to the Government and donor community for providing inputs and feedback. We would like to thank our World Bank colleagues: Vattana Singharaj, Boualamphan Phouthavisouk, Souridahak Sakonhninhom, Thalavanh Vongsonephet and other staff for designs, printing and dissemination of the Monitor.

THE WORLD BANK TEAM APPRECIATES FEEDBACK ON THE STRUCTURE AND CONTENT OF THE MONITOR.

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EXECUTIVE SUMMARY

Real GDP growth, which was estimated at 7 percent in 2009, is expected to increase to 7.8 percent in 2010 driven largely by resource sectors. Out of this growth of 7.8 percent, around 3.3 percentage points comes from power sector (mainly NT2 - nearly 3 percentage points), 0.9 percentage points from agriculture, around 0.4 percentage points for each of mining and construction, 0.8 percentage points from manufacturing and about 1.7 percentage points from services sector (tourism and retail trade, financial sector services as a result of the recent sharp increases in bank lending, and transport and telecommunication services). Real GNI is expected to slow to nearly 6 percent this year compared to 9.5 percent in 2009 due to significant outflows of income (profit repatriation and interest payment) from resources sectors (mining and hydropower).

Fiscal performance is on track toward achieving the GOL’s targets in FY2010. In the first six months of this fiscal year (from Oct 2009 to Mar 2010), the GOL’s revenue collection has reached nearly 50 percent of the annual revenue target while expenditure implementation has been around 44 percent of the plan. With projected sustained economic growth and strong revenues, the overall budget deficit is expected to decrease to 4.5 percent of GDP in FY2010 from 6.8 percent in FY2009. The increase in revenue is supported by improved domestic taxes (both direct and indirect taxes), implementation of VAT and some contribution from NT2. Decline in off-budget spending is likely to push down the overall expenditure in this fiscal year.

The headline inflation has risen in recent months largely due to recent recovery of energy (fuel) and food prices. The year-on-year inflation has increased notably in recent months to 4.8 percent in April 2010 from 1.5 percent in November 2009. Out of this increase, about 2 percentage points came from energy, 1.6 percentage points from food and 1.2 percentage points from core prices. The averaged inflation is projected at around 5 percent in 2010 (Currently it’s about 4.7 percent for the first four months Jan-Apr). After maintaining a de facto peg of the kip to the US dollar in 2009 and early 2010, BOL has allowed the kip to appreciate against the dollar. This has resulted in monthly appreciation of the kip by 2.1 percent against the US dollar and 0.9 percent against the baht in April 2010.

Although international reserves remained fairly stable during the last six months, net foreign assets dropped by 25 percent. Gross official Reserves at the Bank of Lao PDR were estimated at about $635 million during Oct 2009-Mar 2010 of which $65 million can be attributed to an increase in the IMF’s SDR allocation in late 2009 and $63 million have been borrowed from domestic banks through sales of foreign currency denominated bonds by the BoL. Net foreign assets declined by 25 percent in 2009 and 23 percent in Mar 2010 due to rapid credit expansion and import growth. The current account deficit is projected to decline from 10.6 percent of GDP in 2009 to 7.7 percent in 2010 supported by strong export growth, and in particular NT2 exports of electricity to Thailand. The capital account surplus is expected to decrease slightly from 10.6 percent of GDP in 2009 to 10.1 percent this year although FDI started to rebound. The overall balance is likely to turn into surplus in 2010 to about 2.4 percent of GDP.

Credit grew rapidly in 2009 and in the first quarter of 2010 but is expected to slow by end-2010. Credits grew by about 90 percent last year and during Jan-Mar 2010 partly due to BOL’s direct lending to local projects to finance public infrastructure and associated imports (about 22 percentage points of total credit growth). As the GOL made a decision to stop quasi-fiscal activities in September 2009 and bank liquidity tightened (loan to deposit ratio increased significantly to 73 percent by end-2009 from 55 percent in 2008), credit growth is expected to slow in 2010. Although NPLs have declined during the last two years largely because of rapid credit growth, risks in the sector remain significant in the context of relaxed bank supervision.
# TABLE OF CONTENTS

**EXECUTIVE SUMMARY** .......................................................................................................................... 1

**RECENT ECONOMIC DEVELOPMENTS IN LAO PDR** ................................................................................. 3

1.1 *Growth and Inflation* .............................................................................................................................. 3
1.2 *GOL’s Revenue and Expenditure* ........................................................................................................... 4
1.3 *External Balance* ..................................................................................................................................... 6
1.4 *Monetary Sector* ..................................................................................................................................... 8

**FIGURES:**

Figure 1. GDP Growth and Inflation, (percent change) ............................................................................. 3
Figure 2. Contribution to GDP Growth, (percentage points) ..................................................................... 3
Figure 3. Sectoral Contribution to GDP Growth (percentage points) .......................................................... 3
Figure 4. Monthly CPI Breakdowns (12-month percent change) ................................................................. 4
Figure 5. Contribution to CPI Growth (percentage points) ....................................................................... 4
Figure 6. GOL’s Quarterly Revenue Performance (Billion kip) ................................................................. 4
Figure 7. GOL’s Quarterly Spending (Billion kip) ...................................................................................... 5
Figure 8. Summary of the Medium-Term Fiscal Framework (percent of GDP) ........................................ 5
Figure 9. Exports and Imports ($ million) ................................................................................................... 6
Figure 10. Sectoral Exports ($ million) ....................................................................................................... 6
Figure 11. Imports by Main Categories ($ million) ..................................................................................... 7
Figure 12. Balance of Payments, 2006-13 (percent of GDP) .................................................................... 7
Figure 13. FDI in Lao PDR, 2006-2013 ....................................................................................................... 7
Figure 14. Kip Exchange Rate ..................................................................................................................... 8
Figure 15. Gross Official Reserves ............................................................................................................. 8
Figure 16. Contribution to Credit Growth (percentage points) ................................................................. 9
Figure 17. Bank Lending (percent of GDP) ............................................................................................... 9
Figure 18. Broad Money and Deposits (year-on-year percent change) ..................................................... 9
Figure 19. Banking Sector’s Interest Spread (percent) ............................................................................. 9

**ANNEXES**

Annex 1. The Global Economic Outlook in Summary .............................................................................. 10
Annex 2. Rapid Enterprise Survey monitors crisis impacts in the absence of quarterly data ............... 11
RECENT ECONOMIC DEVELOPMENTS IN LAO PDR

1. GROWTH AND INFLATION

**GROWTH**

Real GDP, which grew by 7 percent in 2009, is projected to accelerate to 7.8 percent in 2010 (Figure 1). This growth is driven by rapid expansion in the natural resource sectors (mainly electricity exports from the Nam Theun 2 (NT2) which comes on-stream in 2010), steady growth in agriculture, construction and a rebound in processing industry and tourism. The resource sectors (hydropower and mining projects) contribute around 3.7 percentage points to this growth (Figure 2), including 3 percentage points from NT2. The remaining 4.1 percentage points come from non-resource sectors: agriculture contributes 0.9 percentage points - a slight decline of 0.1 percentage point from 2009 due to the impact of drought on irrigated rice production during the dry season; Livestock, fishery, industrial forestry as well as nonrice crops are less affected. Thus, agriculture is expected to grow steadily in 2010 supported by increased demand and bank credits to the sector. Manufacturing is expected to contribute 0.8 percentage points - an increase of 0.5 percentage points from 2009 driven by food processing (especially sugar and beverages), wood and furniture, cement industry and recovery of garment exports while construction contributes around 0.4 percentage points from major infrastructure projects and private housing and business construction, and services about 1.9 percentage points - driven by retail, transport and banking services and recovery in tourism. Real GNI growth is projected to decline in 2010 (Figure 1) as outflows of income (profit repatriation and debt service) from resources projects are expected to rise significantly, especially from hydropower (NT2) and mining projects (Sepon and Phubia).

Assumed global economy recovers from the crisis (Annex 1), real GDP is projected to grow on average by 7.7 percent per annum during 2011-2015 (real GNI grows by about 7.3 percent). Natural resources sectors (hydropower and mining) contribute on average by 3.1 percentage points to this growth and non-resources sectors (agriculture, manufacturing, construction and services) by 4.6
percentage points (Figure 2). Recent recovery in demand from neighboring countries (especially China, Thailand and Vietnam) is critical for sustaining the medium term growth as the country continues to integrate into the region with its international trading becoming increasingly regional.

**Inflation**

Headline inflation has risen significantly during the last six months fueled by recent rebound in food and energy prices and presumably the implementation of VAT. Headline inflation increased from 1.5 percent in last November to 4.9 percent in March 2010 and leveled off at 4.8 percent in April. Fuel prices grew by nearly 26 percent during the last few months due to base effects while food prices climbed slowly over 4 percent and core prices grew slowly by a bit more than 2 percent during the same period (Figure 4). Out of the 4.8 percent year-on-year inflation in April 2010, about 2 percentage points came from energy, 1.6 percentage points from food and only 1.2 percentage points from core prices (see Figure 5). The headline inflation is projected to increase to about 5 percent in 2010 from 0.1 percent in 2009 mainly driven by energy and food prices.

**2. Government’s Revenue and Expenditure**

Revenue collection is on track for the first half of FY10 compared to the same period of FY09. Almost half of the annual revenue target has been achieved by March 2010. The increase in revenues was supported by receipts from profit tax, resources royalties and the VAT implementation. In this fiscal year, the GOL is likely to receive significant tax contribution from mining projects due to favorable metal prices (including copper and gold) and some payment from NT2 ($15.6 million). The GOL’s expenditure implementation in the first six months of FY10 has reached about 44 percent and is on annual target (Figure 7).
Both revenues and expenditures record an artificial increase in FY10 due to the new inclusion in the budget of foreign financed projects not executed through the budget (so called “non-project grants). Including these externally-financed projects into the budget mechanically increases both FY10 revenues (grants) and expenditures (externally-financed capital spending) by the amount of 1456 billion kip or 2.6 percent of GDP). Excluding them, the total revenue is expected to be 16.2 percent of GDP while total expenditure is 20.7 percent of GDP (about 2.3 percent decline compared to FY09 of 23.3 percent of GDP), and overall budget deficit remains unchanged at 4.5 percent of GDP.

Domestic revenue as percent of GDP is projected to increase slightly to 14.3 percent in FY10 from 14.1 percent in FY09 (due to higher tax revenue collections) and total revenue (including grants) increases to 18.8 percent of GDP compared to 16.2 percent in FY09 (Figure 8). This increase in grants is mainly due to the inclusion of non-project grants into budget from this fiscal year (see above). At the same time, expenditure is expected to climb to 23.3 percent of GDP this year but without non-project grants it would decrease to 20.7 percent from 23 percent last year. Current expenditure as percent of GDP is expected to decrease to 10.5 percent this year from 11.2 percent in FY09 (due to higher GDP growth and small increases in this expenditure). Consequently, wage spending is projected to decline to 5 percent of GDP in FY10 from 5.5 percent in FY09 and transfers would drop to 2.3 percent of GDP from 2.7 percent last year. Without non-project grants, capital expenditure is expected to decrease to 9.1 percent of GDP in FY10 from 10.9 percent in FY09 (due to decline in domestically financed expenditure, especially off-budget spending). However, with non-project grants, total capital expenditure would rise to 11.7 percent of GDP in FY10 and externally financed capital spending is expected to increase to 6.8 percent of GDP from 4.2 percent last year. Off-budget spending (on pending commitments) is projected to drop to 2.8 percent of GDP in FY10 from 3.9 percent in FY09 (Figure 8).
**Public Debt**

Lao PDR continued to face a high risk of debt distress although its debt profile has improved in recent years. Lao PDR’s debt stock remained elevated and the nominal debt stock increased by $230 million in 2009. Nevertheless, the debt profile (percent of debt in share of GDP, exports and government revenue) has improved in recent years due to robust economic growth and currency appreciation.

**3. External Balance**

**Lao Exports and Imports**

Exports are expected to jump by more than 30 percent in 2010, driven by electricity and mineral exports. Lao exports are expected to surge to about $1.9 billion this year from nearly $1.5 billion in 2009 thanked to recent recovery of regional and global demand and commodity prices. The commercial operation of hydropower projects is expected to generate a significant increase in export earnings for Lao PDR. NT2 is expected to generate about $155 million this year and $240 in 2011. Thus, overall electricity exports are projected to grow by 150 percent this year while mineral exports (copper, gold and other minerals) by about 32 percent. Other non-resource exports (agriculture, garments and wood products) are expected to increase by 33 percent. Garment exports are projected to rebound (to over $200 million) this year as orders from EU have increased significantly for the first half of 2010 while demand from US grows steadily. Tourism started to recover in early months of this year as total tourist arrivals have increased by more than 10 percent in Q1/2010 compared to Q1/2009 driven by regional tourists, especially from Thailand, China, Vietnam, Japan and other Asian countries. Visitors from western countries have also increased but slowly.

Imports are also expected to rise (by over 15 percent) due to increased demand and prices. Imports of capital goods and raw materials for non-resource sectors are expected to increase because of exports growth, demand from large construction activities and recovery in commodity prices while those for resources are likely to fall slightly in 2010 due to completion of construction of some power projects.

The size of domestic public debt increased notably in 2009, although from a very low base. The GOL’s domestic debt has risen recently due to its off-budget spending (BoL’s direct lending) to finance public infrastructure projects of local authorities. BoL extended credit in a total amount of $193 million in 2009 (or about 2.7 percent of GDP) to support these quasi-fiscal activities.
projects, especially NT2. But they are projected to rebound in 2011 when several mega projects in pipeline (such as Hongsa Lignite Power Plan ($2.5 billion), Nam Ngum 3 ($770 million) and others) will resume. Imports of capital goods and raw materials are projected to increase by 11 percent in 2010 while imports of consumer goods, which grew steadily in the past years, would continue to rise by about 16 percent due to increased demand and prices.

CURRENT ACCOUNT BALANCE

The current account balance is expected to improve, driven by a trade surplus in the resource sector in 2010. The current account deficit as share of GDP is projected to drop to 7.7 percent this year from 10.6 percent in 2009 due to large increases in exports of minerals, especially copper and gold (from Sepon and Phibia) and electricity (from NT2), which outweigh reparation of profits from these mega projects (Figure 12), and then rise again in the medium term as investment imports by resources projects increase substantially along with new project preparation. At the same time, capital account surplus is expected to decline slightly from 10.6 percent of GDP in 2009 to 10.1 percent in 2010, mirroring the slowdown in equipment imports financed from FDI from large projects as well as beginning of loan repayment of NT2. It is expected to rebound in 2011, along with the start of new projects. The overall balance is likely to turn into a surplus of 2.4 percent of GDP in 2010 from a small deficit in 2009.

FOREIGN DIRECT INVESTMENT (FDI)

FDI started to rebound this year, especially in natural resources. After notable decline by almost 23 percent in 2009 due to the impacts of the Global financial crisis, FDI is projected to recover by 5.7 percent this year (or to $790 million). Most FDI inflows are expected to go to resources sectors: mining (about $90 million from Sepon project as well as investments in other minerals by China) and power sector (start of Hongsa Lignite power plant construction in 2010 in addition to other ongoing projects under construction). Gradual rise of FDI in non-resource sectors is also expected, especially in processing industries, construction and services (trade and tourism). Recovered regional and global demand is expected to drive such growth.
4. Monetary Sector

Exchange Rate

The kip exchange rate has appreciated notably against the US dollar in recent months. Because of rising inflation and significant weakening of the kip against the baht, BOL has recently allowed the kip to appreciate against the US dollar after maintaining a de facto peg to this currency during 2009 and early 2010. As a result, the kip exchange rate has appreciated by about 2.1 percent against the US dollar and by 0.9 percent against baht in April 2010 (Figure 14). The recent relaxation in exchange rate policy by BOL aimed partly at preserving the public confidence in kip monetary holdings and combating rising inflation.

Although reserve levels remained broadly unchanged, the net foreign assets of banking system dropped y-o-y by about 25 percent by end-2009 and 23 percent by Mar 2010 (Figure 15). The stable gross reserves position of BoL (at around $633 million or nearly 5 months of non-resource imports in 2009) during the last year and the first quarter of 2010 was mainly supported by the IMF’s SDR allocation ($65 million) to Lao PDR and issues of foreign currency denominated bonds by the BoL to domestic banks ($63 million). The expansion in government’s spending and rapid bank credit growth as well as the swap of banks net foreign assets for domestic credit and imports led to a notable growth in broad money (M2) by 31 percent by end-2009 and 29 percent by Mar 2010 and a decline in net foreign assets by 25 percent (or by about $215 million) in 2009 and nearly 23 percent by Mar 2010.

Bank Lending

Credit grew rapidly in 2009 and during the first 3 months of 2010 but is expected to slow by end-2010 with the decline in bank excess deposit headroom and the phasing out of BOL’s direct lending. Huge credit expansion in 2009 and first 3 months of this year by about 90 percent was partly supported by BOL’s direct lending to local projects to finance public infrastructure and associated
imports (about 27.8 percentage points of the credit growth). Out of this 90 percent growth, about 21.9 percentage points came from lending to SOEs and 68.6 percentage points from credits to private sectors (Figure 16). Credit growth is expected to slow by end-2010 (about 47.5 percent) as the GOL stopped quasi-fiscal activities and partly due to tightened bank liquidity. Banking sector’s loan to deposit ratio was 73 percent in 2009 (compared to 55 percent in 2008) and is projected to rise to about 88 percent in 2010 (Figure 17).

Recent decline in NPLs has been mainly due to rapid credit growth. Banking sector’s NPLs dropped to about 3 percent in 2009 from 4.4 percent in 2008 mainly because of high credit growth over 90 percent in last year. Among other banks, SOCB’s NPLs declined slightly to 1.3 percent in 2009 from 1.7 percent in 2008.

Monetary growth accelerated in 2009. Broad money (M2) grew by 31.2 percent y-o-y at end-2009 (compared to 18.3 percent in 2008) and is expected to slow to 28.2 percent by end-2010 (Figure 18). Total deposits, which climbed by 29.5 percent in 2009 from about 17.7 percent in 2008, is projected to grow by 25.2 percent in 2010. Demand for Kip deposits grew strong by 68 percent in 2009 while foreign currency deposit increased by 20 percent during the same time. Deposit rate (one year kip deposit) remains relatively high over 11 percent in 2009. Bank interest spread has decreased in recent years to 5 percent by 2009 (Figure 19). As a result, the cost of borrowings from the banking sector has declined by 8 percentage points since 2002, from 24 to 16 percent in 2009.
Annex 1. The Global Economic Outlook

Although there were some signs of initial recovery in the regional and global economy, including an increase in durable and capital goods orders as well as rallies in the stock markets in early 2010 and a revival of commodity prices, the global outlook still remains uncertain at this time due to concerns over the recent crisis in EU (Greece and other EU member countries) and impacts on China’s manufacturing sector. This paper bases its country-level projections for Lao PDR's FDI and export demand on IMF (WEO Update Jan-2010) and World Bank recent projections (EAP Update Apr-2010) for the regional and global economic outlook and commodity prices, presented in Table 1.

### Annex Table 1. The Global Economic Outlook in Summary

(percentage change from previous year, unless otherwise specified)

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Source: IMF (WEO, Oct-2009 and WEO Update, Jan-2010)

Note:
1/ United States, Euro Area, Japan, United Kingdom, Canada, Korea, Australia, Taiwan Province of China, Sweden, Switzerland, Hong Kong SAR, Czech Republic, Norway, Singapore, Denmark, Israel, New Zealand and Iceland
2/ London interbank offered rate on U.S. dollar deposits minus percent change in U.S. GDP deflator.
3/ GDP-weighted average of 10-year (or nearest maturity) government bond rates for United States, Japan, Germany, France, Italy, United Kingdom, and Canada.
* this figure is the four-year average 2011-14
Annex 2. Rapid Enterprise Survey monitors crisis impacts in the absence of quarterly data

In order to monitor closely the possible impact of the global economic crisis on the Lao corporate sector, a second Rapid Enterprise Survey was conducted during April 2010. About 450 businesses (40 percent of firms in general manufacturing, 30 percent in retail and the remaining 30 percent in services) in four major urban centers of Lao PDR: Vientiane Capital, Luangprabang, Savannakhet and Champasak were interviewed.

The recent survey showed that many firms started to recover from the crisis. The number of firms reporting a decrease in sales in Q1 2010 dropped to 23 percent from 40 percent in Q1 2009 while those reporting a stable business performance increased to 49 percent from 16 percent during the same period (see Annex Figure 1). At the same time, the number of firms reporting an increase in sales decreased to 28 percent in Q1 2010 from 44 percent in Q1 2009 as many businesses started to stabilize.

Among the four centers surveyed, Savannakhet was affected mostly with 38 percent of firms reporting a decline in sales, followed by Luangprabang and Pakse (23 percent for each) while Vientiane Capital was the least impacted (Annex Figure 2). Many firms in these four urban areas were able to increase their sales substantively in early 2010 while majority of firms had a stable sales performance. Similar sales patterns can be observed across three of the three major sectors covered in the survey. Surprisingly, the number of firms reporting an increase in sales was much higher than those reporting decreases in sales (Annex Figure 3).

Recovery of firms from the crisis was explained by reduction in adjustment effort in terms of reducing workers and wages and delays in investment (Annex Figure 4). The Annex Figure 4 indicated the number of firms reducing workers, wages and investment declined notably while the number of firms adopting new strategies increased significantly (from 12 to 19 percent) as they started to take up new opportunities arising from the crisis. Nevertheless, a close monitor on rapidly changing global economic environment is needed in order to cope with emerging risks and future uncertainty.