



# Lao Economic Monitor

Towards Restoring Macroeconomic Stability and  
Building Inclusive Growth

April 2015

## **Selected Issues:**

ASEAN Economic Community 2015 – Implications for Lao PDR  
Creating Productive Jobs for Inclusive growth

Macroeconomic and Fiscal Management Global Practice  
East Asia and Pacific Region



**WORLD BANK GROUP**



## Currency Equivalents

(Exchange Rate Effective as of March 11, 2015)

Currency Unit	=	LAK (Lao Kip)
LAK8,105	=	US\$1.00
Fiscal Year	=	October to September

## Acronyms and Abbreviations

ATIGA	ASEAN Trade in Goods Agreement	MCH	Mother and Child Health
AEC	ASEAN Economic Community	MOF	Ministry of Finance
AFAS	ASEAN Framework Agreement on Services	MOIC	Ministry of Industry and Commerce
ASEAN	Association of Southeast Asian Nations	NA	National Assembly
BOL	Bank of Lao PDR	NEER	Nominal Term Effective Exchange Rate
BOP	Balance of Payment	NFA	Net Foreign Assets
CLMV	Cambodia, Lao PDR, Myanmar and Vietnam	NPL	Non-Performing Loan
COD	Commercial Operation Date	NSEDP	National Socio-Economic Development Plan
CPI	Consumer Price Index	OPEC	Organization of the Petroleum Exporting Countries
DMFAS	Debt Management and Financial Analysis System	PIP	Public Investment Projects
EAP	East Asia & Pacific	PPG	Public and Public Guaranteed Debt
EDL	Electricité du Lao	PV	Net Present Value
FDI	Foreign Direct Investment	REER	Real Effective Exchange Rate
FY	Fiscal Year	SOCBs	State-Owned Commercial Banks
GDP	Gross Domestic Product	SOE	State-Owned Enterprise
GFIS	Government Financial Information System	TSA	Treasury Single Account
GOL	The Government of Lao PDR	VAT	Value Added Tax
HC	Health Centre	WBG	World Bank Group
IMF	International Monetary Fund	WEO	World Economic Outlook
IPP	Independent Power Producers	WTO	World Trade Organization
LDC	Least Developed Country	YOY	Year on year
LSX	Lao Securities Exchange		

Regional Vice President	:	Axel van Trotsenburg
Country Director	:	Ulrich Zachau
Senior Practice Director	:	Marcelo Guigale
Country Manager	:	Sally Burningham
Sector Manager	:	Mathew A. Verghis
Primary Author	:	Keomanivone Phimmahasay

## Acknowledgements

**Lao PDR Economic Monitor - April 2015** was prepared by the country team under the guidance of Mathew Verghis (Practice Manager, Macroeconomics and Fiscal Management Global Practice) and Sally Burningham (Country Manager). The Team comprises of Alain D’Hoore (Senior Country Economist), Somneuk Davading (Senior Economist), and Keomanivone Phimmahasay (Economist) with helpful inputs on the two selected issues in Part II from Konesawang Nghardsaysone (Trade Economist) and Richard Record (Senior Economist) on the “ASEAN Economic Community 2015 – Implications for Lao PDR” and Lars Sondergaard (Program Leader) on the “Creating Productive Jobs for Inclusive Growth”. Administrative and report production assistance from Souksavanh Sombounkhanh (Program Assistant) and Toomkham Luanglath (Communications Associate) and Maniphet Phengsavatdy is gratefully acknowledged.

The team would like to express gratitude to the Government officials from Ministry of Finance, Ministry of Planning and Investment, Ministry of Industry and Commerce, Ministry of Energy and Mines, the Bank of Lao PDR, and representatives from the Lao National Chamber of Commerce and a number of businesses for sharing valuable views and inputs.

The findings and interpretations expressed here are those of the authors and do not necessarily reflect the views of the World Bank Group, its Executive Directors, or the countries they represent.

## Table Of Contents

<b>Executive Summary</b>	<b>10</b>
<b>Part I: Recent Economic Developments</b>	<b>16</b>
Key Regional Economic Developments	17
Recent Economic Developments In Lao PDR	18
Growth	18
Inflation	19
Government Revenue And Expenditure	20
Public Debt	23
External Sector	25
Exchange Rate	28
Monetary Developments	29
<b>Part II: Selected Issues</b>	<b>31</b>
Asean Economic Community 2015 – Implications For Lao PDR	32
Trade in Goods	32
Trade in Services	33
Investment	34
Trade Facilitation	35
Creating Productive Jobs For Inclusive Growth	37
<b>Annex 1: Lao PDR At A Glance</b>	<b>43</b>
<b>Annex 2: East Asia And Pacific: GDP Growth Projections</b>	<b>45</b>

## List Of Figures

Figure 1: GDP Growth and Inflation	18
Figure 2: Contribution by sectors to real GDP growth	18
Figure 3: Monthly Inflation	19
Figure 4: Contribution to Food Inflation	19
Figure 5: Government Fiscal Performance	20
Figure 6: Government Expenditures	20
Figure 7: Social sectors expenditures	20
Figure 8: Government Revenue	21
Figure 9: Public spending on education	22
Figure 10: Public spending on health	22
Figure 11: Average crude oil price	25
Figure 12: Balance of Payments	26
Figure 13: Merchandise Exports	27
Figure 14: Merchandise Imports	27

Figure 15: Foreign Direct Investment	27
Figure 16: Net foreign assets and foreign reserves	28
Figure 17: Reserves coverage	28
Figure 18: Lao kip exchange rate	28
Figure 19: Real effective exchange rate	28
Figure 20: Domestic credit growth in EAP region	29
Figure 21: Banking sector assets	29
Figure 22: Contribution to credit growth	29
Figure 23: Sectoral contribution to credit growth	30
Figure 24: Composition of credit by sectors	30
Figure 25: Trading costs remain high	35
Figure 26: Percentage of firms in Lao PDR, Vietnam, and Yunnan province (China) complaining that there were no or few applicants to a job, by skill level	37
Figure 27: Sectoral breakdown of output and labor in the overall economy of Lao PDR	39
Figure 28: Early Grade Reading Assessment for Lao PDR	39
Figure 29: Comparison of adult literacy by education level in Lao PDR and Vietnam	40

## List Of Boxes

Box 1: Public Spending on education and health sectors	22
Box 2: The oil price decline should benefit the economy, but also has some downside risks	26

## List Of Tables

Table 1: External PPG Debt Composition	24
Table 2: External PPG Debt Burden Indicators	24









Photo by Bart Verweij / World Bank, 2014.

## Executive Summary

### Recent Economic Developments

**1. Based on preliminary estimates, the Lao PDR economy grew by 7.5 percent in 2014, compared to an average of 8 percent over 2011-13.** Construction, some of which is related to foreign investment in the hydropower sector and spillovers, forestry (wood exports) and services were the main contributors to this growth. The direct output contribution from the resource sector lowered last year due to a fall in total gold output, in part associated with the lower gold price, and flat electricity output from the existing power plants. In addition, fiscal tightening measures through budget cuts and, to a certain extent, a slowdown in bank credit growth also had some impact on domestic activity.

**2. Looking forward, real GDP growth is projected to slow further in 2015 before accelerating in the medium term.** Growth is projected to slow to 6.4 percent in 2015 assuming a high, but stable, level of investment in new large power projects and fiscal consolidation effects. Given the adoption of expansionary economic policies in the past few years and resultant macroeconomic vulnerabilities, a slowdown associated with policy corrections (such as fiscal consolidation and slower credit growth) are expected to help restore macroeconomic stability. This outlook is subject to both downside and upward risks. Further instability in Thailand, a sharper correction in economic activity in China or materializing risks in the financial sector could hurt growth. On the other hand, lower oil prices, faster completion of some hydropower projects as well as better performance of the non-resource sectors could push growth rates

upwards closer to the government's target. The projected reduction in the fiscal deficit as recent fiscal consolidation measures take effect will slightly dampen domestic demand. The external current account deficit should continue to reflect high FDI-funded imports, and only gradually improve in the medium term as power projects come on stream and start to export electricity.

**3. Average annual inflation in 2014 decelerated to 4.2 percent from 6.4 percent a year earlier, driven primarily by slower growth in food prices and a decline in fuel prices.** Food prices in 2014 were, on average, higher by 7 percent compared to 2013; a significant deceleration from 12.6 percent a year ago. After falling by 5.4 percent during 2013, fuel prices fell by an additional 0.8 percent in 2014 reflecting developments on world markets. Inflation is projected to be around 4-5 percent this year.

**4. In response to a widened fiscal deficit in FY12/13, the Government embarked on much needed fiscal corrective measures in FY13/14 and FY14/15.** Total revenues as a share of GDP remained stable at 23 percent in FY13/14, supported by robust receipts from non-resource sectors and improvements in administration that in part offset the effects of lower commodity prices and lower gold output and grants. On the expenditure side, the decision to suspend public benefits that more than offset the wage increase took place at the beginning of the fiscal year. A second round of spending cuts was approved late in the FY13/14, totaling around 1 percent of GDP in full year terms. Close to 40 percent of the cuts came from adjustments to the public investment plan with the remaining affecting administration spending. As a result, the

fiscal deficit narrowed to 4.3 percent of GDP in FY13/14, from 6 percent the previous year. However, the Government's financial position continued to be tight as arrears incurred in previous years were being repaid. Further containment of the deficit is expected in FY14/15 with the deficit projected to stabilize at 4.2 percent of GDP. The Government plans to limit growth in total public spending to about 7 percent in nominal terms, to be supported by lower recruitment in the public service and a wage freeze for most of the civil service. At the same time, revenue administration is expected to be further strengthened, and there are excise increases planned for vehicles and luxury goods.

**5. Foreign exchange reserves coverage remains low as compared with prudential benchmarks.** Reserves stood at US\$ 815 million in December 2014, 23 percent higher than in December 2013, due to strong investment inflows and foreign borrowing. Nevertheless, the reserve cover remains low less than 2 months of goods and services imports, and about 28 percent of foreign currency deposits. These indicators imply significant vulnerability to shocks. The international prudential benchmark for foreign exchange reserve cover is between 3-6 months of imports of goods and services. Therefore, building up reserves to increase buffers against shocks remains critical to macroeconomic stability. The recent trends in fiscal consolidation and credit growth slowdown as well as signs of depreciation will help in curbing domestic demand for imports and therefore lessen the pressure on reserves. Moreover, the recent sharp fall in global oil prices, with annual average crude prices down by 8 percent during 2014 compared to a year ago, should have a favorable impact

on the Lao balance of payments, given that petroleum products constitute nearly 20 percent of total imports.

**6. While the nominal exchange rate remained relatively stable within the band set by the Bank of Laos (BOL), the real exchange rate continued to appreciate.** During 2014, the kip depreciated by 2.7 percent against US Dollar and appreciated by 2.3 percent against the Thai baht. However, with inflation in Lao PDR exceeding inflation in some of the main trading partners, the real effective exchange rate continued to appreciate. The appreciation of the Kip over the last five years reached more than 30 percent, which has undermined the competitiveness for Lao PDR's tradable exports and cheapened consumer imports, and therefore contributes to the pressure on the external balance.

**7. Indications in 2014 are that bank credit growth is slowing down sharply compared to its previous rapid pace over several years.** After having averaged more than 50 percent annually during 2008-13, credit growth slowed down to 14 percent in December 2014. Despite slower credit growth during 2014, the overall health of the banking system continues to be a concern. Rapid sustained growth of credit over several years has continued to stretch supervisory capacity. The non-performing loans (NPL) ratio rose sharply in the first half of 2014. The NPL ratio of state-owned commercial banks rose from below 3 percent at end 2013 to about 8 percent in June 2014, while their capital-to-asset ratio declined to about 3 percent, raising concerns about health of the sector and possible contingent liabilities.

## Selected Issues

### *1. Asean Economic Community 2015 – Implications For Lao PDR*

**8. The commencement of the ASEAN Economic Community by 2015 is expected to present new opportunities for Lao PDR; however, further trade and investment policy reforms and strong implementation of commitments by the authorities are needed.**

The country's export performance continues to skew towards hydropower and mining exports as non-resource sectors still operate in a relatively high-cost business environment with low labor productivity. In the near term, Lao PDR's goods and services exports and investment inflows to non-resource sectors are not expected to suddenly significantly rise due to supply side constraints and the hindrance on competitiveness of the private sector (lack of skilled labor and labor availability, and relatively high trade costs and costs of doing business). A short-term impact could potentially be increased imports of consumer goods when import prices become cheaper. Lao PDR may expect to see new opportunities for foreign investment and some benefits through lower costs of imports and future inflows of some professional services<sup>1</sup> that Lao PDR lacks.

**9. In order to grasp new opportunities and enjoy the benefits of regional integration, it is necessary for Lao PDR to take steps to create a conducive business environment.** These steps include: i) continuing regulatory and policy reforms; ii) ensuring effective implementation of commitments in the areas

of trade facilitation and non-tariff measures in order to lower trading costs; iii) providing mutual recognition of qualifications for professional services; iv) improving labor skills; v) establishing a transparent and non-discriminatory investment regime; and vi) promoting quality investment. Immediate reforms are needed to replace manual processes for business start-up and sectoral business licensing with a modern automated system that is streamlined, time-efficient, transparent and predictable. Such deeper reforms are critical in moving toward a rule-based business model on the ground and aiming at improving the competitiveness of the private sector in Lao PDR.

### *II. Creating Productive Jobs For Inclusive Growth*

**10. In order to achieve broad-based, inclusive growth and poverty reduction in Lao PDR, channeling greater resources toward tackling key workforce skills and productivity challenges is of significant importance.** The majority of labor is in the agriculture sector, where productivity is low. As a result, the movement of labor from the agriculture sector to other non-farm jobs has been slow. Labor movement is also deterred by limited opportunities for higher-paid and higher-productivity non-farm jobs, in part due to constraints on business startup and doing business. Despite the impressive growth in the past decade, in part driven by the development of the resource sector, job creation in this sector has been limited. The skills problems are not only limited to vocational skills, but stem from a lack of basic reading and numeracy skills from early childhood. Boosting agricultural productivity

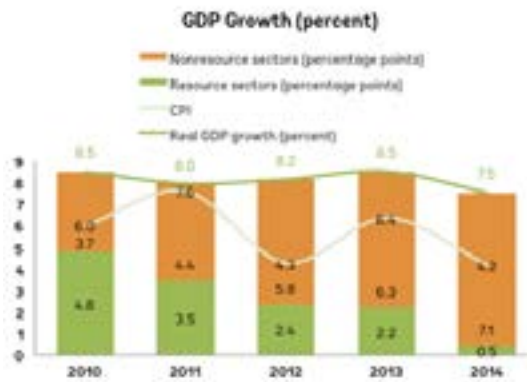
<sup>1</sup> Professional services in the AEC context covers nurses, architects, engineers, medical practitioners, dental practitioners, accountants and surveyors only.

is a top priority for improving livelihoods and reducing poverty, as it will help raise farm incomes and will eventually free some workers to look for higher paying non-farm jobs. In the meantime, this should be coupled with investing in productivity improvement in existing non-agriculture sectors as well as streamlining processes for business establishment and operations in order to enable a diversified private sector that will help generate employment opportunities. On the supply side, strengthening early childhood education and literacy skills and building job-relevant technical skills will be critical.

## Recent Economic Developments In Brief

### Growth moderated in 2014 but remained strong...

Change from the previous year, percent



Source: Government, LNCCI data and staff estimates

### Inflation decelerated driven by slower growth in food prices and declining oil prices

Change from the previous year, percent



Source: LSB and WB staff calculations

### Fiscal consolidation started since FY13/14 (percent of GDP)

(percent of GDP)



Source: MOF and WB staff estimates

### Most effects expected from expenditure measures (percent of GDP)

(percent of GDP)



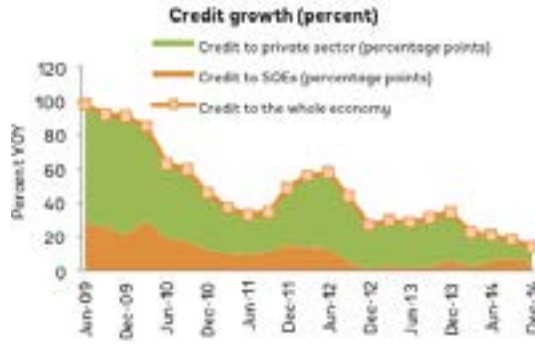
Source: Government, LNCCI data and staff estimates

**Reserve coverage remains low**



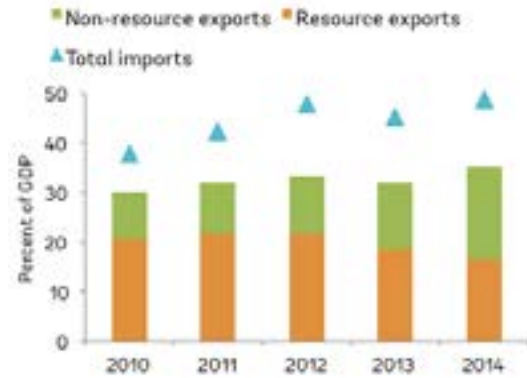
Source: BOL and WB staff calculations

**Despite credit growth deceleration, risks to the banking sector remain**



Source: BOL and staff calculations

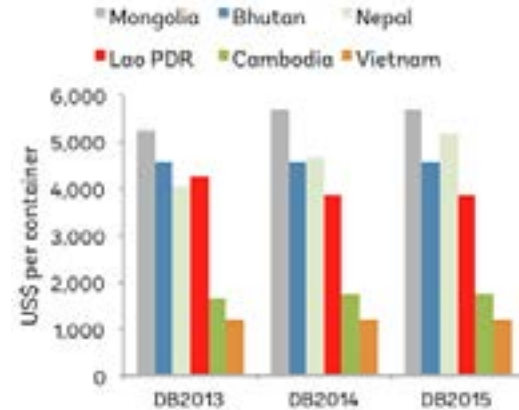
**Lao PDR's trade is more integrated, but most exports are from natural resources...**  
(percent of GDP)



Source: Lao PDR Authorities, trading partners and WB staff calculations

**...and the trading costs remain high**

Trade cost per container# (US\$ per container)

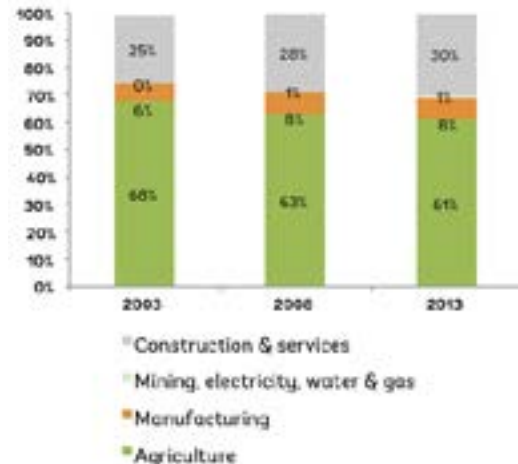


Source: Doing Business 2013, 2014, 2015

Trade cost includes both import and export costs per container

**...and the lack of skilled labor and generally low productivity, including agriculture sector where most people work in...**

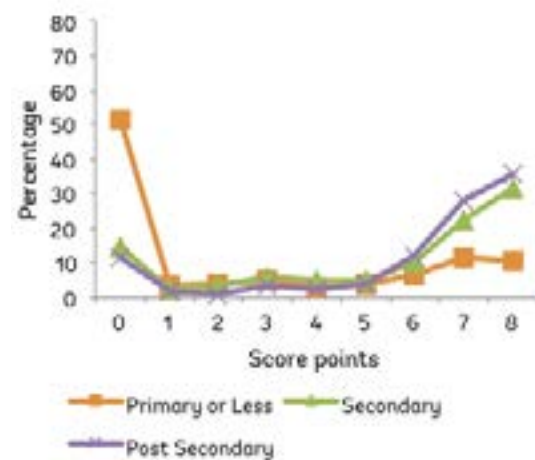
Composition of economy by amount of hours worked in each sector (in % of total)



Source: Lao Development Report 2014

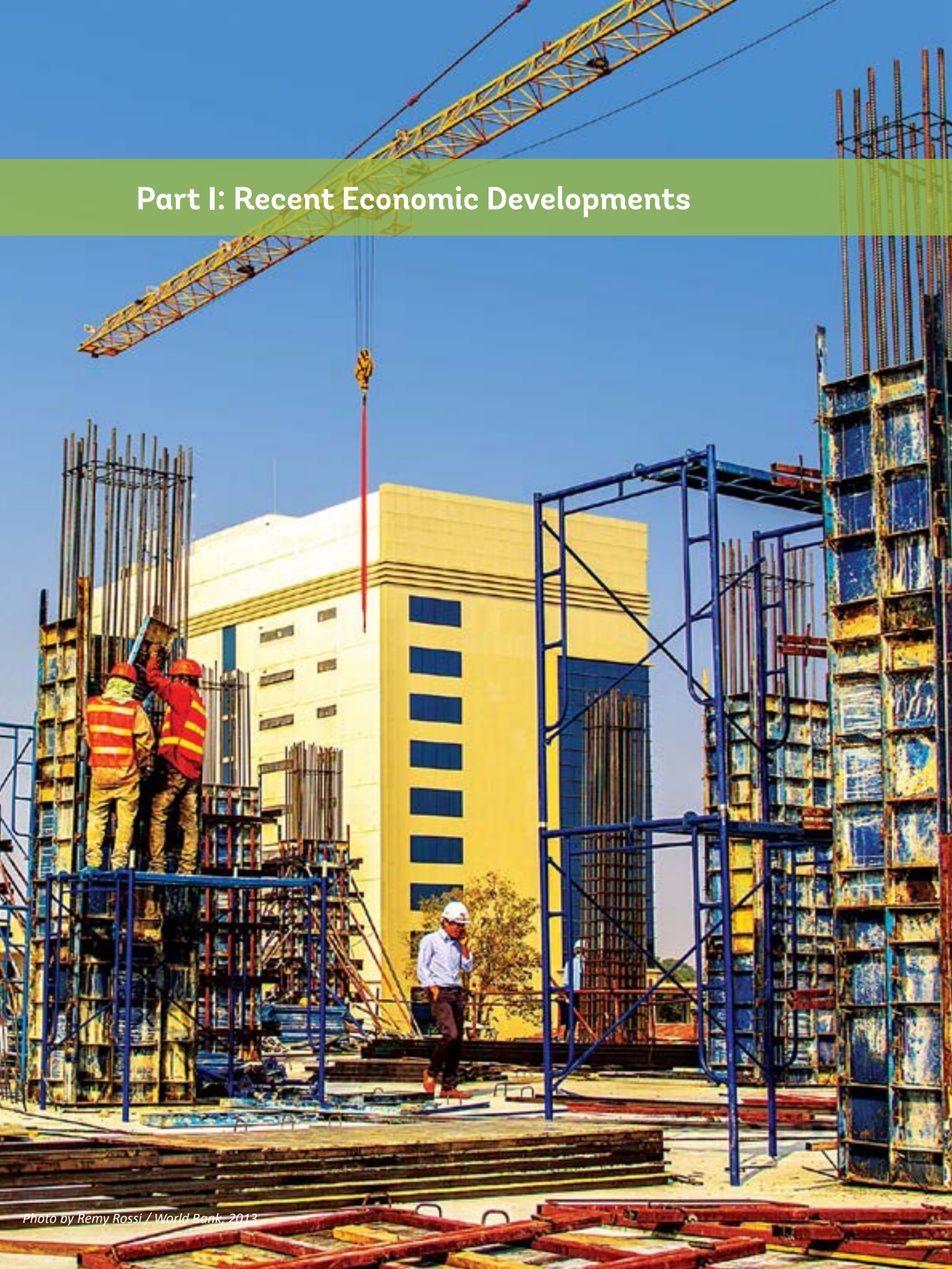
**The issue may be extended to the need for improving overall literacy skills from early childhood education as well**

Scores on basic literacy test (from 0-8 points) for adults with different education levels



Source: Lao Development Report 2014

## Part I: Recent Economic Developments





## Key Regional Economic Developments

The global economy is showing signs of recovery, but at an uneven pace; global growth rose modestly by estimated 2.6 percent in 2014 and is projected to further rise to 3 percent in 2015. The gradual strengthening of activity in high-income economies will boost demand for exports from developing East Asia and Pacific (EAP), helping the region to sustain its growth performance. Growth in developing EAP moderated to 6.9 percent in 2014 and is expected to slightly slow further due to slight moderation in China. Despite such trend, the EAP region will remain the fastest-growing developing region (See Annex 2 for projections).

In the near term outlook, projected growth moderation in China will offset projected pickups in other economies in the region. In China, growth has moderated to 7.4 percent in 2014 and is projected at 7.1 percent in 2015, reflecting intensified policy efforts to address financial vulnerabilities and structural constraints, and to place the economy on a more sustainable growth path. Measures to contain local government debt; curb shadow banking; and tackle excess supply capacity, high energy demand, and high pollution will reduce investment and manufacturing output. Excluding China, the regional growth bottomed out at 4.6 percent in 2014, reflecting the slowdown in Indonesia and Thailand, before recovering to 5.2 percent in 2015. Growth, excluding China, will gradually pick up, as exports firm and the impact of domestic adjustment in the large ASEAN countries eases. However, the capacity to benefit from the global recovery will vary significantly across countries, reflecting structural constraints to investment and export competitiveness, and weak export prices for commodity producers.

Significant uncertainties remain about the strength and sustainability of the recovery in high-income economies, as well as about the timing of policy actions by central banks in these countries. A key risk to the regional outlook is that the global recovery, and the associated pickup in demand for regional exports from the developed economies, may be slower than anticipated. In addition, global financial conditions are likely to tighten, and financial volatility may also rise, especially if geopolitical tensions escalate; this may create debt-service challenges for some economies. Relatedly, real estate prices in some countries are likely to come under pressure.

*Source: EAP Economic Update October 2014, Global Economic Prospects January 2015*

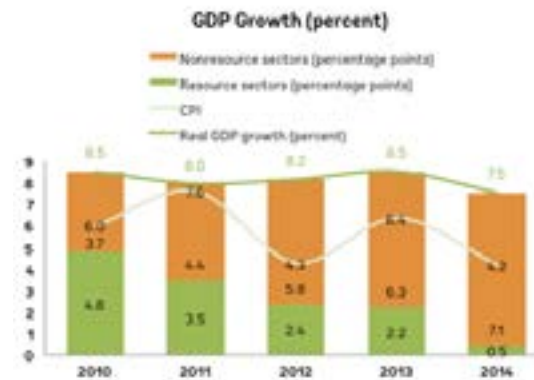
## Recent Economic Developments In Lao PDR

### Growth

1. Preliminary estimates put the growth rate of the Lao PDR economy at 7.5 percent in 2014; slightly below the 8 percent average over 2011-2013 due to slowdown in some real sectors and fiscal tightening (Figure 1). On the supply side, key growth drivers in 2014 came from robust activity in the construction and construction-related industry some of which was related to the resource sector and spillovers, forestry (wood export), and services (Figure 2). In the resource sectors, despite lower direct output contribution<sup>2</sup>, the construction of hydropower projects provided considerable indirect contribution through construction and services sectors<sup>3</sup>. The hydropower output was estimated to have a slow increase in 2014 from existing plants and other smaller projects. The mining sector contribution lowered due to a declining overall gold output and effects of lower commodity prices. However, the development of several large-scale hydropower projects<sup>4</sup> boosted the construction and construction-related industries, as well as spillovers. Overall, the construction and construction-related sectors, particularly related to large hydropower projects, continue to show solid growth driven by FDI in the resource sectors, which more than offset a decline in public investment spending in real term last year due to fiscal consolidation. Forestry (mostly wood exports) contribution is estimated to have risen significantly in 2014, reflecting a significant increase in wood exports in 2014

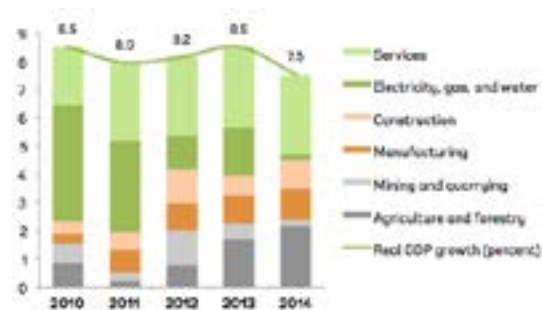
by about 60 percent reaching about US\$ 1.5 billion to neighboring countries<sup>5</sup>. Services were also estimated to have stable growth last year driven by wholesale and retail, banking, transportation, storage, and communication, some of which were spillovers from the resource sector construction.

**Figure 1: GDP Growth and Inflation**  
(percent yoy)



Source: Government, LNCCI data and staff estimates

**Figure 2: Contribution by sectors to real GDP growth**  
(percentage points)



Source: Government, LNCCI data and staff estimates

<sup>2</sup> Direct output contribution refers to the change (increase or decrease) in output (for example, GWH increase after power projects start operation; mineral output change due to expansion plan). Indirect contribution is mostly the spillovers to other sectors (e.g. services, construction) mostly during the construction phase of the resource projects.

<sup>3</sup> Resource sectors cover hydropower and mining sectors.

<sup>4</sup> Projects under construction include Hongsa Lignite power plant, Xayaboury, Nam Ngiep 2, Nam Ou 2,5,6, and Xepian Xenam Noi projects.

<sup>5</sup> According to trading partners' customs websites: [www.customs-info.com/Trade/Commodity.aspx](http://www.customs-info.com/Trade/Commodity.aspx); [www.customs.gov.vn](http://www.customs.gov.vn)

**2. Going forward, real GDP growth is projected to slow to 6.4 percent in 2015.** The forecast assumes a high but stable level of investment in large power projects as well as further fiscal consolidation effects. Real GDP is projected to ease to 6.4 percent in 2015<sup>6</sup>, before accelerating again in the medium term. Given the adoption of expansionary economic policies in the past few years and emerged macroeconomic vulnerabilities, a slowdown associated with policy adjustments (such as fiscal consolidation and slower credit growth) are expected to help restore macroeconomic stability. This outlook is subject to both downside and upward risks. Further instability in Thailand, a sharper correction in economic activity in China or materializing risks in the financial sector could hurt growth. On the other hand, lower oil prices, faster coming on stream of some hydropower projects as well as better performance of the non-resource sectors could push growth rates upwards closer to the government's target. The fiscal deficit should narrow to about 4.2 percent as recent fiscal consolidation measures take effect, with stable revenues to GDP despite lower resource-sector revenues, and a moderate degree of expenditure containment. The external current account deficit should continue to reflect high FDI-funded imports, and only gradually improve in the medium term, beyond 2015, as power projects come on stream and start to export electricity.

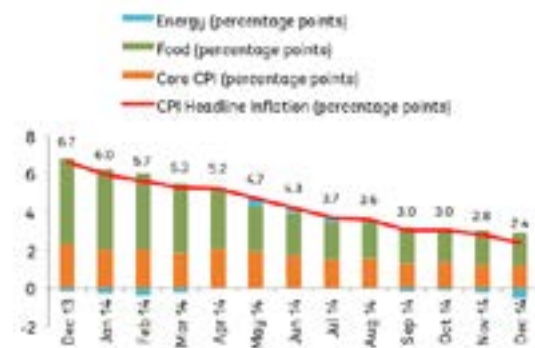
## Inflation

**3. Average annual inflation in 2014 decelerated to 4.2 percent from 6.4 percent a year earlier, driven primarily by slower growth in food prices and a decline in fuel prices.** Food prices in 2014 were, on average, higher by 7 percent compared to 2013; a

significant deceleration from 12.6 percent a year ago (Figure 4). After falling by 5.4 percent during 2013, fuel prices fell by addition 0.8 percent in 2014 reflecting developments on world markets. Inflation is projected around 5 percent next year.

**Figure 3: Monthly Inflation**

(percent yoy)



Source: LSB and WB staff calculations

**Figure 4: Contribution to Food Inflation**

(percentage points)



Source: LSB and WB staff calculations

<sup>6</sup> This projection is at the lower range taking into account some down side risks. If upside risks materialize, growth prospects could be revised upward.

## Government Revenue And Expenditure

4. The fiscal deficit for FY13/14 is estimated to decline as result of fiscal consolidation measures. Early measures in FY13/14 included a cut in public sector benefits that offset the second 40 percent wage increase. Total revenue remained stable at about 23 percent of GDP as improved non-resource revenue performance (VAT, excise, import duties) compensated for the lower mining revenues and grants. With revenue growth falling short of the ambitious revenue target, and arrears repayment bearing on Government cash flows, the financial position remained tight in FY13/14. A new round of fiscal corrective actions was announced in mid-2014, with spending cuts equivalent to about 1 percent of GDP in full-year terms<sup>7</sup>. As a result, the fiscal deficit for FY13/14 is estimated to decline from 6 percent to 4.3 percent (Figure 5) though the financial position of the Government continued to be tight as arrears incurred in FY12/13 (close to an estimated 2 percent of GDP) were largely

**Figure 5: Government Fiscal Performance**  
(percent of GDP)



Source: MOF and WB staff estimates

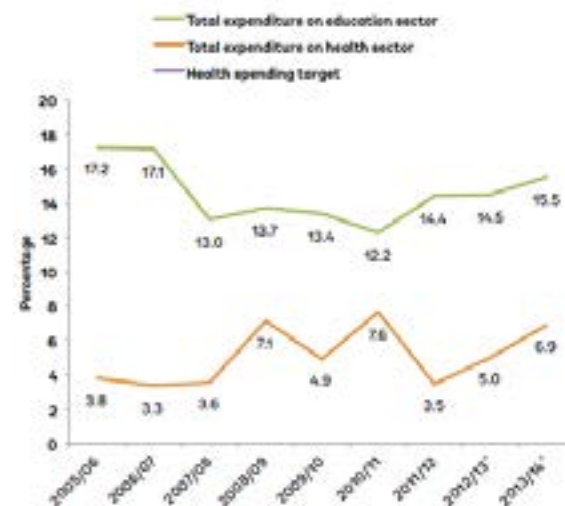
Note: numbers were revised to include on-budget grant-financed investment spending

repaid. The overall non-resource fiscal deficit including grants also narrowed as a result, from about 10 percent in FY12/13 back to 7 percent in FY13/14. Under the implementation of the budget cuts, availability of updated outturn information will enable further analysis of the impacts on the social sector spending especially health and education sectors (Box 1: Public Spending on education and health sectors).

**Figure 6: Government Expenditures**  
(percent of GDP)



**Figure 7: Social sectors expenditures**  
(percent of total public expenditure excl. debt payment)



Source: MOF and WB staff calculations

\* Original Budget Plan

<sup>7</sup> The Government proposed to the National Assembly cuts to public spending in the amount of kip 659 billion, of which kip 250 billion to be cut from the public investment plan, while kip 409 billion to be cut from the recurrent spending plan (Vientiane Times Newspaper, July 8th, 2014, [http://www.vientianetimes.org.la/FreeContent/freeCont\\_Govt%20seeks%20parliament.htm](http://www.vientianetimes.org.la/FreeContent/freeCont_Govt%20seeks%20parliament.htm)).

**5. On the revenue side, total revenue as a ratio to GDP is estimated to remain stable as non-resource revenues compensated for the decline in grants and mining revenues.**

The Government attempted to strengthen revenue administration, which contributed to revenue growth making it stayed around 23 to GDP in FY13/14 (Figure 7). Mining related revenue fell due to lower commodity prices and associated lower overall gold output. Non-resource revenues performed well, particularly import duties, excise tax and value added tax (VAT), making non-resource revenues' share to GDP increased to 14.8 percent. Grants declined from 5.3 to about 5 percent.

**Figure 8: Government Revenue**

(percent of GDP)

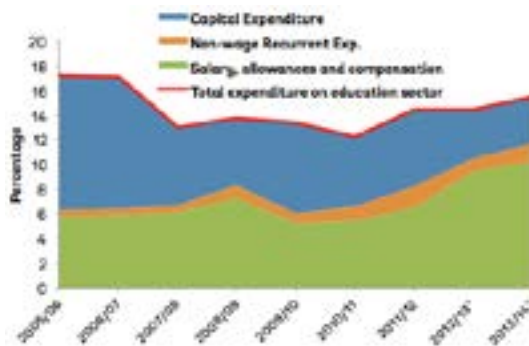


Source: MOF and WB staff estimates

Note: numbers were revised to include on-budget grant-financed investment spending

### Box 1: Public Spending on education and health sectors

**Figure 9: Public spending on education**  
(percent of total government spending\*)



**Figure 10: Public spending on health**  
(percent of total government spending\*)



Source: MOF and WB staff calculations

Note: # total government spending, excluding debt payment

\* Original Budget Plan

**Public spending on priority social sectors, education and health, has expanded under the FY12/13 – FY13/14 original budget plans, though mostly due to the rise of the wage bill.** Public spending on health was set to rise to about US\$ 220 million or 7 percent of total public expenditure, excluding debt payment, in FY13/14 from the sharp drop in FY11/12 implementation. The increase is allocated to recurrent spending (Figure 10). The non-wage recurrent spending on health, which covers the spending for operation and maintenance of public assets and consumables, as a share of total spending was planned to rise to about 2.4 percent in FY13/14 plan (about US\$ 76 million) from 0.7 percent in FY11/12 budget implementation (about US\$ 13 million). Public spending on education was also planned to increase in the last two fiscal years, driven by the increase in wage bills and benefits

(about US\$ 490 million in FY13/14 plan). However, non-wage recurrent expenditures, which are important to the efficiency and quality of public services, remain a small share of less than 2 percent of the total public expenditure (about US\$ 45 million). The lack of non-wage recurrent spending in proportion to public investment and wage bills increase in these two sectors can undermine the quality of public services. With the implementation of wage increase in FY12/13 and the aforementioned budget cut in FY13/14, the outturn information is not yet available to allow assessment of the impacts on these sectors. To help ensure development outcomes, strategic resource allocation and improvement in absorptive capacity in these two sectors would be equally important going forward.

**6. Overall the fiscal deficit in FY14/15 is expected to remain stable at 4.2 percent as fiscal consolidation takes effect.** Total spending growth will be contained, coupled with much slower recruitment rate. The Government has given a priority to completing the existing projects, repaying eligible past public investment project arrears and has restricted new public investment projects that are not related to poverty reduction objective. Under the FY14/15 development plan, key measures include the instruction to spending units to allocate at least 35 percent of the annual capital spending budget for clearing past PIP arrears and stop any off-budget spending without approval from the national assembly. Relevant sectors are advised to periodically update the unit cost for construction related to their sectors and made known to the public as a reference for proper project costing. The revenue measures will focus on strengthening revenue administration. These measures, if implemented strictly, should go a long way to improving the Government's financial position and restoring fiscal sustainability. Nevertheless, the falling of fuel prices might have some impact on the Government revenue and is being monitored closely.

### Public Debt

**7. Preliminary assessment of the Lao PDR total external debt indicates increased external debt stock at end 2013 compared to 2012.** Nominal total external debt (public and private debt) is estimated to increase from about 80 percent of GDP at end 2012 to about 84 percent at end 2013<sup>8</sup>, out of which slightly more than half is public and publically

guaranteed (PPG) external debt stock and the rest is private external debt. The nominal stock of PPG external debt is estimated to rise from US\$4.5 billion in 2012 (47.7 percent of GDP) to about US\$5.1 billion at end-2013 (48.3 percent of GDP), mainly the result of higher borrowing from China and Thailand in part driven by public investment in equity holding in power generation projects. The corresponding net present value of PPG external debt at end-2013 was estimated at 39.8 percent of GDP, significantly increased from 32.5 percent of GDP in 2012.

**8. Lao PDR's risk of debt distress remains moderate, but with heightened risk compared to last year's assessment.** Under the baseline case, the PV of external PPG debt to GDP ratio is projected to breach the debt burden thresholds for PPG external debt for the next few years before declining in the medium term. The breach means that the PPG external debt stock and future repayment flows increase compared to the thresholds that indicate the sustainable level of public external debt. This indicates higher debt burden and limited cushions for the budget in the case of adverse shocks. Other debt and debt service indicators remain low due to the high level of concessionality in official borrowing. Most of the PPG external debt is denominated in foreign currencies, making it vulnerable to a risk of significant sudden exchange rate depreciation.

**9. Bilateral creditors have accounted for a larger share in total external public debt in 2013. Bilateral creditors,** mainly China, Russia, Thailand, Japan and Korea – accounted for 64 percent of total external PPG at end 2013<sup>9</sup>. Multilateral creditors

<sup>8</sup> This is among the high external debt ratios in the region, compared to some ASEAN countries such as Cambodia (33 percent of GDP), Myanmar (25 percent), China (1.5 percent), Indonesia (31 percent), Philippines (28 percent) and Malaysia (31 percent).

<sup>9</sup> This includes a 50-million USD bond that was issued in May 2013, two bonds totaling about 100 million USD have been issued in December 2013 in the Thai capital market. In 2014, about 170 million of bonds were issued. These are for financing the general budget deficit.

accounted for the remaining, of which mostly Asian Development Bank and followed by the International Development Association (the World Bank). The share of bilateral creditors has increased significantly vis-à-vis multilateral creditors, reflecting both higher levels of borrowing and harder average terms.

**11. The Government is taking steps to strengthen the framework for public debt management.** Enhancing capacity in debt management, debt sustainability analysis and project viability appraisal is of crucial importance in Lao PDR. A debt monitoring system (DMFAS) is now fully deployed and

**Table 1: External PPG Debt Composition**

	US\$ billion	Share of total PPG external debt	In percent of GDP
Total	5.1	100	48
Multilateral	1.8	36	17
Bilateral	3.3	64	31
Commercial	0.1	3	1

Source: IMF and WB's Debt Sustainability Analysis 2014

**Table 2: External PPG Debt Burden Indicators**

	Debt Burden Indicative thresholds	End 2013
Present value of debt, in percent of		
GDP	40	40
Exports	150	92
Revenue	250	221
Debt service, in percent of		
Exports	20	5
Revenue	20	12

Source: IMF and WB's Debt Sustainability Analysis 2014

**10. Total public sector (domestic and external) debt is estimated at 59 percent of GDP at end-2013.** Domestic public debt stood at about 11 percent of GDP at end-2013 consisting of commercial bank lending and bond holdings as well as the Bank of Lao PDR (BOL) direct lending to local Government's off-budget infrastructure projects. Given higher costs of domestic borrowing, the share of domestic PPG debt remains relatively small. Going forward, however, as domestic financial markets deepen, the share of domestic public debt is likely to increase.

capacity building for debt management unit has continued. This system has helped the authority to monitor and analyze external public debt portfolio of Lao PDR. Lao PDR start to report detailed debt information to the Debt Report System as per its international obligation. New presidential ordinance on public debt management has been in principle approved. The Ordinance defines the responsibility and authority of the Government agency to borrow and to issue new debt (including public, publically guaranteed debt and contingent liabilities), invest and undertake transactions on the



Government's behalf, and provides for debt management objectives as well as requirements to publish information on public debt on a timely basis. The authorities are taking steps to encourage a transparent public debate over debt and investment projects by publishing information in media and on the National Assembly website, but these efforts are starting from a very low base. All these efforts underscore the authorities' commitment to strengthening debt management.

**12. Reforms to strengthen cash management in the National Treasury have also been initiated.** The MoF has established a National Treasury subordinating local treasury offices to central management. The Government cash accounts are being progressively consolidated on the Treasury Single Account (TSA) comprising a system of arrangements with the BoL and three state-owned commercial banks reporting their treasury balances daily to the National Treasury based on the zero-balance account arrangement initiated with the banks. Cash management will be further strengthened through setting up a cash management unit in the National Treasury, developing cash-flow projections, and establishing clear responsibility for the National Treasury to engage into financial asset and liability management transactions to achieve the targeted balance of the TSA at the lowest cost.

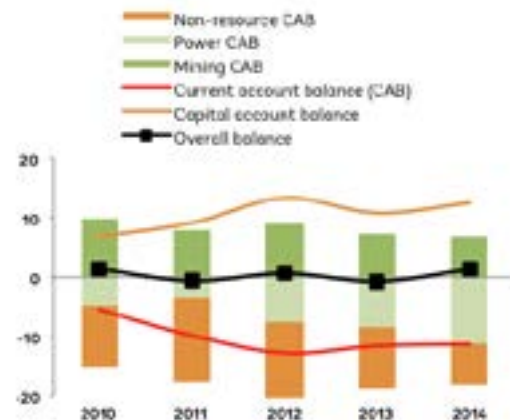
## External Sector

**13. Preliminary estimates indicated a slight improvement in the external balance supported by non-resource exports and still strong inflows of foreign investment in the resource sectors.** The current account

deficit is estimated to slightly decline relative to GDP, from 11.5 percent to GDP to 11.2 percent in 2014 due to estimated significant increase in wood exports this year that will partly compensate for the fall in commodity prices and overall gold output decline (Figure 12, Figure 13). Nevertheless, other non-resource exports still experienced relatively slower growth last year partly related to the constraints on the supply side. Imports growth was driven by capital and consumption goods imports some of which are related to the investment in hydropower projects<sup>10</sup> (Figure 14, Figure 15). External factors such as the sharp recent fall in global oil prices is expected to have a favorable impact on the Lao balance of payments, given that petroleum products imports constitute nearly 20 percent of total imports (See Box 2).

**Figure 12: Balance of Payments**

(percent of GDP)

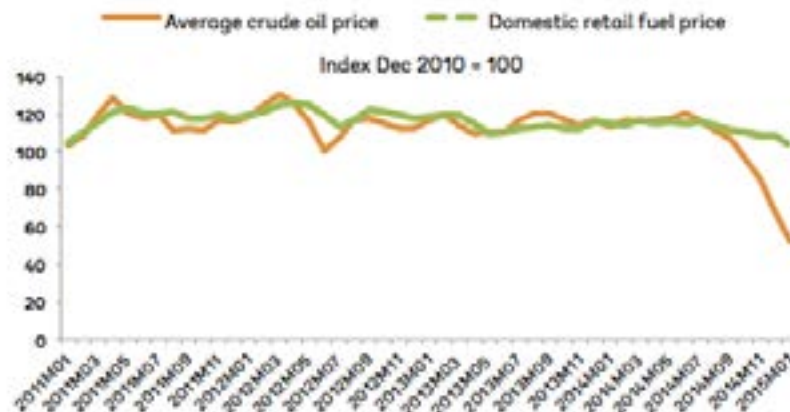


Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

<sup>10</sup> These include Hongsa Lignite power plant, Xayaboury, Nam Ngiep 2, Nam Ou 2,5,6, Xepian Xenam Noi, etc.

## Box 2: The oil price decline should benefit the economy, but also has some downside risks

Figure 11: Average crude oil price



Source: World Bank Commodity Price, March 2015

The average crude oil price plunged sharply in the second half of 2014. Nevertheless, the annual average price fell by about 8 percent in 2014. This resulted from sluggish global demand and a supply glut due to increased supply from US shale production and the reluctance to cut output by the Organization of the Petroleum Exporting Countries (OPEC). Cheaper oil is expected to boost global GDP by around 0.1 percentage point and GDP of oil importing developing economies, including in the East Asia and Pacific region, by around 0.2 percentage points.

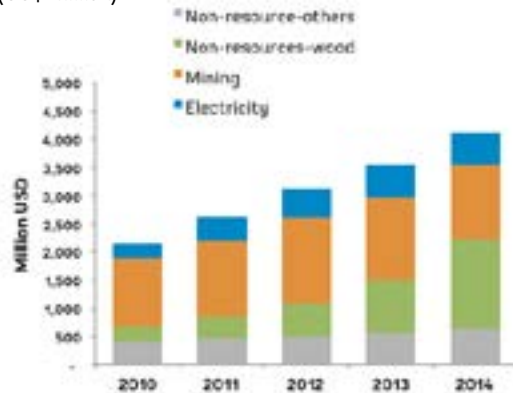
**With Lao PDR being a net importer of oil, the lower oil prices are expected to have a favourable impact on the external balance.**

Oil import accounts for about 20 percent of total Lao PDR imports, or about 9 percent of GDP. The fall in annual average oil price in 2014 is expected to offset the demand, which rises by about 10 percent annually on average, and therefore to keep oil import bills stable compared to the previous year and help contain the current account deficit from largely expanding.

Also, lower fuel prices are expected to bring some benefits to consumers as lower prices boost purchasing power. Already in December 2014, retail energy prices were 6 percent lower compared to a year ago. Fuel consumption accounts for about 8 percent in the Consumer Price Index basket. Lower fuel prices are also expected to be translated in reduced prices of other goods and services due to lower costs for producers.

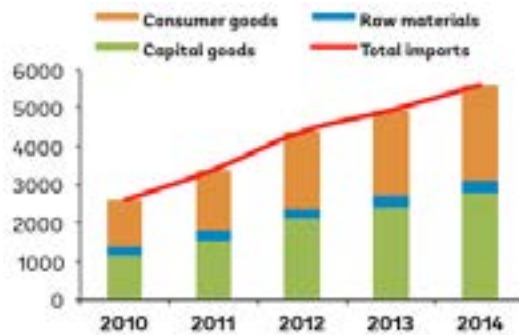
**However, there are also downside risks.** The decline is expected to affect government revenue, where oil revenue (from excise tax and VAT) accounts for about 10 percent of domestic revenue, or about 2 percent of GDP. However, the existing mechanism of fuel price regulation may help soften the impact on revenue. In addition, the recent slide in oil prices comes also in response to moderating growth in China. Further slowdown in China or other key trading partners of Lao PDR might affect their demand for Lao PDR exports.

**Figure 13: Merchandise Exports**  
(US\$ million)



Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

**Figure 14: Merchandise Imports**  
(US\$ million)



Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

**Figure 15: Foreign Direct Investment**  
(US\$ Million)



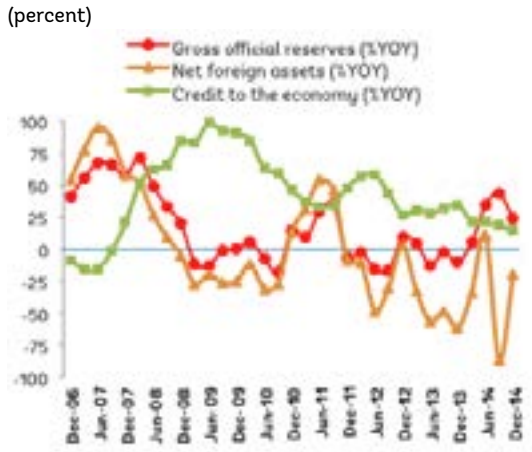
Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

**14. Foreign exchange reserves coverage remains low as compared with prudential benchmarks.** Reserves stood at US\$ 815 million in December 2014<sup>11</sup>, an increase of 23 percent compared to a year ago (Figure 16). However, net foreign assets fell notably by about 20 percent yoy in December 2014 due to a sharp increase in foreign liabilities of commercial banks. To help reduce the pressure on reserves, the BOL has instructed commercial banks since mid-2013 to limit exposure to lending in foreign currency to borrowers with insufficient foreign currency earnings. Nevertheless, exchange management also has contributed to fluctuations of reserves. The ratio of reserves to foreign currency deposits has gradually dropped to slightly less than 30 percent in December 2014 and still less than 2 months of imports of goods and services<sup>12</sup> (Figure 17). These indicators still imply the remaining vulnerability in the external balances. Therefore, building more reserves to increase the cushion against shocks is critical to macroeconomic stability. The recent trends in credit growth slowdown and fiscal consolidation will have an important role in curbing domestic demand for imports as well as lower pressure from falling oil prices therefore are expected to lessen the pressure on reserves.

<sup>11</sup> Reserves can cover only the estimated cash flow on public external debt (interest and repayment) over 2015-16, of about US\$500 million.

<sup>12</sup> This is WB staff estimates based on the trade data from Lao authorities and trading partners. BOL estimates more than 4 months based on Lao authority's trade data. Both agencies use the same nominal foreign reserves data but different measures of imports

**Figure 16: Net foreign assets and foreign reserves**



Source: BOL and staff calculations

### Exchange Rate

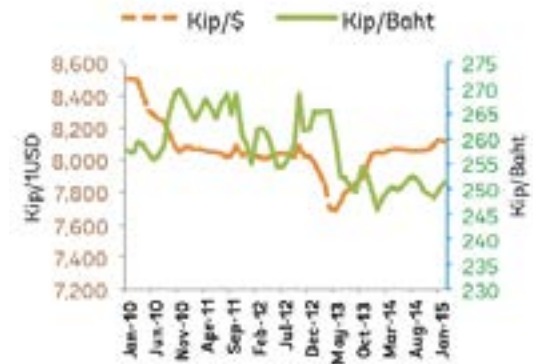
15. While the Bank of Lao PDR maintains nominal exchange rate stability of the Lao kip against major currencies, foreign exchange policy should give more consideration to reserve management and competitiveness. In nominal terms, the kip depreciated by 2.7 percent against the U.S. dollar during 2014 while it appreciated against Thai Baht by about 2.3 percent (Figure 18). However, with inflation in Lao PDR exceeding inflation in some of the main trading partners, the real effective exchange rate continued to appreciate. The real appreciation of the Kip over the past five years reached more than 30 percent (Figure 19), which has undermined the competitiveness for Lao PDR's tradable exports and cheapened consumer imports, and therefore contributes to the pressure on the external balance.

**Figure 17: Reserves coverage** (percent)



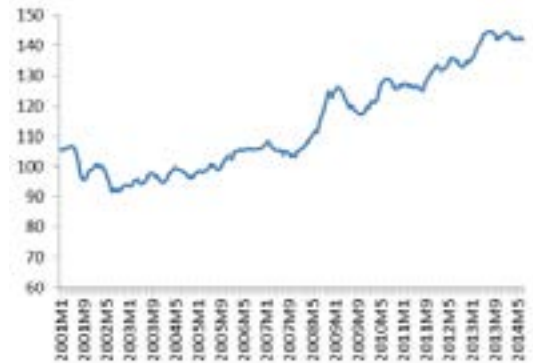
Source: BOL and staff calculations

**Figure 18: Lao kip exchange rate**



Source: BOL

**Figure 19: Real effective exchange rate**



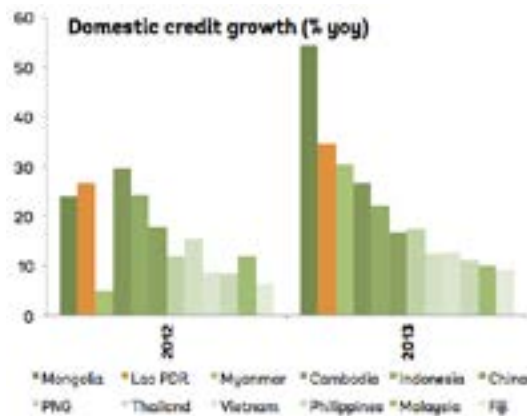
Source: IMF

### Monetary Developments

**16. Credit growth slowed down by December 2014.** Domestic credit grew at about 14 percent yoy in December compared to 35 percent yoy a year earlier due to decelerated credit growth to the private sector across all sectors (Figure 22, Figure 23). This is partly related to the recent fiscal difficulty and fiscal consolidation efforts. Despite such deceleration, overall credit growth in Lao PDR was still among the highest in the region (Figure 20). Industry,

the past few years, the non-performing loans ratio (NPLs) started to rise where the aggregate NPL for SOCBs rose from below 3 percent at end 2013 to about 8 percent by June 2014 and the capital-to-asset ratio dropped to an average of 3 percent in the period. This might have an implication on the contingent liabilities for the Government. The BOL recently issued a notice to suspend the approval of new private bank applications and reassess the performance of the banking sector. At the same time, it also plans to strengthen prudential regulations and

**Figure 20: Domestic credit growth in EAP region**  
(percent yoy)

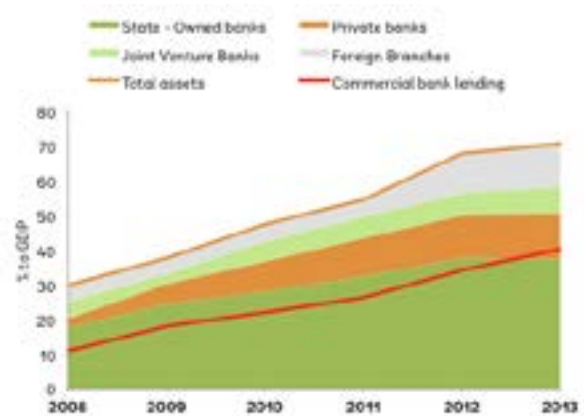


Source: BOL and EAP Update October 2014

construction and commerce sectors account for more than half of the total private sector credits (Figure 24).

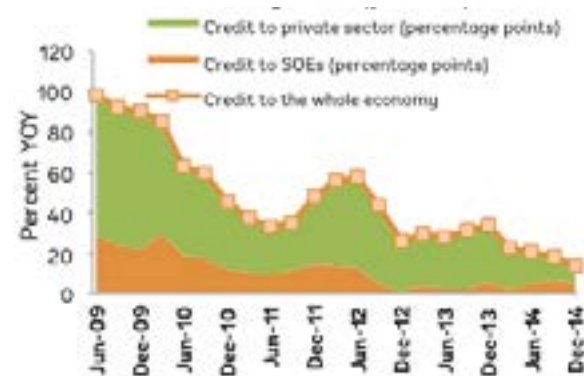
**17. Despite recently deceleration credit growth, the overall health of the banking system continues to be a concern.** The banking sector has notably grown with the total assets expanded to more than 70 percent of GDP compared to slightly less than 50 percent four years ago (Figure 21). State-owned banks (SOCBs) account for about half of that. The rate of sectoral and credit expansion has stretched the bank supervision capacity. After sustained credit growth in

**Figure 21: Banking sector assets**  
(kip billion)



Source: BOL and staff estimates

**Figure 22: Contribution to credit growth**  
(percent and percentage points)

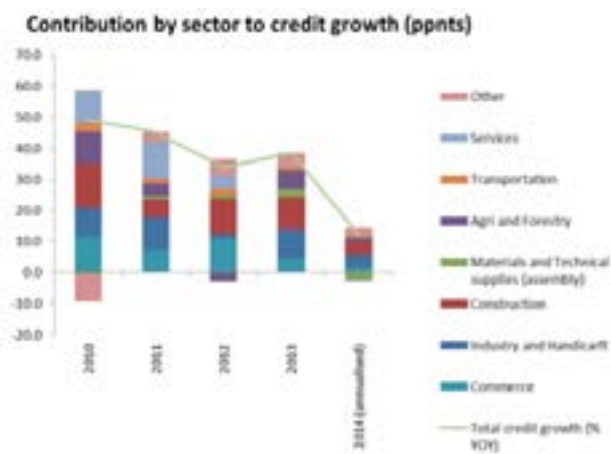


Source: BOL and staff estimates

introduce financial soundness risk indicators. In addition, performing relevant stress tests periodically can also help the BOL to test the strengths and weaknesses and therefore focus the support and reform in the needed areas.

**Figure 23: Sectoral contribution to credit growth**

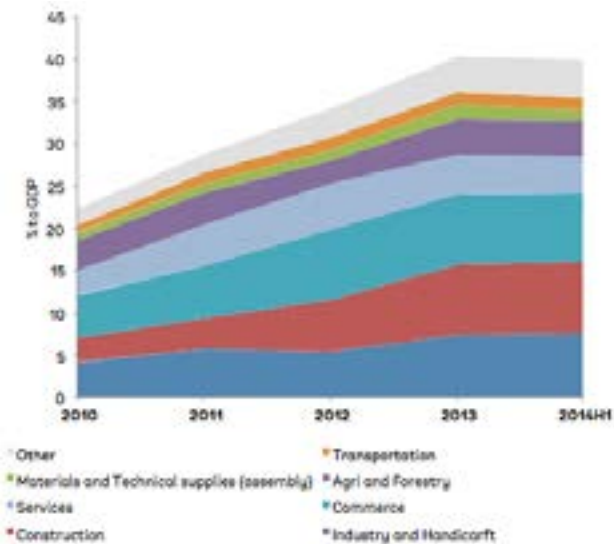
(percentage points)



Source: BOL and staff estimates

**Figure 24: Composition of credit by sectors**

(percent to GDP)



Source: BOL and staff estimates

## Part II: Selected Issues



## Asean Economic Community 2015 – Implications For Lao PDR<sup>13</sup>

**1. The ASEAN Economic Community (AEC), which is set to come into force at the end of 2015,** represents a key first step towards the establishment of a single market among ASEAN member states. In this context, what does it really mean for Lao PDR? The country is already closely integrated with the ASEAN region. In fact, the 2015 AEC milestone should really only be viewed as a first and important step towards establishing a single market, but many more steps will be required in the years afterwards if ASEAN member states are to truly benefit from an economic community. This brief note presents four key aspects of the AEC that most affect Lao PDR: trade in goods; trade in services; cross-border investment; and trade facilitation.

### *Trade in Goods*

#### ❖ What will happen in 2015?

**2. The ASEAN Trade in Goods Agreement (ATIGA) provides the rules and regulations for the import and export of physical merchandise within ASEAN member states.** The key AEC commitment is that all trade within ASEAN will be duty free by 2015. In fact, all tariffs including those on sensitive, unprocessed agricultural imports were eliminated in 2010 by the six original member countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand). The remaining, and less developed, countries CLMV (Cambodia, Lao PDR, Myanmar and Vietnam) have more time to comply and have

progressively removed more than 80 percent of all import tariffs, with the remaining tariffs still applied on sensitive goods, such as unprocessed agricultural commodities. Vietnam reduced all import tariffs for agricultural products to between 0 and 5 percent in 2013, Lao PDR and Myanmar will need to do the same by 2015, and Cambodia by 2017. The CLMV countries are committed to eliminating all remaining tariffs, including on sensitive goods, by 2018. In theory, lower tariffs should see lower cost imported goods across the region. This will benefit consumers and firms requiring imported materials to process into other products, but will also expose businesses to more intense price competition. Governments which receive a notable share of tax revenues from tariffs on imports (about 10 percent of domestic revenue) will also see a loss in revenue.

**3. At the same time, under the AEC countries are also committed to the elimination of non-tariff barriers (these include, for example, quotas, unreasonable standards, licenses or restrictions at the border).** All ASEAN member states were required to meet this commitment by 2010, with the exception of the Philippines in 2013 and the CLMV countries in 2015. In fact, progress has been rather slower and as tariffs have moved closer to zero, countries have increasingly started to apply non-tariff measures as an alternate control measure on imports. Many are formulated without clear and legitimate policy objectives.

<sup>13</sup> This note was prepared by Konesawang Nghardsaysone, Trade Economist, and Richard Record, Senior Country Economist



### ❖ What does it mean for Lao PDR?

**4. Lao PDR will see lower cost imports coming into its economy when most remaining import tariffs are eliminated in actual terms during 2015-18.** This will help improve the efficiency of firms that use imported materials and benefit consumers of imports. Domestic producers who compete with imported products will, however, face tougher competition.

**5. In 2015, Lao PDR expects to eliminate all import tariffs except for around 900 sensitive tariff lines (about 10 percent of total tariff lines) which will remain at 0-5 percent tariff rates and 63 highly sensitive tariff lines (about 1 percent of tariff lines) which will remain above 5 percent.** These remaining tariffs will need to be eliminated by 2018. As of February 2014, some 79 percent of all Lao tariff lines are at zero, 17 percent are at 0-5 percent, and the remaining 4 percent are above 5 percent. These remaining tariffs are mostly applied to unprocessed agricultural commodities, including rice. As these remaining tariff reductions are phased in, the Government is likely to lose considerable customs revenue, most notably on imported vehicles from within ASEAN. In expectation of tariff reductions, the Government is therefore increasingly shifting taxes of vehicles from tariffs (which are applied on imports) to excise taxes (which are applied on sales of vehicles).

**6. On exports, Lao PDR already gained duty free access to the original six ASEAN members in 2010, and will progressively see remaining tariffs on Lao exports applied by Cambodia, Vietnam and Myanmar reduced during 2015-18.** Given that Lao exports to ASEAN did not jump substantially when tariffs were reduced in 2010, it is likely that the most significant constraints are actually associated with supply side capacity and the

competitiveness of the Lao private sector, rather than through the effect of tariffs. Similarly, many Lao exporters struggle to comply with non-tariff measures, such as Sanitary and Phytosanitary requirements and technical standards, applied in export markets. These challenges take much longer to be addressed.

### *Trade in Services*

#### ❖ What will happen in 2015?

**7. Rules regarding trade in services within ASEAN countries are provided in the ASEAN Framework Agreement on Services (AFAS).** This governs the supply of services across borders, foreign investment in services and migration of persons across borders to provide services. ASEAN member states have been progressively attempting to reduce barriers to services trade in line with AEC objectives, but in reality actual implementation lags behind commitments. While there are now very few restrictions on supplying services across border, there are still limits on the maximum amounts that foreigners can invest in services within many ASEAN countries. Contrary to expectations, ASEAN is also still a long way from having free movement of labour across the region. The key AEC 2015 commitments on the movement of labour are for the temporary entry of business visitors, intra-company staff transfers and for the free movement of persons providing some professional services only. Professional services in the AEC context covers nurses, architects, engineers, medical practitioners, dental practitioners, accountants and surveyors only. For example, from 2015 a Lao engineer can temporarily travel to provide his/her services in Thailand upon the mutual recognition of her/his qualifications and experiences by the Thai authorities. The movement of unskilled labor

within ASEAN is still restricted by domestic laws of member states, and there are no AEC commitments on unskilled labor.

#### ❖ What does it mean for Lao PDR?

**8. Lao PDR is committed under the AEC, as well as under other obligations such as at the WTO, to progressively increase the number of service sectors where foreign firms can invest. By 2015, the country is committed to raising the cap on the maximum share that foreigners can invest in services to 70 percent across all sectors. In many sectors there are no limits at all, meaning that 100 percent foreign investment is permitted. However, like with trade in goods, the most significant constraints to attracting increased foreign investment in diversified sectors are associated with a Lao PDR being a small market and having a high cost business environment. Increasing the volume and quality of foreign services investment into Lao PDR can be best seen as a means of improving the competitiveness of other firms in Lao PDR, including manufacturers which depend on the availability of support services.**

**9. AEC commitments on the movement of skilled professionals are unlikely to have a major impact in Lao PDR as the country has significant skills shortages in all of the (limited) areas where free movement will be allowed.** In theory, it may be somewhat easier, and lower cost, for firms to import these professional services after 2015 helping to boost competitiveness, but it is unlikely that Lao PDR will be exporting such professional services in the immediate future. However, implementation will involve not only simplification and streamlining of visa and work permit approval processes, but also reforms to domestic laws and regulations to allow for the mutual recognition of qualifications gained from across ASEAN

within Lao PDR.

### **Investment**

#### ❖ What will happen in 2015?

**10. Under the ASEAN Comprehensive Investment Agreement, member states are committing to putting in place an investment regime that is free, open with no restrictive or discriminatory measures imposed on flows of investment across the region.** Foreign investment is to be facilitated through more transparent, consistent, and predictable rules, regulations and procedures. Investment applications and approvals are expected to be streamlined, simplified and transparent in order to attract and facilitate foreign investment across ASEAN. Outside of the services trade, this covers manufacturing, agriculture, fishery, forestry, mining and quarrying. Investors are to be properly protected through transparently established conflict settlement procedures and mechanisms that conform to international standards and practices.

#### ❖ What does it mean for Lao PDR?

**11. Lao PDR is committed to establishing a free and open investment regime conforming to AEC requirements, and efforts have been made to put in place a revised investment promotion law, removing all discriminatory measures, abolishing the need for investment license and ensuring that foreign and domestic investors are treated in the same way.** However, in practice there are still significant gaps and a generalized lack of transparency that affects the quality of foreign investment that Lao PDR receives. Numerous licenses and permits are required at the sector level, often taking considerable time for the necessary paperwork to be completed. Few processes

are yet automated. Investor protection and dispute resolution mechanisms remain weak due to lack of transparency, and procedures for insolvency are still very basic.

## Trade Facilitation

### ❖ What will happen in 2015?

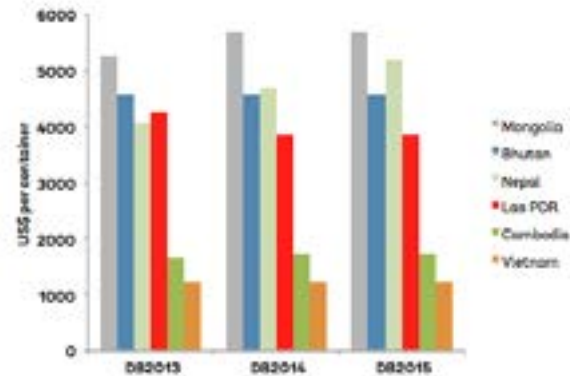
**12. Under the AEC, countries are committed to the free flow of trade through single, harmonized and standardized trade and customs processes and procedures that aim to lower the transaction costs of trade.** At the country level, customs clearance and declaration processes are to be streamlined and automated with the use of risk management systems and integrated with simplified and harmonized processing of regulatory requirements, including customs clearance and the issuance of licenses and permits via a National Single Window. However, in practice it is unlikely that all member states will be able to have fully functioning systems prior to AEC establishment in 2015. Similarly, countries are committed to establishing electronic trade portals or repositories containing all trade laws, regulations, procedures governing and process maps for imports and exports. At the regional level, all National Single Windows will eventually be integrated into an ASEAN Single Window.

### ❖ What does it mean for Lao PDR?

**13. Lao PDR has made some good progress on trade facilitation, but the country's landlocked status keep trade costs high (Figure 25).** Most of the benefits from better trade facilitation, such as faster and simpler border procedures, are beneficial in themselves, although AEC commitments help to some extent. Lao PDR was actually one of the first ASEAN countries to establish an

**Figure 25: Trading costs remain high**

Cost to export and import (US\$ per container)



Source: *Doing Business 2013, 2014, 2015*

electronic trade portal, the Lao PDR Trade Information Portal in 2012 as a national trade repository. The portal provides information to the public on all trade related laws, regulations, procedures and processes. Lao PDR is also progressively introducing automated customs systems to streamline border management, and has commenced work on the design for a national single window. However, much still needs to be done to bring costs down and performance standards up to those seen elsewhere in the ASEAN region.

**14. In order to grasp the new opportunities and enjoy the benefits of such regional integration, it is necessary for Lao PDR to depend reforms in various areas critical for improving the competitiveness of the private sector.** Priority areas include continuing regulatory and policy reforms and effective implementation of commitments in the areas of (i) trade facilitation and non-tariff measures to lower trading costs; (ii) providing mutual recognition agreements for professional services and labor skills improvements; (iii) establishing a transparent and non-discriminatory investment regime; and (iv) promoting quality investment.



*Photo by Stanislas Fradelizi / World Bank, 2011*

## Creating Productive Jobs For Inclusive Growth

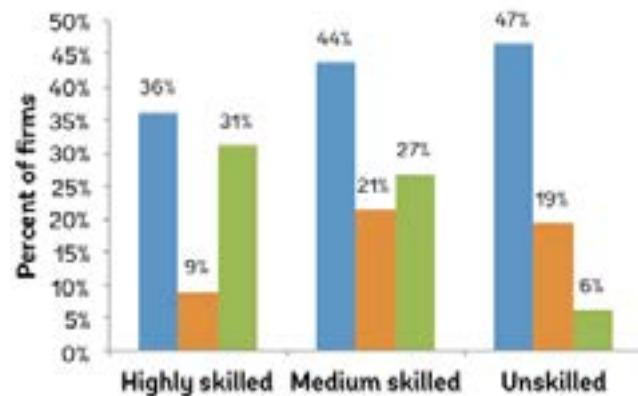
**1. Recent media confirms the above findings and reports of a perceived “skills problem” in Lao PDR have spurred an intense focus on skills development initiatives.** Media coverage of rising wages and complaints among firms of a shortage of skilled workers has raised concerns over whether Lao workers are equipped with the skills sought by firms. According to the recent Investment Climate Assessment<sup>14</sup>, inadequate workforce skills have emerged as the top constraint to private sector expansion in Lao PDR instead of the lack of physical infrastructure as cited by firms in the past enterprise surveys. In addition, productivity in Lao PDR is estimated to be about half what would be expected for a country at this level of development. In addition, there has been almost no observable growth in labor productivity during the last decade.

**2. However, the Lao Development Report 2014<sup>15</sup> argues that the workforce problems, which Lao PDR faces do not only stem from problems in the education sector.** Looking only to skills development as a solution would not address the fundamental problems constraining economic growth, employment creation, and poverty reduction. Creating an environment conducive for farm and non-farm businesses to make investments and grow remains an essential first step for skills development.

**3. One indication of bigger underlying structural problems is that firms complain that not enough workers are applying for jobs, even the low-skilled jobs.** Nearly half of firms in Lao PDR indicated that they had no or few applicants to an unskilled job (Figure 26),

a much higher percentage than in neighboring countries. This phenomenon points to troubling workforce issues. Why are people not moving to fill vacancies in manufacturing that offer potentially better opportunities? Does Lao PDR lack enough workers, and/or is it a problem of workers lacking the right skills? Or the lack of more attractive, higher-paid job opportunities outside the agriculture sector?

**Figure 26: Percentage of firms in Lao PDR, Vietnam, and Yunnan province (China) complaining that there were no or few applicants to a job, by skill level**



Source: World Bank Enterprise Surveys in Lao PDR, Vietnam, and Yunnan province (China) (2012)

**4. Tackling key workforce and productivity issues is particularly pressing given that Lao PDR is undergoing a major demographic transition.** The population is projected to increase by 38 percent from 6.4 million in 2010 to 8.8 million in 2030, with approximately 96,000 additional people reaching working age every year in the coming decade compared to 63,000 in the 1990s. Expansion of the labor force and a decrease in the number of dependents present

<sup>14</sup> Record, R. et al. (2014) “Investment Climate Assessment 2014: Policy uncertainty in the midst of a natural resources boom”, Washington, DC: The World Bank.

<sup>15</sup> Sondergaard, L. et al. (2014) “Lao Development Report 2014: Expanding Productive Employment for Broad-based Growth”, Washington, DC: The World Bank.

an opportunity for growth, particularly if Lao PDR can tap the potential of young workers through productive employment opportunities. Without sufficient prospects for employment for these labor force entrants, poverty reduction and stability could be undermined.

### **Key Challenges**

**5. It is critical for Lao PDR to address a number of key workforce-related challenges in order to manage its demographic transition successfully and advance to the next stage of development.** These challenges include:

- *Overreliance on the natural resources sector.* While there has been a heavy reliance on the natural resources sector as an engine of growth, it does not create shared growth and employment. Because the sector has a high ratio of capital to labor, it was able to produce approximately 18 percent of Lao PDR's GDP in 2013 with only 22,000 people. Furthermore, the boom in the natural resources sector makes it relatively more difficult for the nascent manufacturing sector to grow, including by putting upward pressure on the exchange rate which makes manufacturing exports less competitive and by fueling a consumption and investment boom which can put upward pressure on wages. Such upward pressure on wages is one possible reason why manufacturing workers have seen their wages rise by approximately 12 percent per year in the past 5 years, well above labor productivity growth.
- *Low productivity in the agricultural sector.* Because most of the labor force is currently engaged in agriculture, improving livelihoods for those in the sector is critical to reducing poverty in Lao PDR. However, an estimated 7 in 10 Lao workers are still mainly employed in low-productivity agricultural jobs that keep them on the farm despite lower living standards. This is particularly troubling considering that about 1 million children under the age of 10 live on farms and face dim prospects for breaking out of poverty.
- *Limited opportunities for higher-paying, higher-productivity jobs.* Countries develop by moving workers from low-productivity jobs in agriculture to higher-paying, higher-productivity jobs in manufacturing and services. However, the Lao manufacturing sector appears to struggle to attract workers, and numerous factors discourage the investment necessary to help boost productivity (and therefore wages) in the sector. As illustrated by Figure 27, the share of the manufacturing sector in terms of both output and labor in the overall economy has remained very low relative to the natural resources sector and the construction and services sector in recent years.
- *Very low levels of literacy.* The skills problem in Lao PDR is deeper and more severe than is generally recognized, being a problem not simply of vocational skills but of even basic reading and numeracy skills. An Early Grade Reading Assessment showed that over 30 percent of 2nd graders could not read a single word, and among those who could read, 57 percent did not understand what they had just read (Figure 28). In an adult

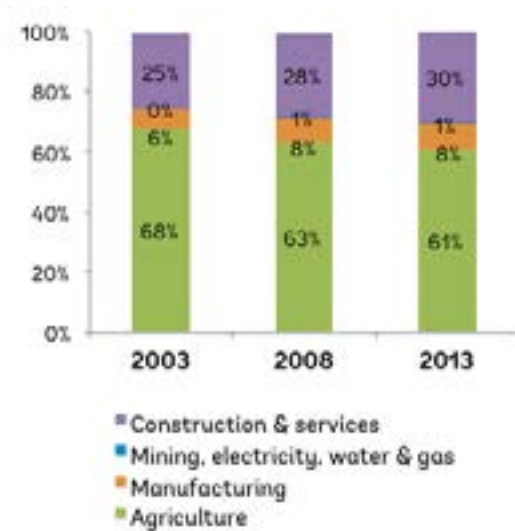
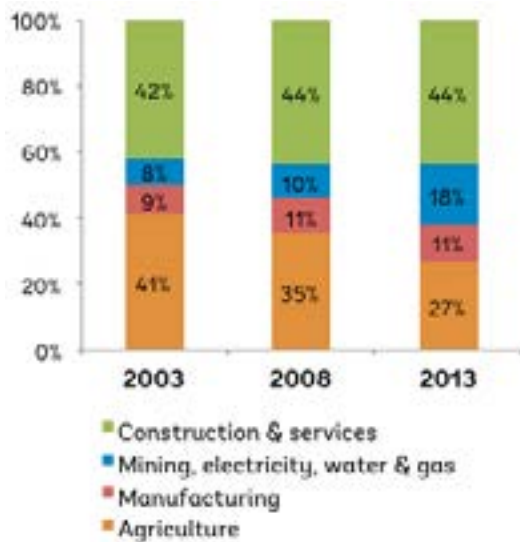
literacy assessment carried out in six countries around the world—including Vietnam, Yunnan Province (China), and Lao PDR—adults in Lao had the poorest literacy skills among the adults tested. Post-secondary graduates in Lao PDR performed almost on par with people with only primary schooling in Vietnam

(Figure 29). Given how important reading ability is for learning more advanced skills, the low level of basic literacy has serious implications for the country’s productivity, growth, and competitiveness.

**Figure 27: Sectoral breakdown of output and labor in the overall economy of Lao PDR**

Composition of economy by amount of output produced by each sector (measured as value-added and expressed in % of total value-added)

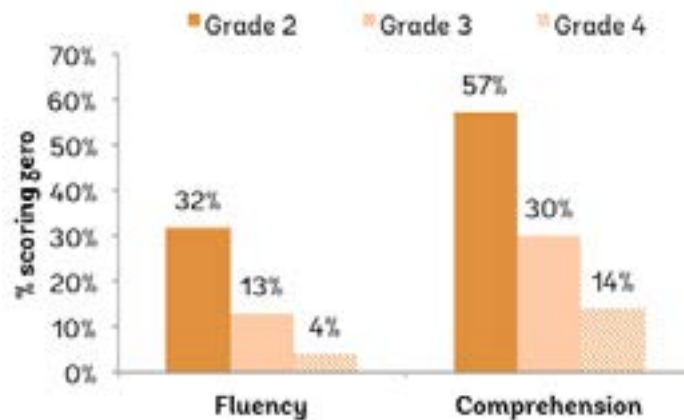
Composition of economy by amount of hours worked in each sector (in % of total)



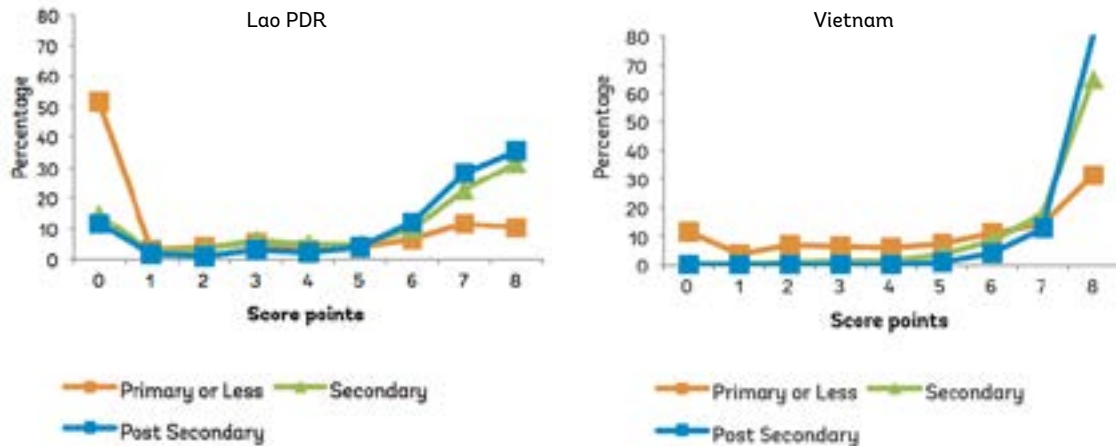
Source: National Statistical Center of Lao PDR

Source: Authors’ calculations based on LECS III, IV, and V

**Figure 28: Early Grade Reading Assessment for Lao PDR**



Source: World Bank (2014). “2012 Lao PDR EGRA Survey Report” [draft].

**Figure 29: Comparison of adult literacy by education level in Lao PDR and Vietnam**

Source: STEP Household survey 2011/2012. Within the survey, there is a literacy assessment designed by Educational Testing Service (ETS)

Note: Graphs show scores on basic literacy test (from 0-8 points) for adults with different education levels in Lao PDR and Vietnam

### The Way Forward

6. Given that the majority of the country's workforce is currently engaged in agriculture, raising agricultural productivity is arguably the top development priority for Lao PDR. In the shorter term, higher agricultural productivity will help generate better livelihoods for the 4.5 million Lao people living on farms. Over the longer term, increased productivity on the farms would eventually lower the need for labor, freeing up agricultural workers to move to more productive jobs in other sectors. In particular, greater attention is needed in two areas:

- *Facilitating trade in paddy and rice to encourage private investment in milling, which would help reduce milling costs and give farmers greater incentive to increase production for export;*
- *Making better use of public resources supporting rice farmers, with a more balanced approach in allocating resources for extension activities, technology development and transfer (including good seed), and irrigation.*

7. As agricultural productivity increases and more workers are able leave farming, the Lao economy will need to generate more attractive off-farm jobs to absorb these workers. Contrary to what media reports might suggest, Lao PDR is not facing a labor shortage, as it has a very large "reservoir" of farm workers that could potentially move to the non-agricultural sectors; rather, Lao PDR has a shortage of attractive job opportunities that make it worthwhile for a farmer to give up farming. To help create more attractive off-farm employment opportunities, barriers to doing business in Lao PDR must be removed to encourage investment and spur productivity growth in diversified sectors. In particular, action is needed on three fronts:

- *Streamlining and simplifying the business compliance and transaction costs associated with dealing with Government to create a more business-friendly environment;*
- *Improving transparency in the provision of public sector services to business through measures such as publication of all fee schedules, permits, and licensing requirements; and*



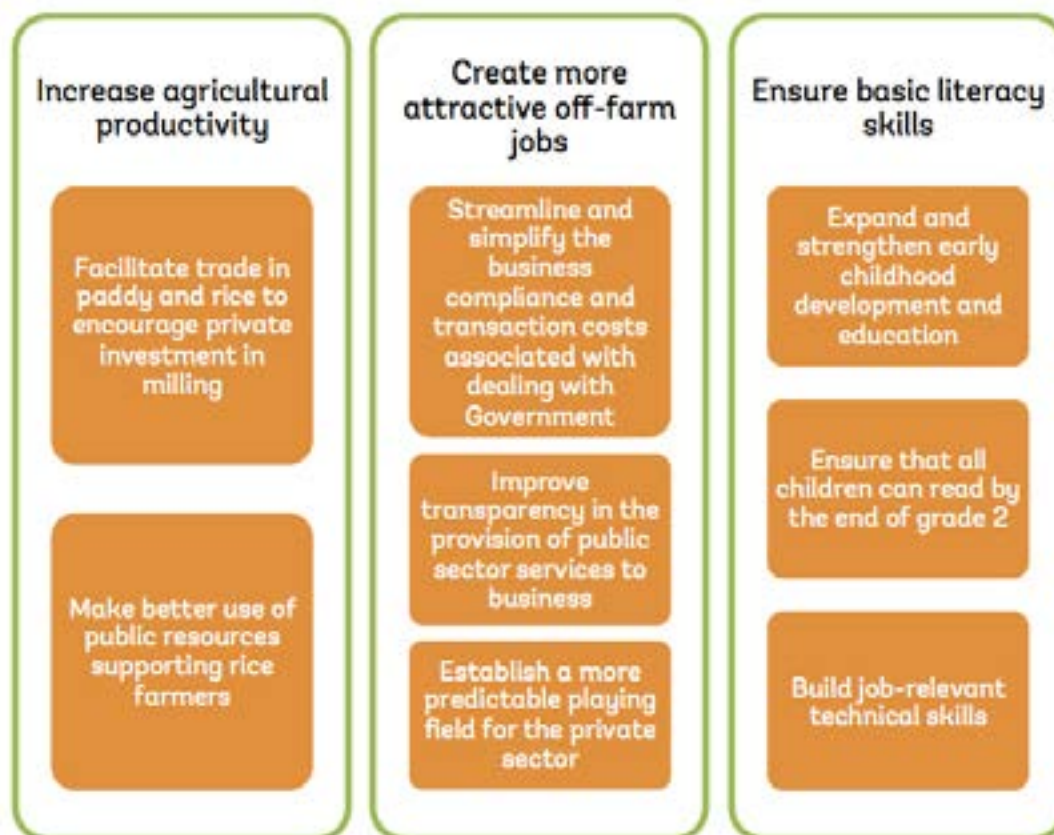
- *Establishing a more predictable playing field for the private sector, with consistent implementation of publicly available legislation, rules, and regulation and with reduced bureaucratic discretion.*

**8. As greater diversification generates more productive employment opportunities, it will be critical to ensure that the Lao workforce is equipped with the knowledge and skills to be able to take up these jobs.** Greater priority should be placed on cultivating a workforce that possesses the basic foundational skills needed to be productive. Resources need to be focused more effectively on the critical windows of opportunity when skills are built by:

- *Expanding and strengthening early childhood development and education to help develop school readiness skills and basic cognitive and behavioral skills, which also includes efforts to reduce chronic malnutrition which threatens cognitive development;*
- *Ensuring that all children can read by the end of grade 2, making reading a national obsession so Lao PDR can build a skilled and productive workforce; and*
- *Building job-relevant technical skills, with the Government taking on a more strategic role in vocational skills development by developing policies, setting standards, investing in training materials and instructors, improving public information about the training system, and carrying out training evaluations.*

**9. In the process of planning specific reforms in these areas, it will be critical for policies to be grounded in better information.**

For example, policies affecting the workforce should be based on a complete and accurate picture of labor market dynamics—what is happening, who is affected, what the implications of potential policies might be. However, crucial information on sectoral employment, migration, and other labor market indicators are lacking. Instruments such as a labor force survey could help provide essential information for policymakers to understand the key challenges and design appropriate solutions. Further work is also needed to understand the array of factors affecting the workforce-related challenges discussed above, including determining why manufacturing wages have been rising faster than labor productivity and identifying other barriers to worker mobility between jobs and sectors.



## Annex 1: Lao PDR At A Glance



	2011	2012	2013	2014	2015
				Est	Proj
<b>Output and prices (percent change, unless otherwise indicated)</b>					
Real GDP	8.0	8.0	8.5	7.5	6.4
<i>(excluding resources, percentage points)</i>	4.4	4.8	6.0	6.6	4.4
GNI per capita (in US dollars)	1100	1260	1460	1570	..
Consumer prices (% change, period-average)	7.6	4.3	6.4	4.2	5.0
<b>Public finances (in percent of GDP) 1/</b>					
	FY10/11	FY11/12	FY12/13	FY13/14	FY14/15
Total revenue	22.1	23.9	23.0	23.2	22.8
Domestic Revenue	16.4	17.3	17.4	17.9	17.9
Domestic Revenue (non-resource)	13.0	13.0	13.7	14.8	15.4
Domestic Revenue (excl. mining)	13.6	14.0	14.6	15.9	16.4
Grants	5.7	6.6	5.7	5.3	4.9
Expenditure	24.9	25.2	29.1	27.5	27.1
Expenditure	24.9	25.2	29.1	27.5	27.1
Current	10.4	11.0	16.3	14.8	15.2
Capital and on-lending	12.9	13.4	12.2	12.1	11.3
Overall budget balance (deficit)	-2.7	-1.3	-6.0	-4.3	-4.2
Overall budget balance (deficit, excl. mining)	-5.6	-4.6	-8.8	-6.3	-5.7
Overall budget balance (deficit, excl. hydro and mining)	-6.2	-5.6	-9.8	-7.4	-6.8
<b>Balance of payments</b>					
Current account balance (% of GDP)	-9.8	-12.7	-11.5	-11.2	-11.5
Capital account balance (% of GDP)	9.2	13.4	10.8	12.5	12.0
Overall balance (% of GDP)	-0.6	0.6	-0.7	1.3	0.5
Gross official reserves					
In millions of US dollars	679	740	662	815	884
In months of imports of goods and services	2.3	1.9	1.5	1.7	1.7
<b>External public debt stock /<sup>2</sup></b>					
In millions of US dollars (end period)	3,769	4,500	5,092	5,601	6,118
In percent of GDP (end period)	46.7	47.7	48.3	48.5	48.7
External public debt service					
PPG debt service-to-exports ratio (in percent)	2.7	4.1	5.1	4.8	5.2
PPG debt service-to-revenue ratio (in percent)	7.4	9.8	12.4	11.2	12.3
<b>Monetary Sector</b>					
Credit growth	48.1	26.6	34.5	14.2	15.0
Broad money growth	29.0	31.0	17.0	20.0	20.0
<b>Memorandum items:</b>					
Nominal GDP (millions of US dollars)	8,234	9,390	11,187	11,837	13,030
Exchange rate (kip/US\$, average)	8,058	7,982	7,862	8,035	8,035

Sources: Staff estimates and projections based on data provided by the Lao authorities.

1/ Fiscal year basis (October to September).

2/ DSA 2014 data



## Annex 2: East Asia And Pacific: GDP Growth Projections

	2012	2013	2014	2015
			Est.	Forecast
World	2.4	2.5	2.6	3.0
High income	1.4	1.4	1.8	2.2
Developing countries	4.8	4.9	4.4	4.8
East Asia and Pacific	7.4	7.2	6.9	6.7
China	7.7	7.7	7.4	7.1
Indonesia	6.3	5.8	5.1	5.2
Malaysia	5.6	4.7	5.7	4.9
Philippines	6.8	7.2	6.4	6.7
Thailand	6.5	2.9	0.5	3.5
Vietnam	5.2	5.4	5.4	5.5
Cambodia	7.3	7.4	7.2	7.5
Lao PDR	8.0	8.5	7.5	6.4
Myanmar	7.3	8.3	8.5	8.5
Timor Leste				
East Asia - exclude	6.3	5.3	4.6	5.2
China				
ASEAN	5.7	5.0	4.5	5.0

Source: EAP Economic Update October 2014, Global Economic Prospects January 2015





The World Bank Lao PDR  
Patouxay Nehru Road  
P.O Box: 345  
Vientiane, Lao PDR  
Tel: (856-21) 266 200  
Fax: (856-21) 266 299  
[www.worldbank.org/lao](http://www.worldbank.org/lao)

The World Bank  
1818 H Street, NW  
Washington, D.C. 20433, USA  
Tel: (202) 4731000  
Fax: (202) 4776391  
[www.worldbank.org](http://www.worldbank.org)

