

Lao PDR Macroeconomic Update - May 2018

1. Introduction

This paper summarises both short-run macroeconomic performance (2017-2018) and medium-run macroeconomic performance (2011-2015) in Laos, with a view to inform DFAT policies and investments in Lao PDR. The assessment proceeds in two steps. The first step aims to characterize macroeconomic fluctuations with respect to economic growth, economic stability and economic prospects in 2017-2018. The second step aims to explain the key features of structural change with respect to inclusive growth, Laos-ASEAN trade, the linkages between growth and poverty dynamics, and human development. The paper was developed by LADLF based on a review of existing literature and analysis of national statistics (see References in Section 4).

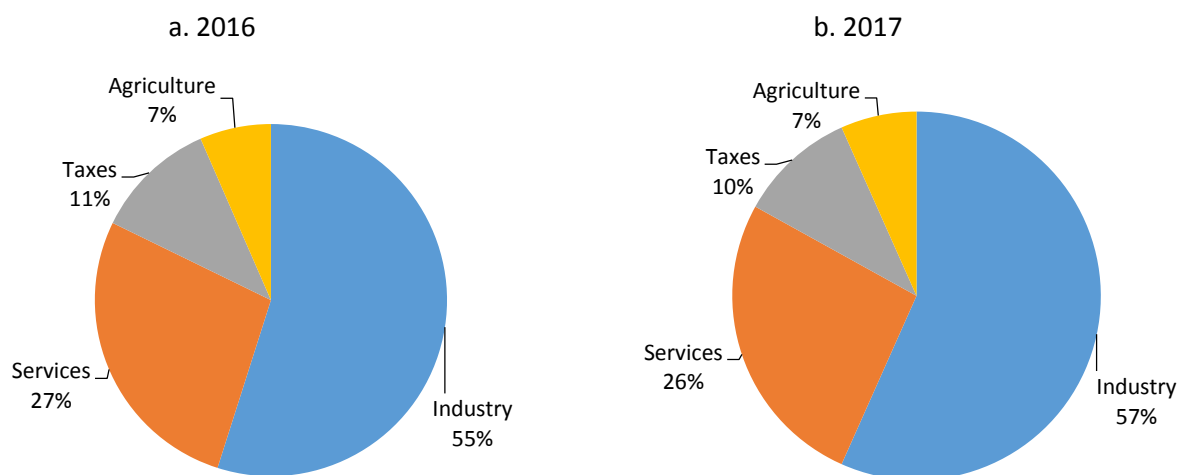
The assessment reveals that the Lao economy in 2017 grew slower than its past performance, but grew faster than the average growth rate of economies in Asia and the Pacific. The key sectors contributing to economic growth were electricity, construction, and services. These sectors will remain the key drivers of growth in 2018. Since the electricity, construction and service sectors have limited contribution to economic diversification and employment, economic growth will continue to have limited impact on poverty reduction and hence slowly improving inclusive growth and human development over the next few years.

2. Recent economic development

2.1 Economic growth

Recent economic growth of Laos showed a downward trend, dropping from 7.02% in 2016 to 6.9% in 2017. Industry sector was the largest sector contributing to economic growth. Its share in sectoral contribution to total economic growth rose from 55% in 2016 to 57% in 2017. The contribution of agriculture sector to total economic growth remained unchanged and recorded at 7%. In contrast, the contributions of service sector and taxes to total economic growth reduced from 27% to 26% and 11% to 10%, respectively, over the same period (Figure 1).

Figure 1: Sectoral contribution to economic growth (%), 2016 and 2017



Source: Author's calculation using data from NIER (2018).

Key elements of the industry sector included electricity (i.e., Namthern 2, Hongsa Lignite) and construction (i.e. Laos-China railway). Key elements of the service sector included wholesale and retail trade and financial services and insurance. Within the service sector, however, the tourist sector in Laos lagged behind that in neighboring countries. In 2017, Laos' tourist sector recorded a negative growth rate at 8.73%, while the tourist sector of Vietnam, Thailand, and Cambodia recorded positive growth rates at 29.05%, 8.76%, and 5.69%, respectively (NIER, 2018).

2.2 Economic stability

Monetary development and prices remained stable, but fiscal deficit and external balance raised concern over economic instability. Inflation rate continued to decline from 1.60% in 2016 to 0.83% in 2017 (NIER, 2018). Broad money supply and bank credit to the economy increased by more than 10%, which should increase domestic prices. But the contribution of money supply and bank credit to prices was offset by the fall of rice price and meat price due to the Government of Lao PDR's control measure in local markets. Parallel to the falling inflation rate was the depreciation of exchange rate of Kip against Thai Baht and US dollar, which contributed to the improvement of trade and current account balance and hence increasing international reserve.

However, low level of international reserve and high level of budget deficit constrain the use of monetary and fiscal policies to address adverse shocks such as disaster, currency and economic crises. According to NIER (2018), the level of international reserve accounted for only 1.4 months of total imports in 2017, which was lower than that of Vietnam (2.2 months), Cambodia (5.5 months) and Thailand (11 months). The low level of international reserve limits the role of the Bank of Lao PDR in foreign exchange market intervention for managing exchange rate and maintaining liquidity of foreign currency in the economy. In addition, fiscal deficit accounted for 5.7% of GDP in 2016-2017, which exceeded the threshold of fiscal deficit specified in the National Socio-Economic Development (NSED) for the period 2016-2020. The high level of fiscal deficit constrains domestic resource mobilization for supporting the implementation of NSED.

The high fiscal deficit raised the level of public debt from 59% of GDP (US\$9 billion) in 2016 to about 60% in 2017 (World Bank, 2017b, pp.22-23). 80% of total public debt was accounted by external debt, which was used to finance fiscal deficit. There are three main channels of external borrowings: multilateral borrowing, bilateral borrowing, and bond issuance. Bilateral borrowing made up of the largest source of total external debt. Bilateral creditors, mainly China, Thailand, and Japan accounted for 56% of total external public debt. Multilateral creditors, mainly the Asian Development Bank and International Development Association, accounted for 18% of total external public debt. Bond issuance accounted for 15% of total external public debt.

2.3 Economic prospects in 2018

In 2018, Laos' economic growth is estimated between 6.5-7% (NIER, 2018). Key sectors contributing to growth include electricity, construction, and services. Electricity generation will increase by 14% in 2018 due to the completion of new hydropower projects such as Nam Ou 2, Nam Ou 5, Nam Ou 6, Xekhaman 1, and Nam Mang 1. The growth of construction sector will mainly come from the on-going construction of Laos-China railway. The growth of service sector will mainly come from potential expansion of wholesale and retail trade due to the promotion of tourism.

3. Structural change

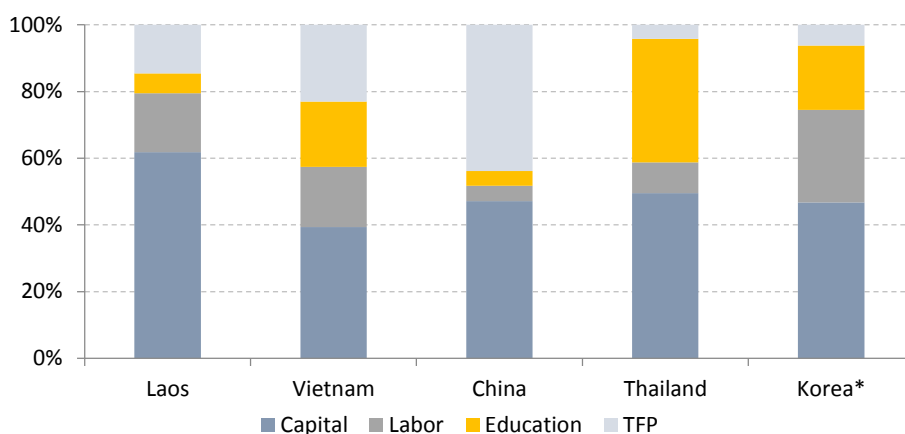
3.1 Inclusive growth

Inclusive economic growth refers to the broad-based economic growth driven by the non-resource sector which shares benefits of economic growth to every segment of society. Over the period 2011-2015, Laos has achieved rapid economic growth, but partially achieved inclusive economic growth. Growth rate of the Lao economy, measured by the annual growth of real gross domestic product (GDP), recorded at 7.8% over the period 2011-2015, which was almost twice higher than the average growth rate of GDP (4.1%) for economies in East Asia and the Pacific over the same period. Sustaining rapid GDP growth raised the level of its real GDP

per capita by 28%, increasing from US\$1,216 in 2011 to US\$1,557 in 2015 (World Bank, 2017c). This is an encouraging result for utilizing economic growth as an instrument to narrow income gap across countries in the region and to fight poverty in poor countries.

GDP growth in Laos has been mainly driven by growth in physical capital accumulation. Sources of GDP growth can be categorised into four factors: physical capital, education, labour input, and total factor productivity (TFP) based on the augmented Solow-growth model (Lee & Hong, 2012; Park, 2012). Figure 2 below illustrates the contributions of the growth of each factor to the growth of real GDP for Laos and some selected Asian countries over the period 2011-2015. It shows that the growth rate of physical capital accounted for 62% of GDP growth in Laos, which was higher than other Asian countries such as Vietnam, China, Thailand, and Republic of Korea. In contrast, education was the smallest contributor to growth in Laos, which accounted for only 6% of GDP growth.

Figure 2: Sources of GDP growth for Laos and selected Asian countries, 2011-2015



Note: * Republic of Korea. TFP stands for total factor productivity.

Source: Author's calculation using data from World Bank's database, 'World Development Indicator', available at <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>.

Figure 3: Types of investment in Laos, 2011-2015

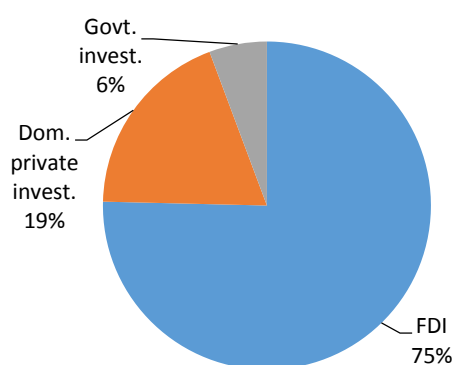
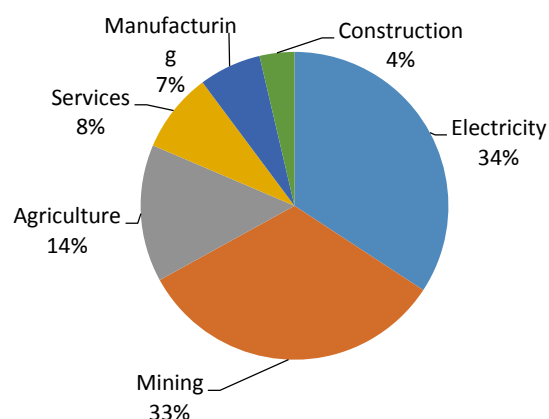


Figure 4: Sectoral distribution of FDI in Laos, 2011-2015



Note: 'Govt. invest.' stands for 'government investment'. 'Dom. Private invest.' stands for 'domestic private investment'. Data on types of investment and sectoral distribution of FDI are based on value of approved investment projects.

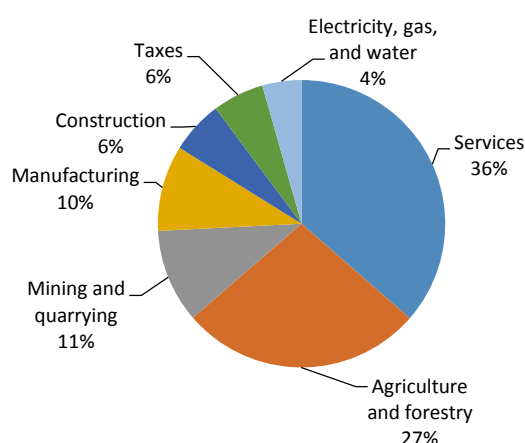
Source: Author's calculation using investment data from Ministry of Planning and Investment (2017).

The growth in physical capital accumulation has been driven by foreign direct investment (FDI) inflows. Figure 3 shows the proportion of three types of investment in Laos during 2011-2015: FDI, domestic private investment, and government investment. FDI accounted for 75% of total investment, while domestic private investment accounted for only 19% of total investment (Figure 3). About two thirds of FDI inflows concentrated in electricity and mining sectors (Figure 4). It is still unclear whether rapid economic growth driven by FDI in Laos has resulted in the diversification of economic activities and generated sufficiently large number of jobs in the country.

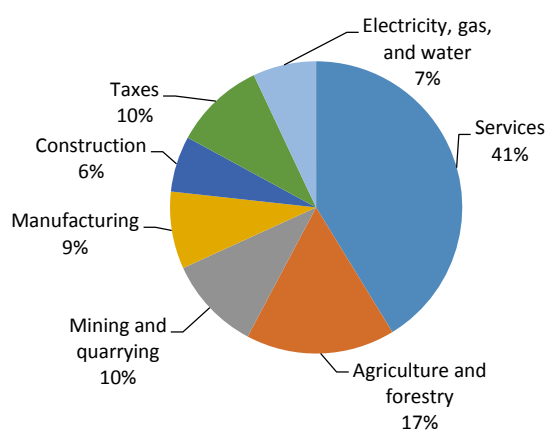
The service and electricity sectors have increasingly become the key driver of economic growth in Laos. The share of services in GDP increased from 36% in 2011 to 41% in 2015, while the share of electricity in GDP increased from 4% to 7% over the same period. Meanwhile, the share of agriculture and forestry in GDP reduced from 27% to 17% in the same period. The shares of manufacturing and construction in GDP remain unchanged or slightly decreased (Figure 5). According to World Bank (2017a, p.14), the expansion of services has been resulted from the liberalization of trade, tourism, banking, and transport sectors, and spillovers from natural resource projects.

Figure 5: Sectoral distribution of GDP in Laos (%), 2011 and 2015

a. Sectoral distribution of GDP in 2011



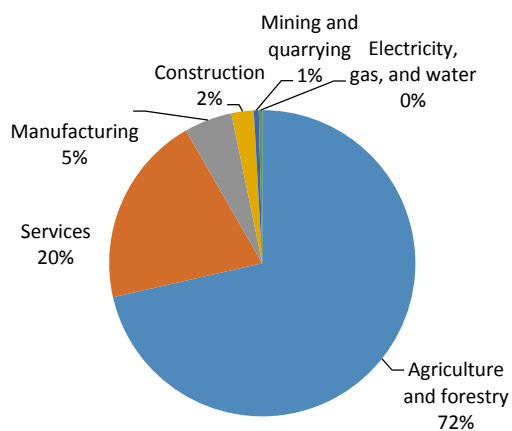
b. Sectoral distribution of GDP in 2015



Source: Data for 2011 were obtained from Lao Statistics Bureau (2012, p.28). Data for 2015 were obtained from Bank of Lao PDR (2016, p.20).

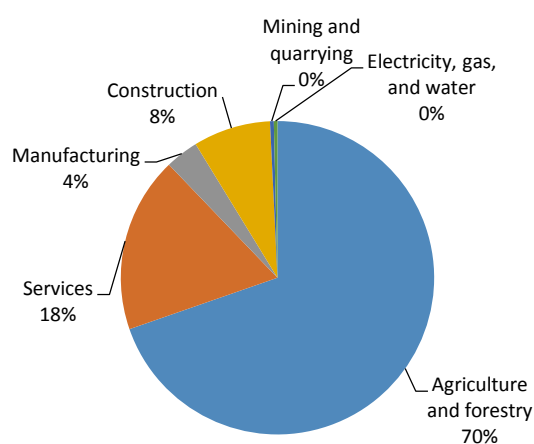
Figure 6: Sectoral distribution of employment in Laos, 2010 and 2015

a. Sectoral distribution of employment in 2010



Source: Author's calculation using data from Lao Statistics Bureau (2010, p.79).

b. Sectoral distribution of employment in 2015



Source: Author's calculation using data from Lao Statistics Bureau (2015, p.81).

Significant changes in the structure of outputs have been associated with limited changes in the structure of employment for the period 2010-2015. The analysis of outputs in Figure 5 and employment in Figure 6 reveals three salient features of structural change in the Lao economy.

- Increased share of services in GDP was not associated with greater share of employment within the sector. The share of employment in the service sector fell from 20% of total employment in 2010 to 18% in 2015 (Figure 6). This may reflect productivity improvement in services, which could produce more outputs without hiring additional labours. Further expansion of the service sector is needed to absorb additional labour force.
- The agriculture and forestry sector has been characterized by low productivity. The share of employment in agriculture and forestry sector accounted for 70% in 2015 (Figure 6b), but it could generate real output for only 17% of GDP (Figure 5b). This confirms the need for improving productivity and promoting investment in manufacturing and service sectors to absorb surplus labour in agriculture. Employment in the manufacturing sector, for instance, accounted for only 4% of total employment, but its real output accounted for 9% of GDP.
- The construction sector has become one of the key sectors for generating jobs. The share of employment in the construction sector rose from 2% in 2010 to 8% in 2015 (Figure 6) although the share of its real output in GDP remained unchanged (Figure 5).

3.2 Trade between Laos and ASEAN

Bilateral trade between Laos and ASEAN has increased in absolute terms but decreased in its relative importance to each other's total trade. Parallel to the growth of Laos' total trade between 2007 and 2016 was the rise in its bilateral trade with ASEAN, which increased by almost five-fold from US\$0.81 billion in 2007 to US\$4.6 billion in 2016 (Figure 7). While ASEAN countries such as Thailand and Vietnam remain the key sources of Laos' imports, Laos has gradually exported more to rest of the world (non-ASEAN countries). In 2007, 61% of Laos' exports went to ASEAN countries (Figure 8). This changed since 2013, and in 2016, its exports to ASEAN was exactly equal to rest of the world. This indicates that the country has diversified its trading partners from ASEAN to rest of the world. The emerging export destinations for Laos include China, European Union, India, and Japan.

Figure 7: Laos' merchandise trade (exports and imports), 2007-2016 (US\$ billion)

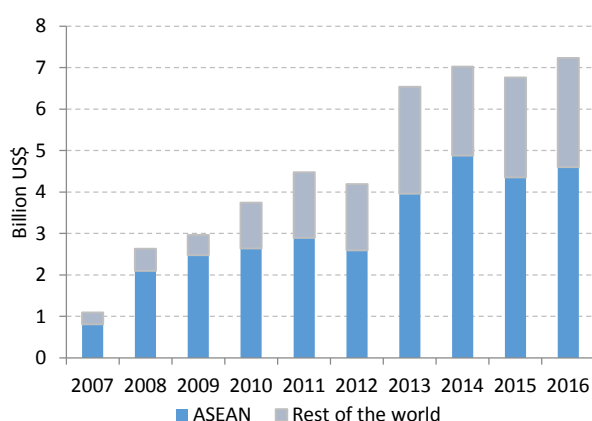
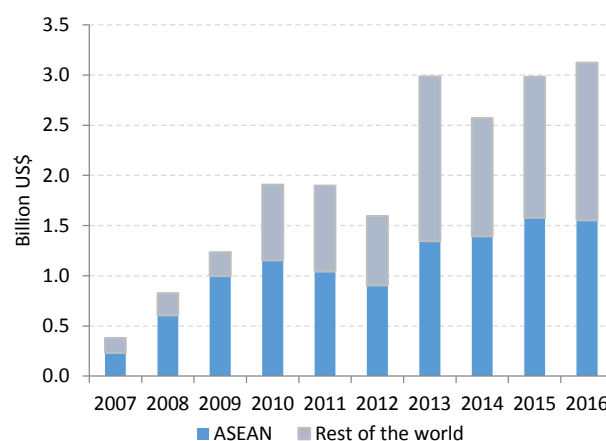


Figure 8: Laos' exports by destination, 2007-2016 (US\$ billion)



Source: Author's calculation using data from ASEAN's online database, available at <https://data.aseanstats.org/trade.php>.

While Laos has made good progress in diversifying its trading partners, its exports are highly dependent on a limited range of products to earn foreign exchange. According to World Bank (2017a, p.28), mining, electricity and wood accounted for three fourths of total exports over the period 2012-2016. High export concentration could make the economy more vulnerable to sector-specific shocks and shifts in terms of trade. Low diversification of export products could be attributed to the low intensity of foreign trade in the private sector, inadequately educated workforce to produce new export products, and the lack of incentives for firms to invest in new products. According to World Bank (2016), number of exporting firms in Laos accounted for only 6% of total firms; and about 33% of large firms ranked the difficulty to recruit adequately

educated workforce as the biggest business environment constraint. Furthermore, a study by Richard Record & Konesawang Nghardsaysone (2010) reveals that the rate of new product discovery has been high, but this process has essentially been overshadowed by the natural resources export boom. This suggests the need for improving a regulatory environment which minimizes business transactions costs to attract new export-oriented firms and to keep existing firms in the market, developing sector-specific workforce in line with potential export-oriented industry, and strengthening the enforcement of law on intellectual property right to stimulate research and development of new products.

3.3 Growth-poverty linkage

Rapid economic growth in Laos has translated into slow rate of poverty reduction over the past decade. Average GDP growth rate recorded at 7.1% for the period 2003-2007 and at 8.0% for the period 2008-2012 (World Bank, 2017c). In contrast, poverty rate reduced by 1.18 percentage points per year for the period 2003-2007 (dropping from 33.5% in 2002/03 to 27.6% in 2007/08), about six percentage points less than the average GDP growth for the same period. The rate of poverty reduction reduced by 0.88 percentage points per year for the period 2008-2012 (dropping 27.6% in 2007/08 to 23.2% in 2012/13), about seven percentage points less than the average GDP growth for the same period (Pimhidzai, Fenton, Souksavath, & Sisoulath, 2014). It is important to note that annual rate of poverty reduction is lower in the high growth period (2008-2012) than in the low growth period (2003-2007).

Poverty reduction in Laos is driven by improved skills and knowledge, increased access to land, and non-farm job creation (Pimhidzai, 2015). Improved skills and knowledge, proxy by the level of education, facilitate the transition into better rewarding non-farm economic activities, with the highly skilled moving out of agriculture completely and low skilled diversifying their income portfolio from agriculture. The analysis of poverty determinants by Pimhidzai (2015) indicates that an agricultural, non-LaoTai household with at least one person with post primary education was at least 80% chance to move out of poverty, compared to the 47% chance faced by a similar household without anyone with formal education. More broad-based economic growth is necessary to further reduce poverty across locations and socio-economic groups.

Despite notable achievement of poverty reduction over the past decade, poverty rate is still high in rural area and among ethnic minority groups. In 2012/13, the majority of the poor were rural residents which accounted for 88% of total poor people. By ethnicity, the proportion of the poor remained highest in LaoTai (44.4% of total poor people), followed by Mon-Khmer (40.3% of total poor people) and Hmong-Lu-Mien (12.1% of total poor people). By gender of household head, poverty headcount rate was significantly lower among female headed (17%) than male headed households (24%) (Pimhidzai et al., 2014). In addition, income inequality within urban areas and between rural and urban areas is rising. This is not well reflected in the aggregate indicator such as Gini coefficient, which slightly increased from 35.0 in 2007/08 to 36.2 in 2012/13. The increase of Gini coefficient was resulted from a slowdown of growth in incomes of the non-poor in rural areas rather than faster growth of incomes among the poor. This offset rising inequality in urban areas where growth of incomes of the non-poor was high.

3.4 Human development

Parallel to the downward trend of poverty is the improvement of human development—a non-monetary measure of poverty. Human development index (HDI) rose from 0.397 in 1990 to 0.463 in 2000 and 0.554 in 2015. The annual average HDI growth during 1990-2015 was 1.57, which was the third fastest HDI- growth country in ASEAN, after Cambodia and Myanmar (UNDP, 2018). Its relative position in the world and in ASEAN has, however, remained unchanged. At the global level, Laos ranked 138th of 187 countries in 2015, which was the same as its ranking in 2012. At the regional level, Laos has constantly been the third lowest HDI in ASEAN from 1990 to 2015. An explanation for this is that Laos started to develop its human capital from very low level of HDI compared to other ASEAN countries. Given the rapid growth of HDI, however, Laos will catch up with other ASEAN countries in the long run.

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