

Lao PDR Economic Monitor

Maintaining Economic Stability

Thematic section:
Constraints to Doing Business for SMEs

August 2019
Macroeconomics, Trade and Investment
East Asia and Pacific Region



Executive Summary

Economic growth in Lao PDR is projected to rebound to 6.5 percent in 2019, up from 6.3 percent in 2018. This pick up is expected to be driven by growth of the construction sector supported by investments in large infrastructure projects, and a resilient services sector, led by wholesale and retail trade growth. The Government has remained committed to fiscal consolidation to contain public debt in the medium term by tightening public expenditure and improving revenue administration. The medium-term outlook remains broadly favorable, but subject to downside risks from heightened uncertainty in the global and domestic environments. Prolonged trade tensions among major economies could dampen growth prospects in Lao PDR's major trading partners, and spillover to the domestic economy through lower trade and investment, and reduced prices for key export commodities. The authorities may face difficulty in responding to such economic shocks given the low level of foreign currency reserves and significant external public debt. A priority is therefore to create fiscal space through improving tax policy and administration as well as build up reserve buffers to respond to shocks. Additionally, improving the business environment and reversing the decline in the global ranking of the ease of doing business, particularly for small and medium-sized enterprises, could also contribute to greater macroeconomic stability, job creation and poverty reduction.

Part I: Recent Economic Developments and Outlook

1. Economic growth in Lao PDR is expected to recover to 6.5 percent in 2019, from 6.3 percent in 2018. Despite continued fiscal tightening, the rebound in growth in 2019 is projected to be mainly driven by: (i) robust growth in the construction sector, driven by strong investment inflows to large infrastructure projects, including the Lao-China railway, of which civil work is reported to be around 70 percent completed by mid-2019; and (ii) a resilient services sector led by wholesale and retail trade growth associated with robust construction.

2. Continued fiscal consolidation contributed to a slowdown in the accumulation of public debt in 2019. Preliminary Q1-2019 estimates indicate the continued containment of investment spending. At the same time, improved revenue administration and modernization contributed to better performance in excise, profit, value-added taxes and non-tax revenues. This is expected to reduce the budget deficit to 4.3 percent of GDP in 2019 from 4.4 percent in 2018. As a result, the public debt to GDP ratio is an estimated 58 percent of GDP in 2019, slightly up from 57.2 percent in GDP in 2018. However, the public debt ratio to GDP is expected to decline to below 56 percent by 2021 and the risk of debt distress remains high. In this context, the Government of the Lao PDR (GoL) intends to borrow only on concessional terms for projects with high economic and social returns. The GoL also suspended public projects with low economic returns that have not yet started to disburse. Additionally, to further lower the need for external borrowing and strengthen supervision on dam safety, the GoL has instituted a moratorium on all new hydropower projects.

3. The current account deficit is expected to widen slightly to 12 percent in 2019 reflecting strong demand for imports related to investments in large infrastructure projects.

During January-May 2019, exports earnings remained relatively stable as strong exports of crops and semi-processed products offset a decline in mining exports that were principally affected by lower metal prices. In contrast, imports grew slightly and the increase in demand for machinery and equipment more than offset the fall in the fuel imports. The current account deficit is mainly financed by foreign direct investment (FDI) associated with large infrastructure projects. Foreign currency reserves marginally picked up to US\$885 million in March 2019 from US\$873 million at end 2018. Nevertheless, foreign reserves buffers remain low at 1.2 months of total imports (or 2.4 months of non-FDI-related imports) in 2019. Therefore, building foreign currency reserves is a priority to provide a cushion against economic shocks.

4. External and domestic factors contributed to the depreciation of the Lao kip in the first half of 2019.

The average kip exchange rate in the first half of 2019 weakened by 3.8 percent against the U.S. dollar and 4.7 percent against Thai baht compared to the average in the first half of 2018. Domestic factors include: (i) continued robust demand for foreign currency for imports and external debt repayments; and (ii) rising demand for foreign currency as a hedge against exchange rate depreciation. External factors include a strong U.S. dollar and Thai baht against regional currencies. More flexibility of the exchange rate within the band contributed to the narrowing of the premium between the official and parallel exchange rates to below 3 percent (on average) during January-June 2019.

5. Price pressure started to mount in the first half of 2019 while credit growth also slightly picked up.

The average inflation rate in the first half of 2019 increased to 2 percent from 1.7 percent over the same period in 2018. This was driven by: (i) higher food prices, particularly rice prices, which increased by almost 13 percent due to the disruption in rice production after the 2018 floods; (ii) some increase in fuel prices; and (iii) the depreciation of the kip against the Thai baht and the U.S. dollar, which increased the price of imported goods. Core inflation remained around 2 percent driven by higher prices in housing and hospitality sectors. Fiscal tightening and still-moderate credit growth, despite a recent modest pickup early this year, also contributed to low pressure on inflation.

6. The short-to-medium-term growth outlook of the Lao economy is expected to remain broadly favorable supported by construction of large infrastructure projects and operation of power projects.

Growth in the construction and service sectors is expected to remain robust in the short to medium term due to continued infrastructure investment. Overall investment will be supported by the ongoing construction of the Lao-China railway, the Vientiane-Vangvieng highway, and reconstruction and repair of infrastructure damaged by the 2018 floods. In addition, the upcoming completion of several large power projects, including the Sayaboury Hydropower Project, is expected to add an extra 2,200 MW of capacity. This is projected to boost generation capacity to almost 10,000 Megawatts by 2020, of which the majority is exported. In contrast, the contribution of the mining sector is expected to gradually decline as current investment matures without any new investment while the moratorium remains effective.

7. The medium-term fiscal framework is consistent with the path of fiscal consolidation set out by the GoL. The fiscal deficit is expected to decline to below 4 percent in 2021 from 4.4 percent of GDP in 2018. To achieve this deficit target, the GoL will focus on improving revenue mobilization and rationalize public expenditure. This fiscal consolidation, coupled with the recently approved public debt management law and upcoming debt management strategy, is expected to reduce public debt levels to below 56 percent of GDP in 2021 from an estimated 57.2 percent of GDP in 2018, reducing the debt repayment burden over this period.

8. The medium-term outlook is subject to increasing external and domestic risks. Heightened external risks include intensified and prolonged trade wars, heightened geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements. The escalating trade conflict between China and the United States, with its adverse impact on regional growth, could in turn dampen trade and investment flows from key economic partners and lower economic growth in Lao PDR. Such disruptions could also adversely impact the price of key export commodities. A worsening trade balance would place downward pressure on the value of the kip and increase the cost of servicing debt. In addition, the high level of external debt against low foreign reserves buffers limits the GoL's ability to respond to economic shocks. Domestic risks include: (i) natural disasters that can adversely affect economic activities and create fiscal pressure; (ii) slower progress in implementing planned measures on the revenue and expenditure fronts, including slower progress on public financial management reforms, which could jeopardize the containment of the fiscal deficit and public debt; and (iii) a slowdown in momentum with respect to doing business reforms and economic diversification.

9. To mitigate these risks, the key priorities include fiscal consolidation and the improving the business environment to promote sustainable growth in the long-run. The GoL has undertaken important revenue and expenditure measures to support fiscal consolidation. However, revenue collection needs to be strengthened to ensure that necessary spending can be carried out while keeping the deficit under control. The approved public debt management law, which seeks to strengthen public debt management and the GoL's commitment to limit new borrowing, can help better manage risks associated with public debt accumulation. Speeding up the formulation of a public debt management strategy is a priority. Additionally, improving the business environment and reversing the decline in the global ranking in terms of ease of doing business, particularly for small and medium-sized enterprises, would also contribute to greater macroeconomic stability, job creation and poverty reduction.

Part II: Constraints to Doing Business for SMEs

1. **Small and medium-sized enterprises (SMEs) constitute an important segment of the private sector in Lao PDR.** SMEs in Lao PDR account for about 99 percent of all registered firms in the country and about 82 percent of employment. Therefore, they are critically important for the livelihoods of the Lao people. However, highlighting their as-yet-unrealized potential in Lao PDR, these firms are estimated to account for under 20 percent of GDP as compared with about 40 percent in Thailand, and 32 percent in Malaysia and the Philippines¹. Improving the performance and prospects of SMEs is one important way to raise incomes and the quality of jobs, while helping the GoL to move closer to its goal of graduating Lao PDR from Least Developed Country status.

2. **Enterprise survey data suggest that formal SMEs are facing constraints in a range of areas – most notably access to finance, practices of informal competitors, and electricity.** First, access to finance has become a more acute constraint over the past two years. This phenomenon could be a combination of persistent factors such as the more caution on risky lending by the banking sector, a lack of SMEs proper business and financial planning and management, low financial literacy, lack of variety of financial services offered to SMEs, especially in rural areas, and high interest rates. Second, practices of competitors in the informal sector – such as poor compliance with regulations combined with inconsistent enforcement by the authorities – result in an unfair disadvantage for formal firms.² Additionally, despite steady progress in the coverage of electricity in recent decades, the access and availability of power remains an issue that affects the operations of SMEs. Firms report facing issues such as substantial delays in setting up a connection and inconsistent electricity supply, with these challenges being most prevalent for small firms and firms in rural areas.

3. **Addressing the aforementioned top constraints faced by SMEs is essential to unlock their potential.** Importantly, improving access to finance for SMEs, a key constraint, could be improved by: (i) improving the capacity of SMEs in business planning, financial management and adoption of proper accounting practices; (ii) diversifying financial products and services offered by banks and non-bank financial institutions; and (iii) improving credit information coverage for financial institutions and supervision authorities to help better assess risks and promote access to finance. In addition, improving efficiency and reducing the costs of formal bureaucratic processes could be an incentive for formalization of informal firms. In effect, creating a level playing field for SMEs through the consistent enforcement of rules and regulations could reduce the challenges associated with informal competitors. Finally, investing in improving the efficiency of the energy distribution network and electricity connections can markedly reduce the impacts on the business operation for SMEs.

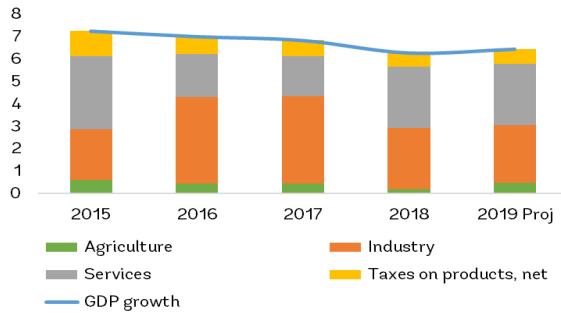
¹ World Bank Group (2017). “Systematic Country Diagnostic for Lao PDR”.

² ‘Practices of competitors in the informal sector’ is one of 15 categories of business obstacles that firms can identify in the enterprise survey. This could refer to practices such as inadequate registration and “flying under the radar”; tax evasion; irregular adherence of complex regulations; and non-compliance with basic rules and standards.

The August 2019 Lao PDR Economic Monitor in Figures

Growth moderated to 6.3 percent in 2018, affected by the floods, but is still driven by the services and industry sectors

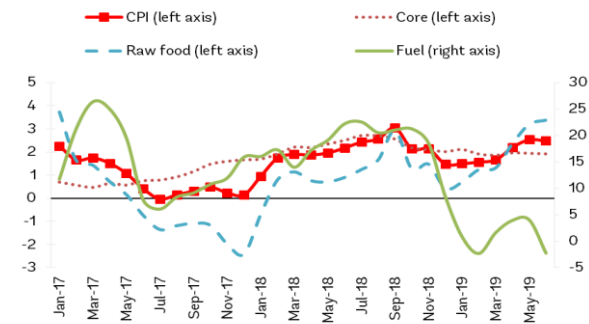
(Percent change)



Source: Lao Statistics Bureau

Headline inflation picked up in early 2019 due to an increase in food prices

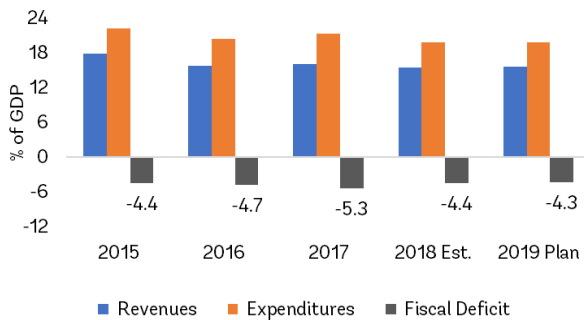
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Source: Lao Statistics Bureau

Expenditure controls have contributed to a lower fiscal deficit...

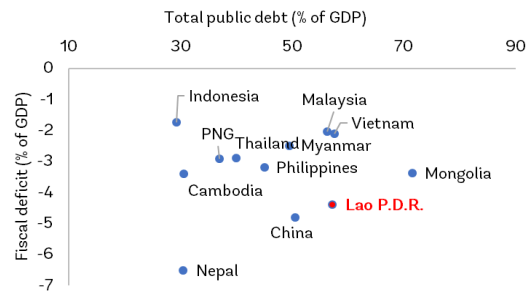
(Percent of GDP)



Source: MOF and World Bank staff estimates

...but public debt has remained relatively high compared to regional peers in 2018

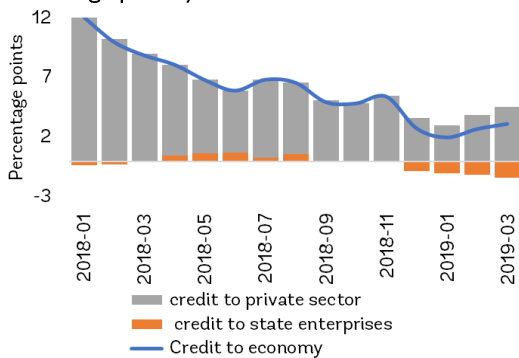
(Percent of GDP)



Source: MOF and World Bank staff estimates

Fiscal consolidation has also been linked to a slowdown in credit growth

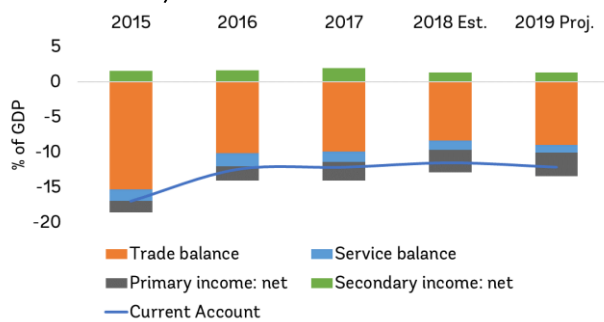
(Percentage points)



Source: BOL

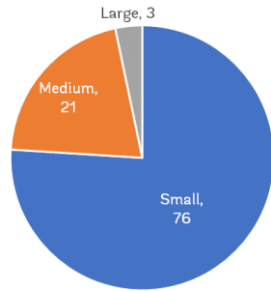
The current account deficit remains high, but mostly financed by FDI

(Percent of GDP)



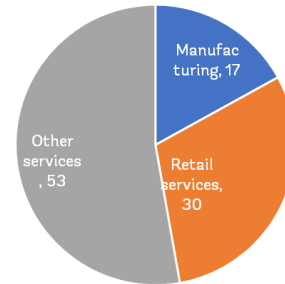
Source: BOL, trade partners' data and WB staff estimates

SMEs represent the majority of firms in Lao PDR
(Percentage share)

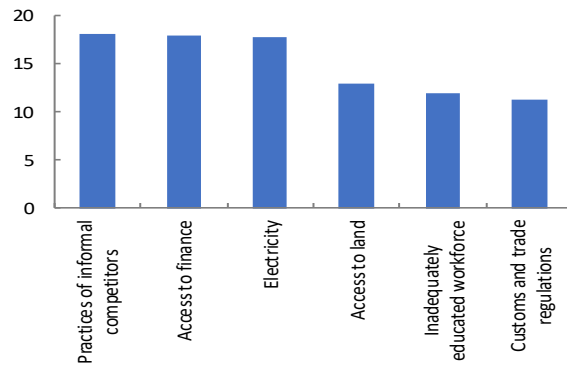
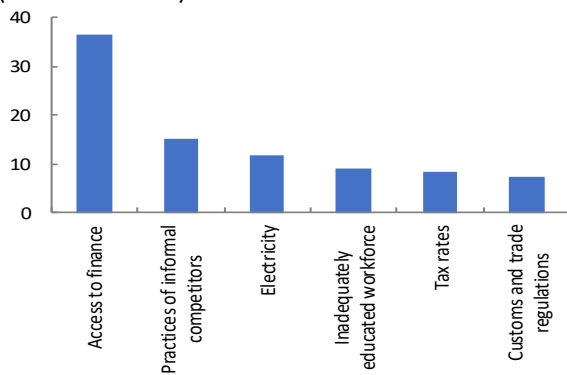


Source: WB Enterprise Surveys

The majority of SMEs are in the services sectors
(Percentage share)

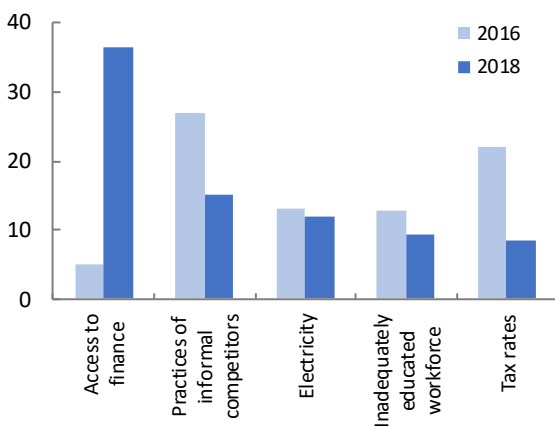


Main obstacles to the operations and growth of registered SMEs in Lao PDR include: (i) access to finance; (ii) practices of competitors in the informal sector; and (iii) electricity outages
(Percent of firms)

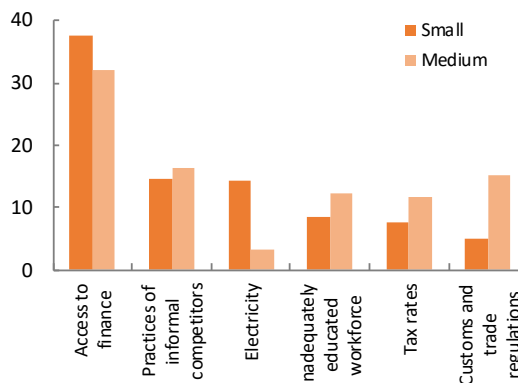


Source: WB Enterprise Surveys

Access to finance has recently become a more prominent obstacle
(Percent of firms reporting issue as biggest obstacle, 2016 and 2018)



The constraints faced by small and medium sized firms are not always the same
(Percent of firms reporting issue as biggest obstacle, small- versus medium-sized firms, 2018)



Source: WB Enterprise Surveys