Lao PDR Economic Monitor

Macroeconomic Stability amidst Uncertainty

Thematic section:

Building Human capital for Poverty Reduction

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Macroeconomics, Trade and Investment
East Asia and Pacific Region

WORLD BANK GROUP

Executive Summary

Part A: Recent Economic Developments and Outlook

1. **Although decelerating from 6.9 percent the previous year, economic growth in 2018 is estimated to remain robust at 6.5 percent.** The slowdown in growth in 2018 has been partly due to the following domestic factors: (a) the severe floods which hit the country during July–September 2018, and adversely affected agricultural production and damaged infrastructure in several provinces; (b) the weak performance of the mining sector despite higher commodity prices; and (c) continued fiscal consolidation, which contributed to slower credit growth. These downside factors offset the gains from the industry sector with the expansion of construction activities and electricity exports, and robust growth in wholesale and retail trade.

2. **There is evidence of increasing job creation between 2010-2017.** According to the 2017 Labor Force Survey[1], wage jobs are estimated to have gradually increased since 2010. This has resulted in 28 percent of households situated mostly in urban areas reporting an increase in income. As a result, ownership of consumption goods among the more affluent households increased faster than in poorer, mainly rural, households. Therefore, while poverty is still expected to decline modestly, inequality is likely to have increased.

3. **The Government intends to remain on the path of fiscal consolidation, with the deficit estimated to decrease to 4.7 percent of GDP in 2018 from 5.3 percent in 2017, owing to some improvement in revenue collection and expenditure restraint.** Improved revenue performance has been primarily driven by higher excise revenues due to increasing oil imports coupled with a higher price of oil. Other drivers include an increase in income taxes, dividend earnings, and other non-tax revenues. Strengthened revenue administration, such as the use of electronic tax payment platforms, has also supported revenue mobilization for certain tax types. Public outlays have been rationalized through tighter control of the public wage bill and downward adjustment of non-wage current spending. These measures offset an increase in capital spending financed by external loans and higher interest payments. Fiscal consolidation is estimated to have slowed the accumulation of public debt this year, though not enough to reverse the rising debt-to-GDP ratio, which is estimated to have risen from 60.1 to 60.6 percent of GDP between 2017 and 2018.

4. **The current account deficit is estimated to narrow in 2018, with the support of higher net exports.** Key exports have driven the increase in export earnings: electricity, due to more generation, and minerals, due to relatively higher metal prices despite flat output. These helped compensate for the decline in agricultural exports due to the impact of floods, and lower agriculture commodity prices such as rubber and coffee. Import growth slowed due to a moderation in import of consumption goods despite higher oil imports. As a result, the current account deficit is estimated to have declined to 11 percent in 2018 from 12.1 percent in 2017, with

[1] The labor survey was conducted in 2017 and published in 2018

the improvement in the trade balance. However, FDI inflows and external borrowing are inadequate to finance the current account deficit. This, together with repayments of debt obligations, contributed to lower foreign currency reserves. Reserves were recorded at US$ 812 million in October and are estimated to remain at this level at year end. At this level, the reserve buffer is expected to remain relatively low covering 1.1 months total imports in 2018 compared to 1.5 months in 2017.

5. **Increased pressure on the local currency has led to an upward shift in the exchange rate band, resulting in a depreciation of the exchange rate in 2018.** The official nominal kip/U.S. dollar reference rate has depreciated by almost 2 percent (yoy) in 2018 while the kip/baht exchange rate depreciated by 7.8 percent. Similarly, the real effective exchange rate for the first seven months in 2018 depreciated by 5.6 percent. The pressure on the kip emanates from both domestic and external factors. Domestic factors include: the restrictions placed on the purchase of foreign currency at commercial banks; and rising demand for foreign currency as a hedge against exchange rate depreciation. External factors include: a general strengthening of the U.S. dollar against emerging market economies' currencies; and higher demand for foreign currency for external debt repayment. The increased flexibility of the exchange rate within the band, a more active interbank market and moral suasion by the Bank of Lao PDR resulted in the spread between the official and parallel market exchange rates narrowing to below 2 percent (on average) in 2018, which is below the annual average spread of 2.5 percent for 2017.

6. **Rising core inflation coupled with higher food and fuel prices during most of 2018, and the depreciation of the kip against the currencies of its major trading partners, contributed to higher inflation in 2018.** Core inflation is estimated to have picked up from 0.9 to 2.3 percent yoy between 2017 and 2018 due to higher prices for household furnishings, clothing and footwear, and restaurants and hotels. The headline inflation rate has edged upward, in line with regional trends, to an estimated 2.1 percent in 2018, up from 0.8 percent the previous year. The headline inflation rate was driven by: (a) rising domestic retail fuel prices of 19 percent yoy; (b) a rise of 1.2 percent in fresh food prices due to the temporary disruption on food supply after the flooding; and (c) the depreciation of the kip against the Thai baht and the U.S. dollar, which resulted in higher import prices by an estimated 3.9 percent in 2018.

7. **While the policy interest rates remain unchanged in 2018 after the drop at the end of 2017, credit growth has continued to slow in 2018.** Banks' lending to the private sector and State-Owned Enterprises declined from 12 percent yoy in October 2017 to 5 percent in October 2018 due to the moderation of economic activity and tightening fiscal spending. As a result, total credit to GDP is estimated to slightly decline to about 51.5 percent in 2018 from 52 percent of GDP in 2017.

8. **In the near term, growth is expected to remain robust.** Growth in 2019–20 is expected to remain robust on the back of large hydropower projects expected to begin commercial operation during 2019-2020 and continued infrastructure investment. Further, the medium-term fiscal framework envisages a fiscal consolidation path that aims to stabilize and eventually put public debt on a more sustainable path. The budget deficit is expected to decline over the

medium-term from 4.7 percent in 2018 to 4.3 in 2019 and to below 4 percent in 2020 following revenue improvement and expenditure rationalization. The reduction in the fiscal deficit coupled with the positive impact of a more measured public borrowing strategy, in wake if the recently passed Public Debt Management Law, is expected to reduce the public debt/GDP ratio over 2019-20.

9. **The risks to this outlook continue to weigh on the downside.** Domestically, notwithstanding the efforts undertaken by government to consolidate the fiscal position, the fiscal deficit and public debt are at risk of remaining elevated if there is limited progress on domestic revenue mobilization coupled with increased expenditure on infrastructure projects, rising payments on debt service and disaster relief efforts owing to weather-related shocks. Additionally, key downside risks to growth include delay in the construction and operation of other pipeline power projects following the breakdown of the saddle dam of the Xe-Pian Xe-Namnoy project that triggered tighter supervision for safety. The risk of prolonged flooding may also dent growth in the agriculture sector. Furthermore, external risks include escalating and prolonged trade protectionism, heightened global and regional geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements and impact on global demand and commodity prices.

10. **Addressing the domestic risks associated with macroeconomic challenges remains a key priority, while building human capital can boost productivity and long-term growth.** Regarding fiscal and public debt management, the authorities should maintain reform momentum and make further progress as planned through enforcement of the current fiscal measures and maintain fiscal discipline. Promoting sustainable growth through investing in human capital and improving the business climate, particularly in the non-resource sector, should support job creation and promote inclusive growth.

Part B: Building Human Capital for Poverty Reduction

11. **Lao PDR has room for improvement to boost human capital – improving skills, health, knowledge, and resilience – to make its citizens more productive, flexible, and innovative.** Using elements of the Human Capital Index (HCI) developed by the World Bank under the Human Capital Project, the report sets out to answer three questions: (i) Why does human capital matter in the Lao PDR context? (ii) What is the status of human capital indicators? and (iii) How can Lao PDR further make progress in boosting human capital? Evidence shows that, despite progress, Lao PDR displays significant gaps in human capital outcomes and lags behind when compared to regional peers, leaving the country poorly prepared for achieving sustainable and inclusive growth.

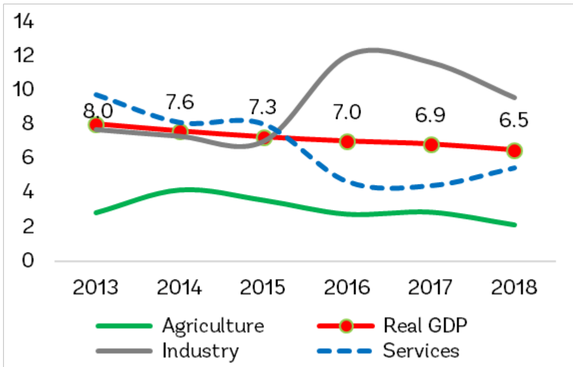
12. **In Lao PDR, the Human Capital Index PDR improved by 10 percent from 0.41 to 0.45 between 2012 and 2017 but is still lower that what would be expected for its income level.** What this means is that a child born today in Lao PDR will only be 45 percent as productive when she grows up as she could be if she enjoyed complete education and full healthcare. The country has made some good progress over the years: and delivers some basic education and health services such as working hospitals and schools, but the quality of the services offered is poor. Moreover, compared to compared to the average HCI attained by lower middle-income countries and EAP countries, Lao PDR still does perform poorly. In the region, Lao PDR's HCI is 0.45 in 2017 compared to 0.47 for Myanmar; 0.49 for Cambodia; 0.6 for Thailand and 0.67 for Vietnam.

13. **In Lao PDR, compared to other lower-middle income countries, stunting levels among children remain stubbornly high at 33 percent and the quality of education remains relatively low.** The proportion of children under-5-years of age who are stunted decreased from 48 percent to 33 percent between 2000 and 2017. Those children who are stunted are at risk of cognitive and physical limitations that can last a lifetime. In education, children in Lao PDR can expect to complete 10.8 years of schooling by the age of 18, but the quality-adjusted learning is relatively low at 6.4 years, implying a learning gap of 4.4 years. Moreover, access to quality education and, consequently, educational outcomes, have significant variation across (non-mutually exclusive) characteristics of geographic location, ethnicity, income and gender.

14. **A combination of systemic and sector specific interventions are needed to enhance human capital in Lao PDR.** Given limited fiscal space, systemic and sector-specific interventions will require prioritization of areas and population groups where education and health outcomes are relatively poor, i.e., in rural areas amongst the non-Lao Tai population who are usually at the lower income deciles. Interventions should be targeted at the poor and ethnic minorities to have the greatest likelihood of reducing disparities in health, education, and labor market outcomes. In many cases, this will require social and behavior change to stimulate demand for and consumption of these services as a large part of the unserved population are ethnic groups in remote areas.

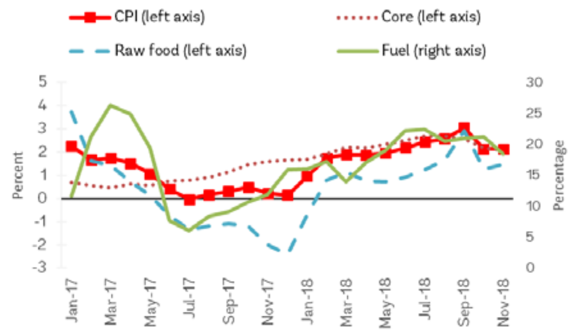
The January 2019 Lao PDR Economic Monitor in figures

Growth remained robust despite the recent floods…



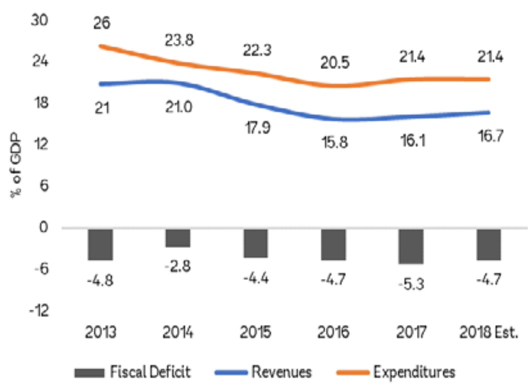
Source: LSB

Headline inflation has risen, but declined toward year end



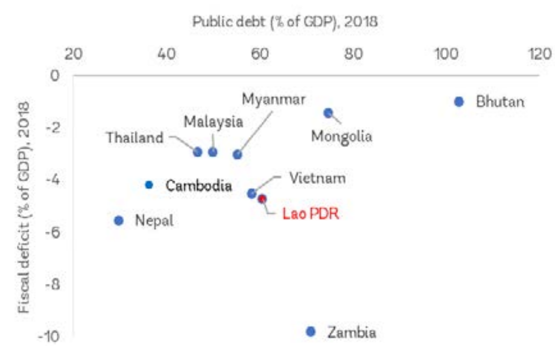
Source: LSB

The fiscal deficit remains high but is estimated to decline in 2018, following a fiscal consolidation plan



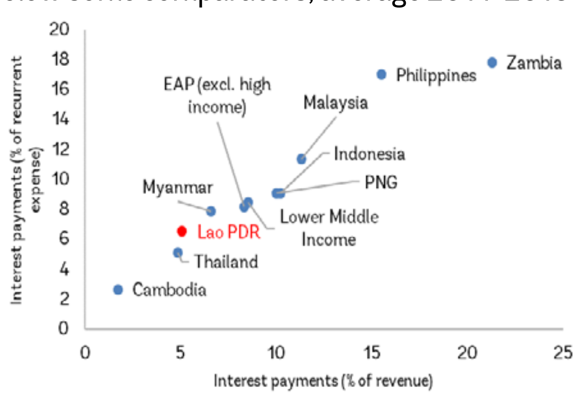
Source: MOF

Despite recent fall, the persistent fiscal deficit still results in high public debt in 2018



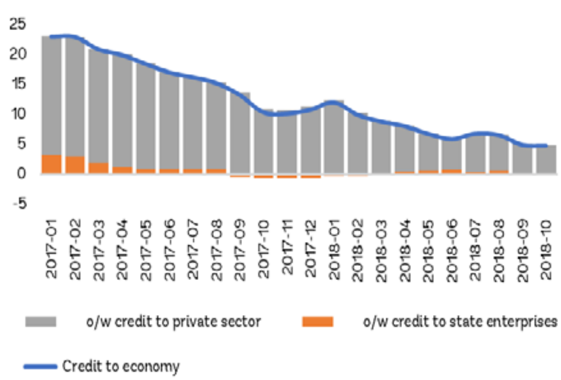
Source: MOF, IMF *WEO October 2018.*

Lao PDR's debt services ratios to revenues and recurrent spending have risen, but remain below some comparators, average 2014-2016



Sources: MOF, WDI and IDS

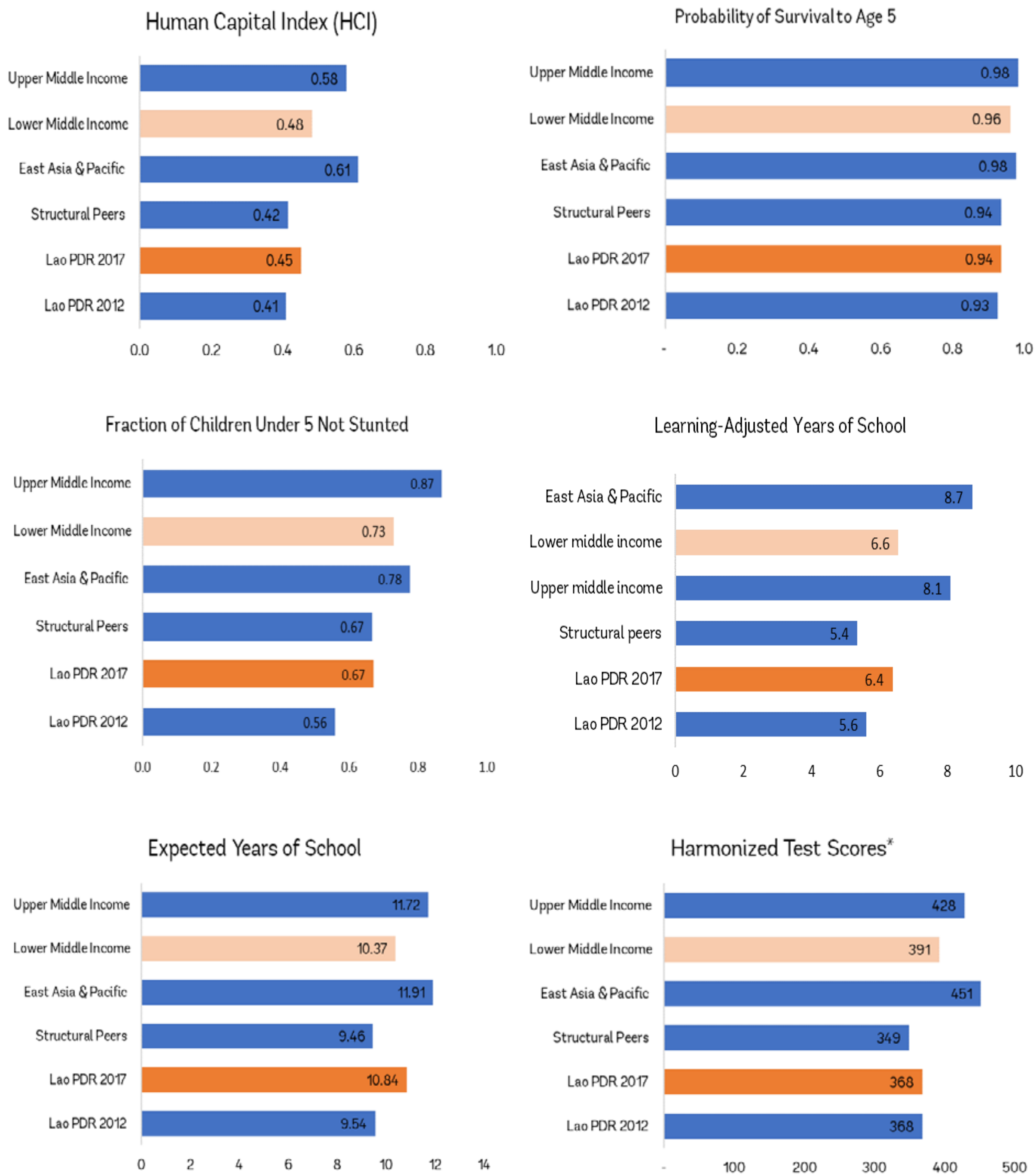
Credit growth has continued to slow in 2018



Source: BOL

Thematic topic: Building Human Capital for Poverty Reduction

Lao PDR has improved overtime in relation to human capital components, but this level is relatively lower than what would be expected for its income level



Note that data on harmonized test scores for Lao PDR for 2017 quotes the level in 2012 due to the lack of recent available data.
Source: World Bank. 2018. The Human Capital Project.