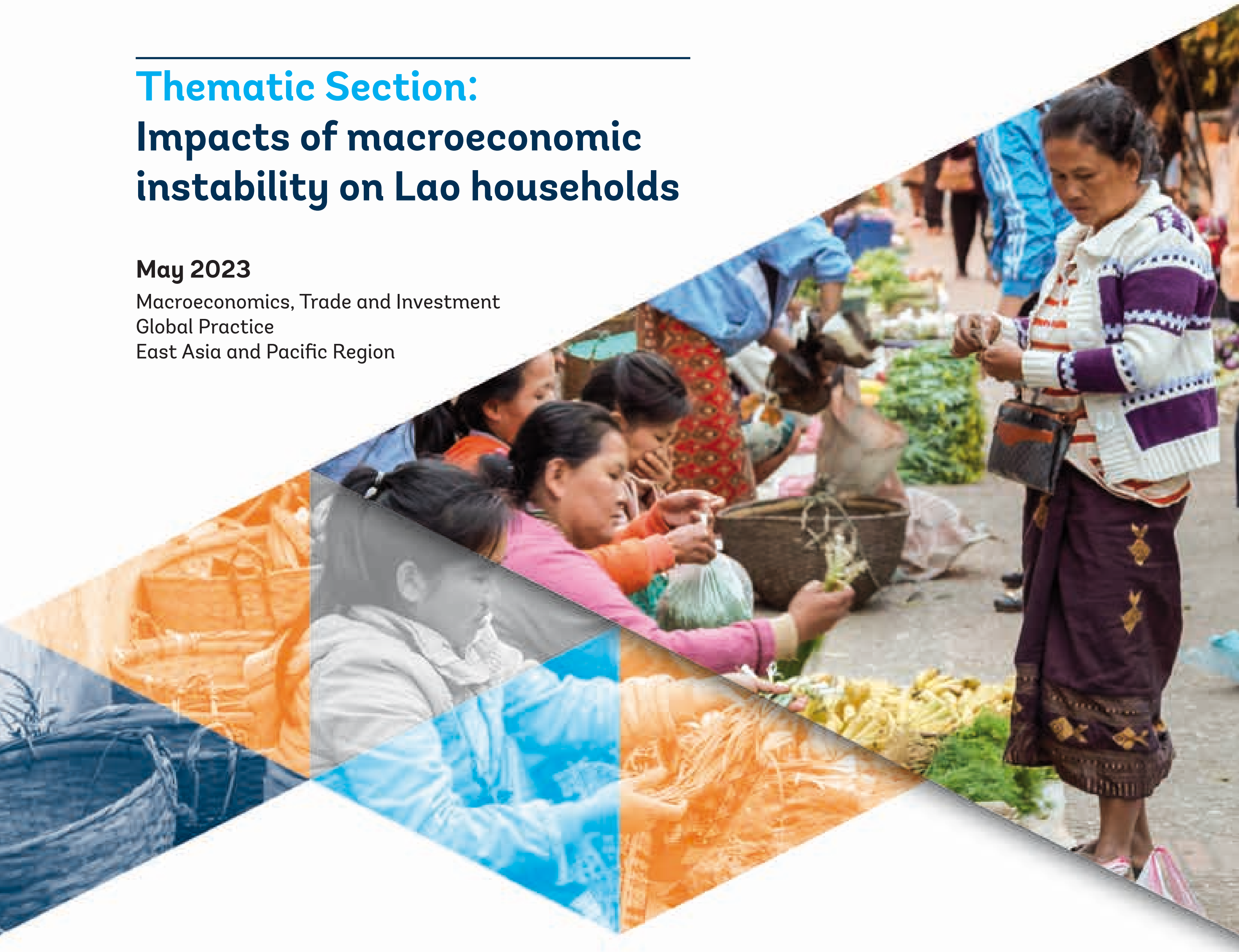
LAO PDR ECONOMIC MONITOR

Addressing economic uncertainty

Thematic Section:
Impacts of macroeconomic instability on Lao households

May 2023

Macroeconomics, Trade and Investment
Global Practice
East Asia and Pacific Region



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Contents

Figures

Tables

Boxes

Abbreviations

BCEL	Banque Pour Le Commerce Exterieur Lao Public
BOL	Bank of the Lao PDR
CAR	Capital adequacy ratio
CIT	Corporate income tax
CPI	Consumer price inflation
EAP	East Asia and Pacific
EDL	Electricite du Laos
EMDE	Emerging markets and developing economies
GDP	Gross Domestic Product
NPL	Non-performing loan
NTM	Non-tariff measures
PPG	Public and publicly guaranteed
PPP	Public-private partnerships
REER	Real effective exchange rate
SOE	State-owned enterprise
VAT	Value-added tax

Acknowledgements

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The Lao PDR Economic Monitor provides updates on macroeconomic developments and sectoral issues in the country. It is produced biannually and distributed widely to government agencies, development partners, the private sector, think tanks, civil society organizations, and academia.

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Executive Summary

Part A: Recent Economic Developments and Outlook

Economic activity has been weighed down by compounding structural challenges, persistent macroeconomic instability, and a deteriorating external environment. GDP growth is estimated at 2.7 percent for 2022, supported by a gradual recovery in tourism and other services. The commencement of the Laos-China railway operations and the dry port have facilitated travel and trade flows. Industrial sector activity was supported by natural resource exports, even if growth moderated compared with 2021. However, recovery has been undermined by macroeconomic instability and external factors. A large external debt service burden and high import prices (in a context of limited foreign exchange liquidity) contributed to a sharp depreciation of the Lao kip in the second half of 2022. This drove high inflation, which in turn weakened incomes, consumption, and investment. Macroeconomic instability has distributional impacts on Lao households (see the analysis in the chapter on macroeconomic impacts on households).

The Lao kip depreciated sharply in 2022, driven by persistent external imbalances. The exchange rate has recently stabilized, supported by tighter monetary policy. However, limited foreign exchange liquidity and low foreign reserves have resulted in foreign exchange rationing by commercial banks, thereby driving a parallel exchange rate market. The Lao kip depreciated by 32 and 43 percent against the Thai baht and US dollar respectively in the year to April 2023. The parallel market premium was about 4 percent in April 2023.

The depreciation of the kip and rising global prices have translated to high inflation. A weakened kip has fueled domestic inflation and exacerbated external debt service costs since most debt is denominated in US dollars. Inflation remained at 40 percent in the year to April 2023. The increase in global commodity prices, particularly fuel and fertilizers, has been transmitted to the cost of raw materials and locally produced goods. Food price inflation reached 52 percent year-on-year, well above overall inflation, severely affecting urban poor households. Core inflation reached 32 percent in the year to April 2023.

Real household incomes have suffered from rampant inflation. The share of households reporting income losses due to the pandemic fell from 43 percent in May 2022 to 35 percent in December 2022, reflecting a continued recovery in nominal incomes. However, rising inflation meant a significant fall in real earnings for most workers. As inflation accelerated in the second half of 2022, nearly two-thirds of workers saw their labor income stagnate (41 percent) or decline (24 percent), thereby failing to keep up with the rising cost of living. In December 2022, when inflation reached 39 percent year-on-year, 64 percent of Lao families were still living on the same or lower budget compared to December 2021.

Fiscal consolidation was driven by expenditure tightening and a marginal increase in domestic revenue collection. Domestic revenues improved slightly in 2022, supported by higher economic activity and price effects that offset rate reductions on fuel excise and value-added tax. However, revenue was still lower than before the pandemic. In the meantime, the government continued to tighten public expenditure amid rising inflation and higher interest payments despite debt service deferrals. As a result, the fiscal deficit dropped slightly to 1.1 percent of GDP in 2022, and the primary balance (which excludes interest payments) turned into a surplus of 0.6 percent of GDP. Nonetheless, gross financing needs remain considerable, owing to high external and domestic debt service obligations. Limited fiscal space has constrained the government's ability to provide support to poor households affected by rising living costs and to increase investments in growth-enhancing expenditures (e.g. health and education).

Public and publicly guaranteed (PPG) debt has reached critical levels, undermining macroeconomic stability and development prospects. Laos faces both solvency and liquidity challenges due to significant financing needs, limited financing options, low foreign exchange reserves, and considerable depreciation pressures. The country's PPG debt is estimated to have surpassed 110 percent of GDP in 2022. The energy sector, primarily Electricité du Laos (EDL), has been a significant factor in public debt accumulation, accounting for about 37 percent of total PPG debt in 2021. China accounts for about half of the external public debt stock and repayments scheduled for 2023–26. Despite the temporary relief provided by debt service deferrals during 2020–22, the ratio of debt service (i.e. principal and interest) to domestic revenue increased from 35 percent to 61 percent between 2017 and 2022. Meanwhile, combined public spending on education and health declined from 4.2 percent of GDP to an estimated 2.6 percent between 2017 and 2022. Contingent liabilities arising from state-owned enterprises (SOEs) and public-private partnerships (PPPs) are also a source of fiscal risks.

External imbalances remain high amid high demand for imports and debt service. As a ratio to GDP, the current account balance slightly worsened in 2022 due to a lower trade surplus and increased net income payments. Higher exports (supported by mining, electricity, wood pulp, and some agriculture products, as well as tourism) were partly offset by higher import prices, particularly for fuel. Net income payments remained high, despite debt service deferrals. Capital inflows remained limited as foreign direct investment declined. Moreover, only one-third of export receipts enter the domestic banking sector, depriving the economy of vital foreign exchange. Official reserve levels are inadequate. Lower foreign exchange inflows place pressure on the overall balance of payments, contributing to a decline in reserves to $1.1 billion in December 2022. Limited foreign liquidity and reserves drive depreciation pressures.

The economy is projected to grow at 3.9 percent in 2023 and accelerate to an average of 4.3 percent in the medium term, led by a continued recovery in services and exports. The services sector is expected to continue benefiting from a recovery in tourism and improved transport connectivity. External demand, coupled with improved logistics services and connectivity, is expected to help sustain manufacturing and agriculture exports. The industry sector will also benefit from investment in the power sector and special economic zones. However, growth is expected to remain below pre-COVID levels, weighed down by structural weaknesses. Depreciation pressures could reemerge owing to high import demand, large debt service obligations, and the prevalent rationing of foreign exchange in the official market. Inflation will remain at the two-digit level in 2023, partly due to high commodity prices and additional depreciation. If structural imbalances (such as low foreign reserves, low revenue collection, and a high debt burden) are addressed, the economy could recover at a faster pace.

Household nominal incomes are expected to gradually improve, albeit undermined by high living costs. Inflation has eroded purchasing power, increased consumption costs, and depleted household savings and human capital spending, thereby placing many households at risk of falling into poverty. The slow progress in poverty reduction will likely continue. Assuming Laos remains on this path of vulnerable recovery, per capita income growth will stay below pre-pandemic and regional peer levels in the medium term, causing more divergence on poverty reduction and living conditions.

High debt levels will continue to constrain fiscal space. Domestic revenue is expected to increase slowly as a ratio to GDP, supported by improving economic activity and tax administration improvements. Grants are expected to decline gradually. Non-interest expenditure curbs are likely to continue due to pressures from debt service obligations. As a result, the fiscal deficit is expected to rise, while the primary balance (excluding interest payments) is projected to remain in surplus into the medium term. Nevertheless, gross public financing needs will remain high due to substantial debt service, averaging $1.3 billion per year over 2023–26 compared to official foreign exchange reserves of about $1.1 billion at the end of 2022. Therefore, a successful conclusion to the ongoing debt negotiations and higher domestic revenue mobilization will be the key to creating fiscal space for critical growth-enhancing spending.

External imbalances are expected to persist. The current account deficit is expected to remain at around 3 percent of GDP as improvements in exports, tourism, and remittances are offset by higher import demand and interest payment obligations. Despite the regulatory requirement for exporters to remit export receipts, reserve adequacy is expected to remain relatively thin, covering less than two months of imports.

The economic outlook is subject to significant downside risks. The main external risks include lower-than-expected growth in regional economies, which could lower external demand. On the other hand, faster-than-expected growth in China could boost external demand but could also revive inflationary pressures. If inflationary pressures in advanced economies persist, further interest rate increases in these economies could renew depreciation pressures on the kip and thus fuel domestic inflation, which could drive further macroeconomic instability. Domestic risks include problems in refinancing external debt, slow progress on structural reforms, and deteriorating bank balance sheets. The outcome of ongoing debt negotiations with key creditors will have significant implications for macroeconomic stability. Fiscal adjustment alone, particularly through protracted expenditure curbs, will be insufficient to restore debt sustainability without harming medium- and long-term growth prospects. The debt overhang will undermine critical investment in human capital, crowd out private investment, and drive macroeconomic instability. Labor shortages due to out-migration for better wages could also undermine recovery prospects in labor-intensive sectors, including the agriculture, manufacturing, and service sectors.

Table 1. Summary of Key Economic Indicators

	2019	2020	2021	2022	2023	2024	2025
					Projections		
Real GDP growth (% change)	5.5	0.5	2.5	2.7	3.9	4.2	4.4
Inflation (period average, % change)	3.3	5.1	3.8	22.7	16.8	5.1	3.5
Fiscal balance (% of GDP)	-3.3	-5.2	-1.3	-1.1	-2.0	-2.2	-2.4
Current Account Balance (% of GDP)	-12.1	-5.9	-2.9	-3.2	-3.0	3.1	-3.2

Source: Lao Statistics Bureau, Ministry of Finance, Bank of the Lao PDR, Ministry of Industry and Commerce, World Bank staff estimate and projections based on inputs from Lao authorities and trade partner data as of April 2023.

To restore macroeconomic stability, a strong commitment to ambitious reforms in five crucial policy areas is essential: (i) raising public revenues to protect spending on education, health, and social protection; (ii) improving expenditure allocation and efficiency; (iii) expediting debt negotiations; (iv) strengthening financial sector stability; and (v) improving the business environment to promote investment and exports. In addition, improving data availability, timeliness, and quality is key to effective evidence-based policymaking.

The Vital Five

Reforms to Secure Macroeconomic Stability in the Lao PDR

1. CUT COSTLY TAX EXEMPTIONS TO RAISE PUBLIC REVENUE, PROTECT SOCIAL SPENDING

2. IMPROVE THE GOVERNANCE OF PUBLIC AND PUBLIC PRIVATE INVESTMENT

3. RESTRUCTURE PUBLIC DEBT THROUGH ONGOING NEGOTIATIONS

4. STRENGTHEN FINANCIAL SECTOR STABILITY THROUGH LEGAL AND REGULATORY TOOLS

5. ENHANCE THE BUSINESS ENVIRONMENT VIA EFFECTIVE REGULATORY REFORMS

Tax exemptions deprive the budget of much revenue every year, so less can be invested in human capital or used to service debt. Without investment in knowledge, skills and health, Laos will fall further behind.

Inefficient public investment is costly and public-private partnerships often create liabilities for the government.

High public debt levels undermine macroeconomic stability by constraining fiscal space, exerting pressure on the exchange rate, and jeopardizing banking sector stability.

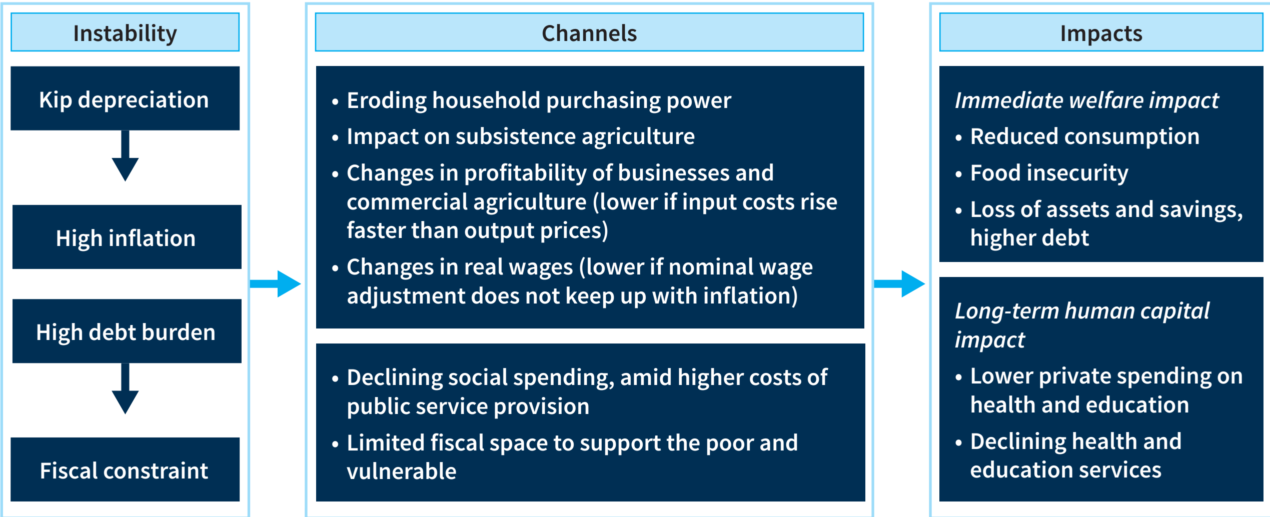
Vulnerabilities in state-owned banks may hamper private sector credit growth. This exposure to risk can have widespread impacts on the rest of the economy.

Burdensome processes and regulations raise business costs and reduce productivity, undermining investment and exports.

Part B: Impacts of Macroeconomic Instability on Lao Households

Lao households are suffering the impacts of continued macroeconomic instability. Macroeconomic instability (e.g. sharp currency depreciation and a double-digit inflation rate amid high levels of public debt) affects households in various ways and usually with distributional consequences (Figure A). Low-income households tend to be more vulnerable to inflation than better-off households due to their limited coping ability and lack of financial buffers to deal with higher living costs. Poorer households are also more likely to be affected by a decline in social spending, as benefits from public health and education services represent a greater share of their income.

Figure A. Potential Impacts of Macroeconomic Instability on Lao Households



Source: World Bank staff illustration.

Inflation has affected almost 90 percent of Lao families, forcing them to adopt coping strategies. Soaring inflation during the second half of 2022 placed a heavy burden on Lao families. It is estimated that between May and December 2022, urban and high-income families saw their living costs rise by 24.5 percent and 22.5 percent respectively, owing to sharp increases in market food and transportation prices. While rural and low-income households, especially those relying on subsistence agriculture, are less exposed to inflation, the impact has still been widely felt as farm input prices rose for fuel, seeds, fertilizer, and farm labor. Between 2020 and 2022, fertilizer prices doubled or tripled while the price of certified seeds rose by 40–50 percent and fuel prices jumped by 80 percent on average. Some commercial farmers and household businesses gained from higher output prices, but higher input costs cut into profits and income. Meanwhile, evidence points to nominal wage increases being outpaced by inflation, hurting most wage workers. Despite the adjustments, minimum wages and public sector wages lost their real value by 27 percent and 24 percent over 2020–22. In response to inflation, more than three-quarters of affected households adopted consumption-based strategies by choosing to reduce food consumption or switching to cheaper, self-produced, or wild foods. This could lead to poor food and nutrition security.

Constrained government and household budgets have led to a decline in human capital spending, especially among low-income households. Inflation and currency depreciation led to higher costs for public health and education, while a rising debt burden, stagnant public revenues, and increases in other expenditure categories have crowded out social spending. This has made it difficult for the government to maintain the coverage and quality of public service delivery. Adverse effects are expected to be most keenly felt by low-income households as better-off households are more likely to have alternatives to access private health and education services. Spending on public health and education services also represents a greater share of income for poorer households. At the same time, inflation has compressed household budgets, forcing Lao families to cut their human capital spending. Among families affected by inflation, more than half reduced education and health care spending, and contractions in both expenditures were more common among low-income families — 65.6 percent reduced healthcare spending and

68.2 percent cut education spending. It was reported that about 7 percent of children from low-income households dropped out of school in 2022, mainly for financial reasons.

Key policies to alleviate the adverse impacts of macroeconomic instability are:

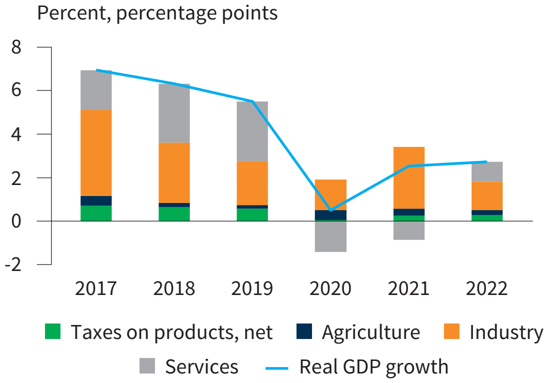
i) Restoring macroeconomic stability (see key reforms in Part A).

ii) Reallocating public spending into priority areas: High inflation has led to a decline in private spending on human capital, which is the foundation for inclusive and sustainable development. The public sector plays an important role in sustaining human capital investment by providing education and healthcare services. To mitigate the impact of macroeconomic instability on long-term inclusive and sustainable development, it will be necessary to improve the efficiency and equity of spending, and to reallocate budget from non-essential activities to health and education, to keep up with the rising costs of service provision at minimum.

iii) Redesigning fiscal policy to enable targeted support to the poor and vulnerable: Cash transfer programs have been implemented in many countries. These programs direct cash to groups of beneficiaries to mitigate the impact of inflation. In Laos, to effectively implement these measures in a constrained fiscal environment, it is essential that the government adopt tax reforms that expand its fiscal space and use part of the additional revenue to provide targeted cash transfers, while improving the existing targeting tools and benefit transfer systems. Moving away from tax cuts and exemptions to more progressive fiscal interventions like targeted cash transfers will allow the government to protect household livelihoods from ongoing price shocks at a smaller fiscal cost.

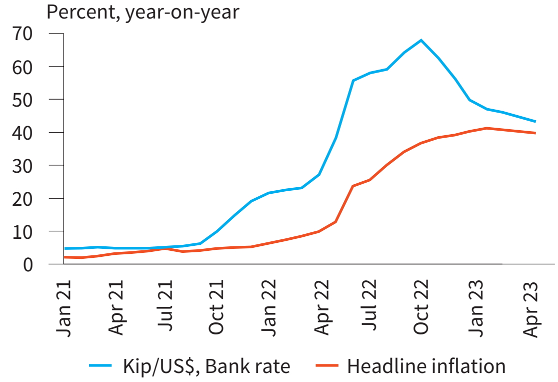
Lao PDR: Key Macroeconomic Indicators at a Glance

GDP growth is estimated at 2.7 percent in 2022, supported by a recovery of the services sector.



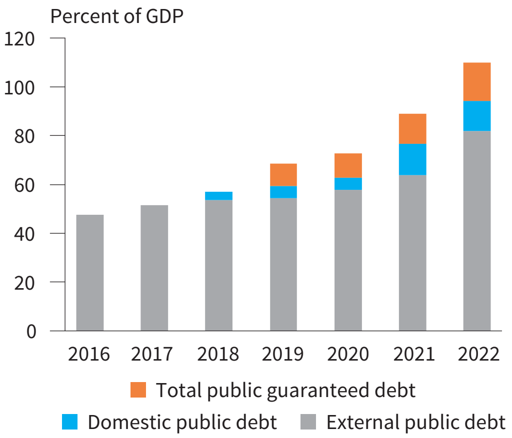
Source: World Bank estimate, Lao Statistics Bureau.

A weakened kip and rising inflation have undermined the economic recovery.



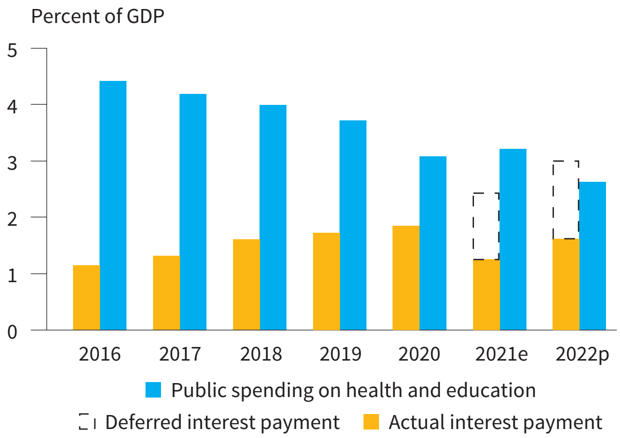
Source: Lao Statistics Bureau.

A growing public debt burden is fueling macroeconomic uncertainty.



Source: World Bank estimate based on Ministry of Finance data.

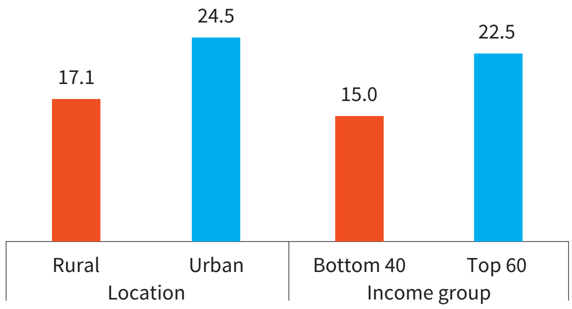
Limited fiscal space is constraining public spending on education and health.



Source: World Bank estimate based on Ministry of Finance data

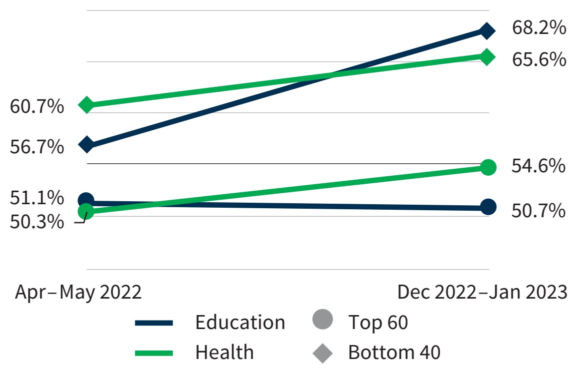
Rising prices are increasing the cost of household consumption

Changes in the cost of household consumption basket between May–December 2022 (percent)



Source: World Bank staff calculation based on Lao Expenditure and Consumption Survey 6 and inflation (May–December 2022).

Households have reduced spending on education and health due to rising living costs



Source: World Bank Rapid Monitoring Phone Survey Round 5 (April – May 2022) and Round 6 (December 2022 –January 2023)

PART A

Recent Economic Developments and Outlook

1. Regional Economic Developments

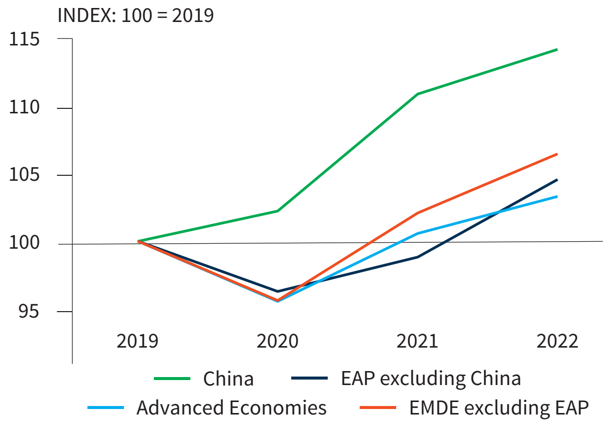
Economic activity in developing East Asia and Pacific (EAP) is accelerating gradually. GDP growth has recovered from recent shocks in most of the EAP region, driven primarily by strong private consumption and goods exports. China's economy grew by 3 percent in 2022, significantly slower than the 8.4 percent rebound in 2021, partly because of COVID public health measures and weaknesses in the housing sector. The rest of the region, including Thailand and Vietnam, grew at an estimated 5.8 percent, up from 2.6 percent in 2021, supported by buoyant domestic and external demand.

Inflation rose markedly in 2022 and remains higher than the targets set in most countries. Consumer price inflation (CPI) increased considerably during 2022 in most EAP economies, driven by rising energy and food prices, as well as regional currency depreciations. Core and nominal CPI inflation have surpassed central banks' target ranges in most major EAP economies. While inflation has recently peaked in several countries, it continues to rise in the Philippines and Vietnam and remains high in Laos, Mongolia, and Myanmar.

High inflation raises concerns about the pace of poverty reduction in the EAP region. Slower growth in China has slowed down poverty reduction. In the rest of the region, the rate of poverty reduction has been moderate. Overall, 12 million people in the region are expected to escape poverty between 2022 and 2023 at the lower-middle income class poverty line ($3.65/day, 2017 PPP), whereas 36 million people are projected to escape poverty at the upper-middle income class poverty line ($6.85/day, 2017 PPP).

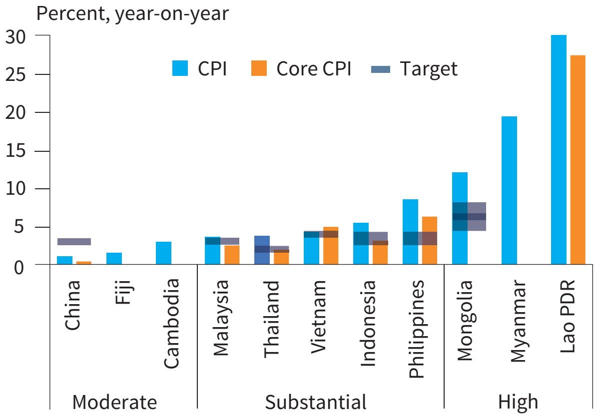
Three interlinked developments are likely to shape external conditions for EAP economies in 2023. First, global growth in 2023 is projected to be slower than in 2022, even though recent projections have become more optimistic. The likely slowdown in growth in advanced economies may be partially offset by a revival in China's growth. Second, commodity prices have moderated recently, resulting in declining food and energy prices in several EAP countries. Finally, the continued inflationary pressures in the US are leading to tighter financial conditions not only in the U.S., but also in the EAP region. Further unanticipated monetary policy tightening by major central banks could renew pressures on regional currencies and pass through to higher inflation, especially in countries that rely on short-term capital inflows. Tighter global financial conditions could also induce debt distress in highly indebted EAP countries.

Figure 1. Regional GDP growth



EAP: East Asia Pacific; EMDE: emerging markets and developing economies
Source: World Bank EAP Economic Update April 2023.

Figure 2. CPI inflation



CPI: Consumer price inflation
Source: World Bank EAP Economic Update April 2023.

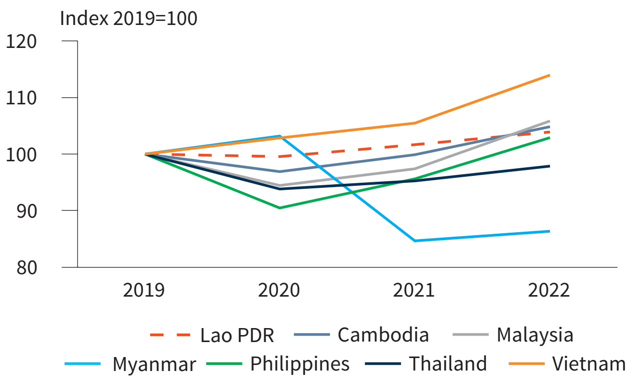
2. Recent Developments in the Lao PDR

2.1 Real Sector

Economic recovery has been gradual, weighed down by macroeconomic instability and external uncertainty.

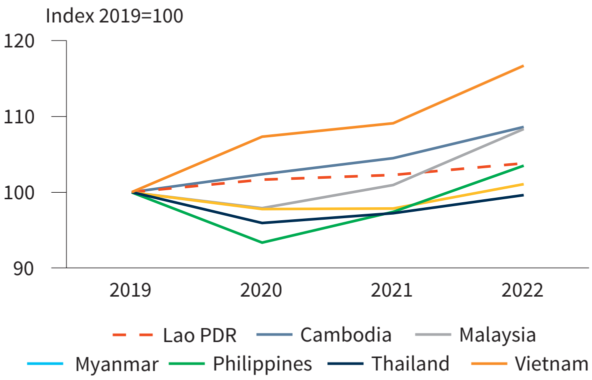
Economic activity has been weighed down by compounding structural challenges, persistent macroeconomic instability, and a deteriorating external environment. GDP growth was estimated at 2.7 percent in 2022, supported by a gradual recovery in the services sector. Economic growth had been slowing since 2013, owing to the limitations of a resource-driven economic model and accumulated structural imbalances, aggravated by the COVID-19 pandemic in 2020. Although the initial economic impact was not as severe as in most countries, the subsequent economic recovery has been subdued and lagging behind regional peers (Figure 3). This is mainly due to domestic structural issues, particularly a high public debt burden, which has been recently exacerbated by the sharp kip depreciation. Limited fiscal space has also constrained public spending on human capital, which is crucial for labor productivity and long-term growth. The depreciation of the kip and high global commodity prices translated to increasing domestic prices, particularly fuel and fertilizers, which affects consumption and business costs. A slower recovery also means that people's incomes and living standards lag behind some regional peers (Figure 4).

Figure 3. Real GDP growth



Source: International Monetary Fund, World Economic Outlook April 2023 and World Bank staff calculations.

Figure 4. GDP per capita at constant prices



Source: International Monetary Fund, World Economic Outlook April 2023 and World Bank staff calculations.

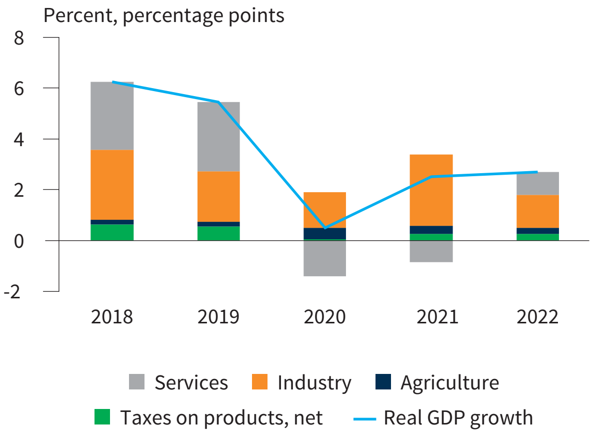
Economic growth has been supported by a gradual recovery of the services sector. The services sector benefited from increased international and domestic tourism after international borders reopened in May 2022, partly supported by a depreciation of the Lao kip (Figure 5).[1] The opening of the Laos-China railway also helped attract regional tourists, particularly from Thailand. Nevertheless, international tourism in 2022 rebounded to only one-fourth of pre-COVID-19 levels, suggesting the sector will take time to fully recover. In addition, the commencement of operations of the Laos-China railway and the Thanaleng Dry Port has facilitated travel and trade flows. However, the kip depreciation and high inflation weighed down on consumption and pushed up business costs. This was reflected in a contraction of wholesale and retail sales in real terms in 2022, albeit lower than last year (Figure 6).

Industrial sector activity was partly supported by natural resource exports, but growth moderated compared to 2021. Electricity generation continued to rise, mostly thanks to increased power exports. The mining sector observed output growth in gold, iron ore, and potash, while copper output declined as existing reserves were gradually depleted. The rapid expansion of mining exploration concessions in the past few years is a cause for concern, particularly given the supervision capacity of the mandated authorities and the lack of compliance with regulations and social and environmental safeguards. High fuel and input costs affected manufacturing, particularly

[1] The number of international tourist arrivals rose to 1.3 million in 2022. https://laotiantimes.com/2023/02/16/almost-1-3-million-tourists-visited-laos-in-2022/

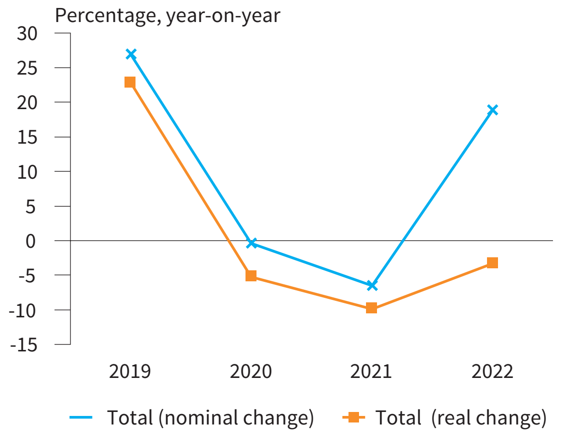
goods produced for the local market and some construction activities. However, some manufacturing exports seemed to be resilient, such as wood pulp and wood products. Meanwhile, low wages in Laos, exacerbated by the kip depreciation and high inflation, encouraged more workers to migrate to Thailand where average wages are about three times higher. This trend is challenging for labor-intensive sectors such as garment manufacturing and hospitality.

Figure 5. Real GDP growth



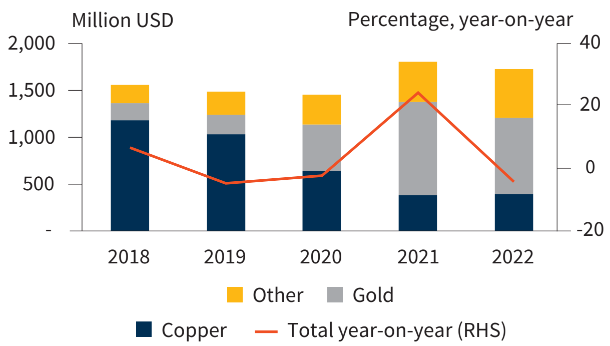
Source: Lao Statistics Bureau and WB staff estimates

Figure 6. Wholesale and retail sales



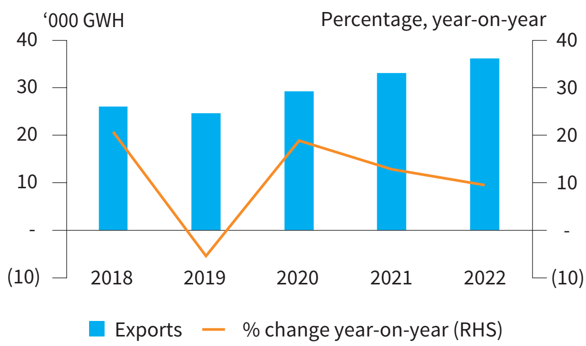
Source: World Bank calculations based on data from Ministry of Industry and Commerce.

Figure 7. Mining exports



Source: Ministry of Energy and Mines, mining companies, Ministry of Industry and Commerce.

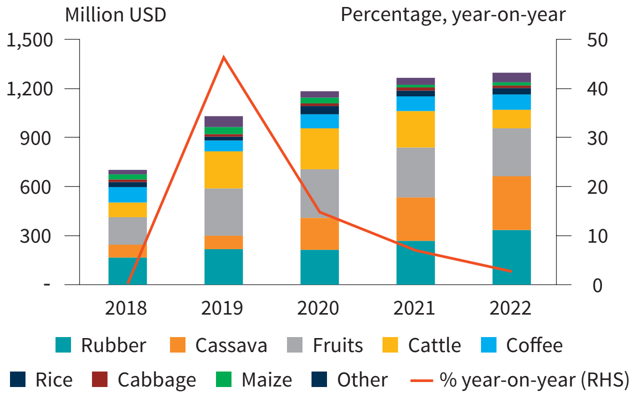
Figure 8. Electricity exports



Source: Ministry of Energy and Mines, trade partners' import data.

The performance of the agriculture sector was undermined by high input costs and trade disruptions. Fuel shortages during April–June 2022 and a rise in agricultural input prices (including fertilizers and animal feed) affected crop plantation and livestock breeding. Increased input costs have translated to higher local food prices. Agriculture export growth moderated in 2022 (Figure 9). The main crops exported were cassava and rubber, while fruit exports slightly declined, partly because the latter are transported by trucks, which were affected by trade disruptions at the Laos-China border in 2022.

Figure 9. Agricultural exports



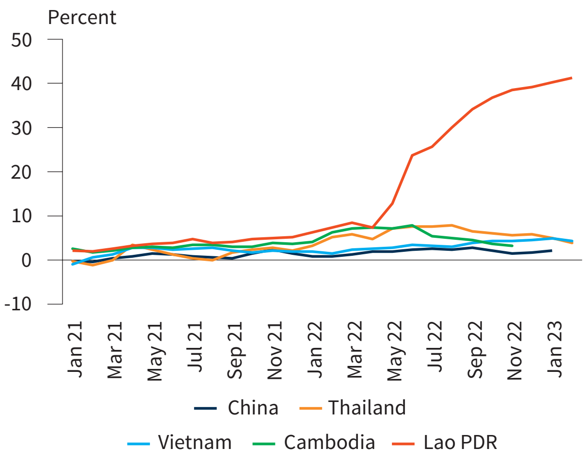
Sources: World Bank staff calculations based on data from Ministry of Industry and Commerce, trading partners' customs data.

2.2 Inflation

The depreciation of the Lao kip and rising global prices have translated to high inflation across the board

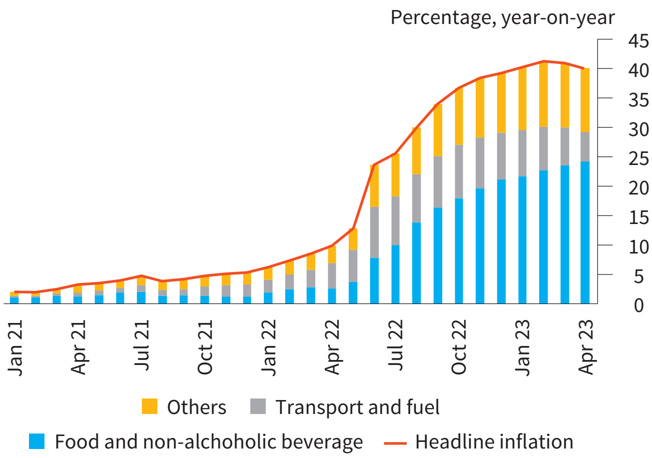
While depreciation pressures have eased in recent months, annual inflation remains by far the highest in the EAP region. Average annual inflation climbed to 23 percent in 2022 from 4 percent in 2021. Although inflation marginally moderated in April, partly due to easing global prices, it remained high at 40 percent year-on-year in April 2023, mostly due to the depreciation of the kip by 32 and 43 percent against the Thai baht and US dollar over the same period. Food and transport price increases have been the main drivers of inflation, accounting for about 73 percent of overall inflation. The increase in global commodity prices, particularly fuel, has been transmitted to the cost of raw materials and locally produced goods as well. Higher fertilizer and animal feed prices have also pushed up food prices.[2] Food inflation accelerated by 52.2 percent in April, well above overall inflation, placing Laos among countries with the highest food price inflation (see further discussion in the Thematic Chapter). Core inflation reached 31.6 percent over the same period.

Figure 10. Inflation among regional peers



Sources Lao Statistics Bureau, World Bank East Asia and Pacific Economic Update April 2022.

Figure 11. CPI inflation



Sources Lao Statistics Bureau, World Bank East Asia and Pacific Economic Update April 2022.

[2] MRI/LASES-UN RCO High Frequency Data Joint Program. 2023. Macroeconomic Outlook for the Lao PDR.

2.3 Households

Labor market indicators gradually improved in 2022 but have been undermined by the rising cost of living

Non-farm employment continued to recover in the second half of 2022 but remained slightly below pre-pandemic levels. According to the World Bank's rapid monitoring phone survey of households, overall employment had rebounded in 2022, surpassing pre-COVID levels, and the share of working respondents rose from 69.4 percent in November 2021 to 88.2 percent in May 2022 and increased marginally to 89.6 percent in December 2022. By contrast, non-farm employment had yet to return to pre-pandemic levels. Although the share of respondents working in the non-farm sector steadily increased from 45.3 percent in November 2021 to 49.8 in May 2022 and 54.6 percent in December 2022, it was still 6.6 percentage points below pre-COVID levels in March 2020 (Figure 13).

While nominal incomes gradually recovered from the pandemic's impacts, households suffered from rising inflation and lower real income. The share of households reporting income losses due to the pandemic fell from 43.4 percent in May 2022 to 35.1 percent in December 2022, reflecting a continued recovery (Figure 14). However, rising inflation meant a significant fall in real earnings for most workers. As inflation accelerated in the second half of 2022, nearly two-thirds of workers saw their labor income unchanged (40.8 percent) or decline (23.9 percent) during this period, which meant they were unable to keep up with the rising cost of living (see the Thematic Chapter for further analysis of different labor income sources). In December 2022, when inflation reached 39.3 percent year-on-year, 64 percent of Lao families were still living on the same or lower budget compared to December 2021.

Lao kip depreciation and high inflation have led to more workers migrating to neighboring countries after the border re-opening in May 2022. More than 40,000 Lao families had at least one family member who left to work in another country in 2022. Among them were migrant workers who returned to Laos during the pandemic and have now begun returning to Thailand for work. According to the Thai Department of Employment, the number of documented Lao workers coming to Thailand increased to about 225,000 in November 2022, approximately a 19 percent increase from July 2022. The wage differential is one of the main causes, along with the sharp depreciation of the Lao kip against the Thai baht since the end of 2021. Despite the monthly minimum wage hike in Laos from 1.1 million kip to 1.2 million kip (about $70 per month) in August 2022 and then to 1.3 million kip in May 2023 (about $74), the Thai minimum wage, at the rate of 300 baht per day or $250 per month, is about triple the rate in Laos. Lao migrant workers are mostly employed in domestic work, construction, and agriculture. Labor-intensive manufacturing and some Lao service businesses reported that the labor outflow has affected their operations.

Figure 12. Employment

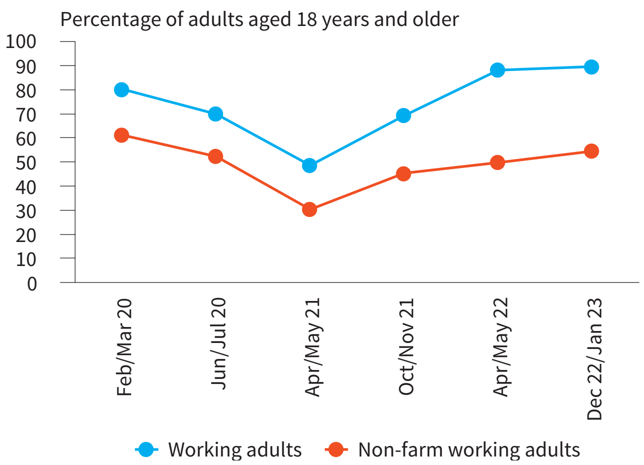
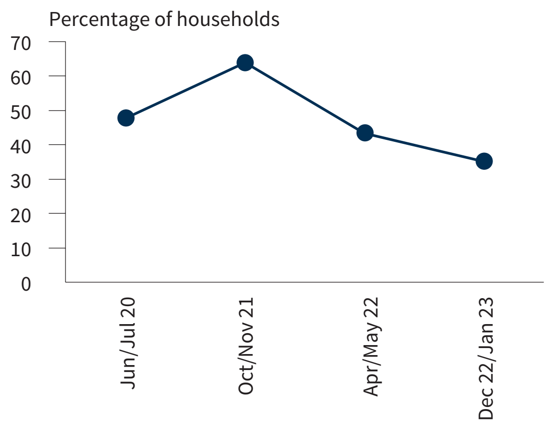


Figure 13. Households experiencing income losses compared to pre-pandemic levels



Source: World Bank's rapid monitoring phone survey of households Round 1-6

Note: Employment is defined as those who worked at least an hour in the last seven days before the interview date.

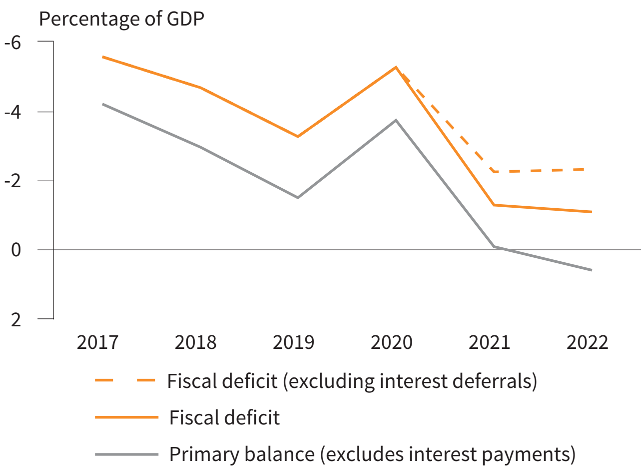
The impact of inflation on household welfare and its distributional consequences are considerable.[3] Mounting inflation during the second half of 2022 placed a heavy burden on Lao families, with nearly 90 percent having been affected. The share of households experiencing a significant impact increased across the board, although the increase seems to be more evident among low-income families, from 48.3 percent in May 2022 to 54.6 percent in December 2022. On the one hand, urban households and better-off rural households experienced a substantial loss in their purchasing power during this period owing to higher expenses for market food and transportation, for which prices increased sharply. On the other hand, for low-income families in rural areas, especially those relying on subsistence agriculture, the impact was felt most strongly through rising farm input prices. The adverse impacts of inflation have led to households adopting coping strategies, some of which have negative welfare consequences. For example, some families adopted consumption-based strategies by choosing to reduce food consumption or switching to cheaper, self-produced, or wild foods, which could be detrimental to food and nutrition security. Some households, especially rural and low-income families, have also cut their health and education spending.

2.4 Fiscal Developments

Fiscal consolidation has been driven by expenditure tightening and a marginal increase in domestic revenue collection

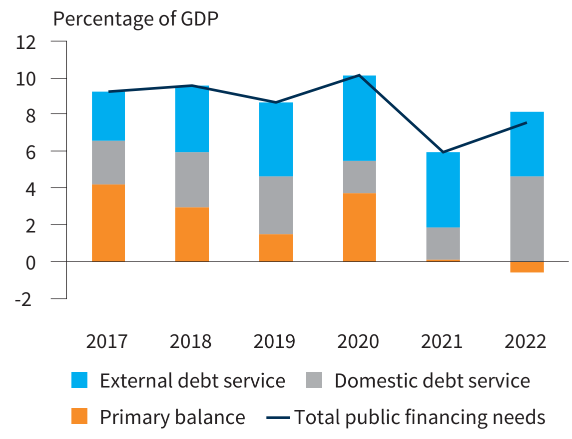
The fiscal deficit declined slightly to 1.1 percent of GDP in 2022 owing to a containment of public spending and a slight increase in revenue collection. The primary balance (which excludes interest payments) turned into a surplus of 0.6 percent of GDP in 2022 (Figure 14). However, gross financing needs remain high, at around 7.6 percent of GDP, due to the amortization of both external and domestic debt (Figure 15). The government resorted to asset sales, state-owned enterprise (SOE) on-lending repayments, and bond issuances (both domestic and external) to meet financing needs. These needs will remain elevated in the medium term due to high debt service obligations.

Figure 14. Fiscal deficit



Source: Ministry of Finance.

Figure 15. Total public financing needs[4]



Source: Ministry of Finance.

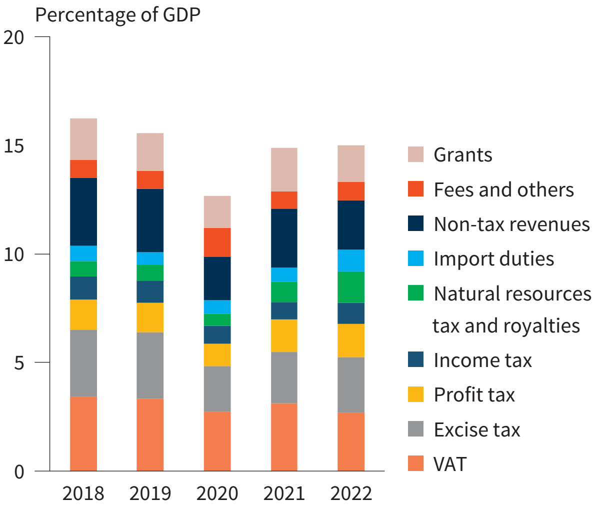
Despite the economic recovery, domestic revenues improved only marginally, as higher economic activity and price effects were partly offset by tax cuts. Domestic revenue rose from 13 to 13.3 percent of GDP between 2021 and 2022, driven mostly by higher import duties, excise, income, natural resource taxes, and concession fees.

[3] See a full description in the Thematic Chapter: Impacts of Macroeconomic Instability on Lao Households.

[4] This estimate of financing needs excludes deferred debt service payments until 2022.

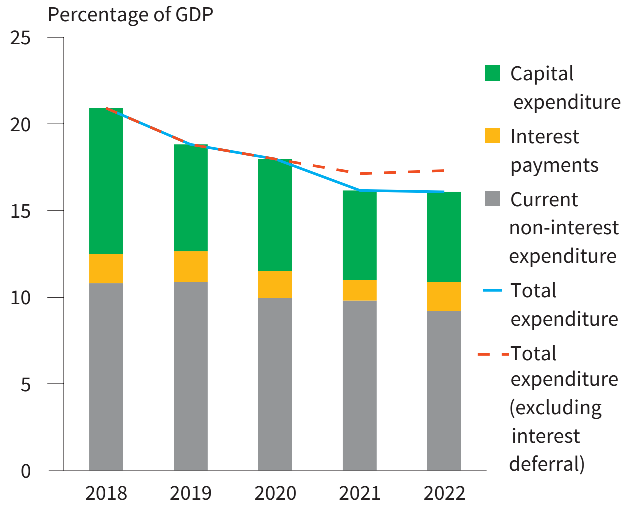
The latter was due to the expansion of pilot mining projects (Figure 16). Higher fuel and commodity prices supported excise tax collection, which compensated for the lower excise tax rates on fuel and the lower value-added tax (VAT) rate introduced in 2022. Profit tax collection remained around the 2021 level but is still low by regional benchmarks. The difference between potential and actual corporate income tax (CIT), known as the CIT gap, is estimated at nearly 90 percent, implying very large foregone revenues from tax exemptions.[5]

Figure 16. Total revenues



Source: Ministry of Finance.

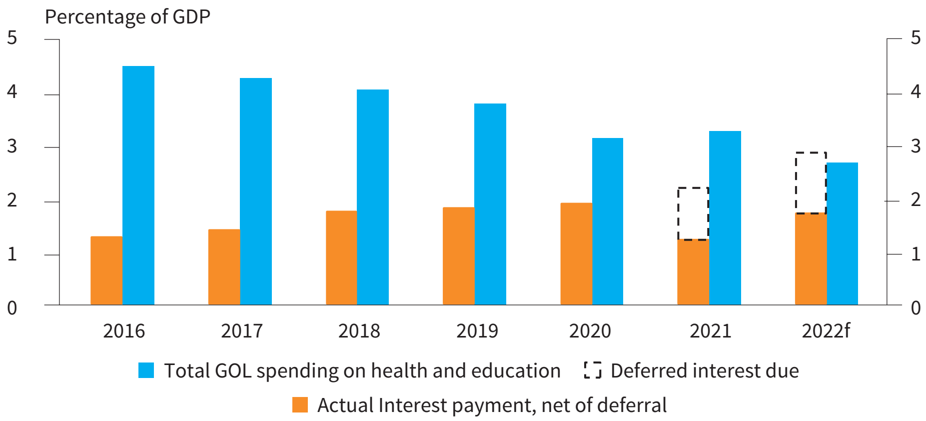
Figure 17. Total expenditures



Source: Ministry of Finance and World Bank staff estimate.

The government continued to tighten public expenditures amid higher interest payments in 2022. Total expenditure was estimated to remain stable at 16 percent of GDP in 2022 but still much lower than pre-pandemic levels (Figure 17). High prices reportedly affected the construction costs of some public investment projects and the purchase of goods and services. New projects have either been cancelled or postponed. However, interest payments increased to 1.7 percent of GDP, despite the deferral of sizable external interest payment obligations owing to the

Figure 18. Social spending and interest payments



Source: Ministry of Finance and World Bank staff estimate

[5] The revenue generated by corporate income tax (CIT), generally known as 'profit tax', declined from 2.6 to 1.4 percent between 2011 and 2019 and then to 1.0 percent of GDP in 2020. In 2019, the CIT-to-GDP ratio was the 9th lowest in the world and well behind regional peers.

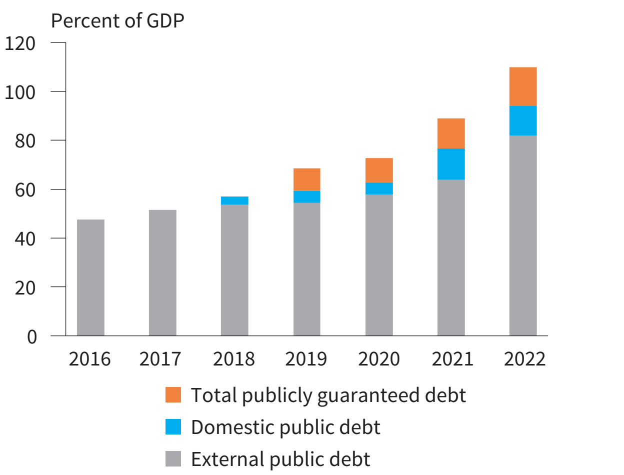
kip depreciation and higher domestic interest payments. Accumulated debt service deferrals during 2020–2022 (of principal and interest owed to China) are estimated at about 8 percent of GDP. These deferrals have helped ease fiscal pressures in recent years. Nevertheless, limited fiscal space has constrained the government's ability to provide support to poor households severely affected by rising living costs, as well as to invest in growth-enhancing expenditures (health and education), which had already declined from 4.2 percent of GDP in 2016 to an estimated 2.6 percent in 2022 (Figure 18). In addition, expenditure arrears continue to pose a challenge for expenditure management.

2.5 Public Debt Dynamics

A weakened kip has significantly increased the public debt burden, with sustainability contingent on the outcome of ongoing debt negotiations

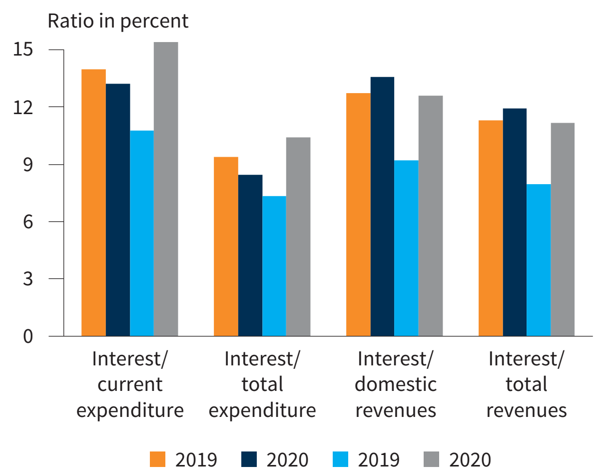
Public and publicly guaranteed (PPG) debt has reached critical levels, which undermines macroeconomic stability and development prospects. Laos is facing considerable liquidity and solvency challenges owing to a high debt burden, slow improvement in revenue collection, low foreign currency reserves, and limited financing options. Total PPG debt increased from 73 percent of GDP in 2020 ($13.3 billion) to 89 percent of GDP in 2021 ($14.5 billion), and it is estimated to have surpassed 110 percent of GDP in 2022[6] (Figure 19). The sharp exchange rate depreciation experienced in 2022 and (to a lesser extent) domestic bond issuances were the main factors responsible for the recent deterioration of public debt service ratios (Figure 20). Despite the temporary relief provided by debt service deferrals during 2020–22, the ratio of debt service (i.e. principal and interest) to domestic revenue increased from 35 percent to 61 percent between 2017 and 2022.

Figure 19. Public and publicly guaranteed debt stock



Source: Ministry of Finance, World Bank staff estimate.

Figure 20. Increasing interest payment burden



Source: Ministry of Finance, World Bank staff estimate.

The PPG debt stock is mostly external and highly exposed to foreign exchange risk. External PPG debt accounted for 86 percent of total PPG debt in 2021, of which 72 percent was public debt, and 14 percent was publicly guaranteed SOE borrowing.[7] In terms of external public debt, debt denominated in US dollars accounted for 54 percent, followed by International Monetary Fund Special Drawing Rights (15 percent), Chinese yuan (10 percent), and Thai baht (9 percent). The significant depreciation of the Lao kip against major foreign currencies in 2022 had a considerable effect on the debt burden.

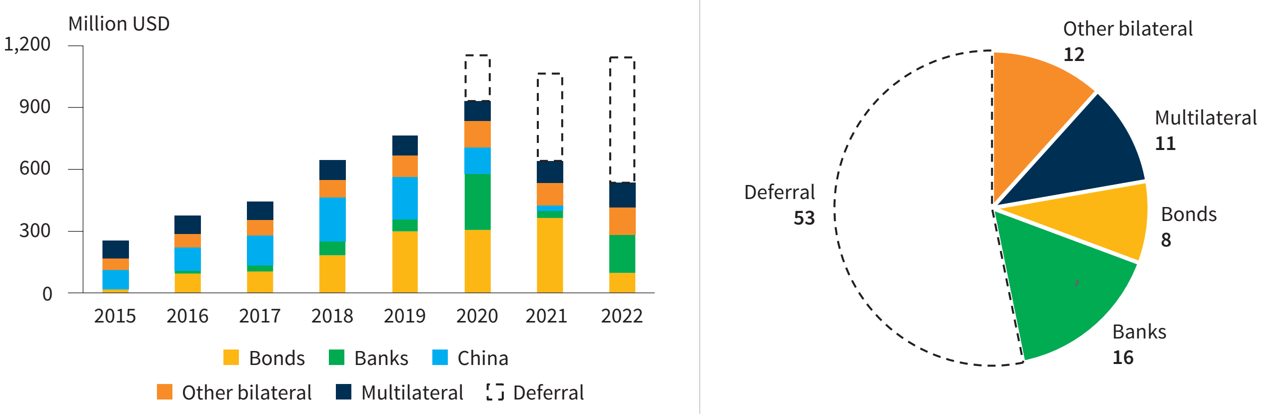
[6] Preliminary estimate from the authorities. A Debt Sustainability Analysis was concluded in May 2023.

[7] Laos uses the currency criterion (i.e. external debt is all debt denominated in foreign currencies, irrespective of where it is issued. Domestic debt is all kip denominated debt).

Despite recent deferrals, external public debt service obligations remain high, with debt sustainability contingent on a successful conclusion to ongoing negotiations. Laos has benefited from deferrals on debt service obligations to China since 2020. There is little information about how or when these will be repaid. A successful conclusion of ongoing negotiations will be crucial to place Laos on a sustainable path and restore macroeconomic stability. External public debt service obligations will average more than $1.3 billion per year in 2023–2026, about 9 percent of the 2022 GDP and more than two-thirds of domestic revenue. With limited foreign reserves, at about $1.1 billion as of December 2022, high debt service obligations will continue to jeopardize macroeconomic stability.

Figure 21. External public debt repayment

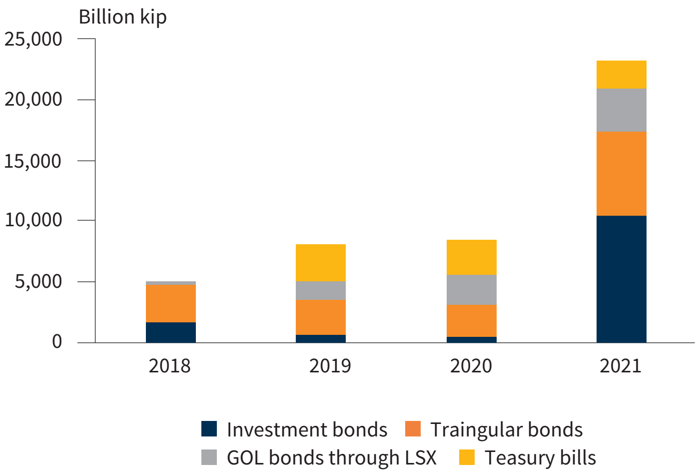
A. By creditors (in million USD, 2022) | **B. By creditor (in % share of total plan, 2022)**



Source: Ministry of Finance.

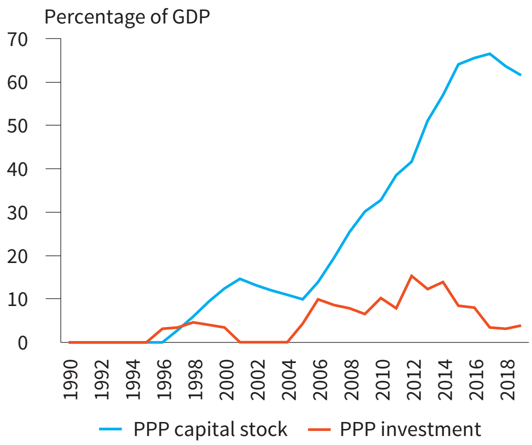
Source: Ministry of Finance.

Figure 22. Domestic debt stock composition



Source: Ministry of Finance.

Figure 23. Public-private investment stock



Source: International Monetary Fund (Investment and Capital Stock Dataset).

Domestic public debt has increased through the issuance of domestic bonds to recapitalize a state-owned bank. Domestic debt stock rose substantially from 5 to 13 percent of GDP between 2020 and 2021, mainly due to the issuance of triangular and investment bonds (amounting to 9.6 trillion kip, or nearly $1 billion) to clear domestic expenditure arrears and recapitalize a state-owned bank (Figure 22). Additional recapitalization bonds were issued in early 2022 for another state-owned bank. Domestic public debt service increased significantly in 2022, partly because matured bonds and repayments of foreign currency denominated loans to domestic banks were made in Lao kip.[8]

The operations of state-owned enterprises and public-private partnerships can also create fiscal risks through additional contingent liabilities. SOE debt accounted for 43 percent of total PPG debt in 2021 (in the form of on-lending and public guarantees), of which 42 percent was held by SOEs in the power sector (namely, EDL, EDL-Generation, and Lao State Holding Enterprise). EDL alone accounted for 37 percent of total PPG debt in 2021. Unsustainable debt accumulation and large operating losses pose significant fiscal risks to the government. The recent currency depreciation has affected enterprises that earn revenues in kip but have expenses in foreign currencies (e.g. input purchases and debt repayments). In addition, if not appropriately designed and managed, increasingly complex public-private partnerships (PPPs) can create fiscal risks through additional contingent liabilities. The government is undertaking SOE reforms and planning to upgrade the PPP decree to a law, which could help improve the governance of PPPs.[9]

Since external market access remains limited, the government increasingly relies on domestic borrowing to meet its financing needs. In March 2022, the authorities issued bonds amounting to 5 billion baht in the Thai market to help cover existing debt repayment obligations. The authorities have also tapped into domestic financing sources, including borrowing from the banking sector, bond issuances, asset sales, natural resource sector revenues, and SOE on-lending repayments. Bank lending to the government rose to 12 percent of GDP in 2022, compared to only 5 percent in 2019. Domestic borrowing may crowd out private-sector credit, which would harm private-sector growth.

2.6 External Sector

External imbalances remain high amid high demand for imports and debt service

The current account balance as a ratio to GDP slightly worsened in 2022 due to lower net trade on goods and services and increased net income payment.[10] Imports of goods and services grew faster than exports, partly owing to higher import commodity prices and higher service imports (Figure 24). Main imports were fuel, machinery, and raw materials. The oil price shock led to doubling the oil import bill to 1.2 billion in 2022 compared to 640 million in 2021. On the other hand, exports of goods and services were supported by growth in mining, electricity, wood pulp and paper products, cassava, and rubber exports, as well as a recovery in tourism receipts. Though goods exports are fully recorded, only 33 percent of export proceeds are reportedly repatriated to the Lao economy, contributing to limited foreign exchange liquidity.[11] According to the official data, the current account surplus was estimated to decline from 2.4 percent of GDP to 0.8 percent in 2022. When using statistics compiled by trade partners, which reflect unrecorded imports by Laos, the current account balance is estimated to remain a deficit of 3 percent of GDP. Despite public debt service deferrals in 2022, net income payments remained high.

The financial account as a ratio to GDP rose in 2022. While the nominal net inflow remained stable at around $310 million, net financial inflows as a ratio to GDP rose marginally due to a lower nominal GDP in US dollar terms. Foreign direct investment net inflow was down by 41 percent year-on-year as many large investment projects were completed in 2021 (Figure 25). Portfolio investment net inflows rose in 2022 due to a government bond issuance in March 2022. In the meantime, other investments experienced net outflows, partly due to principal repayments on external debt. The combination of relatively low foreign exchange net inflows and the current account deficit put pressure on the overall external balance, resulting in a decline of foreign reserves to $1.1

8 According to the Public Debt Bulletin 2021, this includes principal and interest payments related to loans from domestic commercial banks disbursed in 2020–2021 (amounting to $199.6 million), which matured in 2021 but were rolled over to 2022. The Ministry of Finance and the banks have an agreement that enables these payments to be made in Lao kip.

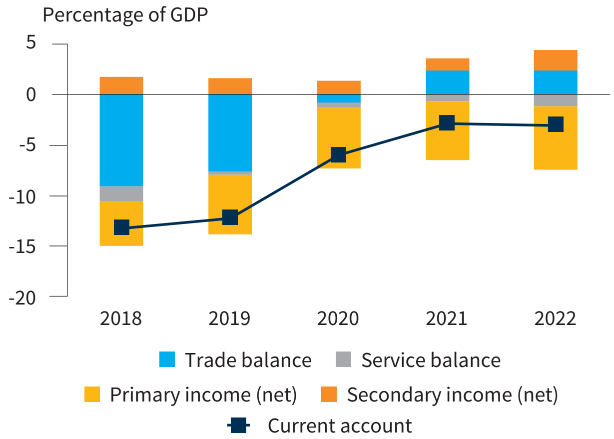
9 There are 178 State Owned Enterprises (SOEs). Under the SOE reform program, two state-owned banks, Lao Development Bank (LDB) and Agriculture Promotion Bank (APB) were restructured in 2021. The government sold its 51 percent share in the Lao State Postal Enterprise. Other SOEs being reformed include EDL, EDL-Gen, Lao Airlines, Agro-industrial Development Company, Lao Export-Import Trading Company, Lao State Fuel Enterprise, Lao Logistics State Enterprise, and MSIG Insurance. See https://www.vientianetimes.org.la/freeContent/FreeConten121_PM_y22.php

10 The worsening of external balance GDP ratio was also due to a lower nominal GDP in US dollar terms as a result of the sharp kip depreciation.

11 Laotian Times. 2022. “Laos Economy Short-changed by Foreign Currency Outflows”. Available https://laotiantimes.com/2022/05/19/laos-economy-short-changed-by-foreign-currency-outflows/

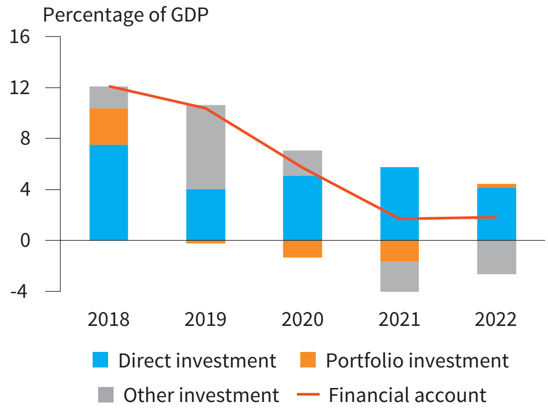
billion in December 2022 from $1.2 billion the year before. Based on an indicative scenario below, the pressure on foreign exchange demand is considerable. Potential net foreign currency outflows are estimated to be much larger than officially recorded (Figure 26).

Figure 24. Current account composition



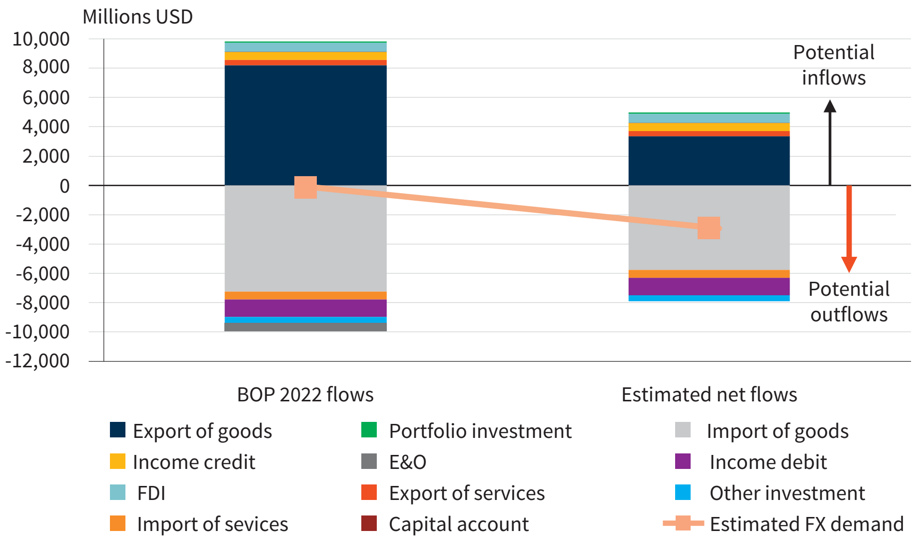
Source: World Bank staff estimate based on data from the Bank of Lao PDR.

Figure 25. Financial account balance



Source: World Bank staff estimate based on data from the Bank of Lao PDR.

Figure 26. Indicative scenario of potential demand for foreign exchange based on balance of payments in 2022

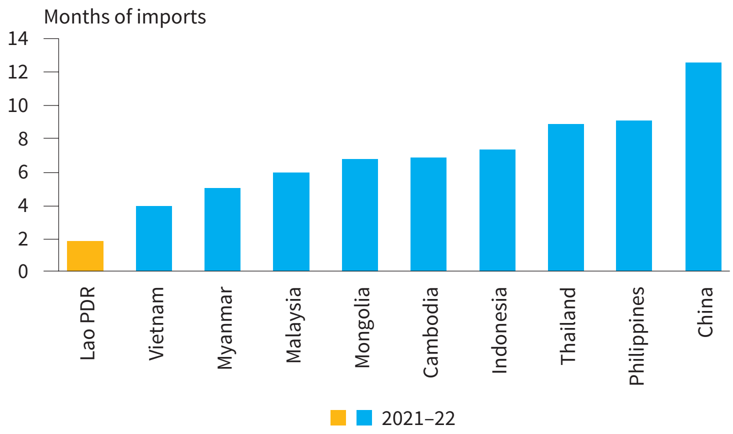


Source: World Bank staff assessment based on data form from the Bank of Lao PDR, Ministry of Finance, and various other sources.

Note: Estimates of foreign exchange demand are based on these assumptions: (i) goods export proceeds adjust for underreported exports, but only 33 percent of the officially reported amount flow back into the economy; (ii) goods import payments adjust for underreported imports but one-third of imports are financed by investment projects, (iii) net services trade and net primary and secondary income are as officially reported; (iv) net financial account is as officially reported and (v) errors and omissions are negligible after these adjustments.

Reserve buffers are inadequate, which undermines the ability to absorb shocks and defend the currency. Gross official reserves stood at $1.1 billion in December 2022, covering less than two months of imports of goods and services. This is lower than the debt service due in 2023. Despite support from a swap arrangement with the People's Bank of China, foreign reserves were low partly because only one-third of export receipts entered the country through the banking system. This is particularly low in the natural resource and informal trade sectors.

Figure 27. Foreign currency reserve adequacy



Source: World Bank EAP Economic Update April 2023

2.7 Exchange Rate

Recent measures have helped stabilize the official exchange rate, but structural imbalances remain

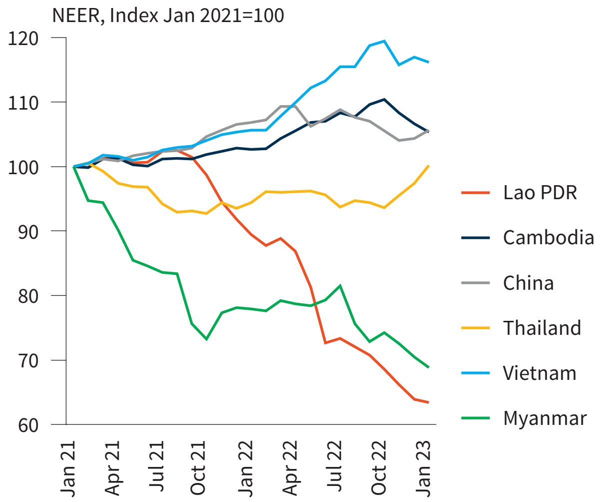
The kip depreciated significantly against foreign currencies during 2022, but the exchange rate appears to have stabilized in recent months. Depreciation pressures have eased since November 2022 owing to a weakening US dollar and recent monetary policy tightening in Laos. However, the kip still depreciated by 32 and 43 percent against the Thai baht and the US dollar in the year to March 2023. The depreciation pressures faced by the Lao kip were much stronger than in regional peers, suggesting that domestic factors account for most of this trend (Figure 28). Among these are foreign exchange liquidity constraints (despite substantial external debt repayment deferrals), low foreign reserves, and depreciation expectations, which undermine confidence in the kip. Commercial banks are rationing the supply of foreign exchange by prioritizing imports of essential goods, particularly fuel. The demand for foreign currencies is not fully met at the official exchange rate, leading to the operation of a parallel market. The premium widened to around 4 percent by the end of April 2023 compared to 0.5 percent in January (Figure 30).

The real effective exchange rate (REER) depreciated in line with the trend in the nominal rate. The REER depreciated by 18 percent in 2022, compared to 6 percent in 2021. It further weakened by 3 percent year-on-year during January–March 2023. A REER depreciation can contribute to boosting export competitiveness, but only if certain preconditions are met (e.g. adequate productive capabilities).

To ease depreciation and inflationary pressure, the Bank of the Lao PDR tightened monetary policy and introduced administrative measures to manage the exchange rate. To mop up excess kip liquidity, the central bank issued savings bonds in June 2022 amounting to 5 trillion kip with a six-month maturity at 20 percent per annum. Subsequently, bonds amounting to 2 trillion kip were issued in both January and February 2023, although offering a lower interest rate of 15 percent per year in the February offer. The policy rates were raised twice since mid-2022, from 3.1 to 6.5 percent in October 2022 and then to 7.5 percent in February 2023. However, these increases are undermined by weak monetary transmission mechanisms, as commercial bank deposit and lending rates have not adjusted to the policy rate changes. Exchange rate controls were introduced by placing daily limits on foreign exchange transactions at banks, while exchange bureaus were instructed to close in January 2023. The impact of these measures is likely temporary since the underlying structural imbalances remain unaddressed, as evidenced by the rationing of foreign exchange by commercial banks. To improve foreign exchange liquidity, the law on foreign exchange management was revised to introduce repatriation requirements in which exporters are required to bring export receipts to the Lao banking system. The BOL is developing secondary legislation to support the law's implementation. However, these administrative measures could be counterproductive if businesses lack confidence in the domestic financial sector.

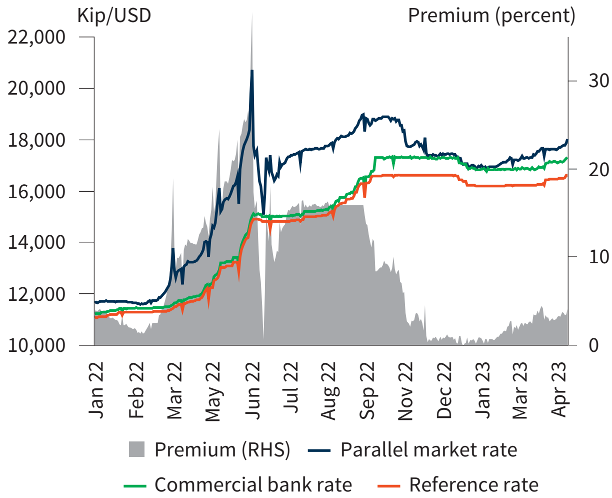
Figure 28. Exchange rate

(An increase means appreciation. A decrease means depreciation)



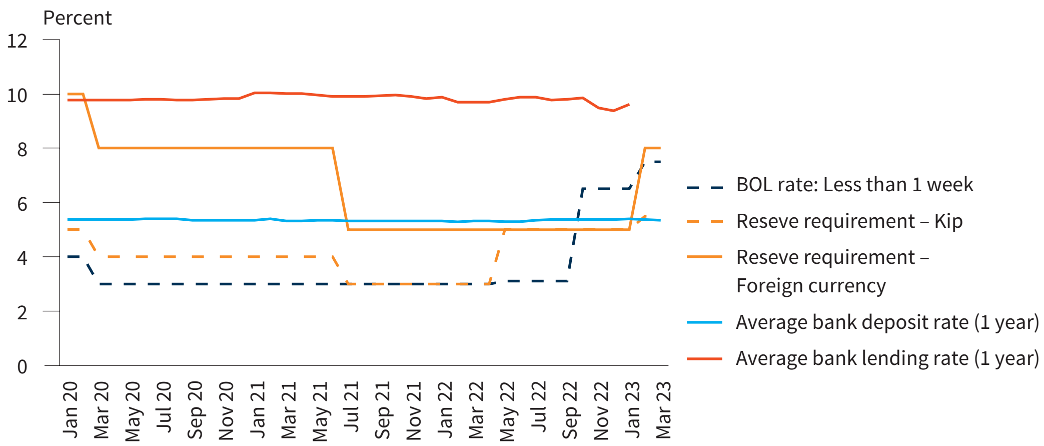
Sources: www.bruegel.org

Figure 29. Kip/USD exchange rates



Source: Bank of Lao PDR

Figure 30. Monetary policy tightening (Rates)



Source: Bank of Lao PDR

2.8 Financial Sector

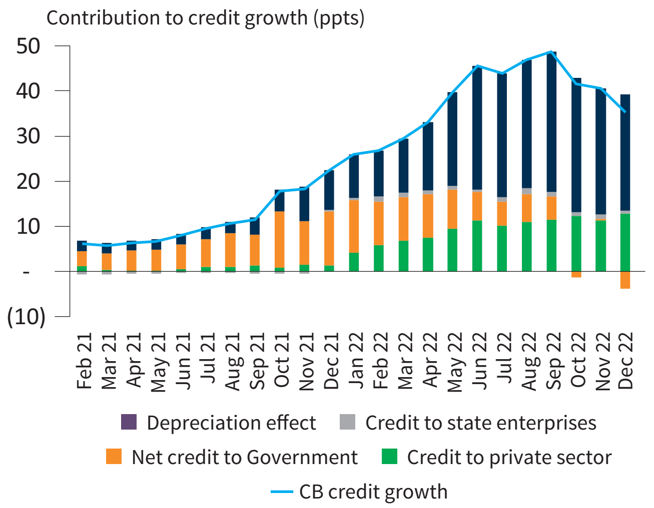
Despite improvement in some aggregate financial soundness indicators, vulnerabilities in the financial sector persist.

Domestic credit grew strongly until September before moderating by the end of 2022.[12] Domestic credit growth accelerated to 49 percent in the year to September 2022 mostly due to the impact of the exchange rate depreciation on the value of foreign-currency denominated credit. However, credit growth slowed to 37 percent by December 2022 due to moderated lending to the government by commercial banks. Credit to the economy, including private and state-owned enterprises rose from 52 to 62 percent of GDP between 2021 and 2022, reflecting lending support during the COVID-19 epidemic and the depreciation effect. Domestic credit to the economy mostly comprises lending to industry, commerce, service, and construction sectors.

Banking sector exposure to government borrowing has increased. As external financing options are limited, the government has increasingly resorted to domestic borrowing. Total lending to the government rose to 12 percent of GDP in 2022 compared to 5 percent in 2019. This reflected higher public borrowing from the domestic banking sector to meet its financing needs (due to limited access to international capital markets) and higher holdings of government bonds as a form of repayment of public expenditure arrears. While commercial banks account for about two-thirds of total lending to the government, the central bank's share increased during 2022.

Broad money grew strongly compared to 2021, mostly due to the depreciation effect on foreign currency deposits. As the kip loses value against other currencies, holding foreign currencies has been preferred as a hedge against depreciation expectations. This contributes to an increase in the ratio of foreign currency deposits to broad money in kip equivalent term, from 51 percent in January 2021 to 63 percent in December 2022. Nevertheless, broad money growth moderated by the end of 2022, partly reflecting the recent effort in reducing kip liquidity through BOL's bond issuances and the relatively stable kip/USD exchange rate between the end of 2022 to early 2023. Some banks reported that deposits were drawn down to purchase kip savings bonds.

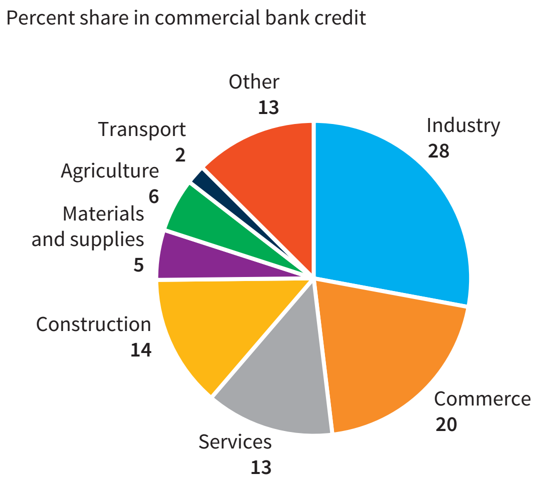
Figure 31. Domestic credit growth



Source: World Bank staff estimate based on Bank of Lao PDR data.

Note: This illustration covers only lending by commercial banks to the government, SOEs and private sector. The demonstrated depreciation effect assumes the difference between the monthly actual kip-equivalent credits and estimated kip-equivalent credit amount assuming a constant kip/USD exchange rate in Jan 2020 = 100.

Figure 32. Commercial bank lending to the economy in 2022[13]

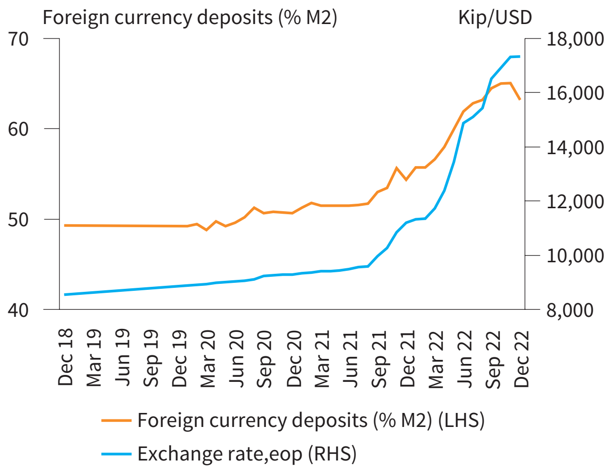


Source: Bank of Lao PDR.

[12] Domestic credit covers credit from the Bank of the Lao PDR and commercial banks to the private sector, state-owned enterprises., and the government.

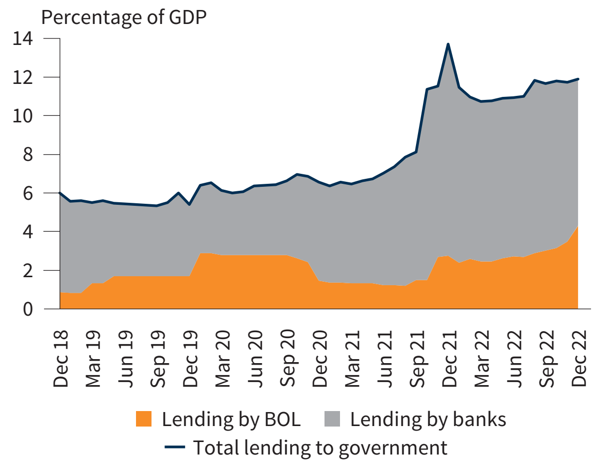
[13] This includes commercial bank lending to private sector and state-owned enterprises. Lending to the government is separate.

Figure 33. Foreign currency deposits



Source: Bank of the Lao PDR.

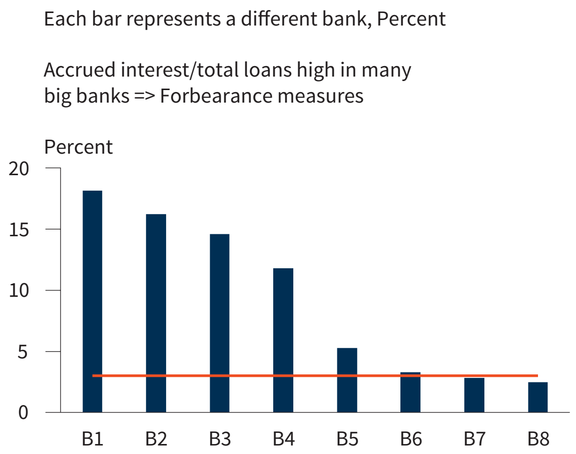
Figure 34. Exposure to government borrowing



Source: Bank of the Lao PDR.

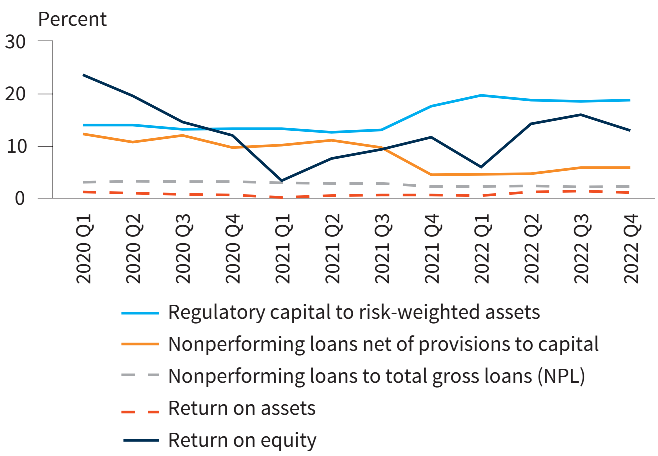
Financial sector vulnerabilities persist, despite positive system-wide averages. While the aggregate capital adequacy ratio (CAR) for the banking system seems comparable to regional peers, it masks significant variation in capital buffers and asset quality across banks. The CAR ratio increased to almost 20 percent in the first quarter of 2022, reflecting the restructuring of two state-owned banks (Lao Development Bank and Agriculture Promotion Bank) and capital increase of bank branches as per regulatory requirements. However, the ratio then dropped to 18.7 percent in December 2022, partly owing to a declining CAR in the largest bank (BCEL). BCEL accounts for 38 percent of banking sector assets and saw its CAR decline to 5.7 percent in Q3-2022 from 7.37 in Q4-2021.[14]

Figure 35. Accrual interest to loans ratios[15]



Source: World Bank staff calculation based on banks' financial reports on their websites

Figure 36. Financial soundness indicators



Source: Bank of the Lao PDR

[14] According to Interim Financial Information for the three-month period of Quarter 3 ended 30 September 2022. See https://www.bcel.com.la/bcel/bcelweb-datas/financial-info/quarter-rpt-unaudited/en/bcel_web_file_49_14797606d4f8dce5a9cffeb1fc6902cf.pdf

[15] This accrual interest to loans ratio provides an indication of how much interest has been accounted but is yet to be collected by the bank. It aims to highlight cases of deterioration of the loan portfolio that might not be captured solely by looking into non-performing loans. They reflect forbearance practices like those observed during the pandemic (COVID-19) where payments were deferred but accrual of interest continued.

Reported non-performing loan (NPL) ratios slightly declined, partly due to continued regulatory forbearance. The decline in reported NPL ratios partly reflects faster credit growth and loan classification flexibility under the forbearance policy (Figure 35). While some banks are reporting the withdrawal of forbearance measures to businesses on a case-by-case basis, the lack of a clear timeline to phase out these measures (such as the freeze of loan classifications) and the practice of ever-greening loans could undermine credit discipline and present risks to the financial system. Six of the top eight banks have significant accrued interest receivables (more than the prudent level of 3 percent of total loans), a sign of generous extension of forbearance by banks. Sector profitability and liquidity remain low, despite an uptick in Q2–Q3 of 2022, and are lower than some regional peers (Figure 36). In this context, balancing the phasing out of forbearance measures and the health of bank balance sheets is important to minimize vulnerabilities in the financial sector while supporting the economic recovery.

3. Outlook and Risks

Box 1 Key assumptions for the baseline

The outlook assumes a gradual recovery in international tourism and exports, but macroeconomic stability is contingent on a successful conclusion to the ongoing debt negotiations. Tourism and trade are expected to benefit from China's re-opening and connectivity improvements. The outlook assumes that the accumulated debt payment deferrals during 2020–22 will continue into the medium term. However, pressures from debt service payments in the next few years are expected to persist unless there is a comprehensive and favorable agreement on debt restructuring with the main creditors. Oil and food price rises are expected to moderate, but domestic structural constraints are expected to intensify pressure on the exchange rate and hence affect inflation in the near term. Revenue collection gradually improves as revenue-enhancing measures are implemented and tax compliance improves. As debt service obligations remain high, expenditure control policies continue to be considered to achieve fiscal consolidation in the medium term.

The economy is projected to grow at 3.9 percent in 2023 and accelerate to an average of 4.3 percent in the medium term led by a continued recovery in the services sector and exports. The gradual resumption of tourism, particularly from China and Thailand, will stimulate the services sector. External demand, coupled with improved logistics services and connectivity, would help sustain manufacturing and agriculture exports. The industry sector will also benefit from investments in the power sector and special economic zones.[16] However, growth prospects will remain below pre-COVID levels as structural imbalances will continue to weigh on recovery. Depreciation pressures could reemerge, given high import demand, debt service obligations and the prevalent rationing of foreign exchange by commercial banks. In an upside scenario, if structural imbalances are gradually addressed, coupled with a successful debt negotiation outcome, Laos could achieve faster growth.

Inflation will remain high in 2023, in part due to high commodity prices and possible depreciation pressures. Global price increases are projected to ease compared to 2022, but depreciation pressures will continue to feed into inflation. High inflation will dampen real incomes and consumption and add to business costs. These factors could further incentivize labor migration to Thailand, which is already reported as a key constraint for the manufacturing and hospitality sectors.

High debt levels will continue to constrain fiscal space. Revenue is expected to gradually increase with economic activity and tax administration improvements, while high interest payment obligations will subdue other expenditures. The outlook assumes a primary surplus in the next few years, but the fiscal deficit is expected to increase, reflecting a high debt service burden. External debt service obligations average $1.3 billion per year over 2023–2026, keeping total public financing needs high. This is compared to about $1.1 billion official foreign exchange reserves at the end of 2022. High interest payments will put pressure on the fiscal deficit and constrain

[16] Pipeline power projects include Luang Prabang hydropower project (1460 MW), Nam Phak (128 MW), Nam Theun 1 (650 MW), Nam Ngum 3 (480 MW).

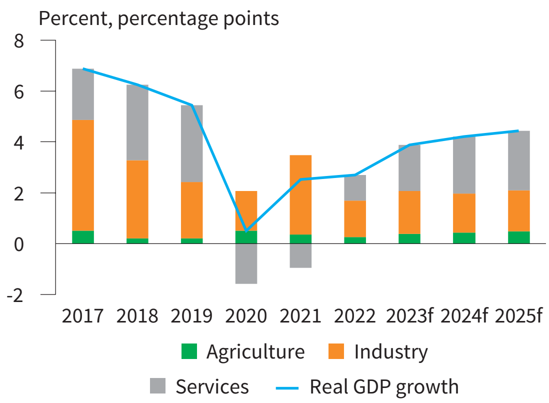
critical spending on the social sectors in the absence of bold revenue reforms. Therefore, a successful conclusion to the ongoing debt negotiations and enhanced domestic revenue mobilization will be the key to creating fiscal space for critical growth-enhancing spending.

External imbalances are expected to persist. The current account balance is expected to remain at around 3 percent of GDP as improvements in exports, tourism, and remittances are offset by higher import demand and interest payment obligations. Despite the requirement for exporters to remit export receipts, reserves adequacy is expected to remain relatively thin (covering less than two months of imports) without substantial reform progress on revenue (e.g., review of foregone revenues from tax exemptions) and the investment climate to promote re-investment opportunities.

Household incomes are expected to gradually improve in nominal terms, albeit undermined by high living costs. Inflation has eroded purchasing power, depleting household savings and reducing household consumption and human capital spending, thereby placing many households at risk of falling into poverty. Slow progress in poverty reduction will likely continue. On a vulnerable-recovery path, per capita income growth is likely to remain below the pre-pandemic and regional peer levels in the medium term, thereby causing further divergence on poverty reduction and living conditions.

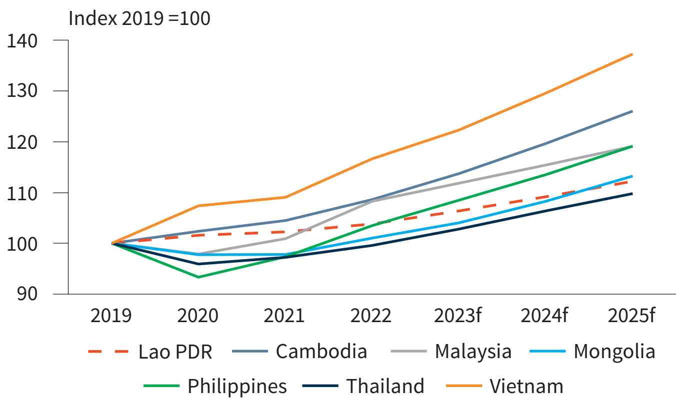
The outlook is subject to significant downside risks. The main external risks include lower-than-expected growth in regional economies, which could lower external demand. On the other hand, faster-than-expected growth in China could boost external demand, but it could revive inflationary pressures. If inflationary pressures in advanced economies persist, further interest rate increases in those economies could renew depreciation pressures on the kip and thus domestic inflation, which could drive further macroeconomic instability. Domestic risks include challenges with refinancing external debts, slow progress with structural reforms, and deterioration of bank balance sheets. In particular, the outcome of ongoing debt negotiations with key creditors will have significant implications for both debt sustainability and macroeconomic stability. A fiscal adjustment alone, particularly through protracted expenditure curbs, will be insufficient to improve debt sustainability without harming medium- and long-term growth prospects, as the debt overhang will undermine critical investments in human capital, crowd out private investment, and drive macroeconomic instability. Labor shortages due to out-migration for better wages could also undermine recovery prospects for labor-intensive sectors, including the agriculture, manufacturing, and services sectors.

Figure 37. Lao PDR GDP growth



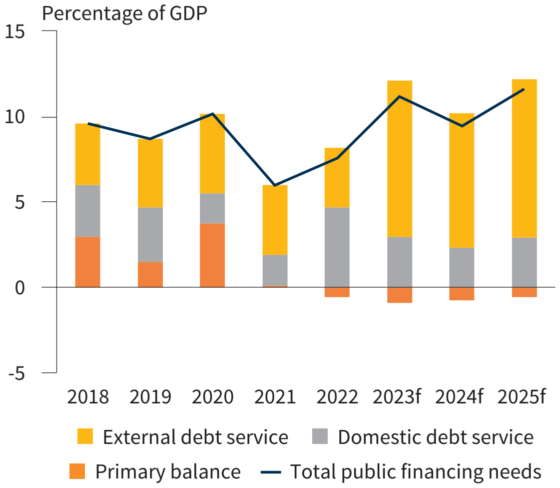
Source: Lao Statistics Bureau and World Bank staff estimate

Figure 38. Projected GDP per capita growth



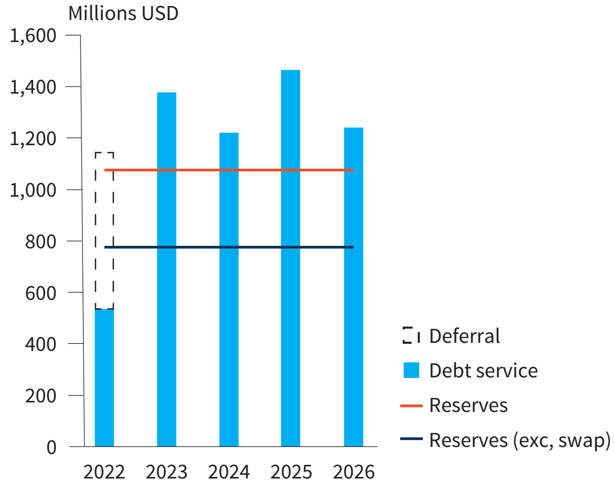
Source: International Monetary Fund World Economic Outlook April 2023, World Bank staff calculation.

Figure 39. Total public financing needs



Sources: Ministry of Finance and World Bank staff estimate.

Figure 40. Public debt service and foreign reserves



Sources: Ministry of Finance, Bank of Lao PDR and World Bank staff estimate.

4. Policy Options

To restore macroeconomic stability, a strong commitment to ambitious reforms is essential in five crucial policy areas: (i) raise public revenues to protect spending on education, health, and social protection; (ii) improve expenditure allocation and efficiency; (iii) expedite debt negotiations; (iv) strengthen financial sector stability; and (v) improve the business environment to promote investment and exports. In addition, improving the availability, timeliness, and quality of data is essential to inform evidence-based policy making. Specific reforms are as follows:

- **Review tax incentives and exemptions.** Broadening the tax base is critical to boosting domestic revenue mobilization. The corporate income tax (CIT) gap (i.e. the difference between potential and actual CIT revenue) is estimated at nearly 90 percent, implying large foregone revenues from tax exemptions. Profit tax collection in 2022 was still below regional benchmarks. Large capital-intensive investments in energy, mining, and transport infrastructure have benefited from generous tax incentives, which deprive the country of vital fiscal revenues and foreign exchange inflows. International evidence shows that tax incentives do not always encourage foreign investment in the natural resources sector, which is geographically specific. To better link incentives to investment, it would help to replace the current profit-based tax incentive system (based on tax holidays and reduced rates) as granted in the current Investment Promotion Law with a cost-based tax incentive system based on accelerated depreciation and additional tax deductions.

- **Restore the value-added tax (VAT) rate to 10 percent and reduce VAT exemptions.** The VAT accounted for about 30 percent of total tax revenue in 2015–2019. In January 2022, the VAT rate was reduced from 10 to 7 percent. As a result, the VAT collection declined in 2022, although it is unclear if this tax cut has been passed on to consumers. Therefore, restoring the VAT to 10 percent could (immediately and efficiently) raise over $150 million a year. Part of this could then be earmarked to support the most vulnerable households through, for example, the expansion of targeted cash transfer programs, so that the tax rate increase does not affect income inequality. Reducing VAT exemptions, such as those for large-scale agricultural activities, would help widen the tax base and thus support domestic revenue mobilization.

- **Reprioritize spending toward the social sectors.** Improving the allocative efficiency of public expenditures is particularly important given the persistent fiscal constraints. Development spending (on health, education, and social protection) has been declining as a share of GDP due to pressures from declining

[17] This projection of financing needs does not yet include the payment of accumulated debt service 2020–22.

revenues, rising debt service payments, and spending on other sectors and government organizations. This trend has undermined public service delivery. Reprioritizing public spending toward education, health, and social protection would be critical to building human capital and thus improve economic growth prospects in the medium term. It would also make public spending more pro-poor, thus helping to reduce poverty and inequality (see further discussion in the Thematic Chapter).

- **Expedite debt renegotiations with key lenders to restore debt sustainability.** Liquidity and solvency challenges are due to rapid debt accumulation, particularly in the energy sector, and limited revenue collection. The current debt service schedule is not achievable without a socially damaging compression of public expenditure. Restructuring public debt would be vital to secure macroeconomic stability and support the economic recovery. Bringing ongoing bilateral debt negotiations to a successful conclusion in a transparent way would ease debt pressures, create fiscal space for growth-enhancing expenditures, and improve market confidence.

- **Assess and manage contingent liabilities.** Implementing a robust framework to assess, approve, monitor, and manage fiscal risks related to public-private partnerships (PPP) would help limit the accumulation of contingent liabilities in the public sector. Governments can choose to finance public assets and services through a PPP model, which may enable investments that otherwise could not be undertaken. However, PPPs may turn out to be more costly than traditional procurement if they are not carefully designed. Therefore, it is crucial to enhance the current legal and regulatory framework by upgrading the Decree on PPPs to a law, and strengthening institutional capacity and transparency in the processes of preparing, procuring, and managing PPP projects.

- **Enhance bank supervision and operationalize emergency arrangement**. The protracted economic vulnerabilities and the unclear plan for withdrawal of regulatory forbearance measures negatively impact bank balance sheets and threaten the sector's ability to support the economic recovery. Putting in place a clear plan and timeline for withdrawing forbearance measures would help reduce bank burdens and vulnerabilities. The rapid depreciation of the Lao kip places an additional stress on the highly dollarized banking sector. A bank failure could have considerable economic repercussions. Therefore, strengthening the deposit protection fund and employing an early warning system would help manage vulnerabilities in the sector. It is critical that regulations and procedures are put in place as the government may need to mobilize liquidity facilities and emergency liquidity assistance arrangements to manage sector weaknesses.

- **Improve investment climate.** Creating a conducive business environment by implementing electronic business registration processes, streamlining the operating licensing regime, and reducing and simplifying entry conditions would facilitate the entry and expansion of both domestic and foreign firms. This would, in turn, contribute to improving productivity and economic growth. In addition, trade facilitation reform would benefit from streamlining non-tariff measures (NTMs) and promoting electronic customs clearance to facilitate trade. Such NTMs act as export restrictions. Improved transparency, harmonization, and mutual recognition of NTMs among trading partners would facilitate trade flows. More important, investing in human capital would stimulate economic diversification by focusing on basic education and partnering with the private sector to build and meet industry-specific skill needs.

Table 2. Key macroeconomic indicators

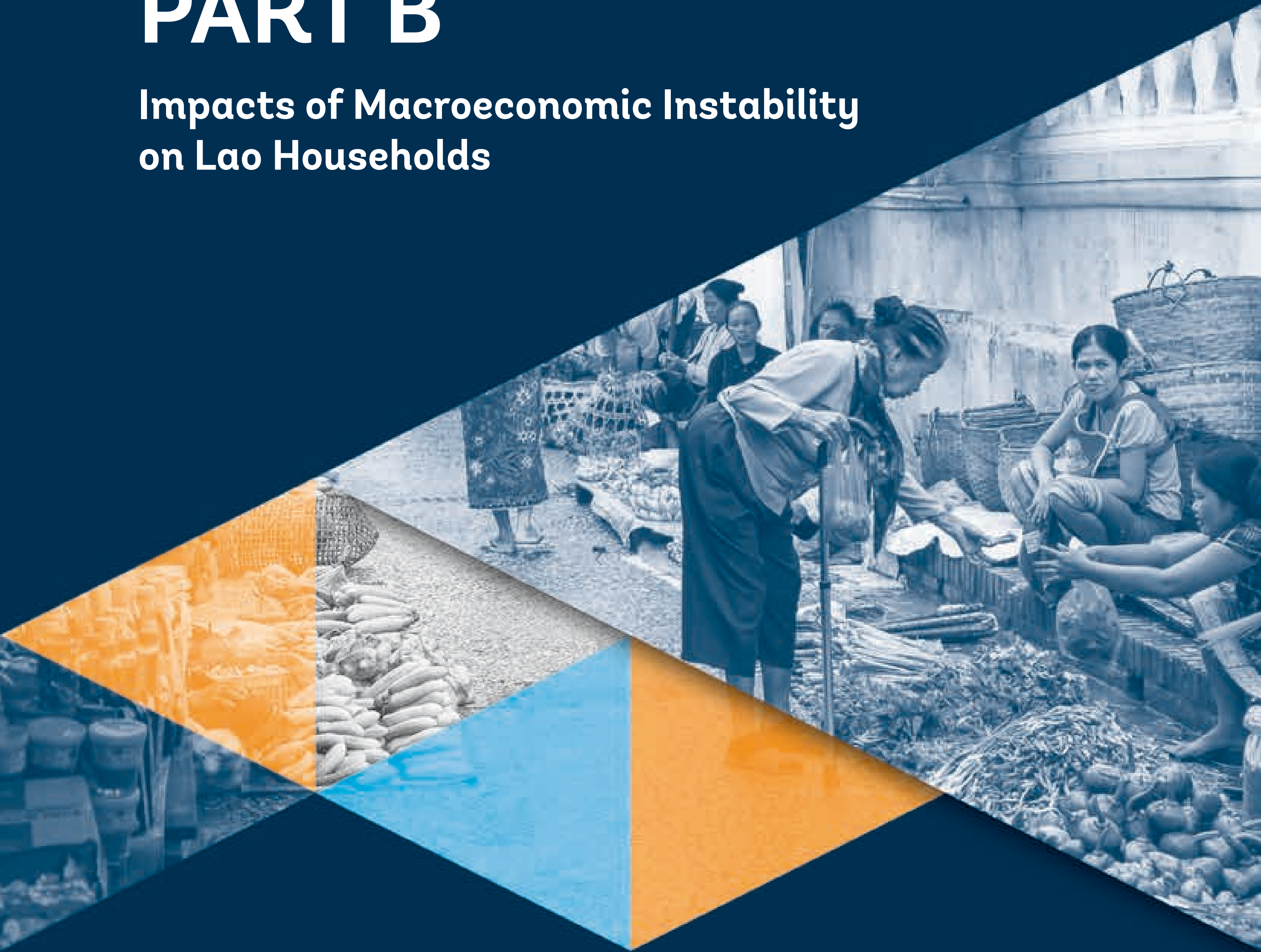
	2019	2020	2021	2022	2023	2024	2025
						Projections	
Real Economy		Percent change year-on-year					
Real GDP growth	5.5	0.5	2.5	2.7	3.9	4.2	4.4
Agriculture	1.2	3.2	2.3	1.6	2.4	2.8	3.2
Industry	5.6	4.0	7.6	3.3	3.9	3.5	3.8
Services	7.0	-3.5	-2.2	2.5	4.5	5.5	5.6
Inflation (period average)	3.3	5.1	3.8	22.7	16.8	5.1	3.5
Fiscal Account		Percent of GDP					
Revenues	15.6	12.7	14.9	15.0	15.1	15.2	15.5
Domestic Revenues	13.8	11.2	13.1	13.3	13.7	13.8	14.2
Taxes	10.9	9.2	10.1	11.1	11.2	11.4	11.7
Non-tax	2.9	2.0	2.7	2.3	2.4	2.4	2.4
Grants	1.7	1.5	1.8	1.7	1.4	1.4	1.3
Expenditures	18.8	18.0	16.1	16.1	17.0	17.5	17.9
Current expenditure	12.6	11.5	11.1	10.9	11.8	12.3	12.7
Wages	6.4	6.2	6.0	5.5	5.5	5.6	5.7
Other current expenditure excl. wages and interest payments	4.5	3.8	3.9	3.8	3.5	3.7	4.0
Interest payment	1.8	1.5	1.2	1.7	2.9	3.0	3.0
Current expenditure without interest	10.9	10.0	9.9	9.2	8.9	9.3	9.7
Capital expenditure	6.2	6.5	5.2	5.2	5.2	5.2	5.2
Fiscal balance	-3.3	-5.2	-1.3	-1.1	-2.0	-2.2	-2.4
Primary balance	-1.5	-3.7	0.0	0.6	0.9	0.8	0.6
Total Public Debt [1/]	59.0	62.3	76.6	102.8	100.9	98.7	96.4
Selected Monetary Accounts		Percent change year-on-year					
Broad money	18.9	16.3	24.0	36.9			
Credit to the economy	7.4	4.3	11.5	45.6			
Balance of Payments		Percent of GDP					
Current Account Balance	-12.1	-5.9	-2.9	-3.2	-3.0	3.1	-3.2
Trade balance	-7.9	-1.3	1.7	1.2	3.1	2.9	2.7
Export of G&S	37.6	35.2	42.1	59.8	65.4	68.2	71.4
Import of G&S	45.5	36.5	40.4	58.6	62.3	65.3	68.6
Primary and secondary income balances	-4.2	-4.6	-4.5	-3.9	-5.8	-5.8	-5.7
Gross international reserves	997	1,319	1,263	1,121	1,172	1,306	1,447
Months of G&S import cover	1.4	2.3	2.0	1.5	1.5	1.6	1.6
Memorandum items							
Nominal GDP (Billion kip)	162,657	171,741	182,584	220,695	259,011	280,517	300,795

Source: Lao Statistics Bureau, Ministry of Finance, Bank of Lao PDR, Ministry of Industry and Commerce, World Bank Staff estimate and projections baed on inputs from Lao Authorities and trade partners' data as of April 2023.

Note: 1/ public debt excludes public guaranteed debt.

PART B

Impacts of Macroeconomic Instability on Lao Households

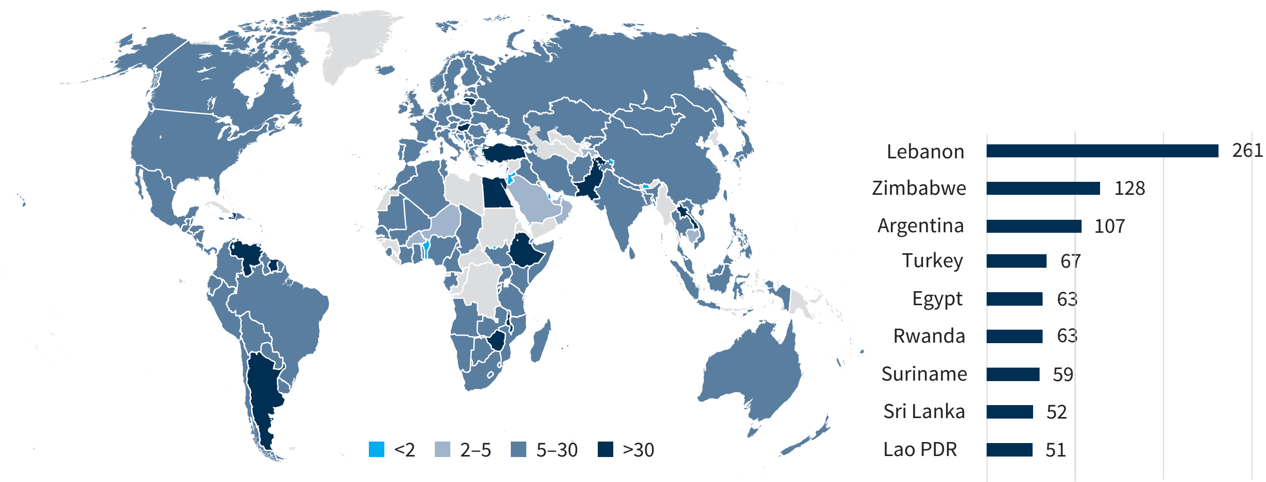


1. Introduction

As outlined in part 1 of this report, Laos is facing increased macroeconomic instability from a sharp currency depreciation and a double-digit inflation rate amid high levels of public debt. The Lao development model is driven by capital accumulation in the natural resource sectors and often financed by foreign debt. After achieving two decades of high and sustained growth, the development model is strained. Signs of macroeconomic instability have been growing. Public debt has increased considerably in recent years, as have publicly guaranteed debt and other contingent liabilities. Public and publicly guaranteed debt (PPG) was estimated to have reached over 110 percent of GDP in 2022. Rising debt service payments, coupled with the limited availability of foreign currency, which was exacerbated by the economic effects of COVID-19, have led to a sharp depreciation of the Lao kip against the US dollar. The strong depreciation and rising global inflation drove annual inflation to a two-decade high of 40 percent in April 2023.

Food inflation has accelerated in recent months, placing Laos among countries with the highest food price inflation. While overall inflation started to ease in Q4 2022 (month-over-month), food prices continued to soar and reached 52.2 percent in April 2023, partly due to higher input costs during the latest crop season. The price of rice, a staple food, rose by 72.6 percent year-over-year in April 2023, followed by bread (64.7 percent), milk, dairy products, and eggs (52.8 percent), and meat and fish (45.8 percent). Surging food prices have placed Laos among the 15 countries with the highest food price inflation (Figure 41).

Figure 41. Food inflation (%)

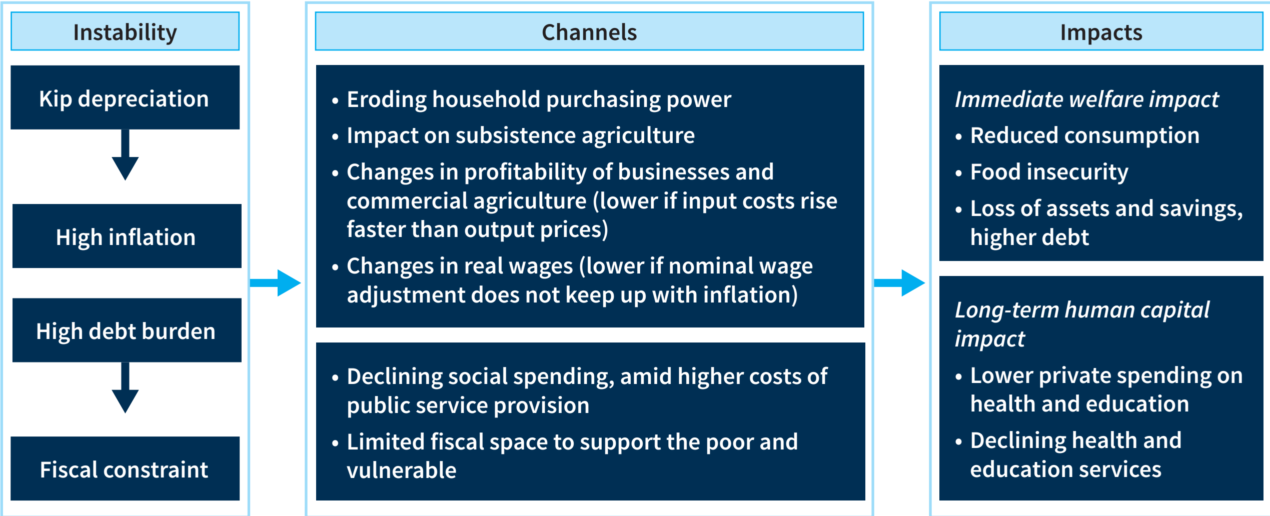


Sources: World Bank Food Security Update. Data retrieved from International Monetary Fund, Haver Analytics, and Trading Economics.

Note: Food inflation for each country is based on the latest month from October 2022 to April 2023, for which the food component of the CPI and overall CPI data are available.

Increased macroeconomic instability could potentially impact Lao households in various ways with distributional consequences (Figure 42). First, inflation erodes household purchasing power. Price increases generally do not affect all households in the same way because the consumption baskets of urban and rural households or high-income and low-income households differ in composition. Second, for poor households relying on subsistence farming, higher input costs could cut into farm production and productivity, reducing food availability. Third, while inflation may imply that some commercial farmers and family businesses benefit from higher output prices, rising input costs may negate this impact by cutting producers' margins. Fourth, price jumps generally erode real wages, especially among low-income workers whose wage growth usually does not keep up with inflation. Fifth, fiscal consolidation as a result of high debt levels and fiscal unsustainability creates distributional consequences through their impacts on taxes as well as public spending, investment, service delivery, and transfers. Lastly, macroeconomic instability could have a long-term negative impact on welfare through shocks to human capital. Constrained government and household budgets may lead to a decline in human capital spending. The impact is expected to be disproportionate for low-income households who rely on public health and education services and have limited resources to invest in human capital.

Figure 42. Potential impacts of macroeconomic instability on Lao households

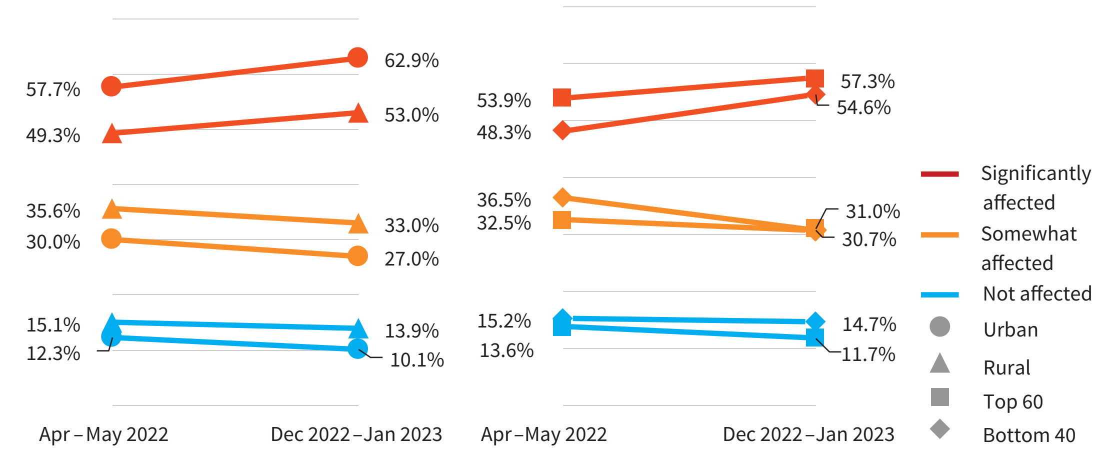


Source: World Bank staff illustration.

2. Immediate welfare impact

Inflation has affected almost 90 percent of Lao families. Urban and better-off households tend to be more exposed to inflation partly due to their heavy reliance on market goods and services. Based on the World Bank Rapid Monitoring Phone Survey, 87 percent of households had been affected by inflation by the end of 2022. The impact is persistently higher among urban and better-off families, with 62.9 percent of urban families and 57.3 percent of better-off families significantly affected by inflation compared to 53.0 percent and 54.6 percent of their counterparts, respectively (Figure 43). In Laos, urban and better-off households tend to be more exposed to inflation, given a larger spending share on market goods and services, while rural and low-income households tend to rely more on self-produced goods. It is estimated that urban and high-income families saw their living costs rise by 30.7 percent and 30.9 percent in 2022, compared to 21.3 percent and 20.5 percent for rural and low-income households respectively.[18] Despite lower exposure, low-income households tend to be more vulnerable to inflation as they have limited coping ability and fewer financial buffers to deal with higher living costs.

Figure 43. Percentage of Lao households affected by inflation



Source: World Bank Rapid Monitoring Phone Survey Round 5 (April – May 2022) and Round 6 (December 2022 – January 2023).

Note: The "Bottom 40" refers to individuals in the bottom 40 percent of the consumption distribution. The "Top 60" refers to individuals in the top 60 percent of the consumption distribution.

The impact of inflation has increasingly been felt across the board, largely through the impact of rising consumption and farm input costs. Soaring inflation during the second half of 2022 placed a heavy burden on Lao families, with the share of households experiencing a significant impact of inflation increasing across all groups. The increase is more evident among low-income families, from 48.3 percent in May 2022 to 54.6 percent in December 2022. Urban households and better-off rural households faced a larger increase in the cost of their consumption baskets during this period owing to their higher expenses for market food and transportation, for which prices increased sharply (Figure 44, Figure 45). For low-income families in rural areas, especially those relying on subsistence agriculture, the impact was widely felt through rising farm input prices such as fuel, seeds, fertilizer, and farm labor (Figure 46).

Commercial famers benefited from higher crop prices, but higher input costs cut into their income. Two-thirds of crop farmers produced crops for sale. Those who were net sellers could benefit from higher crop prices. However, this effect was negated by rising prices and shortages of inputs. While the wet-season paddy price per kilogram rose by 40–85 percent between 2020 and 2022, the price of fertilizer doubled or tripled (2022 Lao Agriculture Competitiveness Project survey). At the same time, the price of certified seeds rose by 40–50 percent, and fuel prices jumped by 80 percent on average. Some farmers who faced rising prices and shortages of farm inputs had to reduce fertilizer usage, use animals as an alternative to tractors, and cut their crop production (World Bank Community Survey, May–November 2022). Although 84 percent of commercial crop producers reported an increase in the price of their main crop, only half decided to increase production, and a quarter even cut production. Price shocks, coupled with weather-related shocks, led to surge in food prices even after the harvesting season.

Figure 44. Household expenditure by category

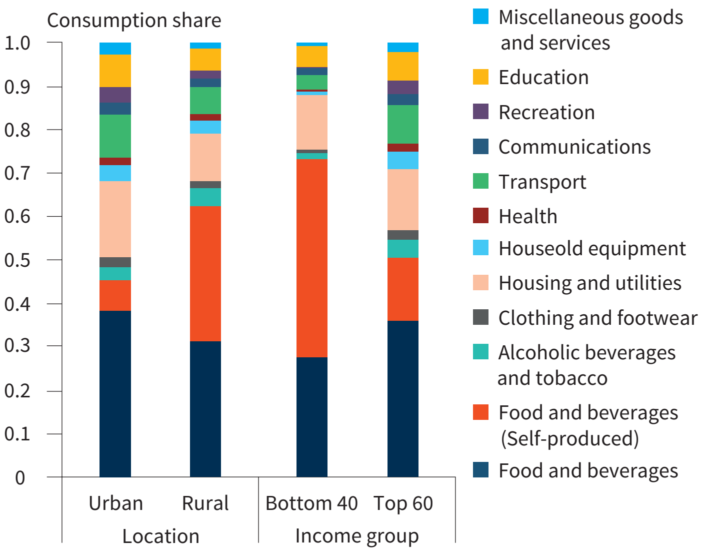
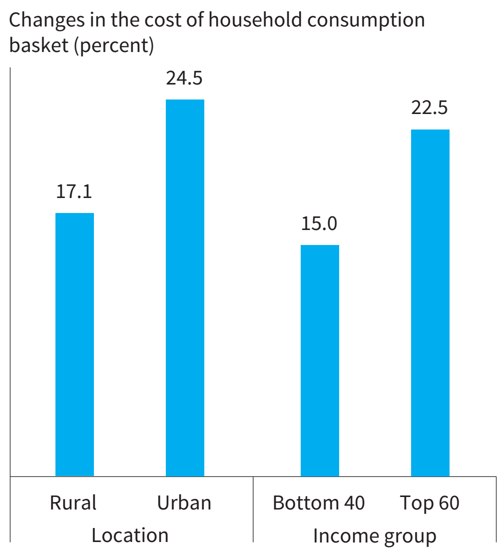


Figure 45. Increase in the cost of household consumption basket (May 2022 – Dec 2022)



Source: World Bank staff calculation based on the Lao Expenditure and Consumption Survey 2018/19. Lao Statistics Bureau for inflation by category.

Note: The consumption basket for each group of households is constructed from the Lao Expenditure and Consumption Survey 2018/19 by aggregating expenditures by category of all households in each group. An increase in the cost of consumption baskets due to price increases seen in each expenditure category between the two survey rounds (May 2022 - December 2022) assumes the fixed 2018/19 consumption bundles and zero inflation for self-produced food, implying that the analysis does not assume changes in consumption patterns in response to rising prices and the cost of inflation for rural households could be larger if rising agricultural input prices are factored in.

[18] An increase in the cost of consumption baskets due to price increases seen in each expenditure category in 2022. The consumption basket for each group of households is based on the Lao Expenditure and Consumption Survey 2018–2019, implying that the analysis does not assume changes in consumption patterns in response to rising prices.

Many household businesses gained from higher output prices, yet nearly half saw their profits undermined by currency depreciation and inflation. The impact of recent price shocks on the profitability of family businesses is uneven across sectors. Construction businesses were able to reap more profits from the shocks, with more than half making higher profit margins from the Lao kip depreciation and inflation. In contrast, businesses in the service sectors were hit hard by these shocks. Less than one-third of these businesses earned higher profit margins from the shocks, while more than half claimed that rising prices and a sharp currency depreciation had squeezed their profit margins (Figure 47).

Figure 46. Farm input cost (percent of crop producers)

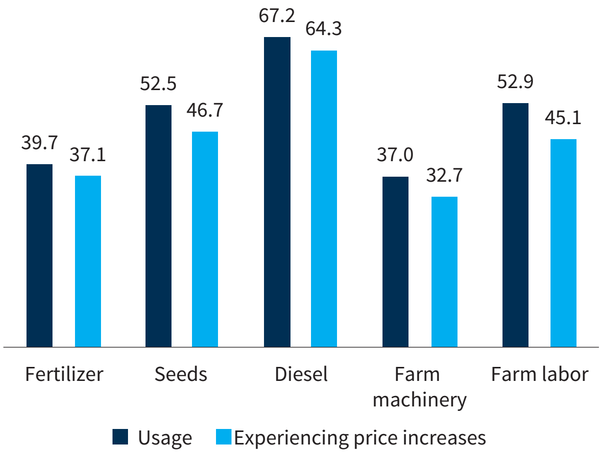
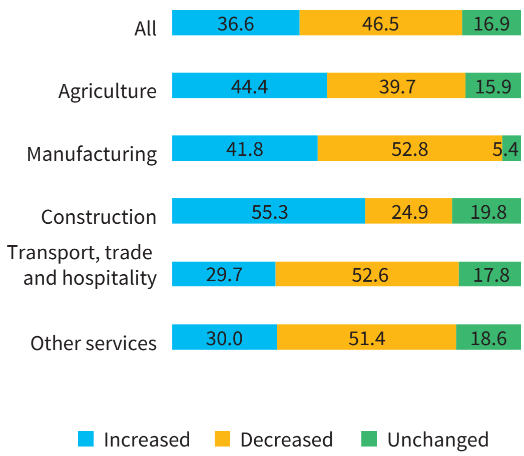


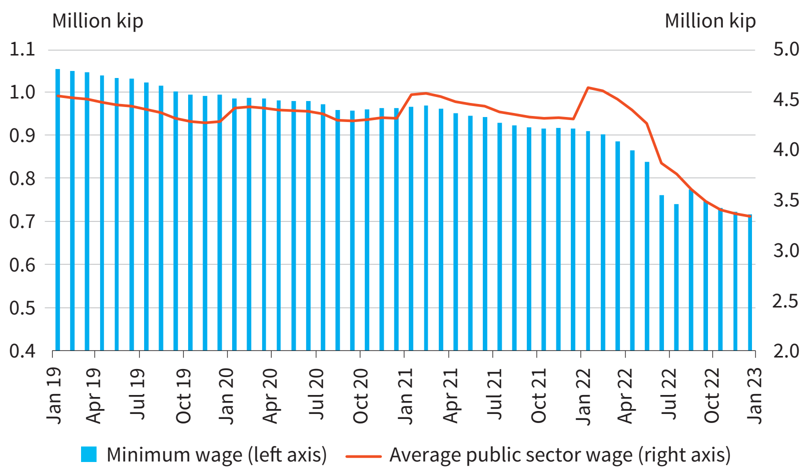
Figure 47. Impact of inflation (excl. fuel) on profitability (percent of household businesses)



Source: World Bank Rapid Monitoring Phone Survey Round 6 (December 2022–January 2023).

Evidence points to wage increases being outpaced by inflation. While wages are rising, they are not keeping pace with inflation. The average public sector wage grew 8 percent in 2022, lower than the 40 percent inflation rate. Annual wage growth was expected to be even lower for low-income workers as the monthly minimum wage hike from 1.1 to 1.2 million kip in August 2022 implies an annual growth rate of only 3.8 percent in 2022 (Figure 48). Record high inflation was also likely to outpace private sector wage growth. Rough estimates from BCEL's wage and compensation transactions and an online salary survey platform (www.salaryexplorer.com) suggest average private

Figure 48. Real wage (monthly, million kip, 2015 prices)



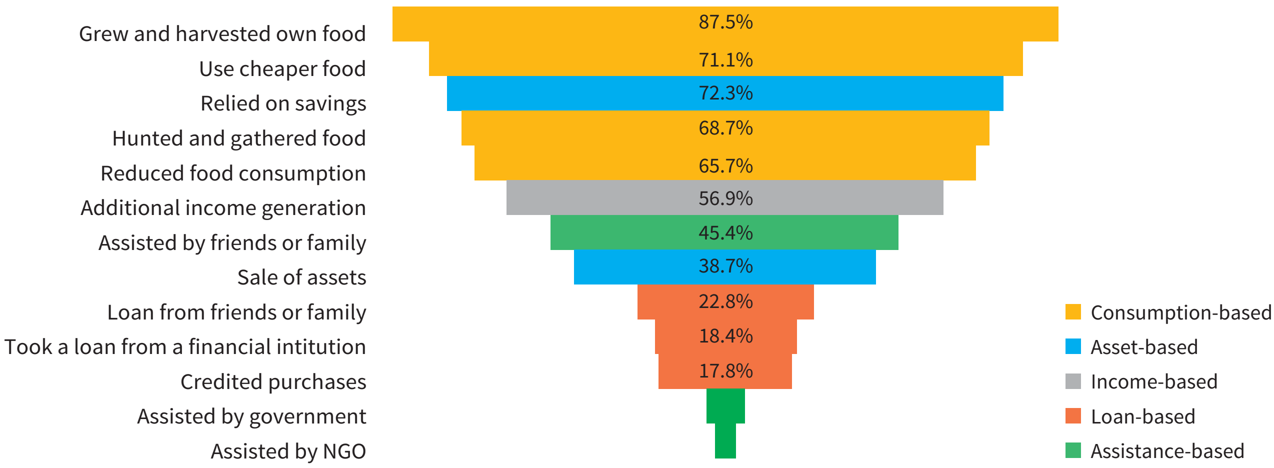
Source: World Bank staff calculation for the average public sector wage.

Note: The average public sector wage is the total wage bill (salary and compensation) divided by the number of public employees.

sector wage growth of 4 percent in 2022. The survey conducted by 108.JOBS, the one-stop service job site in Laos, based on 63 companies shows that only 22 percent of firms expect a salary adjustment of more than 10 percent in 2023, while 30 and 37 percent of firms expect pay adjustments of 1–5 percent and 6–10 percent respectively.

Budget-squeezed families adopted various coping strategies, some of which help mitigate the impact of inflation in the near term but could have longer-term negative effects. In response to rising food prices, most households adopted consumption-based strategies by choosing to reduce food consumption or switching to cheaper, self-produced, or wild foods, which could be detrimental to food and nutrition security (Figure 49). Households with some asset buffers were able to use their savings or sell financial and physical assets such as livestock and cattle, although this implies a depletion of their asset buffers for future shocks. More than half of Lao families worked more to earn additional income, while around one-fifth of affected households adopted some form of loan-based strategy, such as borrowing from friends, family, and financial institutions or using credit purchases to cope with food inflation. Assistance-based strategies were also adopted, but with assistance mainly coming from friends and family. Assistance from the government remained very limited.

Figure 49. Food inflation coping strategies (% of affected housholds)



Source: World Bank Rapid Monitoring Phone Survey Round 6 (December 2022 – January 2023)

3. Long-term human capital impact

Inflation and currency depreciation led to higher costs for public health and education provision, while a rising debt burden, stagnant public revenues and increases in other expenditure categories have crowded out social spending. The average price of health services and medicines surged by 41.8 percent year-over-year in March 2023 due to the substantial rise in the price of imported medical equipment, supplies, and pharmaceuticals following the kip's depreciation. The average cost of education, such as tuition fees, books, uniforms, and other education related expenses, rose moderately by 13.6 percent during the same period. Limited fiscal space has prevented the government from allocating more budget to cover rising costs. In 2019, budget allocations for the education and health sectors in Laos were already low compared to income and regional peer countries (Figure 50). Despite increasing financing needs, the education sector budget remained relatively unchanged between 2019 and 2022, and the health sector budget fell from 2.0 trillion kip to 1.7 trillion kip (Figure 51). This has resulted in a decline in the real purchasing power of public spending on health and education services.

The decline in real social spending makes it difficult for the government to maintain coverage and quality of public service delivery. Non-wage recurrent spending (for school block grants, teacher training, school monitoring, learning materials, etc.) declined by almost 10 percent in 2022, likely affecting teaching quality and learning outcomes. Despite high inflation, the per student amount of school block grants remained roughly unchanged, at 15,000 kip for kindergarten, 50,000 kip for pre-primary education and 30,000 for primary education. Loss of purchasing power of school block grants has undermined their purpose of improving the financing and delivery of education services. Kip depreciation and declining health spending have already affected procurement of essential medicines. Some domestic suppliers were not able to deliver drugs as they could not absorb the foreign exchange loss. To date, essential medicines are still available due to buffer stocks from 2022, but supply shortages are expected in early 2024 if no additional budget is allocated for medicines in this fiscal year.

Figure 50. Public spending on health and education 2019 (% of government expenditure)

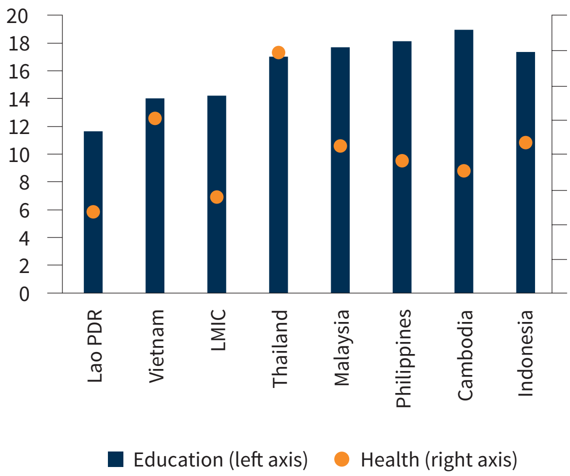
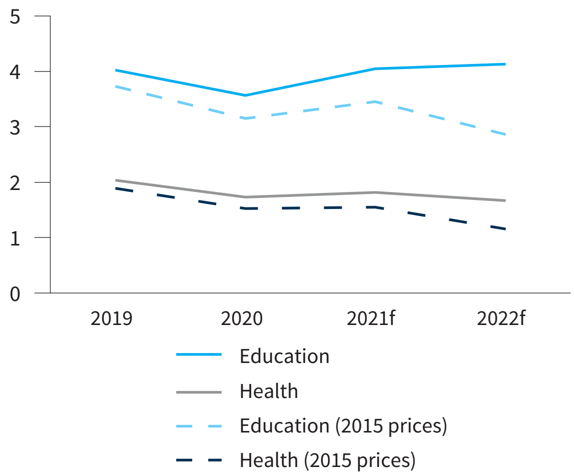


Figure 51. Public spending on health and education 2019 – 2022 (trillion kip)



Source: World Development Indicator Database and Government of Lao PDR. Budget estimates for 2021 and 2022.

Note: Real spending is nominal spending adjusted by overall inflation. LMIC is the average of lower-middle-income countries

Low-income households tend to be disproportionately affected by declining social spending. Low-income households rely mostly on health and education services provided by the government as services from private providers are less affordable. Unlike children from better-off households who might opt for private education, almost all enrolled children from poorer households went to public schools. This implies that although healthcare service utilization and school enrollment in Laos tend to be lower among low-income families, utilization of public services is relatively even across income groups (Figure 52, Figure 53). The monetized value of public health and education services, based on the cost of spending, represents a greater share of income for poorer households (20.4

Figure 52. Health care service utilization (percent of population)

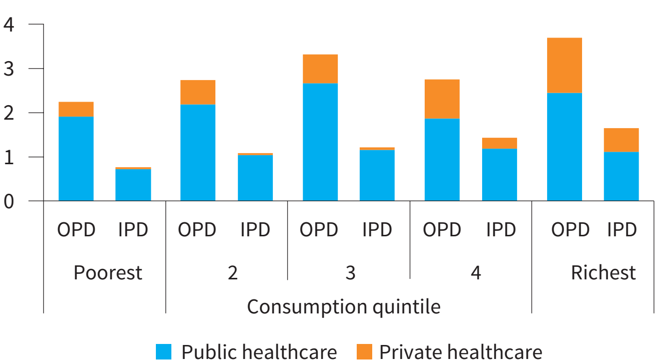
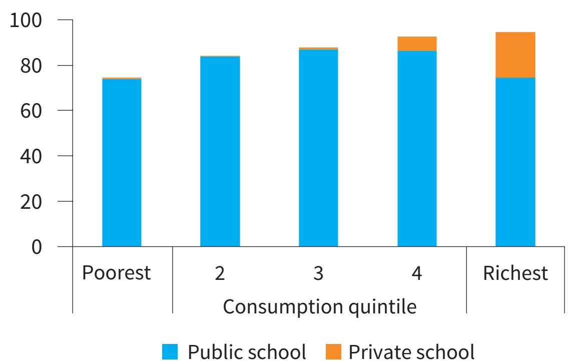


Figure 53. Enrolment rate (percent of children ages 6 – 10)

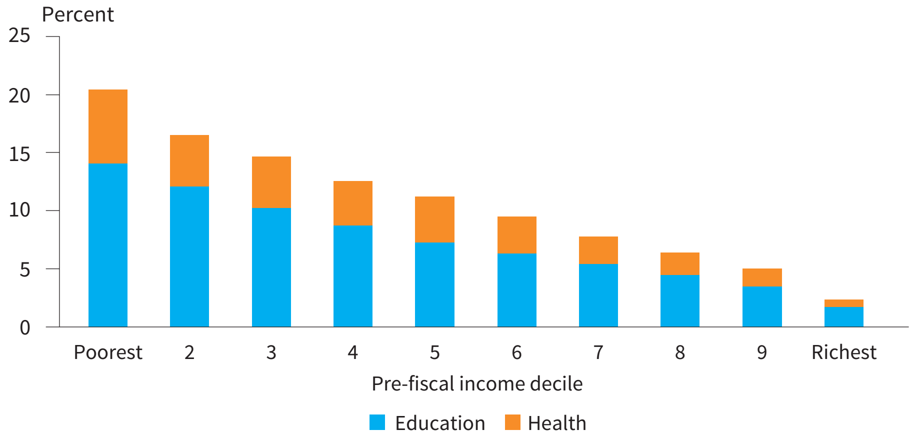


Source: World Bank staff calculation based on the Lao Expenditure and Consumption Survey 2018–2019

Note: The most recent outpatient department visit in the past month. The most recent inpatient department visit in the past 12 months. Persons with private health insurance are assumed to use private healthcare services.

percent of income for the poorest decile compared to 2.4 percent of income for the wealthiest decile, Figure 54). The decline in public spending on the health and education sectors is therefore expected to have disproportionately affected low-income households who also lack access to a high-quality alternative.

Figure 54. Monetized value of education and health services (percent of pre-fiscal income)



Source: World Bank staff simulation based on the Commitment to Equity Tool.

Note: Baseline simulation is based on 2018 data. Pre-fiscal income is income before direct and indirect taxes and government transfers.

Inflation, which has compressed household budgets, also forced Lao families to cut their human capital spending. Among families affected by inflation, more than half had to reduce education and health care spending. Contractions in both expenditures were more evident among rural and low-income families who tend to live on a tighter budget. The share of adversely affected low-income families that cut their human capital spending rose significantly during the second half of 2022, from 60.7 percent to 65.6 percent for healthcare spending and from 56.7 percent to 68.2 percent for education spending (Figure 55). For better-off households, the share increased from

Figure 55. Percent of affected households reducing human capital spending

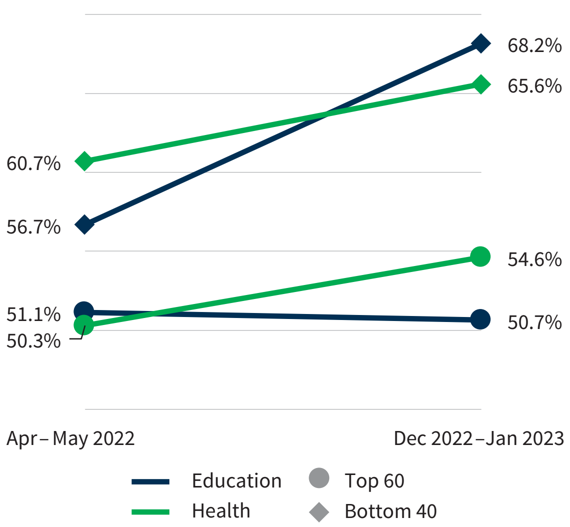
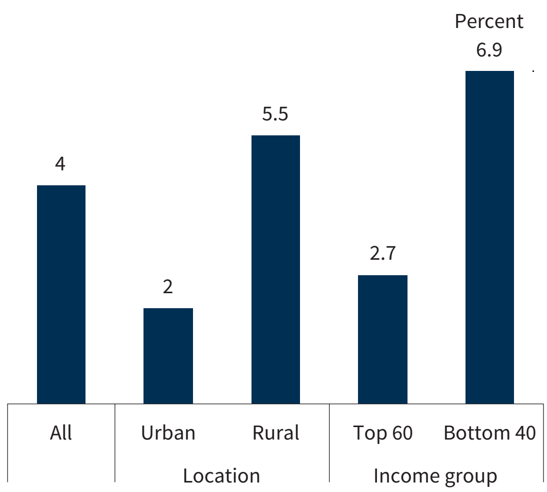


Figure 56. Percent of children ages 6-17 dropping out of school



Source: World Bank Rapid Monitoring Phone Survey Round 5 (April – May 2022) and Round 6 (December 2022 – January 2023)

Note: The "Bottom 40" refers to individuals in the bottom 40 percent of the consumption distribution. The "Top 60" refers to individuals in the top 60 percent of the consumption distribution.

50.3 percent to 54.6 percent for healthcare spending, while it remained relatively unchanged at above 50 percent for education. The long-term effects of inflation on human capital and its distributional consequences are expected to be significantly detrimental.

Incidence of school dropout is higher among children from rural and low-income households. Children from rural and low-income households had higher instances of dropping out of school. By the end of 2022, around 6.9 percent of low-income households had children between ages 6 to 17 drop out of school in the past 12 months, compared to 2.7 percent among better-off families (Figure 56). The dropout rate was also higher among rural families than urban families. Most households attributed this decision either to their inability to pay for school or to the need for children to support the family by performing additional work. These reasons were particularly pronounced among low-income households who strongly felt the adverse impact of inflation across all types of education expenditure (tuition fees, books and stationery, school uniforms etc.).

4. Policies to alleviate the adverse impact of macroeconomic instability

- **Restoring macroeconomic stability**

The widespread social impacts of Laos' unsustainable development model reinforce the urgency of restoring macroeconomic stability. Macroeconomic instability has become a critical concern and is threatening the living standards of Lao families through high inflation, economic recession, and reductions in social spending. Unsustainable public debt levels, limited fiscal space, declining reserve buffers, and growing financial sector risk underscore the need for urgent reforms. Given accumulated macroeconomic imbalances and a highly uncertain outlook, strong political commitment to ambitious reforms is essential to restore economic stability and sustain growth (see more detailed discussion of the specific policy options in Chapter 1).

- **Reallocating public spending into priority areas**

Human capital is a critical foundation of inclusive and sustainable development. Inflation has put the squeeze on Lao families who are struggling to pay for basic necessities and undermining private spending on health and education. The public sector plays an important role in sustaining human capital investment through provision of public education and health services. Despite revenue collection improvement, debt service obligations remain high and expenditure adjustment policies are deemed necessary. Reallocating budgets from non-essential activities to the health and education sectors to keep up with the rising costs of service provisions at a minimum, as well as improving the efficiency and equity of spending are essential to mitigate the impact of macroeconomic instability on the long-term prospect of inclusive and sustainable development.

- **Redesigning fiscal policy to enable targeted support to the poor and vulnerable**

Many countries have ramped up measures in response to inflation. Rising inflation is a global phenomenon, although the extent varies across countries. As of November 30, 2022, a total of 170 economies have announced or implemented 1,016 measures in response to soaring prices of food, fuel, fertilizers, and essential items.[1] Subsidies are the most common measure (34 percent of social protection responses), followed by social assistance (29 percent of social protection responses). The size of social assistance and subsidies represent between one-quarter and one-fifth of median income.

In Laos, despite persistently high inflation, measures to help households cope with rising prices are constrained by limited fiscal space. The government has implemented three key measures: (i) price control measures on 23 essential products; (ii) reduction in excise taxes on fuels; and (iii) a minimum wage hike of 9.1 percent from 1.1 million kip to 1.2 million kip effective from August 2022. Enforcement of price controls in

[19] World Bank. 2022. Tracking Global Social Protection Responses to Inflation Living Paper Version 4.

Laos is generally weak and in places where they are enforced, price controls can lead to market distortions and shortages of food and necessities, thereby exacerbating the impact of inflation on low-income families. Fuel excise tax reduction was untargeted and has disproportionately benefited better-off households owing to a larger share of transportation in their total consumption.

Revenue mobilization through tax reforms that enables targeted cash transfers to the most affected groups is a cost-effective and sustainable policy response to prolonged crisis. In response to soaring prices, a number of new cash transfer programs have been implemented in many countries and directed to multiple groups of beneficiaries such as workers, students, children and families with children, the elderly, low-income households and other vulnerable groups. For example, in Indonesia, the government provides cash transfers to 16 million workers (6 percent of the population) who make less than IDR3.5 million ($245) per month. Some other cash transfers are provided to support health expenses and to help families with children (as child allowances or for education purposes) to alleviate the impact of declining private spending on human capital. In Laos, to effectively implement these measures in a constrained fiscal environment, it is essential that the government adopts tax reforms (e.g. increasing VAT and removing unnecessary tax exemptions) to expand fiscal space and use part of the additional revenue to provide cash transfers to vulnerable households and invest in improving the existing targeting tools and benefit transfer systems. Moving away from tax cuts and exemptions to more progressive fiscal interventions like targeted cash transfers will allow the government to protect household livelihoods from the ongoing price shocks at a lower fiscal cost.

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