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

Lao PDR Economic Monitor
May 2023
PART A
Recent Economic Developments and Outlook
Key messages

1. Current status
   • The economy is gradually recovering.
   • However, economic activity weighed down by structural challenges, persistent macroeconomic instability, and a deteriorating external environment.

2. Outlook and Risks

3. Policy Options
   The Vital 5 to secure macroeconomic stability
   • Raise revenues to protect social spending;
   • Improve the governance of public and public-private investment
   • Expedite debt negotiation
   • Strengthen financial sector stability
   • Enhance the business environment
GDP growth is estimated at 2.7% in 2022, supported by recovery in the services sector.
Labor market improved in 2022, but real incomes have been undermined by rising living costs.
Inflation has risen significantly, driven by food and fuel price increases.

Sources: Lao Statistics Bureau, World Bank East Asia and Pacific Economic Update April 2022.
The kip depreciated significantly during 2022, but the exchange rate appears to have stabilized in recent months.

Sources: www.bruegel.org

Source: Bank of Lao PDR
External imbalances remain high amid high demand for imports and debt service.

**Indicative scenario of potential demand for foreign exchange based on balance of payments in 2022**

- **BOP 2022 flows**
  - Export of goods
  - Income credit
  - FDI
  - Import of services

- **Estimated net flows**
  - Portfolio investment
  - E&O
  - Export of services
  - Import of goods
  - Income debit
  - Other investment
  - Estimated FX demand

Source: World Bank staff assessment based on data form the Bank of Lao PDR, Ministry of Finance, and various other sources.
Fiscal consolidation driven by expenditure tightening, and marginal increase in domestic revenue.
Fiscal deficit declined, but financing needs remained high.

**Fiscal deficit**

- Percentage of GDP

2017 2018 2019 2020 2021 2022

- Fiscal deficit (without interest deferral)
- Fiscal deficit (with interest deferral)
- Primary balance (without interest payments)

**Total public financing needs**

- Percentage of GDP

2017 2018 2019 2020 2021 2022

- External debt service
- Domestic debt service
- Primary balance
- Total public financing needs

Source: Ministry of Finance.
Limited fiscal space has constrained the government’s ability to invest in human capital.
Kip depreciation has significantly increased public debt burden, while debt sustainability depends on debt negotiation outcome.

Source: Ministry of Finance, World Bank staff estimate.
Despite improved aggregate financial soundness indicators, vulnerabilities in the financial sector persist.
A gradual economic recovery is contingent on a successful outcome from debt negotiation.

Source: Lao Statistics Bureau and World Bank staff estimate
Significant downside risks

External risks
• Lower-than-expected growth in regional economies - could lower external demand.
• Inflation in advanced economies could renew depreciation pressures on the kip - and inflation
• Debt negotiations to have significant implications for debt sustainability / economic stability

Domestic risks
• Challenges with refinancing external debts
• Limited fiscal space continues to constrain government investment in human capital
• Labor shortages could also undermine recovery prospects
3. Policy Options

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
Food Inflation has accelerated in recent months, placing Laos among countries with the highest food price 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.
Inflation has affected nearly 90% of Lao households. The impact of inflation has increasingly been felt across the board in H2 2022.

The source of the data is the World Bank Rapid Monitoring Phone Survey Round 5 (April – May 2022) and Round 6 (December 2022 – January 2023).
Impacts of economic instability on Lao households

**Instability**
- Kip depreciation
- High inflation
- High debt burden
- Limited fiscal space

**Channels**
- Rising cost of consumption
- Rising input costs for subsistence agriculture
- Affecting profitability of businesses and commercial agriculture
- Affecting real wages
- Declining social spending, amid higher costs of public service provision
- Limited fiscal space to support the poor and vulnerable

**Impacts**

**Immediate welfare impact**
- Reduced consumption
- Food insecurity
- Loss of assets and savings, higher debt

**Long-term human capital impact**
- Lower private spending on health and education
- Declining public health and education services
Lao households experience an increase in the cost of consumption basket

Urban and better-off households face a larger increase

Owing to higher spending on market food and transportation, for which prices increased sharply

Low-income rural families relying on subsistence agriculture have been widely affected by rising farm input prices.

Fuel price inflation was one of the major challenges for crop producers.

Nearly half of crop producers were affected by higher costs of seeds and labor.

<table>
<thead>
<tr>
<th>Input shortages</th>
<th>High input prices</th>
<th>High fuel prices</th>
<th>Lack of cash</th>
<th>Water supply issues</th>
<th>Weather-related problems</th>
<th>Pest, disease, animal problems</th>
<th>Labor issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>14%</td>
<td>12%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>18%</td>
<td>25%</td>
</tr>
</tbody>
</table>

Farm input cost (% of crop producers):

- **Fertilizer**: 39.7
- **Seeds**: 52.5
- **Diesel**: 67.2
- **Farm machinery**: 37.0
- **Farm labor**: 52.9

- **Usage**
- **Experiencing price increases**

Bar chart showing the percentage of farmers experiencing price increases for different inputs.
Many household businesses gained from higher output prices, yet nearly half saw their profits undermined by inflation.

Construction was able to reap more profits, while services were hit hard.

Male-run and rural businesses fared slightly better than others.

Impact of inflation on profitability (% of household businesses)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Increased</th>
<th>Decreased</th>
<th>Unchanged</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>36.6</td>
<td>46.5</td>
<td>16.9</td>
</tr>
<tr>
<td>Agriculture</td>
<td>44.4</td>
<td>39.7</td>
<td>15.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>41.8</td>
<td>52.8</td>
<td>5.4</td>
</tr>
<tr>
<td>Construction</td>
<td>55.3</td>
<td>24.9</td>
<td>19.8</td>
</tr>
<tr>
<td>Transport, trade and hospitality</td>
<td>29.7</td>
<td>52.6</td>
<td>17.8</td>
</tr>
<tr>
<td>Other services</td>
<td>30.0</td>
<td>51.4</td>
<td>18.6</td>
</tr>
</tbody>
</table>

Impact of inflation on profitability (% of household business by socioeconomic group)

<table>
<thead>
<tr>
<th>Income</th>
<th>Bottom 40%</th>
<th>Top 60%</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male-run</td>
<td>37.2</td>
<td>46.2</td>
<td>16.6</td>
</tr>
<tr>
<td>Female-run</td>
<td>30.1</td>
<td>52.8</td>
<td>17.1</td>
</tr>
<tr>
<td>Rural</td>
<td>38.0</td>
<td>44.6</td>
<td>17.4</td>
</tr>
<tr>
<td>Urban</td>
<td>33.9</td>
<td>50.1</td>
<td>16.0</td>
</tr>
</tbody>
</table>

Evidence points to wage increases failing to keep pace with inflation

Despite the adjustments, minimum wages and public sector wages lost their real value by 27 percent and 24 percent over 2020–22

Monthly real wages (in 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.
For many households, income recovery was not sufficient to outweigh the impact of inflation

While income has improved for many households,...

...two-third of households whose income did not increase suffered from inflation

<table>
<thead>
<tr>
<th>Location</th>
<th>Incr</th>
<th>Unchr</th>
<th>Dchr</th>
<th>% of Households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urban</td>
<td>32.7</td>
<td>32.3</td>
<td>32.9</td>
<td>32.9</td>
</tr>
<tr>
<td>Rural</td>
<td>31.4</td>
<td>37.8</td>
<td>28.0</td>
<td>30.5</td>
</tr>
<tr>
<td>Top 60%</td>
<td>35.9</td>
<td>29.9</td>
<td>39.1</td>
<td>35.8</td>
</tr>
<tr>
<td>Bottom 40%</td>
<td>35.0</td>
<td>30.5</td>
<td>36.1</td>
<td>29.3</td>
</tr>
</tbody>
</table>

% of households reporting income losses due to COVID-19
To cope with food inflation, households have adopted various strategies.

Most households adopted consumption-based strategies, potentially leading to food and nutrition insecurity.

Better-off households tend to rely on savings, while poorer and rural households were more likely to sell their assets.

Source: World Bank Rapid Monitoring Phone Survey Round 6 (December 2022 – January 2023)
Decline in real public spending on human capital makes it difficult to maintain coverage and quality of service delivery.

Inflation and kip depreciation led to higher costs for public service provision.

Low-income households will likely be disproportionately affected.

Monetized value of education and health service (% of household 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 has also forced households to cut their human capital spending

Share of low-income families reducing education spending soar during H2 2022

% of poor/rich households reducing human capital spending

Higher drop-out rate among poorer children mainly due to financial reasons

% of children ages 6-17 dropping out of school
Policies to alleviate the adverse effect of economic instability on Lao households

Restoring macroeconomic stability (Part A)

Reallocating public spending into priority areas (i.e. human capital)

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

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
Download the report: