Lao People's Democratic Republic

The economy slowed last year as floods suppressed growth in agriculture and decelerating growth in electricity generation dragged down industry growth. GDP growth should hold up this year and next as agriculture and electricity generation recover. Inflation is likely to accelerate a little but remain modest, and the current account deficit is forecast to ease. Substantial public finance reform is needed to rein in stubborn fiscal deficits and rapidly rising public debt.

Economic performance

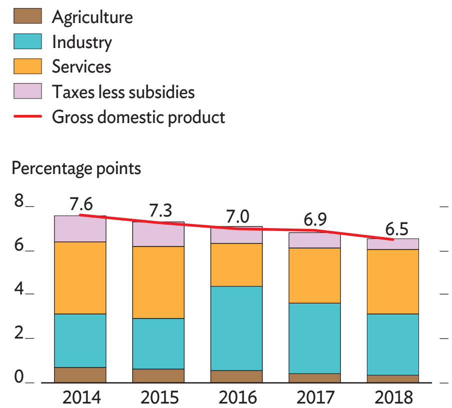
GDP growth slowed from 6.9% in 2017 to 6.5% last year as severe floods hit agriculture and slower hydropower generation drove down industrial growth (Figure 3.25.1). Growth in agriculture and allied activities, comprising 15% of the economy, slowed from 2.9% in 2017 to 2.0% as production was disrupted by floods in August and September 2018.

Even as construction maintained rapid growth and mining climbed almost completely out of contraction, industry growth slowed from 11.6% in 2017 to 7.9% last year. Electricity generation, accounting for 20% of industrial output, decelerated from a 33.0% rise in 2017 to 8.3% last year as no new power plants were added to enhance existing annual production capacity (Figure 3.25.2). Meanwhile, buoyed by an 8.2% increase in international tourist arrivals, growth in services accelerated from 4.5% in 2017 to 7.4% (Figure 3.25.3).

Even as GDP growth slowed, higher food prices caused by weaker farm production and higher international oil prices pushed average inflation from 0.8% in 2017 to 2.0% last year. Inflation peaked in July 2018 at 2.4% year on year but fell back to 1.5% in December (Figure 3.25.4).

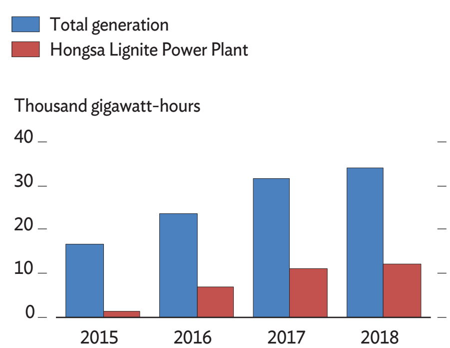
The steep growth slowdown in electricity generation slowed growth in the volume of electricity exports from 19.8% in 2017 to 7.2% last year. As a result, growth in merchandise exports fell by almost half in US dollar terms from 19.8% in 2017 to 10.0%. Meanwhile, despite higher international oil prices, softening demand for imports held growth in imports to less than 3.0% in dollar terms, narrowing the trade deficit from the equivalent of 11.4% of GDP in 2017 to 9.0% last year.

3.25.1 Supply-side contributions to GDP growth



Sources: Lao Statistics Bureau; *Asian Development Outlook* database.

3.25.2 Electricity generation



Source: Lao PDR Ministry of Energy and Mines.

This chapter was written by Rattanatay Luanglatbandith and Soulinthone Leuangkhamsing of the Lao PDR Resident Mission, ADB, Vientiane.

Despite a strong rise in international tourist arrivals, net service receipts worsened last year. In sum, the current account deficit narrowed from the equivalent of 11.2% of GDP in 2017 to 8.6% in 2018. With foreign direct investment rising, the overall balance of payments posted a small surplus, and international reserves edged up from $1.0 billion at the end of 2017 to $1.1 billion a year later. Despite this improvement, reserves remained perilously low, providing cover for only 1.5 months of imports.

The government's efforts to consolidate its finances brought the fiscal deficit down from the equivalent of 5.6% of GDP in 2017 to 4.6% last year as public expenditure, equal 21.8% of GDP in 2017, was contained at 20.3%. Meanwhile, revenue slipped from 16.2% of GDP in 2017 to 15.7% last year. Monetary policy aimed to keep the Lao kip–US dollar exchange rate within a narrow daily trading band of 5% or less, as well as contain growth in credit and the supply of money (Figure 3.25.5).

Economic prospects

Slowing growth in the advanced economies—and closer to home in the People's Republic of China (PRC), Thailand, and Viet Nam—does not augur well for the growth prospects of the Lao People's Democratic Republic (Lao PDR). However, growth in agriculture should edge up, and electricity generation should accelerate with the expected addition of 1,500 megawatts to capacity. The construction of the Vang Vieng–Vientiane Expressway and the ramping up of work on a railway linking the PRC and the Lao PDR, to be completed by 2021, should boost GDP growth, as should likely continued buoyancy in international tourist arrivals. GDP growth should thus sustain last year's pace of 6.5% both this year and next (Figure 3.25.6).

By sector, growth in industry is forecast to edge up slightly to 8.1% in 2019 on solid construction and as growth in electricity generation resumes. Agriculture is expected to grow by 2.5% both this year and next. Meanwhile, the government's promotion of the PRC and the Lao PDR as twin tourist destinations is seen to help services maintain growth at 6.7%.

Inflation is forecast to remain at 2.0% this year and next, with global oil prices forecast lower and food prices subdued as agriculture recovers.

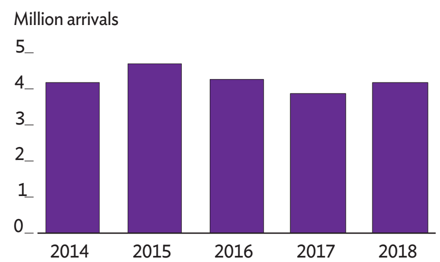
Electricity exports will edge up this year with new generating capacity. Total exports are thus seen rising by 12.0% in US dollar terms this year and next. Meanwhile, import growth will accelerate by 13.5% this year and 12.0% next year on imports of capital goods for hydropower, expressway, and rail projects. The current account deficit is thus forecast to widen to 9.5% of GDP in 2019 and 10.0% in 2020 (Figure 3.25.7). International reserves are forecast to fall to just under $1.0 billion, providing cover for 1.3 months of imports.

3.25.1 Selected economic indicators (%)

	2019	2020
GDP growth	6.5	6.5
Inflation	2.0	2.0
Current account balance (share of GDP)	–9.5	–10.0

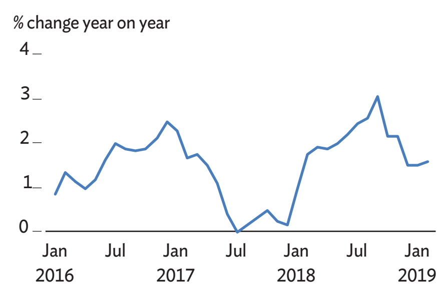
Source: ADB estimates.

3.25.3 Tourist arrivals



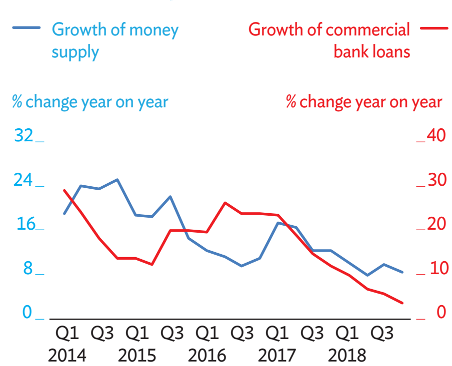
Source: CEIC Data Company (accessed 19 March 2019).

3.25.4 Inflation



Sources: Bank of Lao; CEIC Data Company (both accessed 12 March 2019).

3.25.5 Monetary indicators



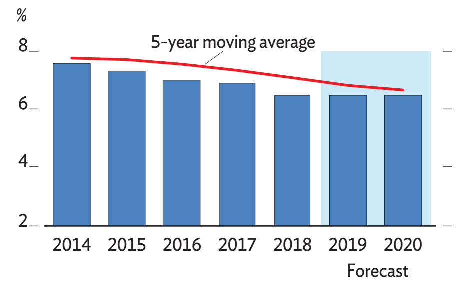
Q = quarter.

Sources: Bank of Lao; CEIC Data Company (both accessed 12 March 2019).

Progress in consolidating government finances is expected to gradually yield better results. The fiscal deficit is likely to subside to the equivalent of 4.3% of GDP this year and 3.7% in 2020. Expenditure is forecast to equal about 20% of GDP this year and next, while revenue including grants is forecast to hover at around 16% of GDP. The government has withheld a salary increase for civil servants and halved the annual intake of new civil servants to 1,500 in 2019.

Although inflation remains low, monetary policy has little room to ease credit conditions because of constant pressure on the exchange rate and the need to shield the country's fragile balance of payments, which poses the major domestic risk to the outlook. Another domestic risk is vulnerability to natural hazards. An uncertain global trading environment poses the main external risk.

3.25.6 GDP growth



Source: *Asian Development Outlook* database.

Policy challenge—reforming public finances

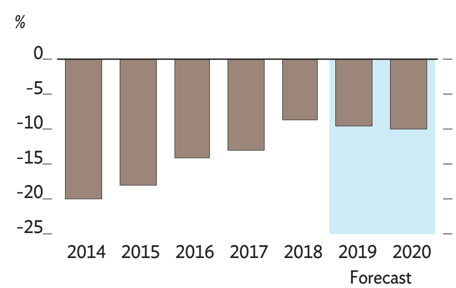
Strong economic growth in the Lao PDR over the years has been shadowed by unsustainable fiscal deficits and rising public debt. Including publicly guaranteed debt, public debt now equals about 65% of GDP (Figure 3.25.8). About 80% of the public debt is in foreign currency. The ratio of debt service to GDP has increased in the last 4 years as the government relied more on capital markets and less on concessional bilateral sources in recent years.

Continued high fiscal deficits and high public debt threaten macroeconomic and financial stability. A 2018 analysis of debt sustainability by the International Monetary Fund places the Lao PDR at high risk of debt distress. Containing fiscal deficits is critical to reaching a more sustainable ratio. This demands in turn further containing government expenditure and raising revenue.

Toward strengthening public debt management and instituting tax reform, the government adopted a law on public debt management in 2018 that establishes a ceiling for public debt at 60.0% of GDP. Any public investment project exceeding $50 million must now seek approval from the National Assembly. The government aims to reduce the fiscal deficit by more than a third, to less than 3.0% of GDP by 2025. The government has delayed a salary increase for civil servants. Its Public Finance Development Strategy 2025 and Vision to 2030 announce reforms that will improve public debt management and medium-term fiscal planning and budgeting.

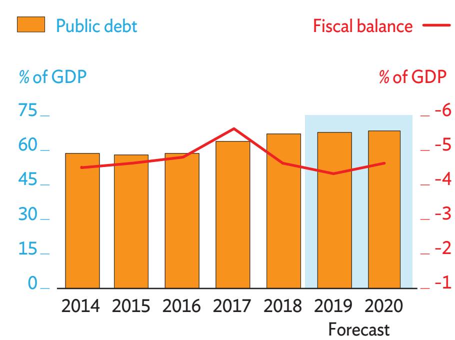
Successful implementation depends on strong political will and leadership in the Ministry of Finance to effectively collaborate and coordinate with other ministries. Only then will the Lao PDR be able to gradually restore fiscal and public debt sustainability.

3.25.7 Current account balance forecast



Source: *Asian Development Outlook* database.

3.25.8 Fiscal indicators



Note: Fiscal balance is on an inverted axis.

Sources: *Asian Development Outlook* database; IMF estimates.