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Lao Economic Monitor FY15-16

{ Challenges in promoting more inclusive growth and shared prosperity }

{May 2016}

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EAST ASIA AND PACIFIC



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Lao Economic Monitor

Challenges in promoting more inclusive growth and shared prosperity

May 2016

Thematic section:
Drivers of Poverty Reduction in Lao PDR

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 25, 2016)

Currency Unit = LAK (Lao Kip)

LAK8,141 = US\$1.00

Fiscal Year=October to September

ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BOL	Bank of Lao PDR
BOP	Balance of Payment
COD	Commercial Operation Date
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
EAP	East Asia & Pacific
EDL	Electricité du Lao
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GOL	The Government of Lao PDR
IMF	International Monetary Fund
MOF	Ministry of Finance
MOIC	Ministry of Industry and Commerce
NA	National Assembly
NEER	Nominal Term Effective Exchange Rate
NFA	Net Foreign Assets
NPL	Non-Performing Loan
NSEDP	National Socio-Economic Development Plan
PIP	Public Investment Projects
PPG	Public and Public Guaranteed Debt
REER	Real Effective Exchange Rate
SOCBs	State-Owned Commercial Banks
SOE	State-Owned Enterprise
VAT	Value Added Tax
WBG	World Bank Group
WEO	World Economic Outlook
YOY	Year on year

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EXECUTIVE SUMMARY

RECENT ECONOMIC DEVELOPMENTS

1. The Lao economy is estimated to have expanded by around 7 percent in 2015, a slight moderation from 7.5 percent in 2014. Similar to the last decade, the resource sectors (hydropower and extractives) continued to make an important contribution to growth. Power generation got a boost from the commissioning of the first two blocks of the 1,878 MW Hongsa lignite power plant and an additional 250-300 MW of installed capacity in the hydro sector. Furthermore, despite lower global commodity prices, mining output still increased as metal prices remained above the mines' cost recovery levels. Construction remained robust as capital inflows (FDI and loans) into the power sector and real estate development remained resilient. Manufacturing and exports of parts and components increased, albeit from a low base, as Lao PDR was able to attract a few companies that relocated part of their production from other countries in the region to special economic zones in Lao PDR. Tourist arrivals, mostly from the region, remained strong. These gains were partially offset by slower external demand (including for timber), stronger control on public spending as well as lower output in agriculture due to unfavorable weather and lower commodity prices. Average annual inflation fell from 4.2 percent in 2014 to 1.3 percent in 2015 and further to 1.1 percent in March 2016 due largely to continued decline in fuel prices, with core inflation at around 1.7 percent.

2. The fiscal deficit is estimated at about 3.7 percent of GDP in FY14/15, slightly down from 3.8 percent of GDP a year earlier. Revenues remained stable in nominal terms, but declined as a ratio to GDP from 24.1 percent to 23 percent in FY14/15 as lower commodity prices affected revenues (royalties and taxes on mining, excises and VAT on oil etc.) and grants declined. This was offset by the robust performance in value added tax and profit tax due to efforts to strengthen collection. At the same time, tight control over the wage bill and public recruitment limited the growth in expenditures with total expenditures, measured as percent of GDP, declining from 28 percent to 26.6 percent. The deficit was largely financed by external public borrowing, bringing Lao PDR's total public debt to about 65 percent of GDP in 2015 (about US\$7.7 billion)¹. The issue of public sector arrears continues to linger on, suggesting that domestic public debt may be understated. An inter-Ministerial Committee has been setup to validate the arrears and fraudulent cases have been investigated. There is a plan to establish a new public investment management division under the Ministry of Finance aiming to improve the coordination with the Ministry of Planning and Investment and supervise the planning and disbursements of the investment spending.

¹ IMF's World Economic Outlook Database, October 2015.

3. Monetary and exchange rate policies remained focused on tight management of the kip/US dollar exchange rate, resulting in further appreciation of the kip against regional currencies. With exchange rate stability being one of the key objectives of the Bank of Lao PDR, the monetary authorities kept the kip/US\$ exchange rate largely stable, which in an environment of strengthening US\$ resulted in further appreciation of the real effective exchange rate of the Kip. In an effort to stimulate credit growth, the Bank of Lao PDR also reduced the discount rate slightly in mid-2015 and introduced inflation-linked caps on deposit and lending interest rates, which led to a reduction in both deposit and lending rates by about 3 percentage points to about 6 percent and 10 percent respectively by end-2015. The reserve requirements remained unchanged while BOL credit to state-owned enterprises remained unchanged. In response, credit growth accelerated slightly in the second half of the year; however, at around 17 percent year-on-year in December 2015, credit growth remained well below rates seen in earlier years. A significant part of the financial sector, mostly some state-owned banks, may be facing declining capital buffers and deteriorating loan portfolios.

4. The current account deficit is estimated to have widened slightly to about 11.6 percent in 2015 as the increase in exports of parts and components and the lower import bills of fuel were insufficient to offset the impact of lower copper and gold prices and slower external demand (including the slowdown of timber export to China and Vietnam from very high levels during the last two years). Still, financing needs are lower as a substantial part of the imports (around 14 percent of GDP) are FDI-related (in the resource sector) and with secured external financing. Significant external borrowing financed the rest of the current account deficit and allowed for an increase in foreign reserves to almost US\$ 990 million in December 2015, covering around 2.2 months of imports of goods and services and about 30 percent of foreign currencies deposits. The level still implies limited buffers, particularly in the context of tightly managed exchange rate of the kip to the US dollar.

5. Several important reforms were undertaken in 2015. The revised State Budget Law, approved in December 2015, enhances the authority of the National Assembly in budget oversight and Ministry of Finance in budget management. In addition, with regards to anti-money laundering and counter-terrorism financing, the Government strengthened key regulations (including on forfeiture of assets, border declaration, penalties for non-compliant entities) recommended by the Financial Action Task Force (FATF), which helped remove Lao PDR from the FATF's list of "jurisdictions not making sufficient progress". The outlook will depend on the progress in the implementation of the recommendations and agreed measures. In the banking sector, the Bank of Lao PDR removed the minimum loan size limit to be recorded in its credit registry database and expanded coverage of borrowers. As a result, the country's rank on the Doing Business getting credit indicator significantly improved from 128th in 2015 to 70th in 2016².

² World Bank (2016) "Doing Business 2016: Measuring Regulatory Quality and Efficiency", The World Bank, Washington DC.



6. The near-term outlook remains favorable with growth projected at around 7 percent in 2016, but with some downside risks. Power generation is expected to increase by more than 30 percent compared to 2015. Recent trends in manufacturing are expected to continue while the liberalization of air transport is expected to give a boost to tourist arrivals. Fiscal expansion is expected as Lao PDR hosts ASEAN chairmanship events in 2016. The current account deficit is expected to narrow to about 10.4 percent of GDP with exports growing by about 7 percent as a jump in electricity export and continued export of parts and components to Thailand is expected to more than offset a risk of further slowdown in external demand for other exports. Imports bill growth are expected to remain contained as oil prices remain depressed in 2016. However, there are a number of downside risks. External risks come from faster-than-expected slowdown in China, prolonged weak growth in Thailand as well as further declines in commodity prices. China accounts for 25 percent of Lao PDR exports, and is among the top three largest source of FDI and among top-ten biggest sources of tourist arrivals, all of which will be affected by a sharper slowdown in China. Similar concerns apply to Thailand, which is also an important migrant destination and export market. The impact of the decline in commodity prices appears to have been contained, with the exception of rubber; however, further price declines may have a bigger impact. Additionally, domestic economic risks remain elevated, including risks in the banking sector that some banks may continue to have limited capital buffers and poor loan portfolio.

7. Similar trends are projected to continue during 2017-2018. GDP is expected to expand at around 7 percent per annum as a healthy pipeline in the power sector keeps investments strong and increases electricity production and exports by almost 40 percent. Stabilization of growth rates in China and some acceleration in Vietnam and Thailand should increase demand for Lao PDR exports. On the other hand, some gradual fiscal consolidation is expected, largely through broadening the revenue base and efforts to improve efficiency in spending and should help strengthen the outlook for public debt sustainability and lower the risk of debt distress from its current level of moderate, but borderline to high.

Thematic Section: Drivers of Poverty Reduction in Lao PDR³

8. Poverty in Lao PDR declined over the past decade. The Lao Expenditure and Consumption Survey 2012/13 (LECS 5) showed that poverty declined from 33.5 percent in 2002/03 to 23.2 percent in 2012/13, helping Lao PDR achieve its MDG target of halving extreme poverty by 2015. This translated into a 0.47 percent reduction in poverty for every percentage point of GDP growth, one of the smallest in the East Asia and Pacific region (with the exception of the Philippines). With growth patterns little changed since the last official poverty measurement survey, the poverty rate may have declined further, but may be at a pace less commensurate than economic growth, following the past pattern.

9. Among those who became non-poor, key factors pulling them out of poverty are increasing education attainment and the move to non-farm jobs as well as better connectivity. Complete primary education helped boost productivity in agriculture while lower secondary education helped the transition into non-farm employment. This shows that the increase in endowments and productive opportunities in non-farm sectors were key drivers of poverty reduction. More recently, notable growth in services (such as trade and tourism) and manufacturing sub-sectors as aforementioned, may have opened up more employment opportunities. In addition, better connectivity through road access in rural areas also increased likelihood of reducing poverty in rural areas compared to rural area with no road access. In this respect, the latest 2015 population census shows the share of rural population with road access increased from 52 percent in 2005 to 59 percent in 2015 while the share of urban population increased from 27 percent in 2005 to about 33 percent in the same period. All in all, the recent trends imply that poverty may have further declined in 2015.

10. Nevertheless, the creation of productive jobs was less proportionate to the strong economic growth. During 2003-2013, GDP more than doubled and employment increased by 20 percent (or around 500,000 jobs) bringing total employment to about 3.1 million. With significant part of the population having access to subsistence farming, the official unemployment rate remained very low. However, only about 80 percent of jobs created were non-farm jobs and 17 percent of these were in the public sector. Most of the jobs created were in wholesale and retail trade, characterized by low technology and productivity. The agriculture sector provided jobs for 64 percent of the employed in 2013, down from 73 percent a decade earlier. Around 10.5 percent of jobs were in the trade sector, up from 8.2 percent in 2003. Manufacturing accounted for 7 percent of employment, only marginally up from 6.2 percent a decade ago, while public services provided jobs for 6.1 percent of the employed workforce.

³ World Bank (2015), "Lao PDR Poverty Policy Notes: Drivers of Poverty Reduction in Lao PDR", The World Bank, Vientiane.

11. The pace of poverty reduction and inclusiveness was less commensurate to the rate economic growth. With the capital intensive resource sectors creating few jobs and a relatively slower pace of new job creation in the non-farm and non-resource sectors, the growth model did not translate into a broad-based proportional increase in households' income and consumption. Consequently, consumption per capita increased by only 2 percent per year lagging behind the annual GDP per capita growth of almost 6 percent. Even this small increase in consumption benefited the non-poor population more than the poor as the consumption of the richest group increased by 2.4 percent compared to only 1.3 percent of the poorest population. As a result, inequality increased with the Gini coefficient increasing from 32.5 in 2002/03 to 36.2 in 2012/13. In this regard, while poverty has declined, the pace appears to lag compared to some other resource-rich countries such as Uzbekistan, Tajikistan, Mongolia and Chile that employ effective redistribution policies.

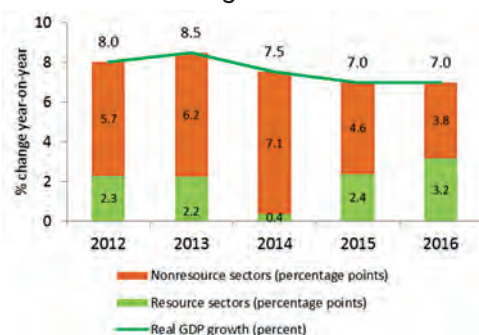
12. In addition, the vulnerability of falling back into poverty is high, particularly due to agriculture and health shocks as well as a lack of adequate safety nets. The observed consumption growth pushed those escaping poverty only slightly above the poverty line, where the risk of sliding back into poverty is high. Actually, half of the poor people in 2012/13 were non-poor five years earlier. Households, especially in agriculture, are vulnerable to shocks from farm produce price fluctuations, loss of land and adverse weather conditions. In addition, with just 20 percent of the population covered by health insurance (mostly public and private sector wage workers), health shocks and catastrophic out-of-pocket expenditures pose a significant risk to households' welfare. Finally, low financial inclusion and the absence of adequate safety nets limit the ability of households to mitigate risks.

13. Going forward, improvement in productivity in agriculture and non-farm sectors as well as off-farm job creation is essential to raising household income and therefore to reducing poverty. In addition, putting in place social safety nets such as insurance programs will help improve people's resilience against shocks.



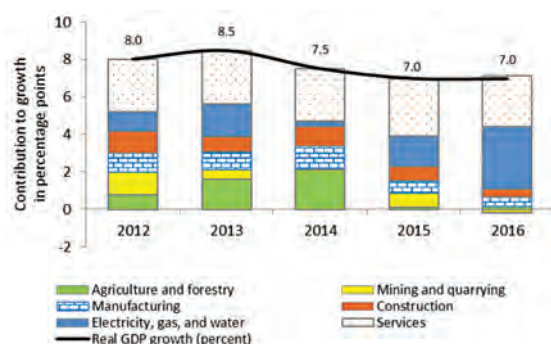
RECENT ECONOMIC DEVELOPMENTS IN SNAPSHOT

Growth moderated but remained strong in 2015, driven by resource sector...



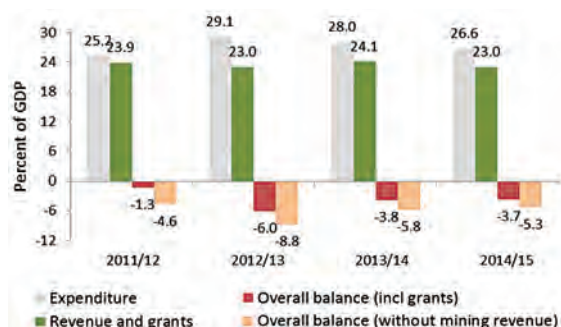
Source: Government, LNCCI data and staff estimates

Particularly a boost from the power sector



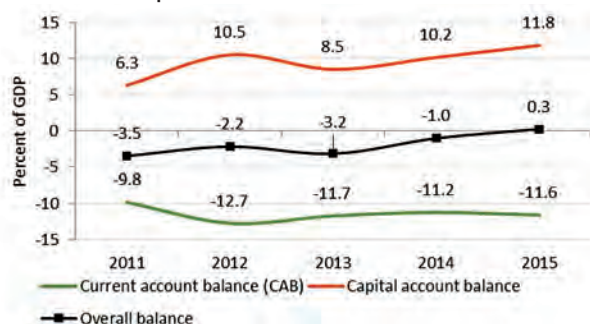
Source: Government, LNCCI data and staff estimates

But offset by a control on public spending, that helped contain the fiscal deficit ...



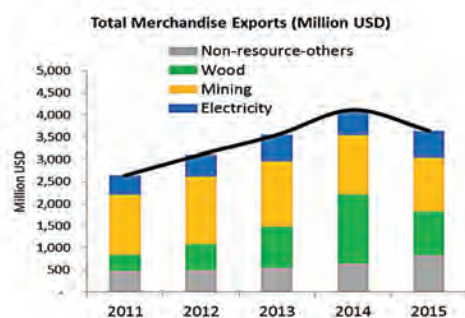
Source: MoF and WB staff estimates

Lower external demand and commodity prices offset lower import, slightly drove up the external imbalance...



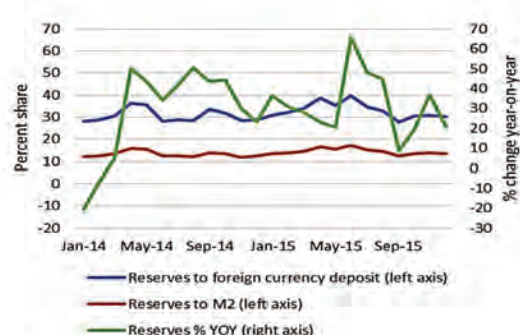
Source: MOIC, BOL, staff estimates

Overall lower external demand and commodity prices offset the export increase from manufacturing sub-sectors



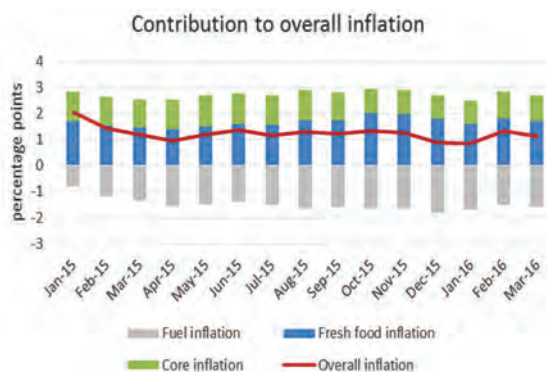
Source: trading partner data, MOIC, BOL, staff estimates

With lower imports, reserves increased but remained low against prudential measures



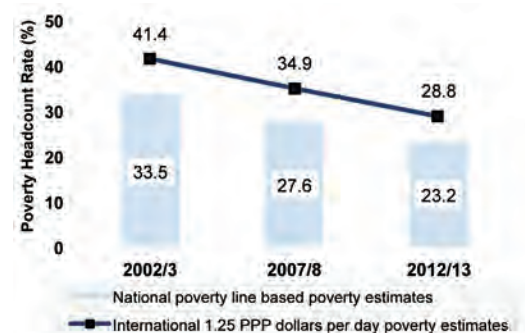
Source: trading partner data, MOIC, BOL, staff estimates

Lower fuel prices keep inflation low



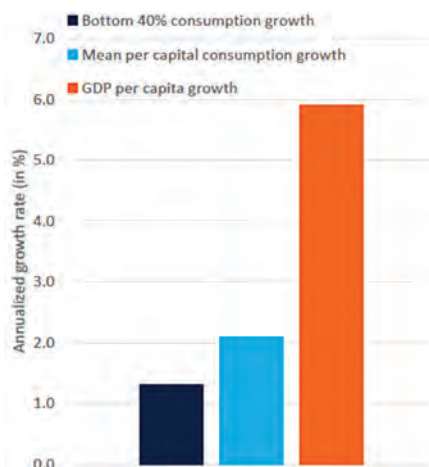
Source: Lao Statistics Bureau

Strong growth coupled with higher education attainment and off-farm income helped poverty reduction...



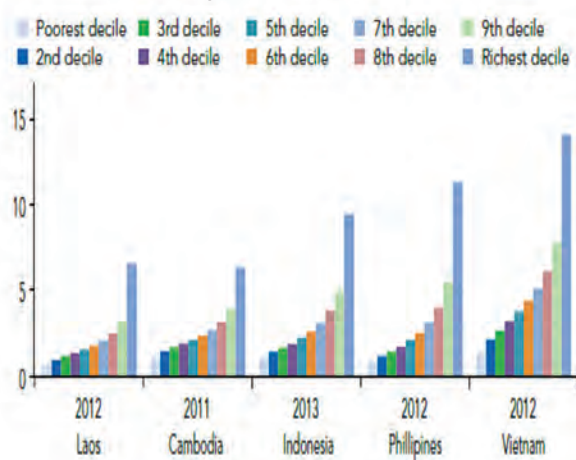
Source: LECS 2002/03-LECS2012/13

...but the fall in poverty happened at a slower pace than economic expansion



Source: LECS 2012/13 and WDI cited in World Bank (2015)

and the poorest population benefited less from the growth process compared to the non-poor



Source: World Bank (2014)

PART I: RECENT ECONOMIC DEVELOPMENTS

GROWTH

1. Lao PDR has been one of the fastest growing economies in the East Asia and Pacific region, to a significant degree propelled by the natural resource sectors. GDP expanded at an average growth rate of 7.8 percent per annum over the last decade with estimated GNI per capita reaching US\$1,730 in 2015 and making Lao PDR a lower middle income country. In response to buoyant external demand, the resource sector attracted strong foreign investments. A mining “boom” began in 2005 with the start of exploitation at the Sepon mine (copper cathode and gold) followed by the commissioning of the Phu Bia mine (copper concentrate and gold); though, the 2007-2008 global crisis and weaknesses in the regulatory environment dampened growth prospects from which the sector is yet to recover. Around the same time, the power sector started its robust export-led expansion as investors began to tap into the ample hydro potential to meet demand from the fast growing region. By 2016, the installed capacity reached around 6,000MW, a ten-fold increase from a decade earlier. More recently, Lao PDR was able to attract investments in real estate development, trade and manufacturing; however, compared to regional peers, the extent of structural transformation (both in terms of GDP structure and employment) remained limited, largely due to weak performance of agriculture and manufacturing. Services and construction account for 48 percent of GDP and 26 percent of employment⁴, but remain characterized by low technology and productivity. Industry, excluding the mining and power sectors, accounts for about 9 percent of GDP with 7 percent of employment.

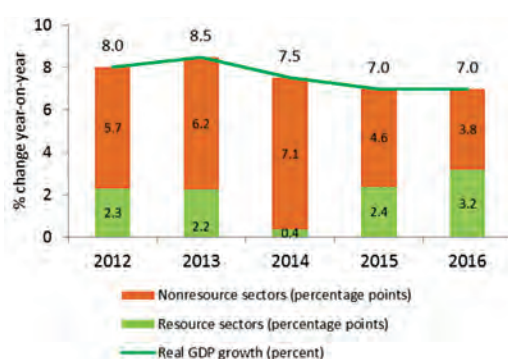
2. In 2015, the Lao economy expanded by an estimated 7 percent, a slight moderation from 7.5 percent in 2014 (Figure 1). Power generation got a boost from the commissioning of the first two blocks of the 1,878 MW Hongsa lignite power plant and an additional 250-300MW of installed capacity in the hydro sector (Figure 2, 3).⁵ Construction remained robust as capital inflows (FDI and loans) into the power sector and real estate development stayed resilient. Furthermore, despite lower global commodity prices, mining output increased by 5 percent for copper (from 159,676 tons in 2014 to 167,700 tons in 2015) and 30 percent for gold (from 168,000 oz in 2014 to 221,000 oz in 2015) as global prices still remained above the cost recovery levels (Figure 4). Still, export earnings from mining are estimated to have declined by about 9 percent in 2015.

⁴ The data was as of 2013 cited in World Bank (2014), Lao Development Report: Expanding Productive Employment for broad-based growth.

⁵ These include Hauylamphanh yai, Nam Khan 2, Nam Ngiep.

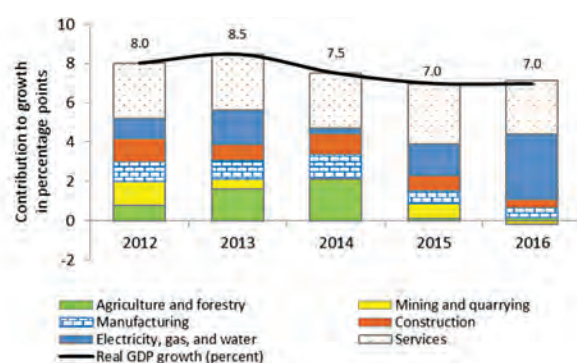
3. Importantly, some non-resource sectors posted strong performance. Manufacturing and exports of parts and components increased, albeit from a low base and much reliance on imported content, as Lao PDR was able to attract a few companies that relocated part of their production from other countries in the region to special economic zones in Lao PDR (see Box 1). Tourist arrivals, mostly from the region, remained strong at 13 percent growth year-on-year in 2015 partly attributable to improved air transport connectivity. For instance, the number of arrivals at the Wattay International Airport increased by about 60 percent from a year earlier, with Korean nationals accounting for the biggest share of the increase facilitated by more frequent direct Vientiane-Incheon flights as well as new routes to some China cities, Singapore and Malaysia. However, this was partially offset by slower external demand (including for timber), stronger control on public spending as well as lower output in agriculture due to unfavorable weather and lower prices.

Figure 1: Real GDP Growth (percent yoy)



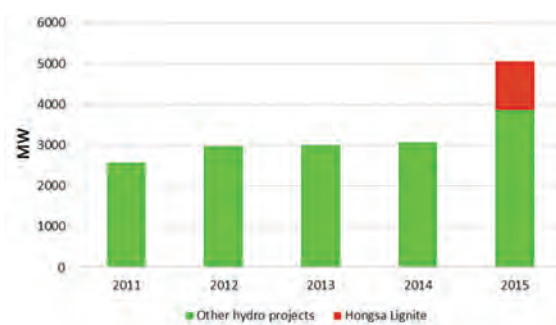
Source: Government, LNCCI data and staff estimates

Figure 2: Sectoral contribution to real GDP growth (percentage points)



Source: Government, LNCCI data and staff estimates

Figure 3: Installed capacity in the power sector (Megawatts)



Source: EDL

Note: the capacity in 2015 take into account 2 production units of Hongsa Lignite project. The full capacity is expected in 2016 with the third unit installed.

Figure 4: Mining output and price indexes (Index 2011 = 100)



Source: www.panaust.com.au, www.mmg.com

Box 1: Special Economic Zones in Lao PDR

The special and specific economic zones (SEZs) have long been promoted but recently some manufacturing sub-sectors start to emerge. There are more than 10 SEZs with about 200 registered business units at varied stages of development across the country with focus mostly on services sector (e.g. entertainment services, logistics) followed by industry (manufacturing) and commerce. Most businesses are foreign owned and relocated to Lao PDR from neighboring countries (Figure 5), due to relatively lower wages, government incentives and perceived political stability. To date, there are more than 11,000 workers employed in the SEZs, out of which about 60 percent are foreign workers (Figure 6).

Over the last few years, Lao PDR was able to attract a number of multinational companies, including Nikon, Essilor, Toyota, Mitsubishi, and Polycom, which resulted in rapid growth in the assembly and equipment parts sectors, albeit from a low base. The export of equipment parts (such as camera parts) has emerged and increased from a low base in 2013 to about US\$ 300 million in 2015⁶. While production relies on imported intermediate inputs to a significant degree, the growth of the sector does show that Lao PDR can effectively participate in regional and global value chains, a feature that was lacking so far in the country's growth model. While a large proportion of labor in all zones are foreign, a few zones (such as Savanh-Seno and VITA park that focus on manufacturing exports as part of the regional supply chain) mostly hire Lao workers (Figure 6).

Figure 5: Share of firms in SEZs by ownership and sectors in 2015 (percentage)

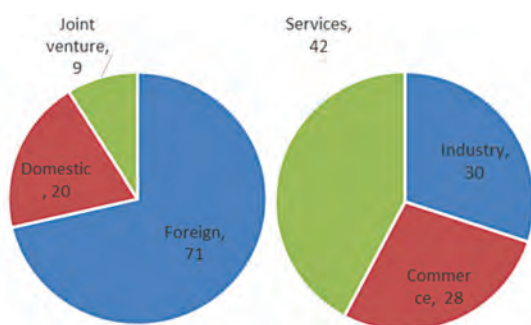


Figure 6: Share of labour in SEZs in 2015 (percentage)



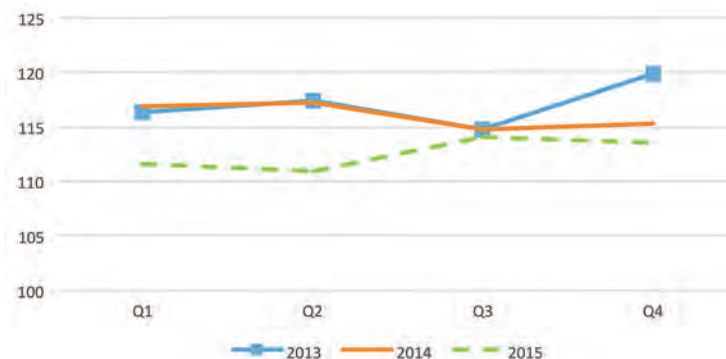
Source: The Secretariat office to the National Committee for Special Economic Zones (SNCSEZ)

⁶ Thailand Ministry of Commerce, <http://www2.ops3.moc.go.th>



4. On the expenditure side, growth continued to be driven by consumption, which was partially offset by a slight moderation in investments, public consumption and widening trade deficit. Data limitation prevents precise estimation of GDP by expenditure. Nevertheless, private consumption increased as reflected by a robust consumer sentiment index⁷ in 2015 (Figure 7) as well as strong household electricity consumption growth (11 percent year-on-year). Tight management of the wage-bill limited the contribution of government consumption. A lower business sentiment index, though still in expansionary territory, suggests that investments have moderated from very high levels in earlier years. Still, investment remain strong as a number of power projects are still under construction and as a few companies relocated their investments to Lao PDR, particularly in the special economic zones. Net real exports were a drag on GDP growth as the real export declined faster (due to agriculture, particularly timber offsetting an increase in power and equipment parts exports) than real imports (increased fuel demand was partly offset by a decline in demand for electrical machinery and equipment due to completion of some power projects).

Figure 7: Consumer Sentiment Index



Source: National Economic Research Institute, MPI

⁷ The consumer sentiment index is collected by the National Economic Research Institute, Ministry of Planning and Investment.

5. Lao PDR's growth model has produced strong GDP growth rates, but has done less well on sharing the benefits of growth. With an average growth rate of around 7.8 percent per annum over the last decade, Lao PDR has been the second fastest growing economy in ASEAN and among the World's 15 fastest growing economies. Still, growth was, to a large degree, driven by natural resources which are capital intensive and create fewer jobs, while low productivity in agriculture and weak performance in manufacturing limited the income generating opportunities for most Lao people. Lao PDR had around 2 million adults engaged in agriculture, representing 64 percent of the country's workforce and making Lao PDR one of the most agrarian economy in East Asia. Productivity in the sector is low and, more worryingly, has not increased significantly. In 2014, average agricultural value added per hectare (in 2005 US\$ prices) was US\$578, compared to US\$994 in Thailand and US\$1,380 in Vietnam. At the same time, a difficult business environment (Lao PDR is ranked 134th out of 189 economies on the 2016 Ease of Doing Business rankings) hampers investment, keeps firms small and informal, which limits job creation. This, combined with still not universal coverage with some basic services (public health, water supply and sanitation etc.) keeps malnutrition rates high. While there are some signs that the situation may be improving more recently, making growth pro-poor remains a priority. Improving agriculture productivity and putting in place a business environment that will be streamlined and effectively implemented can help in raising incomes and creating jobs. All in all, while poverty rates in Lao PDR declined, the pace was considerably slower than other regional peers such as Cambodia and other resource rich countries such as Uzbekistan, Tajikistan, Mongolia and Chile where greater poverty reduction is achieved through effective use of redistribution policies. Part II of this edition of the Lao Economic Monitor provides a more detailed discussion on the drivers of poverty reduction in Lao PDR.



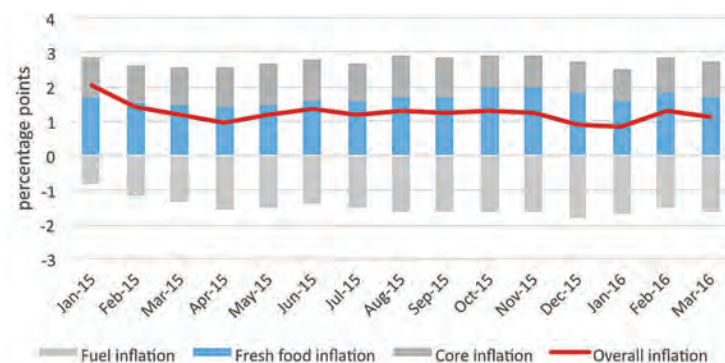
INFLATION

6. Lower oil and commodity prices kept inflationary pressures low during 2015 and so far in 2016. The consumer price inflation averaged 1.3 percent in 2015, down from 4.2 percent a year earlier. Inflation declined further to 0.8 percent (year-on-year) in January and picked up slightly to 1.1 percent in March 2016 (Figure 8). Retail fuel prices reached their lowest level in six years with a 26 percent year-on-year decline in March 2016, mirroring loosely the 29 percent decline in the global crude oil price in the same period (Figure 10). Lower fuel prices are likely to benefit consumers, given that fuel accounts for 8 percent of consumption basket. As global crude oil price are projected to remain depressed in 2016, the low inflationary pressure on the domestic retail fuel prices and the overall price level is likely to persist.

7. Food prices picked up, potentially in response to lower yields due to adverse weather. Food inflation peaked at 5.5 percent (y-o-y) in October 2015 before retreating to 4.7 percent in March 2016 (Figure 9). The average food inflation was 4.6 percent in 2015 and about 4.7 percent during January-March 2016. This was still lower than the 7 percent average food inflation recorded in 2014 as a slower increase in meat prices (higher import of live animals in early 2016 may have lowered price pressures) offset the growing vegetable and rice prices, partly due to unfavorable weather conditions and the base effect from the previous year.

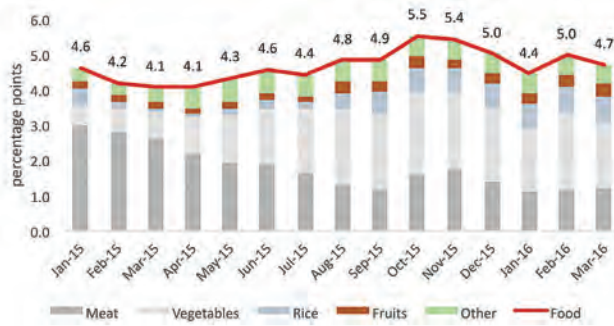
8. The slight moderation of economic activity also kept core inflation low. Core inflation, excluding fuel and food, remained stable at an average of 1.8 percent in 2015 and slightly fell to 1.7 percent during January-March 2016. During the first quarter of 2016, prices for restaurants and hotels experienced slightly slower growth (2.8 percent compared to about 3 percent a year ago) while an increase in housing, water, electricity and gas prices was much slower (1.8 percent compared to 9.2 percent a year earlier) due to upward adjustment in electricity and water supply tariffs last year.

Figure 8: Monthly Inflation
(percent yoy)



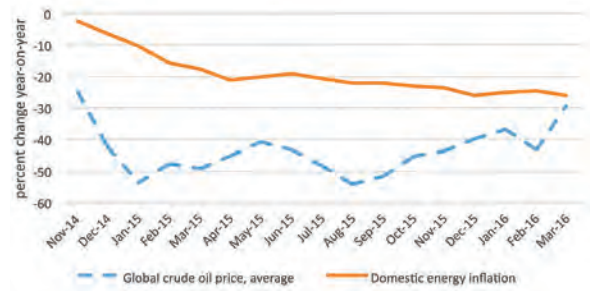
Source: LSB

Figure 9: Contribution to Food Inflation (percentage points)



Source: LSB

Figure 10: Global crude oil price and local retail fuel prices (% change year on year)



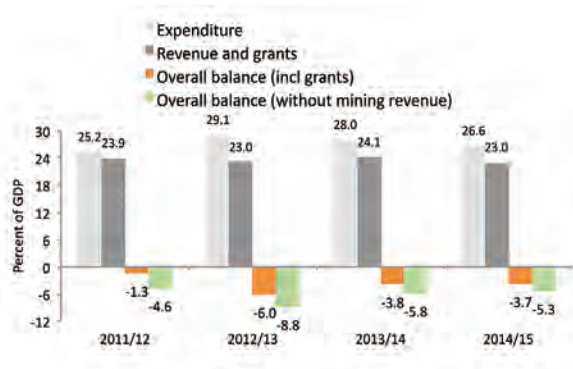
Source: LSB and WB



FISCAL DEVELOPMENTS

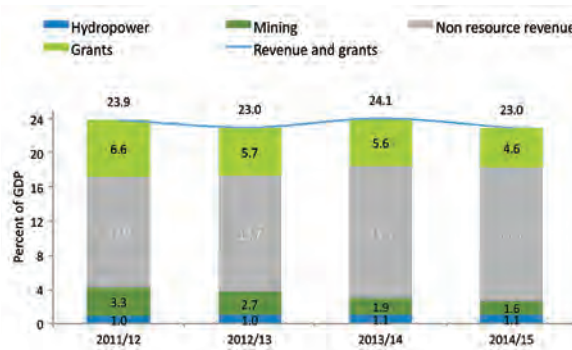
9. The fiscal deficit in FY14/15 is estimated to have declined slightly from the previous fiscal year supported by control on expenditure growth and stronger efforts to increase non-resource revenues. The fiscal deficit in FY14/15 is estimated to have declined slightly to 3.7 percent of GDP from 3.8 percent of GDP in FY13/14 (Figure 11). With revenues related to commodity prices and grants declining, the reduction in the deficit was attributable to strengthening of revenue administration, particularly VAT and profit tax but also tighter expenditure measures to control wages and public recruitment. Despite falling mining revenues, the non-mining fiscal balance (fiscal balance including grants but without mining revenues) declined to 5.3 percent of GDP in FY14/15 from 5.8 percent in FY13/14. Direct financing by the Bank of Lao PDR (BOL)⁸ appears to have declined compared to the previous fiscal year as the Government adopted a decision to limit financing only to ongoing projects and stopped new off-budget projects (Figure 23). The stock of BOL direct lending to state-owned enterprises (with some elements of off-budget spending) reached US\$796 million at the end of 2015, or about 6.3 percent of GDP compared to 7.7 percent back in 2011. This marks a considerable reduction in the pace of financing compared to few years ago, when direct lending was growing by more than 1 percent of GDP per annum. The authorities have also made some important steps towards strengthening the legal framework for public financial management by revising the State Budget Law (SBL), which was approved by the National Assembly in December 2015, and formulating a long-term fiscal strategy (See Box 2).

Figure 11: Government Fiscal Performance (percent of GDP)



Source: MOF and WB staff estimates

Figure 12: Government Revenues (percent of GDP)



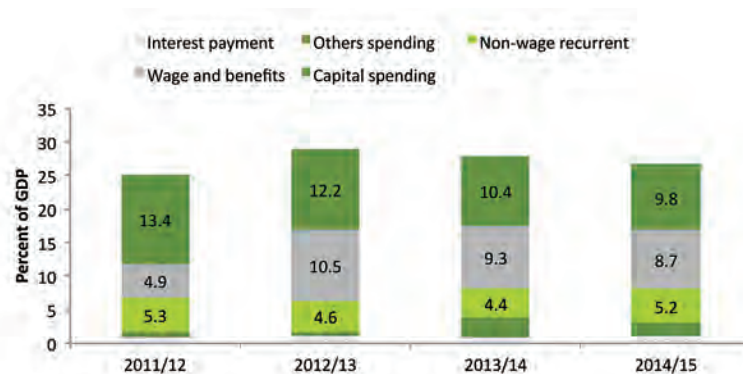
Source: MOF and WB staff estimates

⁸ Direct financing by the Bank of Lao PDR has elements of off-budget spending and is added to the overall fiscal position. This is recorded as BOL lending to state-owned enterprises in the Monetary Survey.

10. Total revenues increased only marginally in FY14/15 compared to the previous fiscal year as important revenue sources came under pressure from lower commodity prices and as foreign grants declined. The modest increase brought the revenues short of plan by 5 percent and as percent of GDP down to 23 percent in FY14/15 (about US\$2.8 billion) from 24 percent a year earlier (Figure 12). Strengthened revenue collection helped boost VAT and profit tax through improved enforcement of regulations and more modalities in tax payment. However, the lower value of imports and oil prices kept customs and excise taxes flat. The mining revenues are estimated to fall by about 10 percent (from about US\$220 million in FY13/14) as gold and copper prices declined by almost 8 percent and 20 percent, respectively, in 2015. Grants fell by 13 percent year-on-year (from US\$650 million in FY13/14 to US\$560 million in FY14/15) as some donor financed projects were completed and disbursements on others was below plans.

11. In response to the revenue shortfall, the authorities also limited expenditure growth. Total expenditures slightly rose but were still about 6 percent below budgeted levels. At around US\$3.2 billion, expenditures were 26.6 percent of GDP in FY14/15, down from 28 percent of GDP in FY13/14. Public wage bill declined from 9.3 percent to GDP to 8.7 percent in FY14/15 (due to continuation of the wage freeze and control on public recruitment (about 5,000 new positions were authorized in FY14/15 compared to 10,000-15,000 in earlier fiscal years). In addition, some under-execution of investment spending as well as lower quasi-fiscal spending helped contain capital expenditure growth. Recent information on planned and actual spending by sectors is not available to enable sectoral breakdown analysis.

Figure 13: Government Expenditures
(percent of GDP)



Source: MOF and WB staff estimates

12. The fiscal deficit was financed largely by external borrowing. Project loans (of about US\$320 million or about 3 percent of GDP) as well as bond issuance at the Thai capital market (US\$365 million in 2, 5 and 10 years bonds or about 3 percent of GDP) largely financed the deficit. An additional issuance of US\$ 182 million (in 10 and 12 years maturities) was issued in December 2015. The increase in project loans, supported by bilateral borrowing, were mostly associated with financing the Government's share in power projects such as Nam Khan 2, Nam Khan 3, Xayaboury and Hongsa Lignite projects while spending on other non-resource infrastructure projects were slightly under plan. This brought Lao PDR's total public debt to about US\$ 7.7 billion or 65 percent of GDP in 2015⁹. The 3-year bonds issued in FY12/13 is maturing in FY15/16 and is expected to be rolled-over through further external borrowing.

Box 2: The authorities' effort in strengthening public financial management

The implementation of recently adopted legislation should strengthen public financial management arrangements in Lao PDR. The State Budget Law (SBL), implemented since 2006, was recently revised and approved by the National Assembly in December 2015. The revised law, to be implemented as of 2017, enhances the authority of the National Assembly in budget oversight as well as the authority of the Ministry of Finance in budget management. In addition, it introduces a new way of budget allocation will take into account roles and responsibilities of the budget units, number of civil servants, population size, poverty status, geography and socio-economic characteristics of the local area, which is expected to improve budget targeting. The revised law also puts in place a new timetable for budget preparation and requires presentation of annual and medium term budget and public debt framework to the National Assembly which should result in a more credible budget preparation process.

In addition, the authorities have been working on a Long-term Fiscal Development Strategy to be adopted in 2016. The objectives of the Strategy include i) maintaining macro-economic stability and low inflation rate; ii) developing revenue-expenditure management policy and arrangements for the State Budget, iii) modernizing debt management and budget financing in accordance with international standards; iv) enhancing effectiveness of State budget expenditure, the coordination between the central and local levels; and lastly adopting and enforcing adequate financial control framework to ensure financial discipline. Several rounds of consultations have taken place.

Source: MOF

⁹ IMF (2015), World Economic Outlook database, October 2015. www.imf.org

13. The still unresolved issue of public sector arrears may mean that the total public debt stock could be understated. Domestic public debt (as borrowing from the banking sector) was estimated around 7.6 percent of GDP at end 2015. However, the issue of public sector arrears continues to linger on, suggesting that domestic public debt may be higher than officially reported. The actual stock of arrears remains unclear with significant differences in numbers reported by various Government agencies. The implementing decree for the FY14/15 Budget stated that about 35 percent of the budget users' annual allocation for domestic investment spending should be used for arrears settlement for completed public investment projects. An inter-Ministerial Committee has been setup to validate the arrears and the Government's inspection services have taken steps to investigate fraudulent cases. In order to strengthen the coordination between Ministry of Finance and Ministry of Planning and Investment as well as monitoring of public investment spending, there are plans to establish a new public investment management division under the Ministry of Finance to supervise the planning and disbursements of the investment spending.

14. Lao PDR has increasingly turned to bilateral borrowing and less concessional sources to finance its budget and investment in resource projects. Most less-concessional bilateral borrowing, particularly from China and Thailand, goes to financing equity stakes in revenue generating projects in the power sector, and general Government budget financing in the case of bond issuance. As a result, the share of bilateral creditors in the external public and publicly guaranteed (PPG) debt stock increased to about 60 percent of total external PPG in 2015 from about 57 percent in 2012 while commercial borrowing increased to about 14 percent from none in the same period. Growing reliance on non-concessional borrowing will have implications for debt service obligations. Currently Lao PDR spends around 2.1 percent of GDP on debt servicing (both interest and principal); however, this is likely to increase fast, especially as bonds begin to mature. Furthermore, while Lao PDR has so far received healthy demand for its debt, the limited access (only the Thai capital market) exposes the country to risks from more significant turbulence which cannot be rule-out in the current external environment.

15. Further increases in the public debt and shift towards non-concessional debt may test the solvency of fiscal accounts in the future. During the 2014 Debt Sustainability Analysis, Lao PDR was already classified as being at moderate, but borderline to high, risk of debt distress¹⁰ and increases in public debt are already increasing the cost of debt servicing. Total public debt reached 7.7 billion or 65 percent of GDP in 2015. External debt service (interest and amortization repayments) increased by more than 60 percent to about US\$250 million in FY14/15 (2.1 percent of GDP) from US\$150 million (about 1.7 percent of GDP in FY12/13) three years ago. Therefore, it would be important to put in place policies that will lead to stabilization of the public debt burden and its gradual reduction consistent with fiscal sustainability level. This will require gradual fiscal consolidation through improving revenue collection and improved efficiency in public spending.

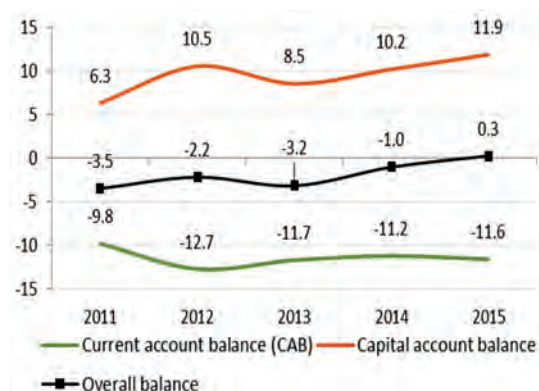
¹⁰ Based on joint IMF-WB Debt Sustainability Analysis, 2014 Article IV Consultation - Lao PDR Staff Report.



EXTERNAL SECTOR

16. The current account deficit is estimated to have slightly widened due to weaker external demand and commodity prices. The trade balance widened as lower external demand (including for timber export to neighboring countries) and the fall in metal prices more than offset the impact of the falling fuel price over imports. On the other hand, robust tourism proceeds (around US\$600 million) are expected to have kept the services account in surplus. The impact of lower profit repatriation by FDI (largely the two copper mines) over the income account may have been offset by higher cost of debt financing. As a result, the current account deficit is estimated to slightly widen to 11.6 percent in 2015 from 11.2 percent a year ago. The deficit was financed by FDI inflows mostly in the power sector and more external borrowing allowing for a slight increase in reserves by year end.

Figure 14: External balance (percent of GDP)



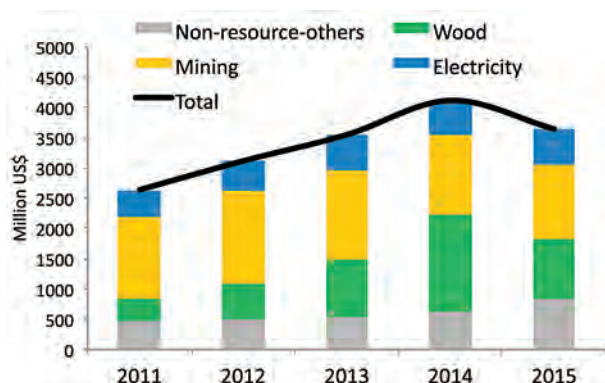
Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

17. Merchandise exports to the three main export destinations¹¹ are estimated to have declined by about 10 percent. Lao PDR mainly trades with Thailand, China and Vietnam, with China having an increasing influence on the external balance and the overall economy (Box 3). Exports to these markets fell to US\$3.7 billion in 2015 driven by a fall in agricultural export earnings, including a welcomed reduction in exports of timber to China and Vietnam from very high levels in the past two years as well as declining mining exports due to lower gold and copper prices (this despite higher output). Average 2015 copper and gold prices declined by 20 percent and 8 percent respectively offsetting the copper and gold output increase of about 5 percent (159,676 tons in 2014 to 167,700 tons in 2015) and 30 percent (from 168,000 oz in 2014 to 221,000 oz in 2015), respectively. As a result, mining export earnings declined by about 9 percent from a year earlier to about US\$1.2 billion. Power export were largely flat as the export from two blocks of the Hongsa Lignite power plant helped offset the under-plan hydropower exports due to lower water flows. Power export to Thailand, the main market, increased by 4 percent in volume while remained flat at about US\$577 million in 2015). On the other hand, importantly, the exports of manufacturing, especially equipment parts to Thailand surged to around US\$300 million in 2015 from US\$150 million a year earlier, although so far contained to a handful of companies located in two Special Economic Zones (See Box 1).

¹¹ Based on trading partners' trade data from the three largest partners, Thailand, China and Vietnam.

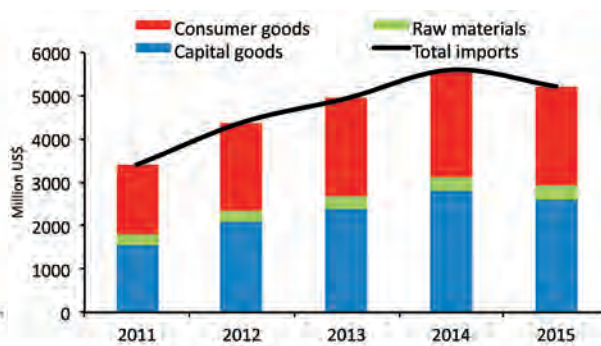
18. Imports also fell but to a smaller extent largely due to lower fuel prices and imports of electrical machineries and equipment parts from China. The completion of some larger projects, including the Hongsa Lignite power plant reduced the imports of investment goods by around 25 percent in 2015. Oil price also fell by 47 percent year-on-year in 2015. Given that fuel accounts for about 20 percent of Lao PDR's imports, the low oil prices have potentially benefited local producers.

Figure 15: Merchandise Exports
(US\$ million)



Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

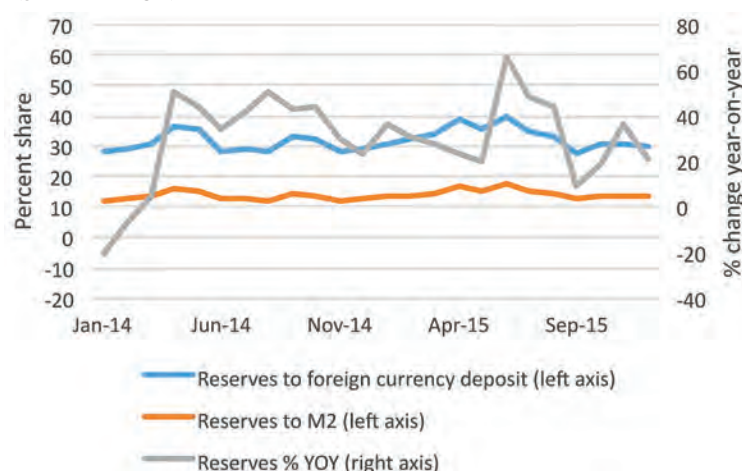
Figure 16: Merchandise Imports
(US\$ million)



Source: Staff estimates based on data from Lao authorities (MOIC) and partner countries

19. Robust FDI inflows and foreign borrowing allowed for some increase in foreign exchange reserves. Capital inflows (FDI and loans) remained resilient reflected in investments in the pipeline of power projects and real estate development, and external borrowing (bond issuance) also helped boost reserves. The reserves reached almost US\$990 million in December 2015, higher than the same period last year by US\$ 170 million, but lower than peak in June 2015 by 16 percent (when reserves got a boost from the inflows of funds from bond issuance in FY14/15). The reserve level is estimated to cover around 2.2 months of imports of goods and services, less than 30 percent of foreign currency deposits and only about 13 percent of broad money. Excluding FDI-financed resource sector imports, reserves are estimated to cover 3.4 months of non-resource imports. The indicators further improve when taking into consideration the foreign assets of commercial banks; however, they still imply substantial vulnerability in the external balances particularly in an environment of growing external economic uncertainty and tightly managed exchange rate policy. A stronger reserves cover, supported with gradual fiscal consolidation can increase the cushion against shocks and is critical for maintaining resilience and macroeconomic stability.

Figure 17: Reserves coverage
(percentage)



Source: BOL and staff calculations

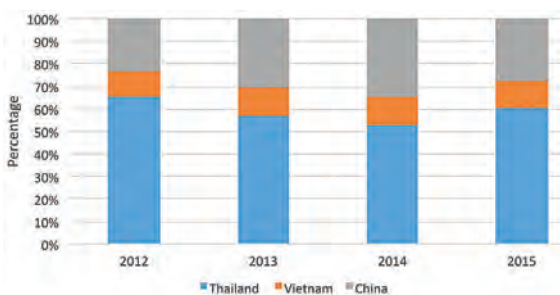
Box 3: Influence of China on the Lao Economy

Lao PDR has strong economic relations with China as the latter is the second largest trading partner and among the top investors and creditors to Lao PDR. To some extent, the uncertainty and a risk of slowdown in the Chinese economy appear to have some direct and indirect impacts on Lao PDR, particularly through trade and commodity prices.

Trade and Tourism

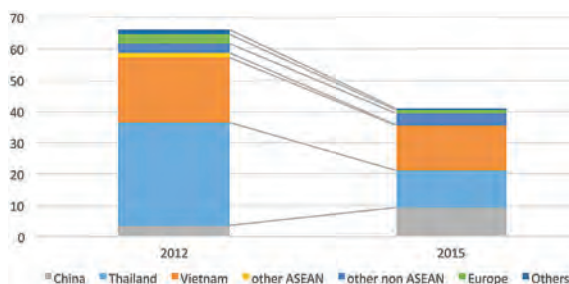
China is Lao PDR's second largest trading partner, accounting for about 25 percent of total trade. China supplies a significant part of capital imports to Lao PDR and is a market for a large part of Lao PDR's agriculture, timber and mining exports. According to China trade statistics, trade flows with Lao PDR declined by about 28 percent in 2015 from the previous year, with timber import from Lao PDR declining from a high base last year and lower mining earnings affected by lower commodity prices, while imports also fell partly due to the completion of large power projects that required capital imports from China, including Hongsa Lignite project. On services export, China has emerged as one of the top ten sources of tourism revenue for Lao PDR. Chinese tourists accounted for 12 percent of tourists visiting Lao PDR in three quarters of 2015, more than 46 percent increase compared to a year ago, despite a slowdown of the Chinese economy.

Figure 18: Share of China in total trade (percentage)



Source: Trading partners' data

Figure 19: Contribution to increase in tourist arrivals by nationality during 2012-2015 (percentage points)



Source: Ministry of Information, Culture and Tourism

Investment

China is one of Lao PDR's biggest investors in various sectors. These include ownership of the two largest copper/gold mines (through Australian-managed companies), investments in energy, agriculture, banking and trade as well as construction of commercial real estates. For instance, many power projects are either partly or entirely financed by Chinese investment. This partly explains the growing number of Chinese bank branch establishments and their increasing assets in Lao PDR in recent years. Chinese labor is also engaged on large investment projects such as those in the power sector and infrastructure construction as well as real estate projects, while some migrated to Lao PDR for trading opportunities. The slowdown of the Chinese economy may effect some potential investment on some pipeline projects that do not yet have secured financing.

External Debt

Lao PDR runs a sizeable current account deficit which is financed by robust investments (mostly in its power sector) as well as increased borrowing, with China being both an important investor as well as creditor. Total public debt outstanding has increased to reach about 65 percent of GDP. Out of public external debt, China accounts for about 44 percent by 2015 compared to 35 percent three years ago. The funding is mostly channeled to infrastructure and power projects. With the discussion on large infrastructure projects going forward, the role of Chinese investment in and lending to Lao PDR could scale up.

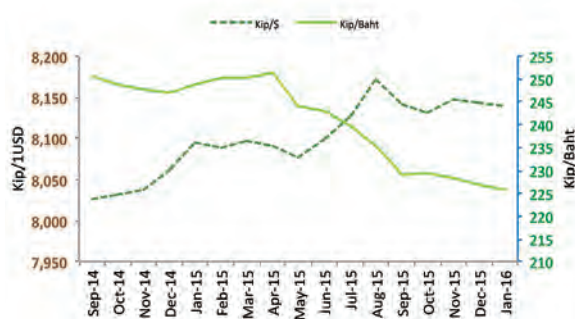
Source: Lao authorities, trading partners' trade data, WB staff estimates

EXCHANGE RATE

20. The authorities continued the policy of maintaining the stability of the Kip by tightly managing the exchange rate of the kip against the US\$. In line with the Bank of Lao PDR key objective of maintaining the stability of the local currency, the kip depreciated by only 1 percent against the US dollar in 2015 compared to the previous year average, without more significant fluctuations throughout the year. With the regional currencies depreciating against the US dollar, the kip appreciated against the Thai baht by 8 percent year-on-year by December and the Vietnamese dong by 6 percent in the same period, for instance. Similar trends continued in early 2016. By the end of February 2016, the kip depreciated by 0.3 percent against the US dollar while it appreciated against the Thai baht by 9 percent compared to a year ago.

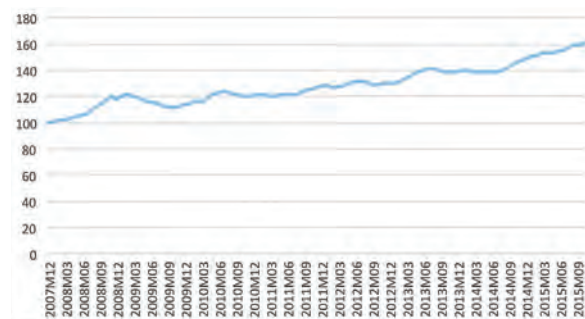
21. In an environment of low inflationary pressures both in Lao PDR and in the region, the real effective exchange rate continued to appreciate. The real effective exchange rate appreciated by 11 percent year-on-year in November 2015, adding further to the overvaluation of the kip. The continued real appreciation, in addition to the supply side constraints, reduces the competitiveness of Lao PDR's exports; though with a minimum wage of around US\$115/ per month, labor costs appear to be still competitive.

Figure 20: Lao kip exchange rate



Source: BOL

Figure 21: Real effective exchange rate



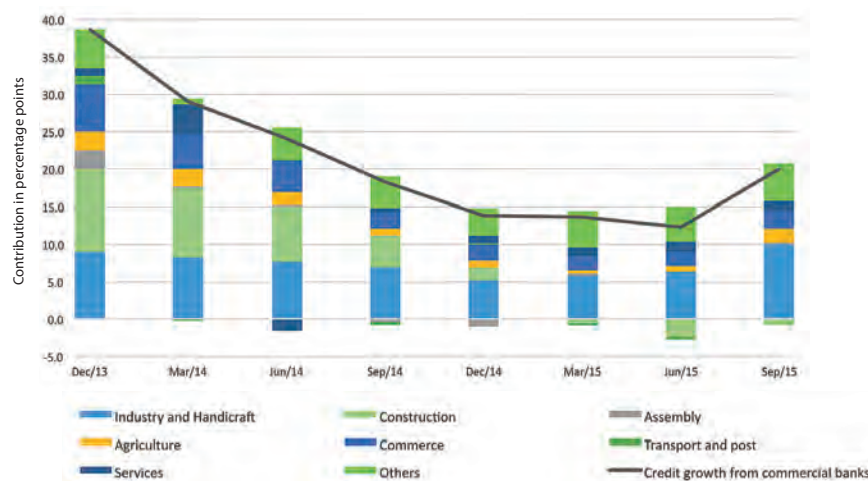
Source: www.bis.org

MONETARY DEVELOPMENTS

22. Credit growth picked up slightly in the second half of the year potentially as a result of BOL's measures to lower the policy rates and cap commercial banks' interest rates. Following credit growth rates of close to 60 percent in mid-2012, the rate of lending gradually moderated, reaching about 11 percent in June 2015. In response, the authorities adopted a few measures in order to stimulate credit expansion. First, BOL lowered the policy rate in July 2015 to 4.5 percent from 5 percent, the first correction since 2010¹². Subsequently in August, this was followed by the setting of (inflation-linked) caps on deposit and lending rates for kip. Under the new regulation, the maximum rate on kip deposits should be at most 2 percentage points higher than the inflation in the previous year while the lending rate can be at most 4 percentage points higher compared to the deposit rate. As a result, kip deposit and lending rates for one year maturity declined from almost 9 percent and 13 percent in 2014 to 6.13 percent and almost 10 percent at end 2015, respectively. In response, the growth rate of time and saving deposits in kip moderated from 25 percent in June to about 18 percent in December. The credit to deposit ratio is well below 1, though most deposits remain short-term and limit banks' ability to provide longer-term loans.

23. The increased lending to the industrial sector offset the contraction in lending to construction. Commercial bank lending to the economy increased by 20 percent year-on-year in September 2015, with half of the increase coming from lending to the industry, followed by commerce (retail and wholesale trade) sector. At the same time, exposure to construction declined with negative growth in September 2015, which could be due to the stronger control on public spending and the attempts to deal with off-budget spending.

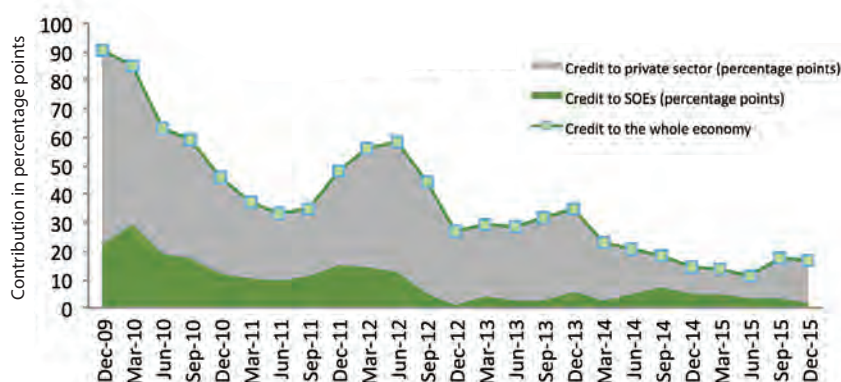
Figure 22: Contribution to credit growth by sectors (percentage points)



Source: BOL

¹² BOL lowered the policy rates from 5% for loans with less than 1 week maturity, 6.25% for loans with maturity between one and two weeks, and 12.5% for loans with maturity of up to 1 year to 4.5%, 5.625% and 11.25%, respectively (www.bol.gov.la).

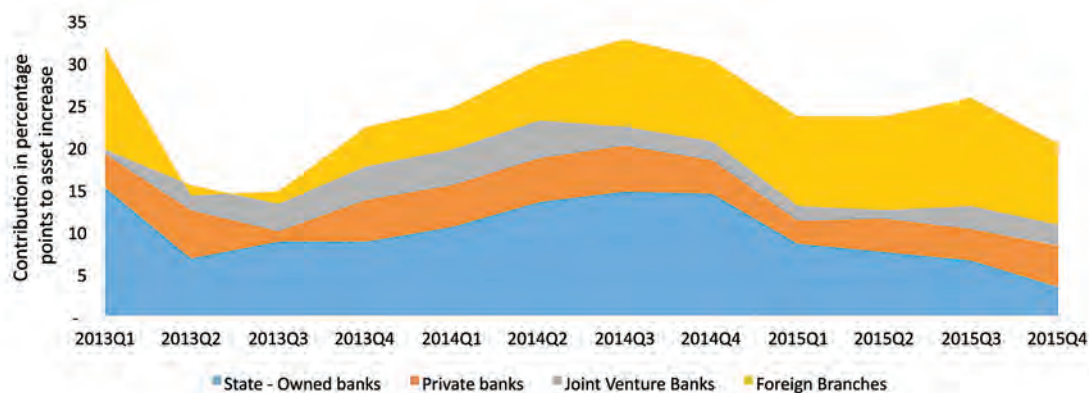
Figure 23: Credit growth (percentage points)



Source: BOL

24. The banking sector expanded significantly with new foreign branches entering the market and existing banks growing their portfolios. The banking sector assets grew by about 57 percent from US\$ 8 billion in 2013 to US\$ 12 billion in 2015, making the ratio of the banking sector assets to GDP rise from 70 percent in 2013 to about 95 percent in 2015. Such increase was driven by the entering of a number of foreign branches from China, Taiwan, Malaysia and Thai banks, bringing the total number of banks to 40. As a result, the share of foreign branches' assets rose from about 18 percent in 2013 to 26 percent in 2015, while the share of state-owned commercial banks (SOCBs) fell from 53 percent to 46 percent in the same period. Nevertheless, the SOCBs still remain dominant, accounting for 47 percent of total bank lending in 2015. The capital buffers were reportedly much lower than a prudential level for some state-owned banks, indicating that the sector is still at risk of distress. Growing banking sector also poses a challenge to bank supervision.

Figure 24: Contribution to growth in banking sector assets (percentage points)



Source: BOL

¹³ World Bank (2016) "Dong Business 2016: Measuring Regulatory Quality and Efficiency", The World Bank. Washington DC.

25. A few important reforms in the financial sector took place over the last year.

With regards to anti-money laundering and counter-terrorism financing, the Government strengthened key regulations (including on forfeiture of assets, border declaration, penalties for non-compliant entities) and is planning to launch a National Risk Assessment as recommended by the Financial Action Task Force (FATF). These helped removed Lao PDR from the FATF's list of "jurisdiction not making sufficient progress". The outlook will depend on the progress in the implementation of the recommendations and agreed measures.

26. In addition, BOL removed the minimum loan size limit to be recorded in its credit registry and expanded coverage of borrowers.

As a result, the country's rank on the Doing Business getting credit indicator significantly improved from 128th in 2015 to 70th in 2016¹³. While improved credit information infrastructure can help, making a stronger improvement in access to finance in Lao PDR would depend on the ability to put in place a business environment that will protect creditor rights and ensure effective enforcement of contracts.

OUTLOOK

27. GDP growth is projected to remain stable at around 7 percent in 2016. The 1,878 MW Hongsa lignite power plant will fully come on stream this year and together with the output expected from other new power projects (around 500MW) will increase power generation by more than 30 percent compared to 2015. In early 2016, power export to Thailand increased by three folds from US\$55 million during January-February 2015 to US\$142 million in the same period in 2016. In addition, the gradual liberalization of air traffic is expected to facilitate more tourist arrivals. Some fiscal expansion (with the deficit projected to increase to 5.1 percent of GDP in FY15/16) and investment as Lao PDR chairs ASEAN in 2016 will add to domestic demand. The current account deficit is projected to narrow to about 10.4 percent of GDP in 2016 from 11.6 percent in 2015 as power exports are projected to increase and recent trends in exports of parts and components continue while global oil prices are assumed to still be pressed in 2016. This will help import bills as fuel import accounts for about 20 percent of Lao PDR's import.

28. However, there are a number of downside risks. A slowdown in main trading partners such as China, with its projected deceleration from 6.9 in 2015 to 6.7 in 2016 and further down to average of 6.5 in the medium term and a scenario of Thailand's slower-than-expected growth (migrant destination, investor and market for electricity exports) might affect trade and investment (Table 1). Additionally, domestic economic risks remain elevated, including systemic risks in the banking sector. Moreover, the situation of some state-owned banks may have deteriorated due to high non-performing loans and limited capital buffers. The 2014 Debt Sustainability Analysis suggested Lao PDR is at moderate, but borderline to high risk of debt distress. The weak enforcement of fiscal discipline, if continues, can result in growing public debt burden.

29. In the medium term, strong, though more moderate, rates of expansion of the power sector will continue to propel growth of around 7 percent. The challenge for Lao PDR will potentially be to secure markets for its rapidly growing power generation and develop the required transmission systems. During 2017-2020, the power sector is expected to be the key growth engine with an average increase in power generation of above 15 percent growth per year. The mining output is projected to remain flat as the main mines gradually exhaust their deposits. The non-resource sector is expected to expand as rents from the resource sector trickle down into higher domestic demand and efforts on investment climate reforms accelerate. The fiscal deficit is projected to gradually decline below 5 percent of GDP as non-resource taxation is strengthened and public financial management improves. Stronger power exports should help gradually narrow the external balance. The start of some large infrastructure projects, including the Lao PDR section of the Kunming – Singapore railway, can boost economic activities such as construction and help Lao PDR make more of its location in the middle of the Indochina region. However, such large scale projects need extensive evaluation of the economic and financial costs, particularly impacts on the debt outlook, as well as environment and social impacts.

Table 1: Economic Growth Projections of countries in East-Asia and Pacific Region

	2014	2015	Forecast 2016	Forecast 2017	Forecast 2018
East Asia and Pacific ²	6.1	5.7	5.8	5.7	5.8
Developing East Asia and Pacific	6.8	6.5	6.3	6.2	6.2
China	7.4	6.9	6.7	6.5	6.5
Indonesia	5.0	4.8	5.1	5.3	5.5
Malaysia	6.0	5.0	4.4	4.5	4.7
Philippines	6.1	5.8	6.4	6.2	6.2
Thailand	0.8	2.8	2.5	2.6	3.0
Vietnam	6.0	6.7	6.2	6.3	6.3
Cambodia	7.1	7.0	6.9	6.8	6.8
Lao PDR	7.5	7.0	7.0	7.0	6.8
Myanmar	8.5	7.0	7.8	8.4	8.3
Mongolia	7.9	2.3	0.7	2.7	6.2
Fiji	5.3	4.0	2.4	3.8	3.5
Papua New Guinea	8.5	8.6	3.0	4.1	2.9
Solomon Islands	2.0	3.3	3.0	3.3	3.0
Timor-Leste	6.0	4.3	5.0	5.5	5.5
Memo: Developing East Asia exc. China	4.6	4.7	4.8	4.9	5.1
Memo: ASEAN	4.4	4.4	4.6	4.8	4.9

Source: World Bank's EAP Economic Update, April 2016

PART II: DRIVERS OF POVERTY REDUCTION IN LAO PDR¹⁴

1. Poverty in Lao PDR declined over the past decade. The Lao Expenditure and Consumption Survey 2012/13 (LECS 5) showed that poverty declined from 33.5 percent in 2002/03 to 23.2 percent in 2012/13, helping Lao PDR achieve the MDG target of halving extreme poverty by 2015 (Figure 25). This translated into a 0.47 percent reduction in poverty for every percentage point of GDP growth, one of the smallest in the East Asia and Pacific region (with the exception of the Philippines). With growth patterns little changed since the last official poverty measurement survey, the poverty reduction rate may have declined further, but may still be at a pace slower than economic growth.

2. Improvements in other socio-economic indicators provided further evidence that living standards of people improved (Figure 27). The number of households that lived in houses built with bricks or concrete and those living in houses with cement floors or floor tiles increased almost three folds compared to a decade earlier (41 percent in 2012/13 compared to 14 percent in 2002/03). Nearly 80 percent of households were connected to electricity in 2012/13 and the proportion of households without any type of toilet almost halved (27 percent in 2012/13 compared to 50 percent in 2002/03). At the same time, net enrollment in lower secondary school increased to about 50 percent in 2012/13 from 26.8 percent in 2002/03, but the increase was higher for the non-poor households than the poor households (See World Bank, 2014)¹⁵. Despite these improvements over time, Lao PDR continues to lag the EAP average on most of these indicators.

Figure 25. Trends in poverty in Lao PDR: 2002/3 – 2012/13

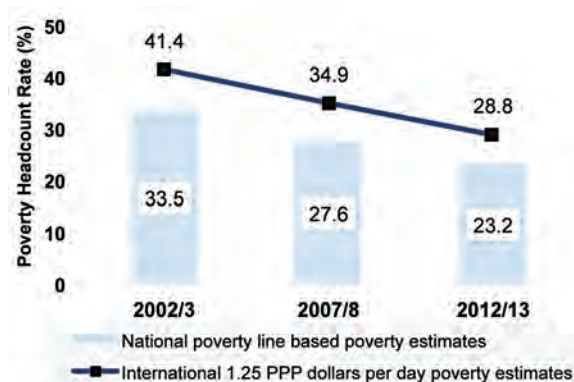
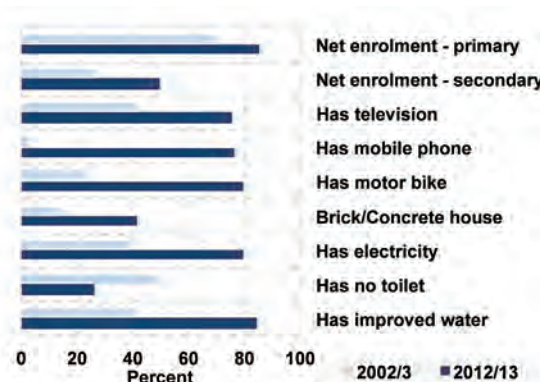


Figure 26. Social indicators in Lao PDR: 2002/3 -2012/13



Source: World Bank (2015)

¹⁴ World Bank (2015), "Lao PDR Poverty Policy Note: Drivers of Poverty Reduction in Lao PDR", The World Bank. Vientiane. <http://documents.worldbank.org/curated/en/2015/12/25516130/lao-pdr-poverty-policy-notes-drivers-poverty-reduction-lao-pdr>

¹⁵ Ministry of Planning and Investment (2014), "Poverty Profile in Lao PDR: Poverty Report for the Lao Consumption and Expenditure Survey", <http://documents.worldbank.org/curated/en/2015/10/25141792/poverty-profile-lao-pdr-poverty-report-lao-consumption-expenditure-survey-20122013>

Increases in endowments, primarily human capital and access to land coupled with non-farm job creation were major drivers of poverty reduction.

3. Welfare gains were driven by increasing educational attainment and transition to non-farm employment as well as better connectivity. The increase in education attainment was especially critical in facilitating the transition to non-farm incomes and in increasing returns to agriculture. Complete primary education was associated with higher productivity in agriculture while lower secondary education facilitated the transition into non-farm activities. Increases in endowments and productive opportunities were thus the key drivers of poverty reduction. More recently, notable growth in services (such as trade and tourism) and manufacturing sub-sectors as aforementioned, may have opened up more employment opportunities. In addition, better connectivity through road access in rural areas also increased likelihood of reducing poverty in rural areas by 10 percent compared to rural area with no road access. In this respect, the latest 2015 population census shows that the share of rural population with road access increased from 52 percent in 2005 to 59 percent in 2015 while the share of urban population increased from 27 percent in 2005 to about 33 percent in the same period. All in all, the recent trends may imply that poverty could have further declined in 2015.

4. Raising agriculture income is also an important driver of poverty reduction. Despite the declining share of agriculture in GDP to about 24 percent in 2015 from 35 percent a decade ago and low productivity compared to regional peers, the sector remains important as it provides work for 64 percent of the labor force (despite a fall from 73 percent in 2002/03) and accounted for 44 percent of the poverty reduction between 2003 and 2013. A more productive agriculture sector will create new jobs in agribusiness sectors and facilitate the move of labor towards other sectors as well as improve livelihoods for the large part of the population that will remain engaged in the sector. A third of farmers are already above 40 years of age and with at most primary education. They are unlikely to transition out of agriculture and will depend on agriculture income growth to move out of poverty. With access to productive land being limited, a more sustainable path to raise agriculture income should be through productivity improvement. The supply chain is not functioning effectively, keeping prices for farmers low and for consumers high, reflecting both agriculture-specific as well as economy-wide constraints to doing business. As a start, providing more education to farmers has the potential to achieve higher productivity (Table 2). Furthermore, a transition away from a focus on rice self-sufficiency to competitiveness of rice-based farming systems is needed. More and smarter government programs (extension services, quality seeds and fertilizers etc.) and market-friendly agricultural policy can facilitate this shift.

Table 2: Selected Agriculture indicators by education level of household head

	Output (KGs) per hectare		Output (KGs) per person per year		Sold produce on market (%)	
Household head's highest level of completed education	2008	2013	2008	2013	2008	2013
No formal education	2119	2016	474	532	40.5	39.6
Some primary education	2437	2265	529	607	48.7	49.0
Complete primary education	2644	2552	660	695	57.7	59.1
Complete lower secondary or more	2743	2700	707	719	59.5	56.7
Lao PDR	2541	2454	610	659	53.0	53.3

Source: World Bank (2015)

However, despite overall reduction in poverty at the national level, progress varied across population groups and regions

5. As overall poverty declined, the pattern was uneven. Poverty was substantially higher in rural areas, at 28.6 percent, compared to 10 percent in urban areas. Such gap widened over the past five years as poverty in urban areas declined faster. Poverty was higher among ethnic groups. Lao Tai accounted for 55 percent of the poor, while Chine-Tibet ethnic group did relatively better. Poverty was also higher among households whose household head had lower education levels and those who mainly relied on agriculture for income as well as those unemployed. Geographically, poverty generally declined in the north (except Bokeo) and central, but increased overall in the south, particularly Saravan and Champasack. The more number of poor people did not necessarily live in provinces with highest poverty rate. As a result, the uneven pattern of poverty reduction progress caused rising inequality, which was shown in an increase in the Gini coefficient from 35.0 in 2007/08 to 36.2 in 2012/13.



In addition, faster poverty reduction could have been achieved had growth been more broad-based.

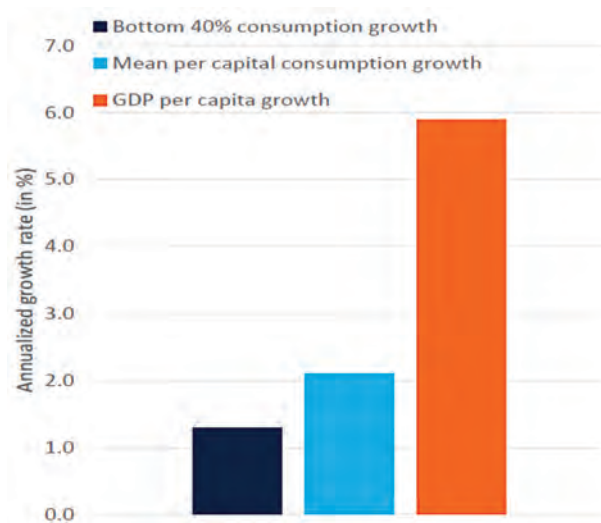
6. Very few productive jobs were created, despite the strong economic growth.

During 2003-2013, GDP more than doubled and employment increased by 20 percent (or around 500,000 jobs) bringing total employment to about 3.1 million. With significant part of the population having access to subsistence farming, the official unemployment rate remained very low. However, only about 80 percent of jobs created were non-farm jobs and 17 percent of these were in the public sector. Most of the jobs created were in wholesale and retail trade, characterized by low technology and productivity. The agriculture sector provided jobs for 64 percent of the employed in 2013, down from 73 percent a decade earlier. Around 10.5 percent of jobs were in the trade sector, up from 8.2 percent in 2003. Manufacturing accounted for 7 percent of employment, only marginally up from 6.2 percent a decade ago, while public services provided jobs for 6.1 percent of the employed workforce. While more recent information is not available, anecdotal evidence suggests that the move towards non-farm jobs may have accelerated in recent years, especially with the emerging manufacturing sector as well as the continued expansion in services.

7. Equally important, when good jobs were created, firms complain about inadequate skills of the labor force.

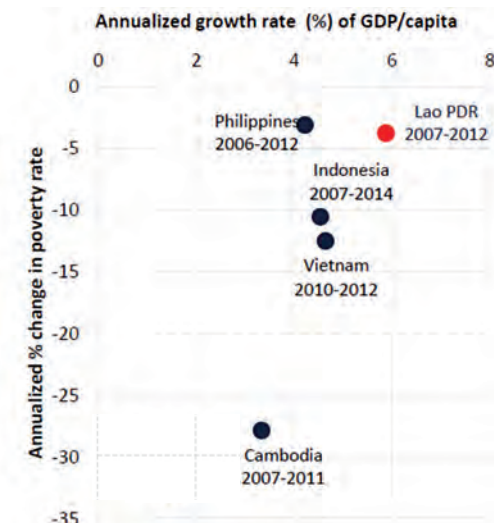
The 2014 Lao PDR Development Report found that many workers lack foundational skills such as the ability to read. Without these foundational skills, workers struggle even in the most basic jobs and teaching them more skills is challenging. In addition, high prevalence of malnutrition and stunting and, in general, the poor health status of the population limit the economic potential of workers, even from their young age.

Figure 27. Growth in GDP per capita growth and consumption



Source: World Bank (2015)

Figure 28. GDP per capita growth and poverty reduction



Source: World Bank (2015)

8. The pace of poverty reduction was slow compared to the relatively high economic growth. Poverty declined by just 0.47 percent for every 1 percent increase in GDP per capita between 2007/8 and 2012/13 – quite low compared to surrounding countries like Cambodia and Vietnam but also Indonesia. As the robust growth of the Lao economy has been led by the natural resource sectors, which are capital intensive and created few jobs, such growth pattern did not translate into broad employment creation and a commensurate increase in household consumption. Therefore, such pattern disproportionately benefited the non-poor, resulting in a smaller decline in poverty compared to a scenario if it had been equitably distributed across all income groups. Average consumption per capita grew by 2.2 percent per year between 2002/3 and 2012/13, almost three times less than the rate of economic growth. Even this small increase in consumption benefited the non-poor more than the poor population as the consumption of the richest group increased by 2.4 percent compared to only 1.3 percent of the poorest group. As a result, Lao PDR had one of the lowest growth elasticities of poverty in the South East Asia region (Figure 28). It also compares less favorably to some other resource rich countries such as Uzbekistan, Tajikistan, Mongolia and Chile that employ effective redistribution policies.



9. Poverty could have declined by more had a large number of vulnerable households not fallen back into poverty. About half of the poor in 2012/13 were previously non-poor in 2007/08 and more than two thirds of them had been non-poor at some point during that 10 year period. Many people escaping poverty remained close to the poverty line where vulnerability is high. About 80 percent of the population in 2012/13 still lived on less than PPP 2005 \$2.5 per day and faced at least a 10 percent chance of falling into poverty in subsequent periods. Such vulnerabilities are induced from various shocks.

Agriculture shocks and health shocks are main drivers of household vulnerability

10. The losses in welfare were driven by agriculture shocks, mainly in the form of food price changes and loss of land, and to some extent catastrophic health expenditures. The observed consumption growth pushed those escaping poverty only slightly above the poverty line, where the risks of sliding back into poverty is high. Actually, half of the poor people in 2012/13 were non-poor five years earlier. There are more net sellers than net buyers of rice in Lao PDR, especially in the rice surplus areas in the center and the south, therefore an increase in the price of rice has a net benefit while a decrease results in a net aggregate loss in welfare. The drop in prices in 2012/13 compared to 2007/8 thus had a negative welfare impact in the center and the south. The loss of land impacted urban dwellers who supplement their non-farm incomes with farming, which serves as a strong reminder that productivity at the entry level in the non-farm sector is not yet high enough to sustain livelihoods of poorly skilled people to completely transition out of agriculture. Vulnerability is highest among ethnic groups, some of whom (the Monkhmer and Hmong-Lu-Mien) are twice likely to fall back into poverty than other groups. In addition, with just 20 percent of the population covered by health insurance (mostly public and private sector wage workers), health shocks and catastrophic out-of-pocket expenditures pose a significant risk to households' welfare. Finally, low financial inclusion and the absence of adequate safety nets limit the ability of households to mitigate risks.



Looking ahead, higher poverty reduction in Lao PDR can be achieved by improving productivity, creating better economic opportunities for both the poor and non-poor, and by strengthening the social protection system.

11. Growth in agriculture incomes is still an important pillar for reducing poverty.

Many people engaged in agriculture, especially the less educated mid-aged, will remain in the sector for the foreseeable future. Raising agriculture income is the main pathway out of poverty for them. This will require i) lowering marketing costs through public investments and better regulations and supporting open trade policies to uplift farm prices and increase the profitability of farming, ii) focusing on increasing productivity more through production methods and labor skills as further land expansion, which was the driver for growth in agriculture, could be unsustainable iii) improving human capital of farmers through training and agricultural extension services to allow the majority of less educated farmers to catch up with more educated farmers in raising their productivity.

12. Promoting greater resilience, especially in the agricultural sector, through improved social safety nets and insurance will be important for ensuring the sustainability of poverty reduction going forward.

Key areas of focus should be i) increasing resilience in agriculture since farming households are twice as likely to fall back into poverty than non-farming households, ii) strengthening social insurance – especially on health insurance or universal access to health care, iii) putting in place social welfare programs that target the vulnerable and the chronically poor and iv) deepening financial inclusion to expand options available for households to cope with shocks.

13. In the meantime, job creation, stimulating productivity growth and improving the quality of jobs in the non-farm sector is also a key pathway for reducing poverty in Lao PDR. This can be achieved by creating a vibrant labor intensive non-farm sectors, especially in services and manufacturing by improving the regulatory and business environment where Lao PDR is the second lowest ranked within the region, while in the meantime continue to invest in education in order to prepare human capital to take up created opportunities. In order to attract more investments that will generate more non-farm jobs and wage income, an improved business environment and higher productivity in the non-farm sectors are necessary. Higher wage earning coupled with improved productivity can reduce the impact on competitiveness. In addition, further investment in education is needed to provide people with the pre-requisite skills to obtain non-farm jobs rewarding enough to keep them out of poverty and alleviate the skills constraints that have also hampered firm growth.

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ANNEX 1: LAO PDR AT A GLANCE

	2013	2014	2015	2016
Output and prices (percent change, unless otherwise indicated)			Est	Proj
Real GDP	8.5	7.5	7.0	7.0
(excluding resources, percentage points)	6.0	6.5	2.2	3.0
GNI per capita (in US dollars)	1460	1660	1730	
Consumer prices (% change, period-average)	6.4	4.2	1.3	3.0
			Est	Proj
Public finances (in percent of GDP) 1/	FY12/13	FY13/14	FY14/15	FY15/16
Total revenue	23.0	24.1	23.0	20.1
Domestic Revenue	17.4	18.5	18.4	17.7
Domestic Revenue (excl. mining and hydropower)	13.7	15.5	15.7	15.6
Domestic Revenue (excl. mining)	14.6	16.6	16.8	16.8
Grants	5.7	5.6	4.6	2.4
Expenditure	29.1	28.0	26.6	25.2
Current	16.3	14.7	15.0	15.9
Capital and onlending	12.2	10.4	9.8	7.6
Overall budget balance (deficit)	-6.0	-3.8	-3.7	-5.1
Overall budget balance (deficit, excl. mining)	-14.4	-11.4	-9.9	-8.4
Overall budget balance (deficit, excl. hydro and mining)	-15.4	-12.4	-10.9	-9.6
Balance of payments				
Current account balance (% of GDP)	-11.7	-11.2	-11.6	-10.4
Resource CAB (% of GDP)	-0.5	-3.6	-4.4	-3.2
Non-resource CAB (% of GDP)/2	-11.2	-7.6	-7.2	-7.3
Capital account balance (% of GDP)	8.5	10.2	11.8	11.1
Overall balance (% of GDP)	-3.2	-1.0	0.3	0.6
Gross official reserves				
In millions of US dollars	662	816	987	1,016
In months of imports of goods and services	1.5	1.7	2.2	2.1
Monetary Sector				
Credit growth	34.5	14.2	16.8	18.0
Broad money growth	17.0	25.2	14.7	20.0
Memorandum items:				
Nominal GDP (millions of US dollars)	11,187	11,760	12,374	13,396
Exchange rate (kip/US\$, average)	7,862	8,035	8,117	8,198

Sources: Staff estimates and projections based on data provided by the Lao authorities.

1/ Fiscal year basis (October to September).

2/ Excluding resource imports and exports

ANNEX 2: LAO PDR's Government Budget

Government Budget (in million USD)	FY12/13	FY13/14	FY14/15	FY15/16
			Est	Proj
Total revenue	2,469	2,798	2,806	2,643
Domestic Revenue	1,862	2,148	2,245	2,332
Non-resource revenue	1,467	1,804	1,918	2,052
Mining revenue	290	220	195	128
Power/hydro revenue	105	125	132	151
Grants	607	650	561	311
Expenditure	3,119	3,250	3,256	3,313
Current	1,751	1,713	1,839	2,084
o.w. interest payments	127	113	139	180
Capital and onlending	1,304	1,213	1,196	1,003
Domestically financed	475	440	420	465
Externally financed and onlending	829	773	776	539
Overall budget balance (deficit)	-649	-452	-450	-670
Budget balance (deficit excl. mining revenue)	-940	-671	-645	-799
Budget balance (deficit excl. hydro and mining revenue)	-1,045	-796	-776	-950
Government Budget (in percent of GDP)				
Total revenue	23.0	24.1	23.0	20.1
Domestic Revenue	17.4	18.5	18.4	17.7
Non-resource revenue	13.7	15.5	15.7	15.6
Mining revenue	2.7	1.9	1.6	1.0
Power/hydro revenue	1.0	1.1	1.1	1.1
Grants	5.7	5.6	4.6	2.4
Expenditure	29.1	28.0	26.6	25.2
Current	16.3	14.7	15.0	15.9
o.w. interest payments	1.2	1.0	1.1	1.4
Capital and on-lending	12.2	10.4	9.8	7.6
Domestically financed	4.4	3.8	3.4	3.5
Externally financed and on-lending	7.7	6.7	6.3	4.1
Overall budget balance (deficit)	-6.0	-3.8	-3.7	-5.1
Budget balance (deficit excl. mining revenue)	-8.8	-5.8	-5.3	-6.1
Budget balance (deficit excl. hydro and mining revenue)	-9.7	-6.9	-6.4	-7.2



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