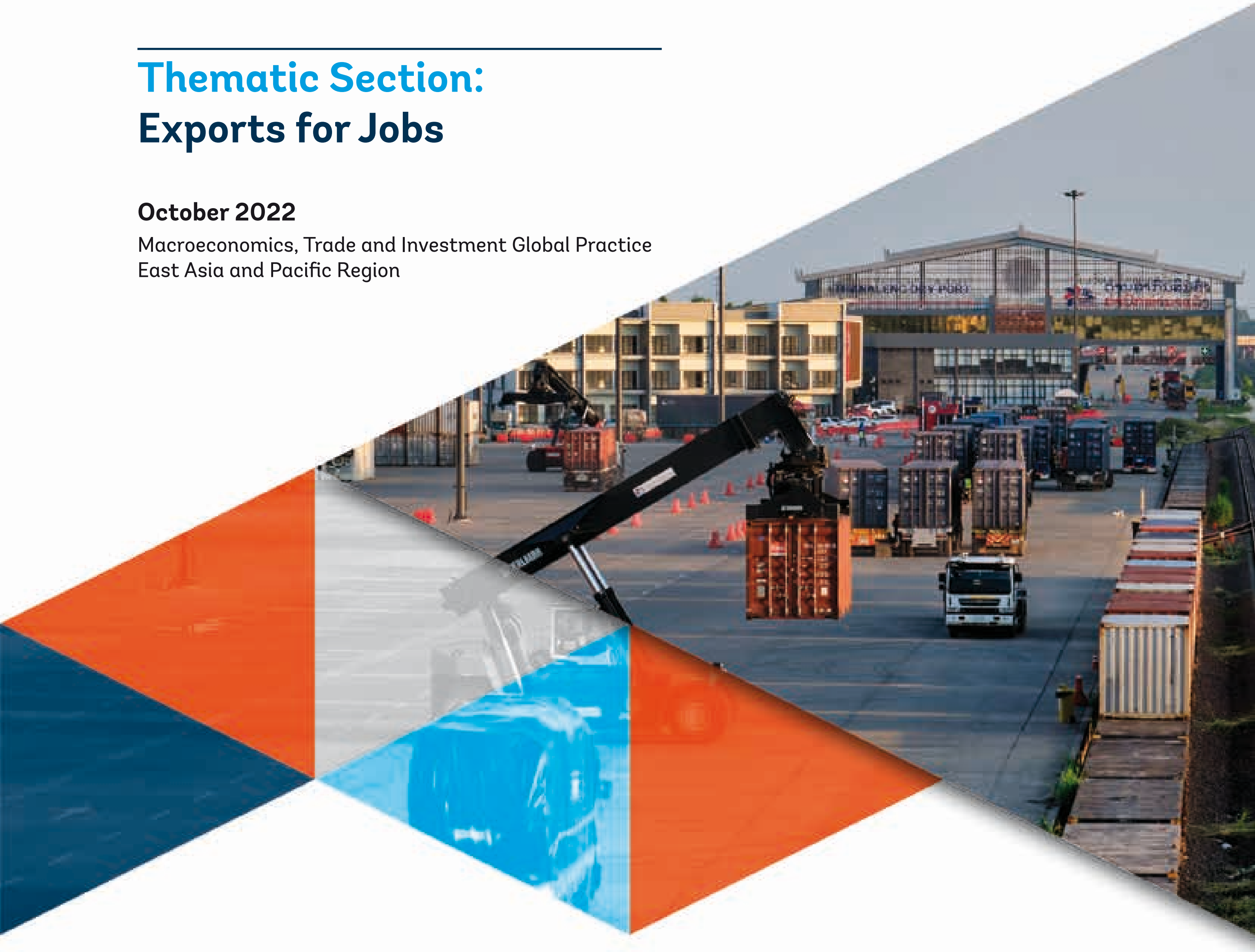
LAO PDR ECONOMIC MONITOR

Tackling Macroeconomic Vulnerabilities

Thematic Section:
Exports for Jobs

October 2022

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



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Layout: Paul Bloxham Design.

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Abbreviations

CAR	Capital adequacy ratio
CEM	Country Economic Memorandum
EAP	East Asia and Pacific
EMDE	Emerging Market And Developing Economies
FDI	Foreign direct investment
GVC	Global value chain
LSX	Lao Securities Exchange
NEER	Nominal effective exchange rate
NPL	Non-performing loans
PPG	Public and publicly guaranteed
REER	Real effective exchange rate
SEZ	Special Economic Zones
SME	Small and medium enterprises
SOE	State Owned Enterprise

All dollar ($) amounts are US dollars unless otherwise indicated.

Acknowledgements

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

For inclusion on the email distribution list, comments and questions on the content, please contact us at: laos@worldbank.org.

Executive Summary

Part A: Recent Economic Developments and Outlook

The Lao economy is facing increased challenges from a sharp currency depreciation and high inflation, amid a deteriorating global economic environment and slow domestic reforms. There were signs of an economic recovery in early 2022, but the domestic and external environment has deteriorated significantly since then. Economic activity in the first half of 2022 was mostly driven by the services sector, supported by the transport and logistics sector, following the opening of the Laos-China railway and the Thanaleng Dry Port, as well as a rebound in regional and domestic tourism. The mining and power sectors have also supported economic activity, while the manufacturing and agriculture sectors have had a mixed performance. In manufacturing, wood and paper products output was resilient while the production of electronic goods declined in the first eight months. In the agriculture sector, cassava and rubber performed well, while livestock declined in the same period. However, the strong depreciation of the Lao kip, 68 percent against the US dollar in the year to October 2022, has undermined the recovery and has fueled inflation which is harming private consumption and investment. As a result, the economic growth forecast for 2022 has been revised downwards to 2.5 percent, from an earlier projection of 3.8 percent.

High inflation is eroding the purchasing power of households, many of whom experienced income losses from COVID-19 and are still recovering. While labor market indicators improved by mid-2022 and poorer households have benefitted from a recovery in nominal wage earnings and remittances, their purchasing power and living standards have been negatively affected by rapidly rising domestic prices. Consumer price inflation rose to 37 percent in the year to October 2022, while food price inflation reached 39 percent. The welfare cost of high inflation is considerable, particularly for the urban poor because more of their income share is spent on food and fuel. Social assistance to households is constrained by limited fiscal space, forcing some households to reduce their consumption of food and fuel. Two-thirds of households have cut spending on health and education, which will likely undermine long-term human capital development.

Despite an improvement in the fiscal balance in the first half of 2022, fiscal space to support the economy remains limited. Domestic revenue has gradually recovered compared to 2021 but is still considerably below pre-pandemic levels. Public expenditure has been tightened by the postponement of capital investments and reductions in civil service intake. An expenditure-driven fiscal consolidation and high debt service obligations have constrained public spending on human capital and social assistance. Despite the improvement in the fiscal balance in the first half of 2022 and significant debt service deferrals, gross financing needs remain considerable, amplified by the kip depreciation. In the absence of debt payment deferrals, total expenditure and the fiscal deficit would be about 1 percent of GDP higher in 2021. To meet financing needs, the government has resorted to asset sales, repayment from SOEs for on-lending, bond issuances and borrowing from commercial banks.

Debt sustainability hinges on a successful conclusion of ongoing debt negotiations with major bilateral creditors. Public and publicly guaranteed (PPG) debt reached $14.5 billion (89 percent of GDP) at the end of 2021. Contingent liabilities arising from state-owned enterprises (SOEs) non-guaranteed debt and public-private partnerships (PPPs) are also a source of concern. Borrowing by SOEs accounted for 43 percent of total PPG in 2021, of which the majority was in the power sector. Given the sharp kip depreciation in 2022, the PPG debt stock, 86 percent of which is denominated in foreign currencies, is projected to increase to over 100 percent by the end of 2022. While debt service deferrals between 2020-2022 have provided important temporary relief, the accumulated amount of deferred payments during these three years has reached around 8 percent of the 2022 GDP. It remains unclear how this amount will be repaid, since it has not yet been incorporated in the debt service plan. Existing debt service obligations are very high, averaging $1.3 billion per year during 2023-2026, which is similar to the stock of official foreign reserves recorded in June 2022.

In the medium term, the outlook assumes a gradual recovery in international tourism and exports, but it is contingent on a successful conclusion of ongoing debt negotiations. In addition, the economic outlook is subject to significant downside risks. The global economy is facing challenges from the impacts of the protracted war in Ukraine, rising geopolitical tensions, and tighter macroeconomic policies (e.g. rising interest rates and the withdrawal of COVID-19 related support measures). Moreover, weaker growth prospects in key trading and investment partners – namely China, due to its structural slowdown and zero-COVID-19 policy – are also weighing on the recovery. These developments affect the Lao PDR through several channels, including lower external demand, higher commodity prices, and further exchange rate depreciation pressures. Domestic risks include challenges with refinancing external debts, slow progress with structural reforms, and a deterioration of bank balance sheets. In particular, the outcome of the ongoing bilateral debt renegotiation will have strong implications for resolving debt distress and macroeconomic instability. A fiscal adjustment alone, particularly through protracted expenditure curbs, will not be sufficient to improve debt sustainability without harming long-term growth prospects, as the debt overhang will undermine critical investments in human capital, crowd out private investment, and fuel macroeconomic instability.

Given accumulated macroeconomic imbalances and a highly uncertain outlook, strong political commitment to ambitious reforms is essential to restore economic stability and sustain growth. The five vital reforms are: (i) cutting costly tax exemptions to raise public revenues and protect social spending; (ii) improving the governance of public and public-private investment, as well as SOEs; (iii) restructuring public debt through ongoing negotiations; (iv) strengthening financial sector stability through the implementation of legal and regulatory tools; and (v) improving the business environment and promoting exports through effective regulatory reforms.

The Vital Five

Reforms to Secure Macroeconomic Stability in the Lao PDR

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

2. IMPROVE THE GOVERNANCE OF PUBLIC AND PUBLIC PRIVATE INVESTMENT

3. RESTRUCTURE PUBLIC DEBT THROUGH ONGOING NEGOTIATIONS

4. STRENGTHEN FINANCIAL SECTOR STABILITY THROUGH LEGAL AND REGULATORY TOOLS

5. ENHANCE THE BUSINESS ENVIRONMENT VIA EFFECTIVE REGULATORY REFORMS

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

Inefficient public investment is costly and public-private partnerships often create liabilities for the government. knowledge, skills and health, Laos will fall further behind.

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

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

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

Part B: Exports for Jobs

Over the past two decades and prior to COVID-19, the Lao PDR recorded one of the highest rates of economic growth in Southeast Asia, largely driven by capital-intensive resource sectors. This growth was largely driven by trade and investment in natural resources (mining and hydropower). Between 2000 and 2018, Lao PDR's real GDP growth averaged 7.5 percent a year, with trade growing at an average annual rate of 17 percent.

Despite the strong growth record, few jobs were created. Trade, growth and job creation typically go hand in hand, yet, in Lao PDR the capital-intensive resource-driven growth model did little for employment. Recent labor market trends in the Lao PDR during 2012-2018 show a labor market characterized by agricultural workers facing seasonal fluctuations in labor demand, high informality, and a growing number of public sector jobs. Importantly, non-farm formal private sector employment, typically a source of productive high-quality formal sector jobs, dropped over the period 2012 to 2018, with salaried jobs mostly created in the public sector. As a result, off-farm job creation was not enough to absorb the surplus agricultural workforce, resulting in the unemployment rate increasing from 4.1 percent in 2012 to 15.7 percent in 2018. In the absence of additional high-quality jobs, rapid economic growth did not bring an equally high rate of poverty reduction. Poverty was reduced, but at a slower pace than seen in comparator countries, and inequality rose.

Policies that can help. In this context, measures to boost non-resource exports are an urgent priority to raise revenue, increase firm productivity, and improve labor market outcomes. Several policies could help spread the benefits from growth more widely, including:

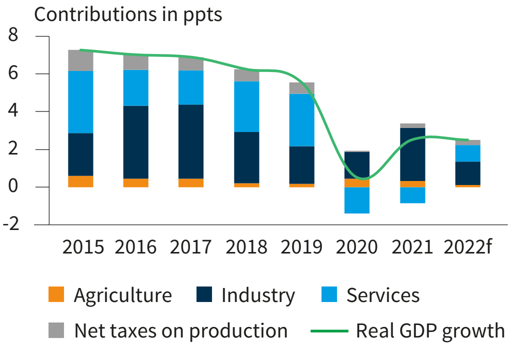
(i) Boosting and connecting exports to markets and people. This requires removing trade barriers and investing in infrastructure to promote exports.

(ii) Diversifying exports into labor-intensive sectors. This requires removing policy-induced distortions that limit the efficient allocation of resources and factors of production to enable higher-productivity firms (both domestic and foreign) to grow and create formal jobs.

(iii) Better preparing the workforce. This requires investing in education and skills, as well as ensuring a well-functioning labor market to prepare the workforce to handle the complexities of globalized production systems and, in turn, contribute to more inclusive growth.

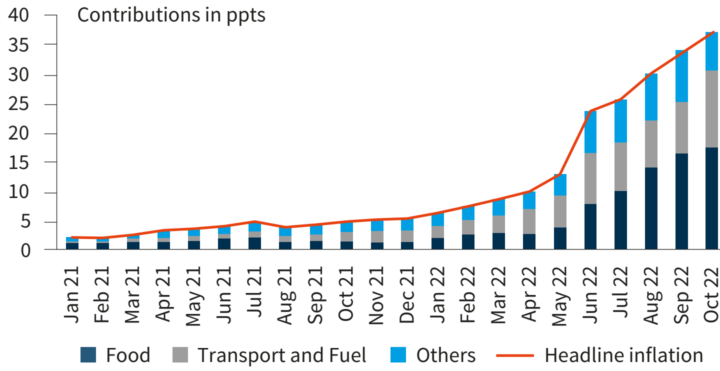
Lao PDR: Key Macroeconomic Indicators at a Glance

GDP growth is estimated at 2.5 percent in 2022, driven by a recovery in services



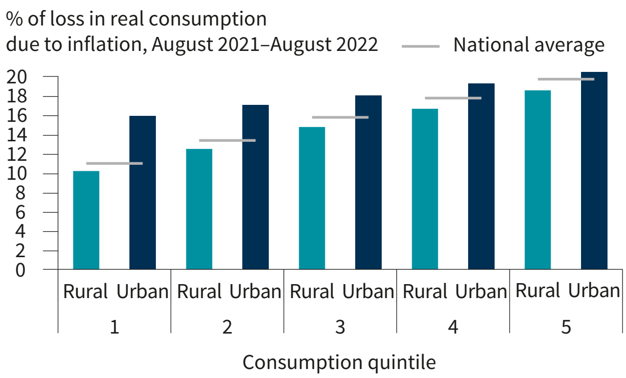
Source: WB estimate, Lao Statistics Bureau.

A weakened kip and rising inflation have constrained recovery prospects



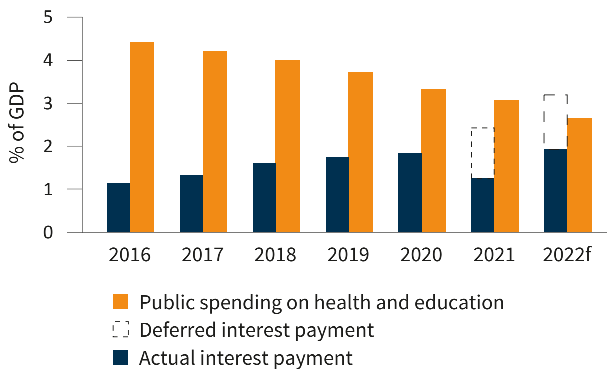
Source: Lao Statistics Bureau.

Rising domestic prices resulted in real consumption losses



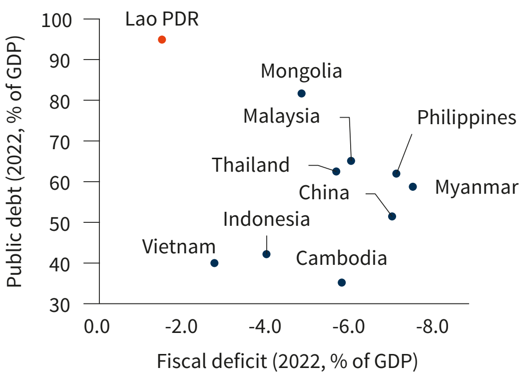
Source: WB staff calculations

Limited fiscal space constrains public spending on the social sectors



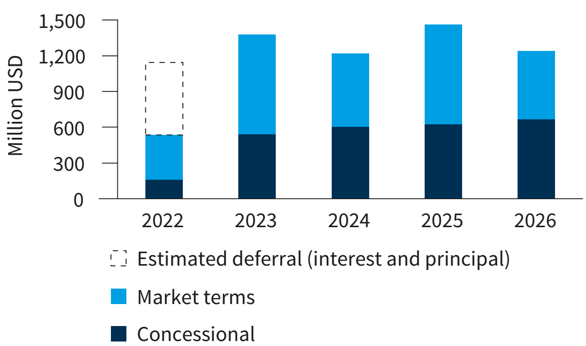
Source: WB estimate based on MOF data

High public debt levels are intensifying macroeconomic risks



Source: WB staff calculations.

Owing to high repayment obligations, debt sustainability hinges on successful renegotiations



Source: WB estimate based on MOF data

PART A

Tackling Macroeconomic Vulnerabilities

1. Global and Regional Economic Developments and Outlook

After a strong initial recovery, global economic growth is expected to decelerate dramatically from 5.7 percent in 2021 to 2.9 percent in 2022.[1] Russia's invasion of Ukraine and its effects on commodity markets, supply chains, inflation, and financial conditions have steepened the slowdown in global growth. In advanced economies, where activity is being dampened by high energy prices and a significant tightening of financial conditions, growth is projected to decelerate from 5.1 percent in 2021 to 2.6 percent in 2022. Growth in emerging market and developing economies (EMDEs) is projected to slow from 6.6 percent in 2021 to 3.4 percent in 2022, reflecting the sharp deceleration in China and negative spillovers from the Russia-Ukraine war.

Quarterly global output growth has slowed considerably since the beginning of this year. The global composite output purchasing managers' index (PMI) remained contracted in September 2022 driven largely by the negative outlook in advanced economies (Figure 1A). Global goods trade has been particularly weak, reflecting softening demand for industrial goods across several large economies and continued trade disruptions associated with the war. At 46.4, the global PMI manufacturing new export orders index fell further in September 2022, recording the seventh straight month of contraction. Many EMDEs, particularly commodity importers, show signs of decelerating activity as recent data have generally undershot expectations.

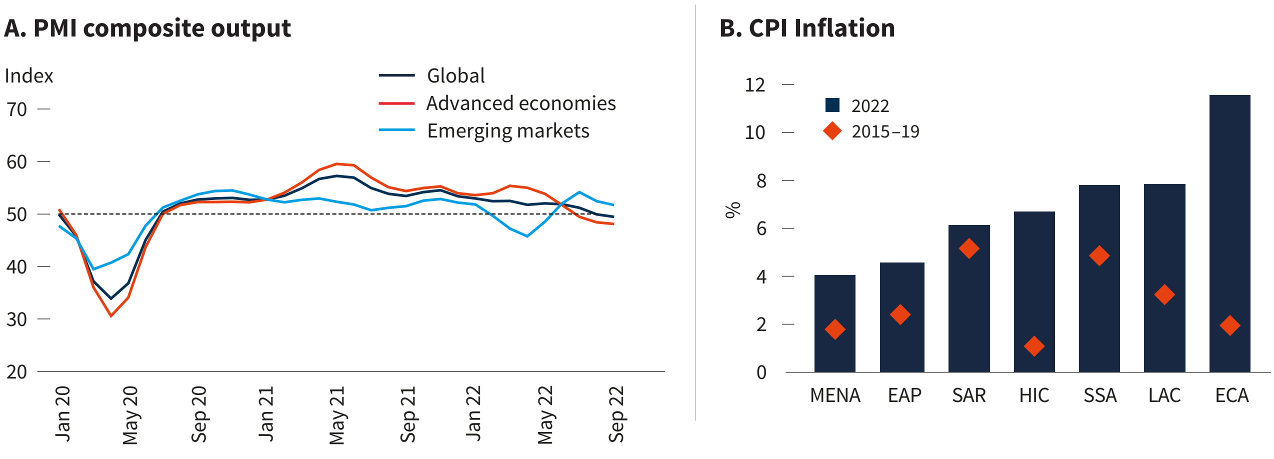
Global inflation has increased to multi-decade highs. Inflation is above target in almost all countries that have adopted inflation targeting. Although some commodity prices have reverted to pre-war levels, inflation is persistent across regions and especially in advanced economies and Europe & Central Asia (Figure 1B). Higher food and energy prices, supply constraints in many sectors, and a rebalancing of demand have driven up headline inflation. But underlying core inflation has also increased, reflecting the pass-through of cost pressures through supply chains and tight labor markets, especially in advanced economies. In response, central banks are withdrawing monetary support and raising policy interest rates faster than previously expected. The resulting rise in borrowing costs and tighter global financial conditions have led to sharp declines in equity prices, capital withdrawal from emerging markets, and currency depreciation against the US dollar, inducing balance sheet valuation losses among economies with dollar-denominated debt. Spreads of below investment-grade sovereign bond issuers have rapidly risen since April, and about one-third of emerging market borrowers now have bonds trading with yields in excess of 10 percent, a post-global-financial-crisis high.

Growth in the East Asia and Pacific region is projected to decelerate to 3.2 percent in 2022, as slower growth in China more than offsets a rebound in the rest of the region. China's GDP is projected to grow by 2.8 percent in 2022, slower than the rest of the region for the first time since 1990. Growth in the rest of the region is projected to accelerate to 5.3 percent in 2022. The robust recovery of private consumption in the first half of 2022, the sustained demand for exports of manufactured goods and commodities, and the limited tightening so far of fiscal and monetary policy allowed strong growth of the region excluding China.

The current global environment is highly unfavorable for Emerging Markets and Developing Economies (EMDEs). Global growth is slowing sharply, financial conditions are tightening, and inflation has soared in many countries. The world's three major engines of growth—the United States, the euro area, and China—are all expected to experience a protracted period of weakness. Many EMDEs have limited policy space given elevated debt loads and rising borrowing costs. Vulnerabilities are particularly acute in low-income countries, over half of which are either experiencing or at high risk of debt distress. If persistently high inflation prompts even more monetary policy tightening in advanced economies, or if the dollar continues to strengthen, EMDEs are likely to face further tightening of global financial conditions, in parallel with a slowdown in global growth, and alongside continued shockwaves from the war in Ukraine which could lead to the risk of severe financial stress in EMDEs.

[1] World Bank. 2022a. Global Economic Prospects, June 2022. Washington, D.C.

Figure 1. Global developments



Source: World Bank, Haver Analytics, S&P Global

Note: Figure A. shows seasonally adjusted composite output PMI, three months moving average. Figure B. shows weighted median inflation of each region in 2022 year to date as of August, compared to the average inflation in 2015-2019.

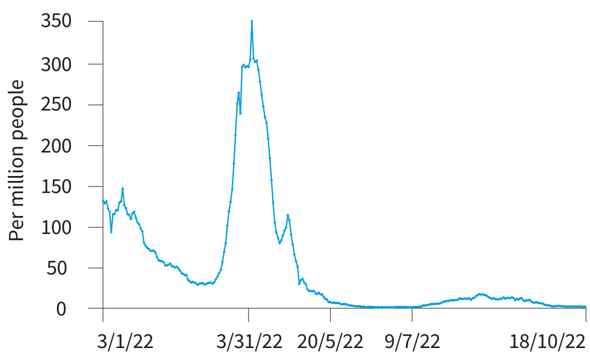
2. Recent Economic Developments in the Lao PDR

2.1 COVID-19 Situation

Reported COVID-19 cases have declined amid steady vaccination rollout

Reported COVID-19 cases declined significantly since March, while the vaccination rate has improved steadily. The number of reported COVID-19 cases declined from more than 2,500 cases per day in early April 2022 to less than 50 cases per day in late-September 2022 (Figure 2.). However, official statistics are likely underestimated because of low rates of self-reporting. Almost 72 percent of the population has completed the initial vaccination protocol as of mid-September, against a target of 80 percent by end 2022. Nevertheless, the coverage ratio is still below most neighboring countries (Figure 3). Difficult access to remote villages and vaccine hesitancy among the elderly are key obstacles to reaching full vaccination of the adult population.

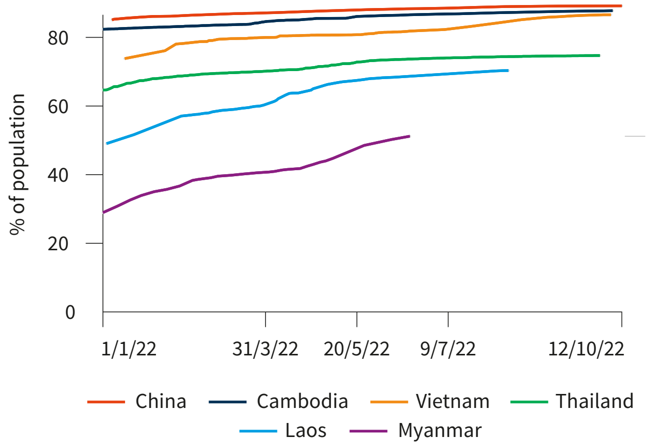
Figure 2. Daily new confirmed COVID-19 cases



Source: https://ourworldindata.org/covid-cases.

Note: 7-day rolling average. Due to limited testing, the number of confirmed cases is lower than the true number of infections.

Figure 3. Vaccination rates in the region



Source: https://ourworldindata.org/covid-vaccinations.

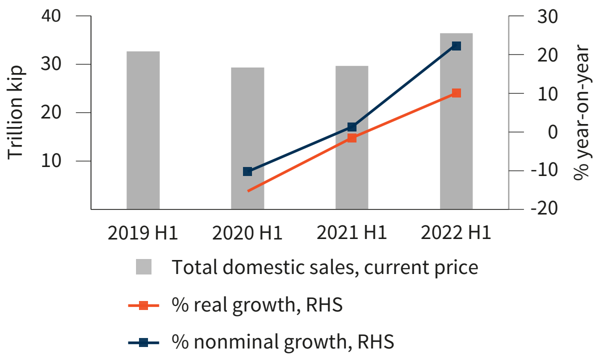
Note: Alternative definitions of a full vaccination, e.g. having been infected with SARS-CoV-2 and having 1 dose of a 2-dose protocol, are ignored to maximize comparability between countries.

2.2 Real Sector

The services sector supported economic activity, but a sharp Kip depreciation, high inflation, and a gloomier external environment are putting pressure on the recovery

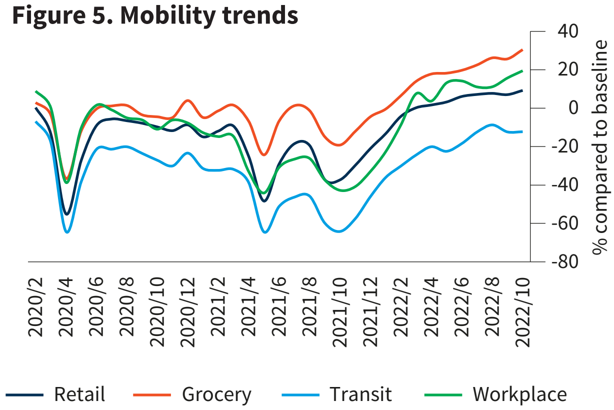
Economic activity was driven by the services sector in the first half of 2022, despite growing domestic and external challenges. The opening of the Lao-China railway and the Thanaleng Dry Port provided a boost to the transport and logistics sector. From its official opening in December 2021 until early August, the Lao section of the Laos-China railway carried more than 1 million tons of cross-border goods, which include manufacturing, agriculture and mining products.[2] As many as 13,000 containers were transported through the Thanaleng Dry Port, some of which were transported on rail.[3] Meanwhile, mobility trends have continued to improve since the beginning of the year, indicating a rebound in domestic economic activity amid the roll back of COVID-19 restrictions (Figure 4). Tourism is also gradually recovering this year, mostly supported by visitors from Thailand and domestic tourism (Figure 6, 7). This has contributed to boosting wholesale and retail sales in the first half of 2022 (Figure 5). However, international tourist arrivals reached only 10 percent of pre-pandemic levels, which suggests that the sector will take time to fully recover.

Figure 4. Wholesale and retail sales



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

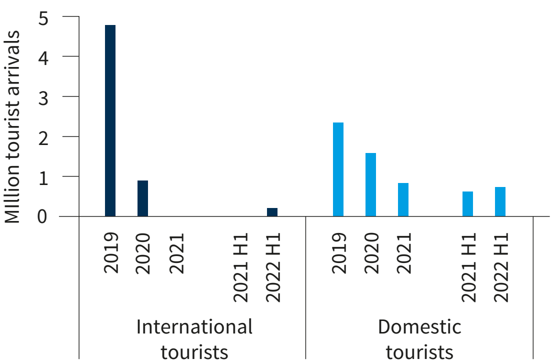
Figure 5. Mobility trends



Source: google.com/covid19/mobility:

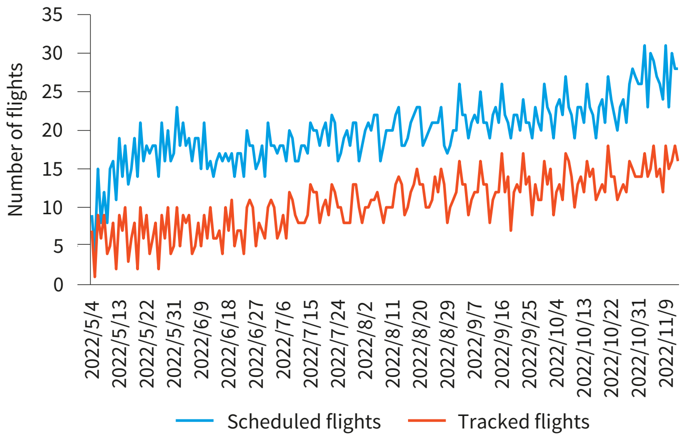
Note: Visitors to (or time spent in) categorized places change compared to baseline days (the median value from the five weeks from January 3 to February 6, 2020). The chart shows a monthly simple average.

Figure 6. Tourist arrivals



Source: Ministry of Information, Culture and Tourism.

Figure 7. Number of scheduled flights

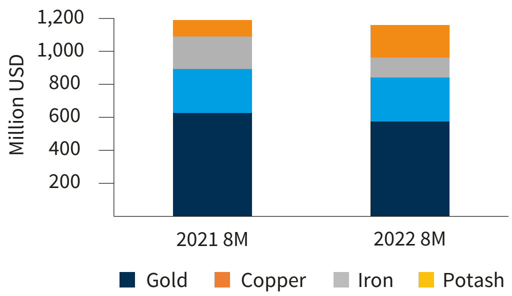


Source: https://www.flightradar24.com/data/airports/vte/statistics

Growth in the industrial sector has been mostly driven by natural resources, particularly mining and the power sector. The mining sector observed output growth in gold, iron ore, and potash, while copper output remained relatively flat. While mining output and exports of key mineral commodities increased, prices during the first eight months declined – except for potash (Figure 8.A, 8.B). As a result, nominal mining exports slightly declined during this period compared to the previous year. Electricity generation increased in the first half of 2022, when compared to the same period in 2021, mostly due to higher domestic demand from the services sector. Electricity exports remained relatively flat. Manufacturing performance has been mixed. Food and beverage production recovered, partly supported by higher domestic consumption. Some export-oriented manufacturing, such as wood and wood products, remained resilient despite moderating growth. However, electrical and electronic parts experienced a contraction, partly due to lower export demand and supply disruptions. The construction sector remained subdued because many large infrastructure projects were completed last year and both public and private investment declined in the first half of 2022. While the depreciation of the Lao kip can make exports relatively more competitive, it also raises input prices, which increases production costs for firms.

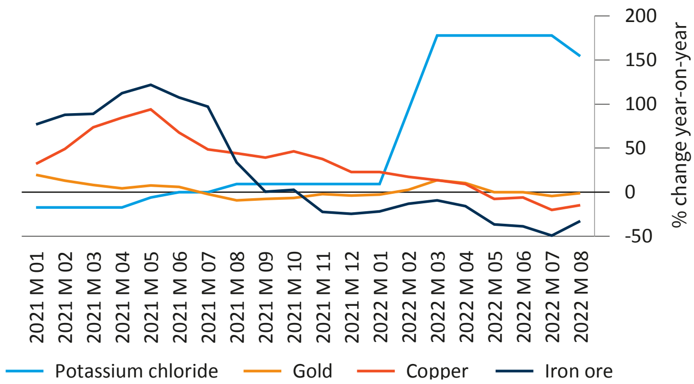
Figure 8. Global developments

A. Mining exports



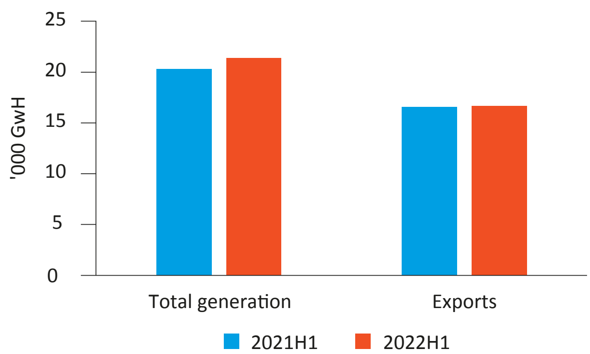
Source: Ministry of Energy and Mines, Mining companies, Ministry of Industry and Commerce.

B. Mineral, metal prices



Source: World Bank

Figure 9. Electricity generation



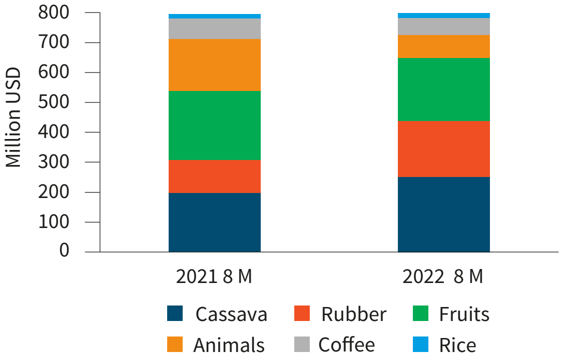
Source: Ministry of Energy and Mines.

[2] Vientiane Times. 2022. Laos-China railway carrying more freight. Available at https://www.vientianetimes.org.la/freeContent/FreeConten183_laochina.php.

[3] Vientiane Times. 2022. Vientiane Logistics Park, Vietnamese officials offer joint effort for logistics, transport links. Available at https://www.vientianetimes.org.la/freeContent/FreeConten162_Vientiane_y22.php

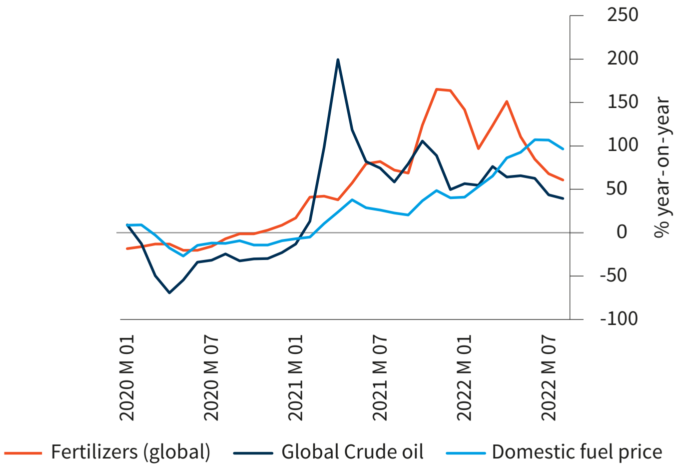
The agriculture sector experienced a mixed performance, undermined by high input prices and trade disruptions. Agriculture export growth moderated in the first eight months of 2022 (Figure 10). The main growth drivers were cassava and rubber, while fruits declined – partly because the latter are transported by trucks, which were affected by trade disruptions at the Laos-China border due to China's zero-COVID-19 policy. Higher fuel and fertilizer prices, coupled with fuel shortages during April–June, prevented the timely plantation of crops and may lead to lower planted areas and yields in the coming harvest season (Figure 11). Despite better dry season rice output earlier this year, many vulnerable subsistence farmers were unable to plant the rainy season rice crop, while others switched to commercial vegetables as they provided a better profit margin. Severe flooding due to recent tropical storms has also affected agricultural areas in northern provinces. In addition, higher animal feed prices have affected livestock rearing and exports. The cost of agricultural inputs has risen sharply since April 2022, while farmgate prices of agricultural produce increased at a much slower rate, leading to lower margins for farmers.[4]

Figure 10. Agricultural export composition



Source: World Bank staff calculations based on data from Ministry of Industry and Commerce, mirror trading partners.

Figure 11. Fuel and fertilizer prices



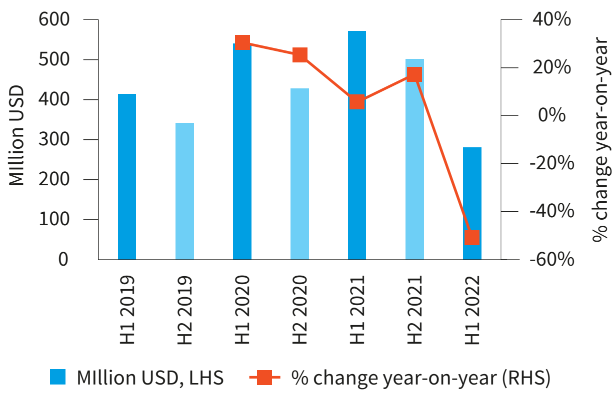
Source: Lao Statistics Bureau, World Bank .

On the expenditure side, the recovery has been undermined by declining investment and lower net exports, while consumption has been affected by inflation. Foreign direct investment inflows in the first half of 2022 fell by nearly 50 percent when compared to in the first half of 2021 (Figure 12), partly because many large investment projects were completed in 2021. Public investment has been constrained by limited fiscal space (Figure 13). Consumption, while appearing to recover earlier in the year, has been hampered by high inflation, which has reached 34 percent in the year to September 2022. According to a recent phone survey, nominal wage earnings have recovered over the past year, but real wages declined from August 2021 to August 2022 owing to high inflation. Many households continued to experience income losses when compared to pre-pandemic levels. High inflation has also reduced real income growth, purchasing power, and real consumption.[5] Given that investment and consumption account for 37 and 56 percent of GDP, respectively, these proxies point to subdued growth prospects for 2022. Net exports were positive in the first half of 2022, although they slightly declined, reflecting mixed export performance and faster growth in imports, mostly due to higher prices of imported commodities.

[4] Food and Agriculture Organization of the United Nations. 2022. Lao PDR Rapid Assessment.

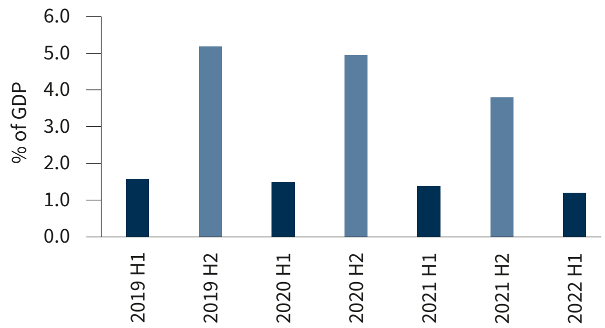
[5] World Bank. 2022. Monitoring the Impact of COVID-19 in Lao PDR. https://www.worldbank.org/en/country/lao/brief/monitoring-the-impact-of-covid-19-in-lao-pdr

Figure 12. Foreign direct investment



Source: BOL

Figure 13. Government capital expenditure



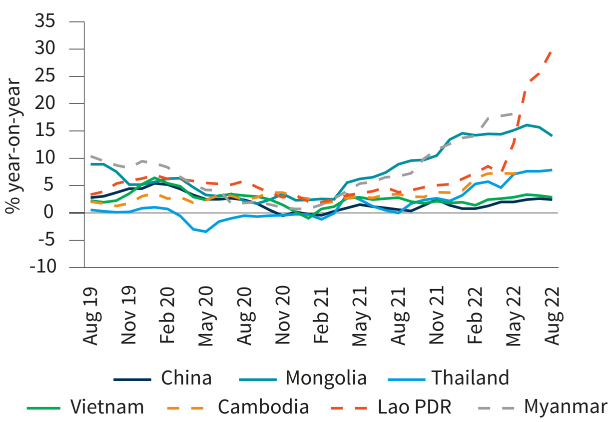
Source: MOF

2.3 Inflation

Inflation has been driven by a sharp kip depreciation and international prices

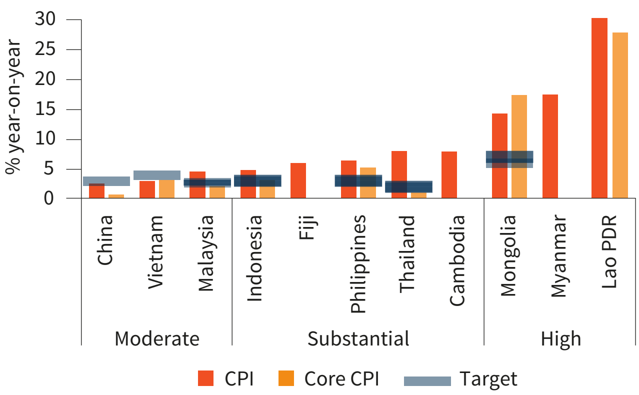
Consumer price inflation has reached a two-decade high, owing to a weakening kip and rising global commodity prices. Headline inflation rose to 37 percent in the year to October 2022, the highest level in more than two decades and the highest among regional peers (Figure 14, 15). Sharp increases in food and transport prices were the key contributors (Figure 17).[6] Food price inflation reached 39 percent while transport prices (including fuel) increased to 58 percent. The initial rise in inflation was driven by higher domestic fuel prices. These increases were subsequently passed on to production costs in broader consumer items, which have been exacerbated by the kip depreciation, given Lao PDR's dependence on imports (Figure 16). As a result, core inflation reached almost 33 percent in the year to October, the highest in the region. Higher fuel import prices coupled with foreign liquidity shortages (at the official exchange rate) and domestic price regulations caused fuel shortages in April–June 2022. In response, the government provided a credit line amounting to $200 million to enable fuel imports until August. In addition, implicit subsidies have been provided through the reduction of excise rates on fuel.[7] Despite these measures and a recent moderation in global oil prices, retail fuel prices have doubled compared to last year.

Figure 14. Inflation among regional peers
(Percent year-on-year)



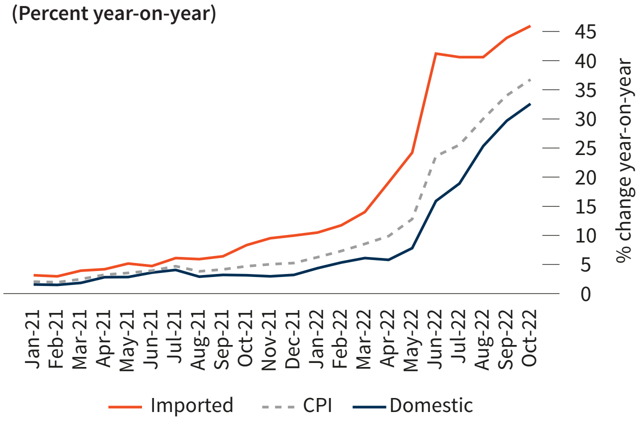
Source: Lao Statistics Bureau, World Bank EAP Economic Update October 2022

Figure 15. CPI, Core CPI and target inflation
(Percent year-on-year)



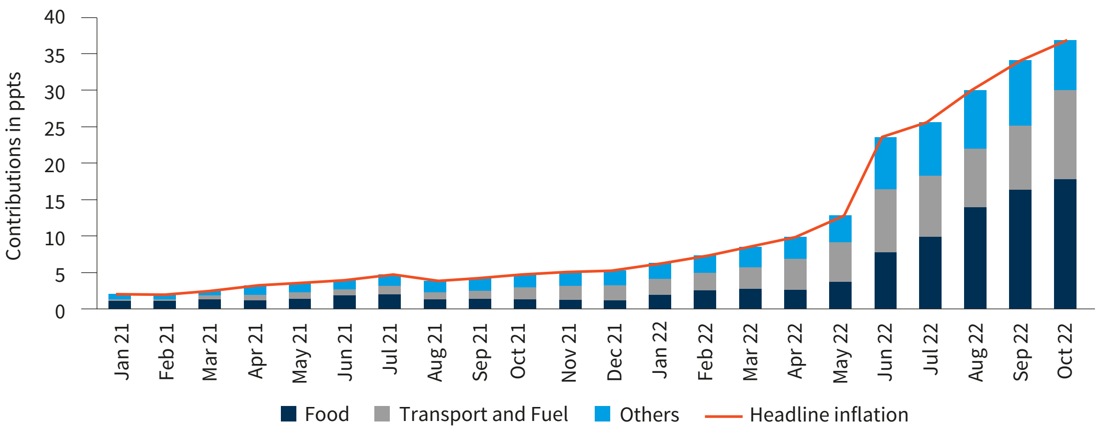
Source: Lao Statistics Bureau, World Bank EAP Economic Update October 2022

Figure 16. Prices of imported and domestically produced goods
(Percent year-on-year)



Source: Lao Statistics Bureau.

Figure 17. Contributions to headline inflation
(Percent year-on-year, percentage points)



Source: Lao Statistics Bureau

2.4 Household Sector

Despite an employment recovery, household incomes have not yet fully returned to their pre-pandemic levels, while surging prices further dent real incomes and consumption

Labor market indicators have improved since the end of 2021 owing to the relaxation of COVID-19 measures and the reopening of borders. According to the latest World Bank rapid monitoring phone survey, the proportion of respondents working was higher in April–May 2022 (approximately 88 percent) than in October–November 2021 (about 69 percent) and pre-pandemic levels (83 percent in February 2020) (Figure 18, 19). Skilled urban males have experienced the fastest improvements in job market conditions since the end of 2021. Many migrant workers, who came back to Lao PDR during the pandemic, have begun returning to Thailand for jobs.

While employment achieved full recovery, many households still experience income losses from COVID-19. Despite a strong recovery in the labor market, incomes are yet to fully catch up to pre-pandemic levels. In April-

[6] Food refers to food and non-alcoholic beverages. Transport also includes fuel.

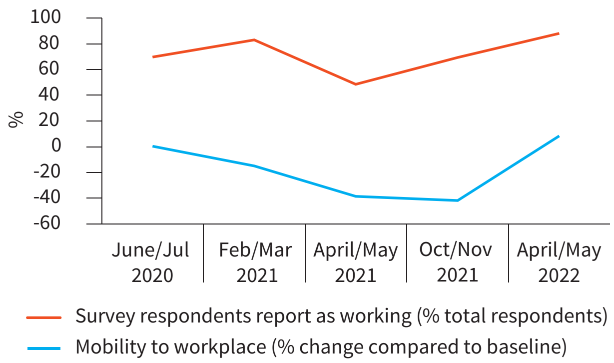
[7] According to The Macroeconomic Research Institute (2022), the excise rate for diesel was reduced from 21 percent to 11 percent, then to 0 percent. The excise rate for regular gasoline was reduced from 31 percent to 16 percent, then to 5 percent. The tariff rate remains at 5 percent for diesel and 15 percent for regular gasoline. The value-added tax rate remains at 7 percent for all fuel types.

May 2022, about 43 percent of households still experienced income losses due to the pandemic, with 21 percent reporting income reductions of more than half. However, the fraction of households reporting COVID-19 induced income losses in April-May 2022 were 20 percentage points lower than in October-November 2021, suggesting green shoots of recovery are currently underway, albeit slow.

Mounting inflation places a greater burden on Lao families. Fueled by rising global inflation and rapid depreciation of the Lao kip, annual inflation hit a two-decade high of 37 percent in October 2022. Price increases were significant for goods and services that are essential to households, namely food and beverages (39 percent), transportation (58 percent), and health services (43 percent). With 43 percent of Lao families still grappling with income losses from COVID-19 (April-May 2022), the rising cost of living has further squeezed household budgets and living standards.

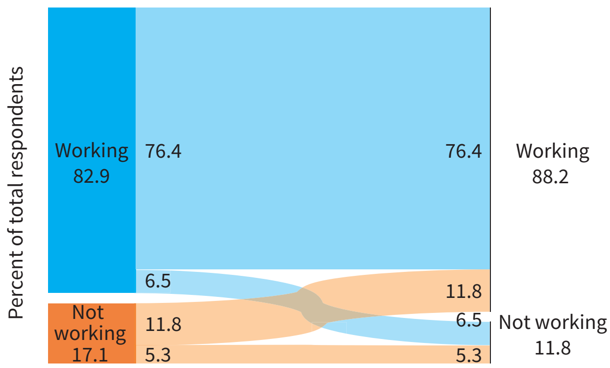
Figure 18. Employment status by survey period

(Percent of total respondents to phone survey)



Source: World Bank phone surveys (various rounds) and google mobility

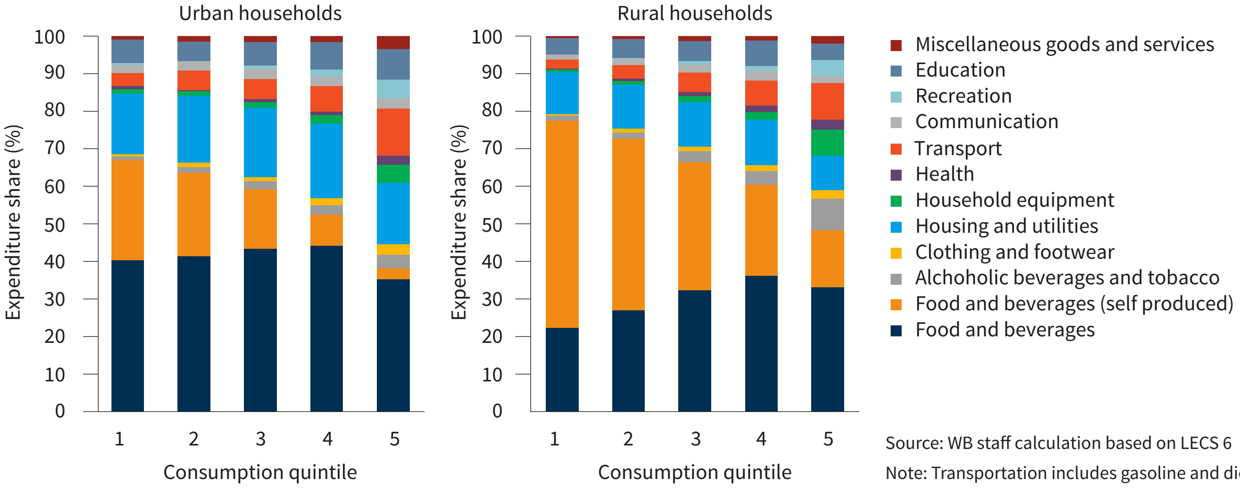
Figure 19. Movement of labor compared to pre-pandemic



Source: The World Bank rapid monitoring phone survey conducted in April – May 2022.

The welfare cost of inflation is especially large for the urban poor. For low-income families who live on a tight budget, the magnitude of inflation could lead to households reducing consumption deemed necessary to meet basic needs. In Lao PDR, the impact of inflation is estimated to be larger for the urban poor than the rural poor who rely primarily on self-produced food for consumption, for which the price impact is likely milder. Among households from the poorest quintile, food purchases account for only 22 percent of total consumption for rural households but constitute 40 percent of total consumption for urban households (Figure 20). Without income or financial buffers,

Figure 20. Household expenditure by consumption category

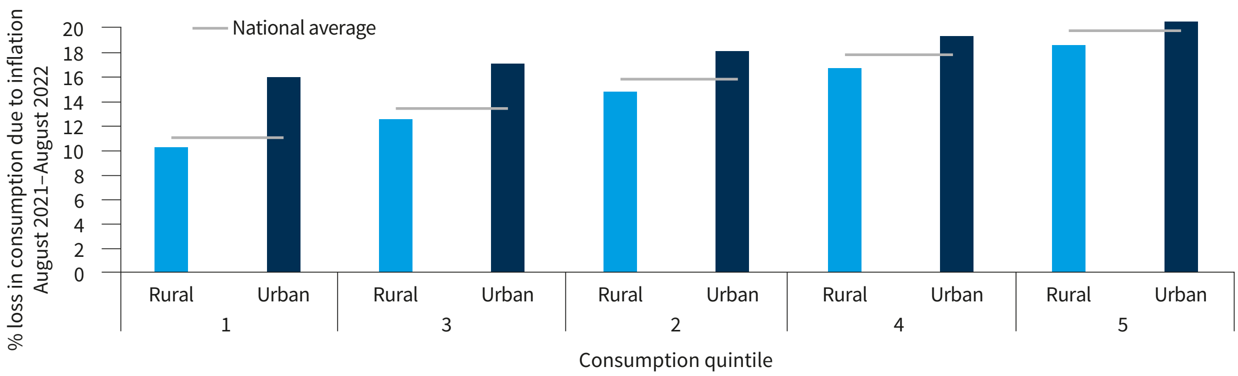


Source: WB staff calculation based on LECS 6

Note: Transportation includes gasoline and diesel.

mounting inflation over the past year could have forced urban households from the poorest quintile to reduce their consumption by 16 percent, compared to 10 percent for their rural counterparts (Figure 21). Richer families have also been significantly affected by inflation given their larger expenses for transportation, for which prices increased sharply. The cost of inflation over the past year was estimated to be equivalent to a 20 percent reduction in household purchasing power for the richest quintile. Nevertheless, with high disposable incomes and financial buffers, these households are more likely to be able to absorb the rising cost of necessities.

Figure 21. Cost of inflation August 2021–August 2022 (Loss in purchasing power or real consumption)

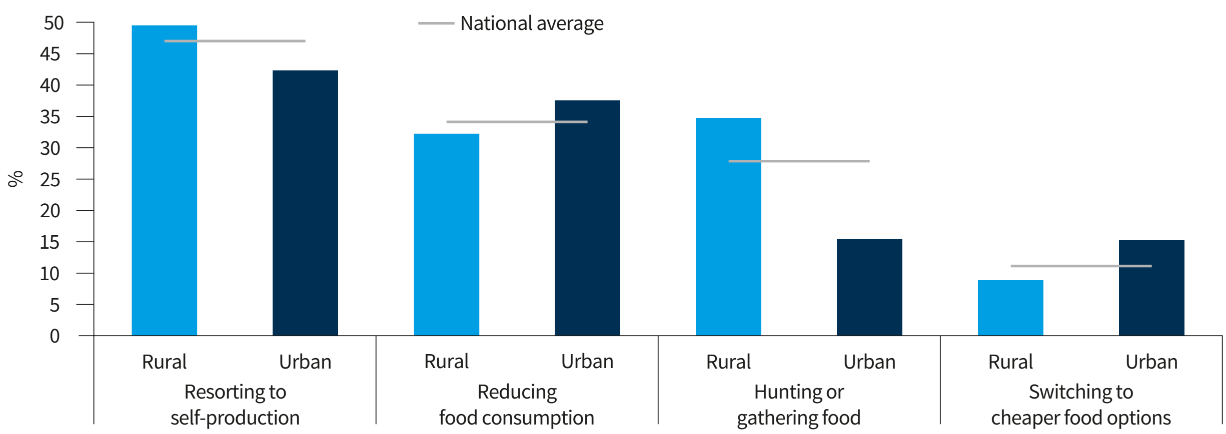


Source: WB staff calculation based on LECS 6 and the annual inflation rate by category (LSB, August 2022)

Note: Assume zero inflation for self-produced food.

Support programs to help households cope with inflation were constrained by limited fiscal space, forcing some households to resort to coping strategies that are detrimental to long term human capital development. Key interventions introduced by the government to mitigate the impact of inflation were price support (i.e., price controls and fuel excise tax reductions) rather than income support measures. With limited support, Lao families had to reduce food consumption (34 percent of respondents), switch to cheaper food options or foraging (39 percent) and resort to self-production (47 percent) in response to food price inflation (Figure 22), while 65 percent of households cut their spending on education and health to cope with additional burdens from rising prices. Many rural households turned to self-production and foraging to cope with inflation while urban households faced limited options and had to reduce food consumption or switch to cheaper foods. These coping strategies are deemed detrimental to long-term human capital development, and the situation is expected to have worsened as food inflation rose from 5.7 percent year-on-year in April, then to 8.2 percent in May and to 36 percent in August.

Figure 22. Coping strategies in response to rising food prices (percentage of households)



Source: WB rapid monitoring phone survey conducted in April – May 2022

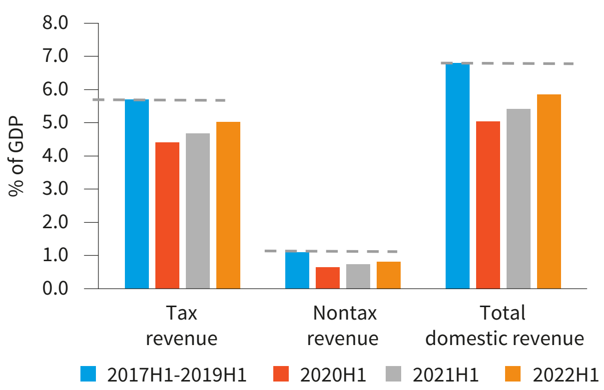
Targeted income support measures could direct limited fiscal resources to those in need but require investments in improving the existing targeting and benefit transfer system. As the price support measures implemented by the government were untargeted, a greater share of spending benefited better-off households owing to a larger share of transportation and market food in their total consumption. Price controls also lead to market distortions and shortages of food and necessities, exacerbating the impact of inflation on low-income families. While untargeted price support measures are relatively easy to implement, targeted income support measures for the most affected groups (e.g., the urban poor) would allow for a more cost-effective and sustainable policy response to persistent inflation, especially in a constrained fiscal environment.[8] To effectively implement these measures, it is essential that the government invests more in improving the existing targeting tools and benefit transfer systems. This will allow the government to protect household livelihoods from the ongoing price shocks and act swiftly to other potential shocks that may occur in the near future. To enable such investment, fiscal revenue mobilization is therefore a critical priority.

2.5 Fiscal Developments

Fiscal consolidation has been driven by expenditure tightening and interest payment deferrals despite recent improvements in revenue collection

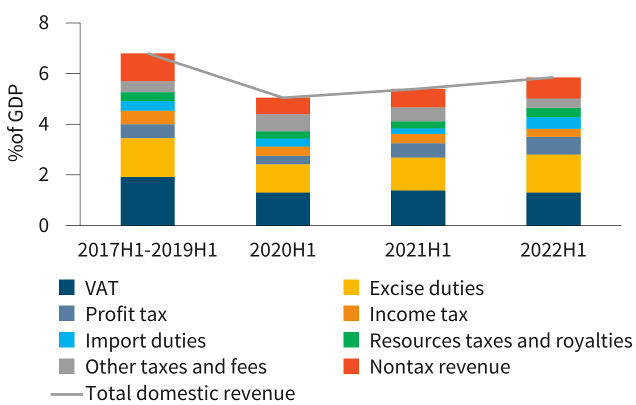
Domestic revenues have gradually recovered but are still below pre-pandemic levels. Nominal domestic revenue collection in the first six months of 2022 rose by 25 percent year-on-year, partly reflecting high inflation. Domestic revenue reached 44 percent of the budget plan in the first half of 2022.[9] Revenue rose to 5.8 percent of GDP[10] in the first half of 2022, compared to 5.4 percent in the previous year, owing to higher collection of excise and profit taxes, hydro and natural resource taxes, as well as import duties (Figure 23, 24). This improvement was supported by a recovery in domestic economic activity and higher commodity prices (including domestic inflation), which offset the lower excise tax rates on fuel and a VAT rate reduction from 10 to 7 percent. Nevertheless, revenue collection remains below pre-pandemic levels. Generous tax exemptions continue to undermine revenue mobilization.

Figure 23. Domestic revenue performance



Source: Ministry of Finance.

Figure 24. Domestic revenue composition



Source: Ministry of Finance.

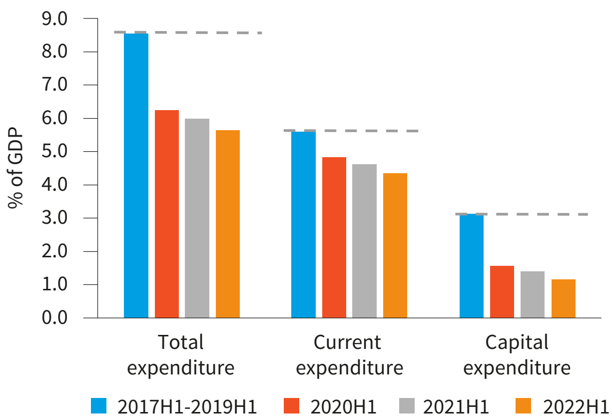
[8] World Bank 2022. Reforms for Recovery: East Asia and Pacific Economic Update, October 2022.

[9] This update is based on preliminary data for the first half of 2022 from the Ministry of Finance as of August 2022.

[10] Ratios presented are ratios to estimated full-year GDP in 2022.

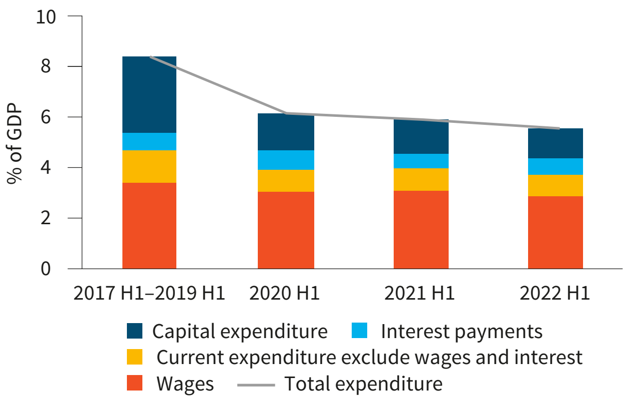
The government continued to tighten public expenditures, partly by postponing capital investments. Total expenditure in the first half of 2022 rose by 9 percent year-on-year, accounting for 34.3 percent of the annual budget plan. Taking inflation into account, there was a decline in real spending in this period. Expenditure declined to 5.6 percent of GDP, compared to 6 percent in the first half of the previous year, due to both lower recurrent and capital spending (Figure 25, 26). The decline in capital spending was due to the postponement of public investment projects, particularly those financed by loans. On recurrent spending, public sector wages slightly declined as a share of GDP owing to higher nominal GDP and a reduction of new civil service recruits, despite an increase in the wage index in 2022. Actual interest payments were much below the plan, suggesting continued debt service deferrals. Total interest payments remained stable as a share of GDP, owing to continued deferrals from key bilateral creditors, which have temporarily eased fiscal liquidity pressures since 2020. In the absence of debt deferrals, the total expenditure and the fiscal deficit would have been 1 percent of GDP higher in 2021. However, the specific terms for these deferred payments are not available, making it difficult to assess implications for future debt service obligations. Limited fiscal space has constrained government support to households affected by the COVID-19 pandemic and the recent surge in inflation, as well as for growth-enhancing expenditures such as investments in health and education.

Figure 25. Government expenditure



Source: Ministry of Finance.

Figure 26. Expenditure composition



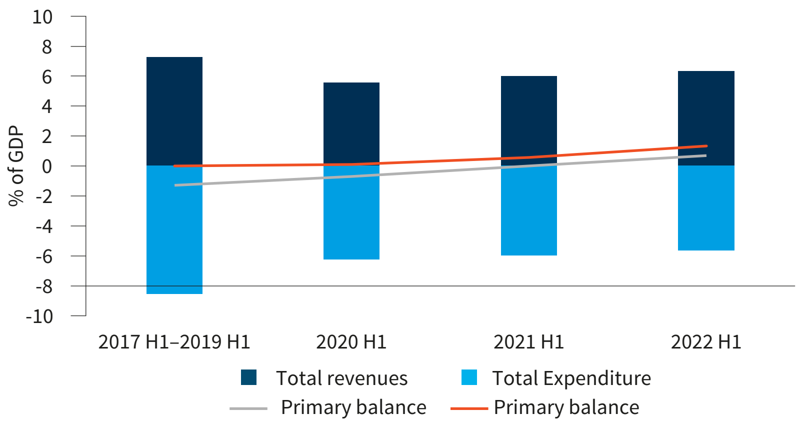
Source: Ministry of Finance.

The fiscal balance turned into a surplus in the first half of the year as revenues improved and expenditures remained moderate, in part due to deferred interest payments. A fiscal surplus of 0.7 percent of GDP was recorded in the first half of the year (Figure 27). However, gross financing needs remained high due to the amortization of both external and domestic debt. To meet these financing needs, the government resorted to asset sales, repayment from on-lending to SOEs, and bond issuances (domestic bonds and bonds issued in Thailand).

Public spending on human capital has been constrained by high debt service obligations and an expenditure-driven fiscal consolidation. Actual interest payments (after deferral) as a ratio of total expenditure and total revenues reached 11.4 and 10 percent, respectively, in the first half of 2022 (Figure 28). These levels exceed pre-pandemic levels, indicating a growing fiscal burden. Interest payments will increase further this year largely due to external debt repayments to commercial banks, which will be exacerbated by the sharp depreciation of the Lao kip.[11] However, this is expected to be partly offset by debt service deferrals from key bilateral creditors. In the absence of debt deferrals, interest payments would have overtaken spending on health and education in 2022, which had already declined from 4.4 percent of GDP in 2016 to 3.1 percent of GDP in 2021, thereby undermining public service delivery (Figure 29).

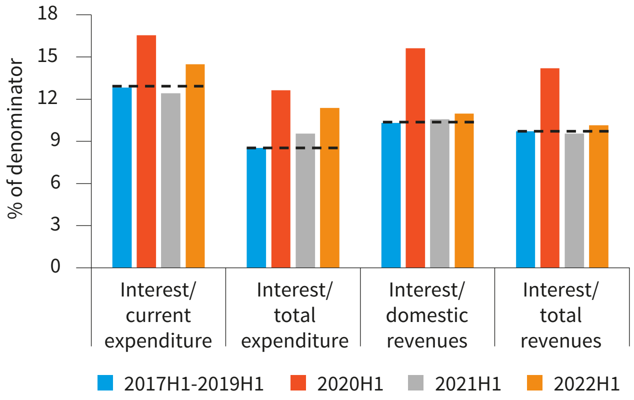
[11] Public Debt Bulletin 2021. Ministry of Finance, Lao PDR. at https://www.mof.gov.la/wp-content/uploads/2022/06/2021-Public-and-Publicly-Guaranteed-Debt-Bulletin-of-Lao-PDR-1.pdf

Figure 27. Fiscal deficit



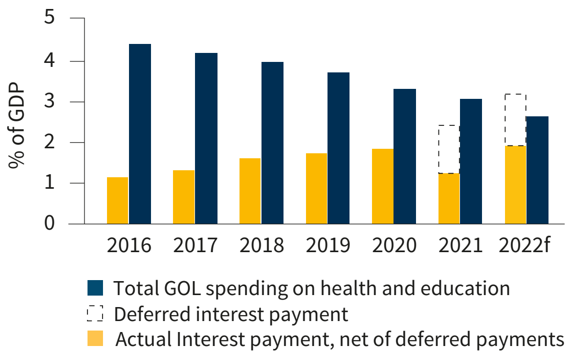
Source: Ministry of Finance.

Figure 28. Interest payments burden



Source: Ministry of Finance.

Figure 29. Interest payment and spending on health and education



Source: Ministry of Finance.

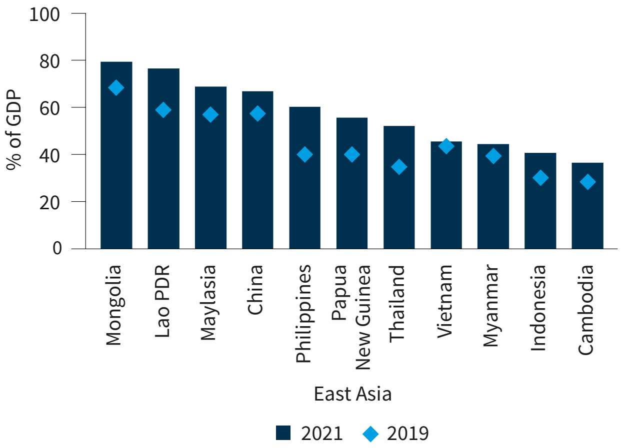
2.6 Debt Dynamics

The kip depreciation and domestic debt accumulation have increased the debt burden, while limited foreign exchange liquidity challenges debt services payments despite recent deferrals

High public debt levels have contributed to acute macroeconomic instability while undermining development prospects. Lao PDR is facing both liquidity and solvency challenges, owing to a high debt burden, poor revenue collection, low foreign currency reserves, and limited financing options. Prior to the COVID-19 pandemic, high fiscal deficits, strong borrowing by state-owned enterprises (SOEs), and a steady GDP growth deceleration since 2013 have all contributed to a deterioration in debt ratios. Despite a lower fiscal deficit in 2021 and limited new external borrowing, public and publicly guaranteed (PPG) debt reached $14.5 billion (89 percent of GDP) at the end of 2021, up from $13.3 billion (73 percent of GDP) in 2020. This is one of the highest levels in the region (Figure 30, 31). The recent increase was mostly driven by the significant depreciation of the Lao kip in the second half of 2021 and the issuance of domestic bonds to clear expenditure arrears. Given the sharp currency depreciation experienced in the first ten months of 2022, the PPG debt stock is projected to increase to over 100 percent of GDP by the end of 2022. A high public debt burden accentuates banking sector vulnerabilities, reduces fiscal space, and contributes to foreign exchange pressures.

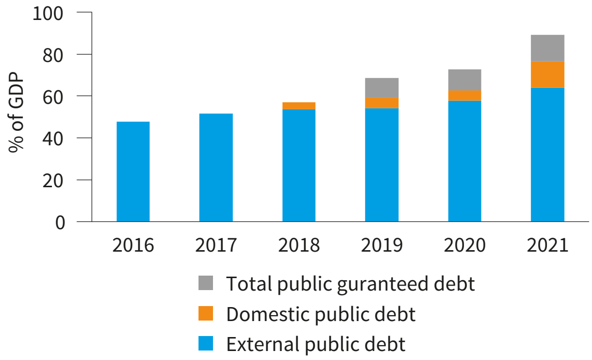
Contingent liabilities arising from the operations of state-owned enterprises and public-private partnerships are also a source of concern. Borrowing by SOEs accounted for 43 percent of total PPG debt in 2021 (in the form of

Figure 30. Public debt stock



Source: World Bank EAP Economic Update October 2022
Note: Public debt stock exclude public guarantees

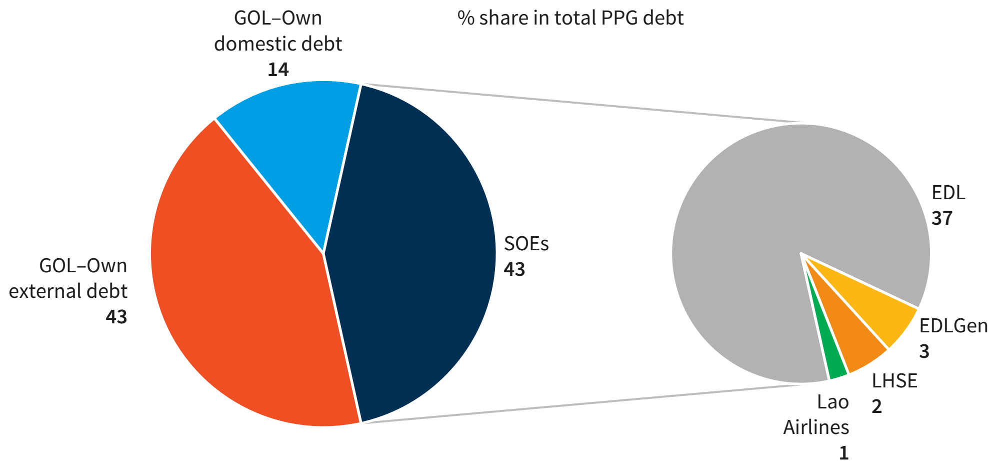
Figure 31. Public and publicly guaranteed debt stock



Source: MOF

on-lending and public guarantees), of which 42 percent was held by SOEs in the power sector (namely, Électricité du Laos (EDL), EDL-Generation, and Lao State Holding Enterprise (LHSE)). Électricité du Laos alone accounted for 37 percent of total PPG debt (Figure 32). Unsustainable debt accumulation and large operating losses pose significant fiscal risks to the government. This could be exacerbated by the depreciation of the kip, particularly for SOEs that earn revenue in kip but have debt repayment obligations denominated in foreign currencies. Most SOEs are reported to incur chronic losses.[12] The government is undertaking SOE reforms by selling shares, restructuring, privatizing, and dissolving unprofitable SOEs.[13] In addition, increasingly complex public-private partnerships (PPPs), if not designed and managed well, could also create fiscal risks through additional contingent liabilities.

Figure 32. PPG debt stock by debtor
(In percent share)



Source: MOF

[12] Vientiane Times. 2022."PM: Embezzlement, lax management key to losses by state enterprises." Available at https://www.vientianetimes.org.la/freeContent/FreeConten121_PM_y22.php

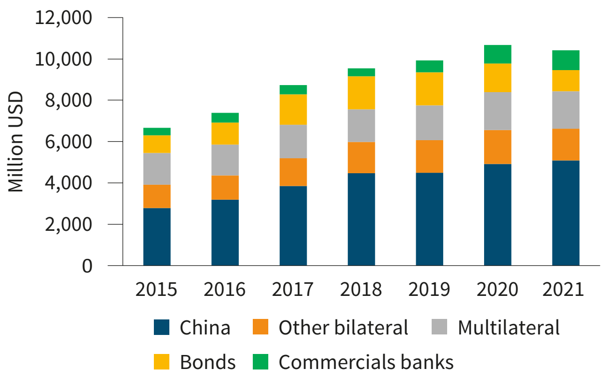
[13] There are 178 SOEs. Under the SOE reform program, two state-owned banks, Lao Development Bank (LDB) and Agriculture Promotion Bank (APB), were restructured in 2021. The government sold its 51 percent share in the Lao State Postal Enterprise. Other SOEs being reformed include EDL, EDL-Gen, Lao Airlines, Agro-industrial Development Company, Lao Export-Import Trading Company, Lao State Fuel Enterprise, Lao Logistics State Enterprise, and MSIG Insurance. Inter Lao Tourism, DAFI and the Lao Cotton State Enterprise will go through a dissolution process. For more information, see https://www.vientianetimes.org.la/freeContent/FreeConten121_PM_y22.php

While almost two-thirds of external debt is concessional, commercial debt accounted for most debt service payments in 2021. About 60 percent of the external public debt stock was on concessional terms, while the rest was on commercial terms: commercial bilateral (21 percent), bonds (10 percent), and banks (9 percent). However, the amortization of bonds accounted for 57 percent of total debt service payments, followed by an additional 18 percent relating to the repayment of commercial bank loans.[14] Borrowing on commercial terms is typically associated with higher interest rates and shorter maturity periods, which heighten the debt burden. The government is committed to reducing external borrowing, particularly on commercial terms, to finance new investment projects. This was also reflected in the decline of new disbursements in 2021 and hence loan-financed capital expenditures.

A successful conclusion of ongoing debt renegotiations with key bilateral creditors is critical for placing the economy on a more sustainable path. China is the largest creditor, accounting for almost half of the external public debt stock (Figure 33). Nevertheless, the deferral of debt repayments to China has provided temporary relief and explained the declining share of bilateral debt repayments (Figure 34). These deferrals are estimated to have

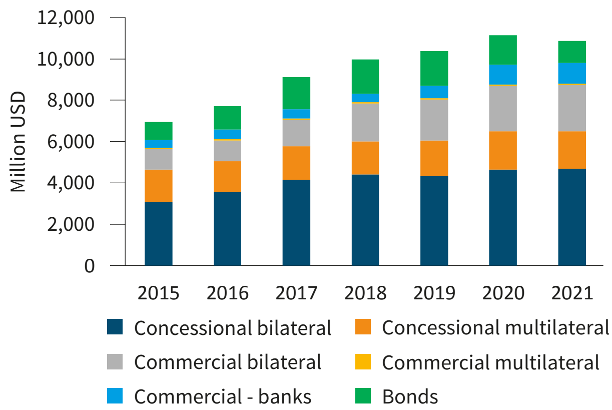
Figure 33. External public debt stock

A. By creditors



Source: Ministry of Finance.

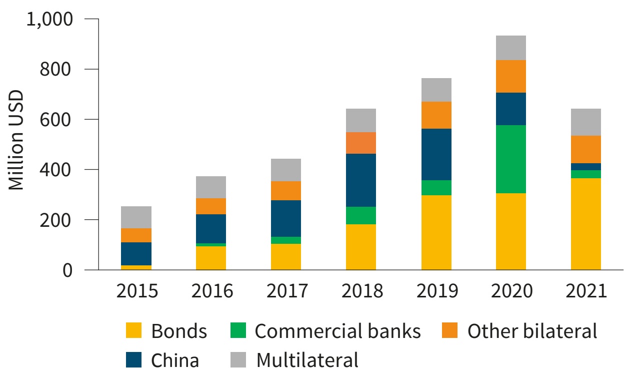
B: By concessionality/terms



Source: Ministry of Finance.

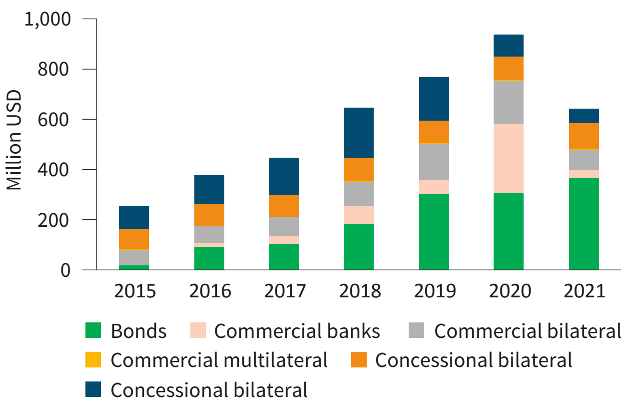
Figure 34. External public debt repayments

A. By creditors



Source: Ministry of Finance.

B. By concessionality



Source: Ministry of Finance.

[14] External public debt service in 2021 declined due to external debt payment deferrals and rollover of debt repayment to commercial banks, which will be paid in local currency.

accumulated to 3.6 percent of GDP in 2021, rising to over 8 percent of GDP if these continue to the end of 2022. There is little information about how they will be repaid. It is therefore crucial to ensure a successful conclusion to ongoing negotiations to restore macroeconomic stability and support economic recovery.

With limited access to international capital markets, the government is facing acute external liquidity concerns. Despite debt deferrals, the severe liquidity stress caused by low reserve buffers and limited access to international capital markets in the face of sizable debt servicing obligations (amounting to $1.1 billion in 2022) has led to recent sovereign credit downgrades by Moody's and Fitch. TRIS Rating reaffirmed its sovereign rating. After unsuccessful attempts to issue bonds in international markets in 2020-2021, the authorities issued a bond of 5 billion baht in the Thai market in March 2022. To meet the financing needs for debt repayments in 2022, the government will resort to proceeds from asset sales, natural resource sector revenues, repayments from SOEs (regarding on-lending), and bond sale proceeds. The latter include bonds issued in Thailand and government bonds issued in the Lao Securities Exchange.

Table 1. Sovereign credit ratings for the Lao PDR

	Fitch		Moody's		TRIS	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Jan 20			B3	Positive		
Feb 20	B-	Stable				
May 20	B-	Negative			BBB	Negative
Jun 20			B3	Under review		
Aug 20			Caa2	Negative		
Sep 20	CCC	N/A				
May 21					BBB-	Negative
May 22					BBB-	Stable
Jun 22			Caa3	Stable		
Aug 22	CCC-	N/A				

Source: https://tradingeconomics.com/laos/rating

With limited external financing options, the government is increasingly borrowing from the domestic banking sector. The government borrowed significantly from the domestic banking sector, particularly in the form of bond issuances and short-term borrowing for liquidity management purposes. Claims on the government by the financial sector rose to 11.4 percent of GDP in June 2022 compared to only 5 percent in 2019. However, domestic financing is unlikely to replace foreign financing in the short- to medium-term. The kip bonds offered on the Lao Security Exchange (LSX) have similar interest rates to commercial banks, but rates are much lower than the recent bonds issued by the central bank.[15] The US dollar bonds offer slightly higher rates than US dollar deposits in commercial banks. Nevertheless, given high inflation, bonds entail negative real interest rates, which may dampen demand.

[15] Bank of the Lao PDR offered kip bonds worth 5,000 billion kip on 15 June 2022. The objective was to reduce kip liquidity and reduce pressure on the exchange rate. As of August 2022, 80 percent were sold to individuals and business entities. Commercial banks are not allowed to buy these bonds.

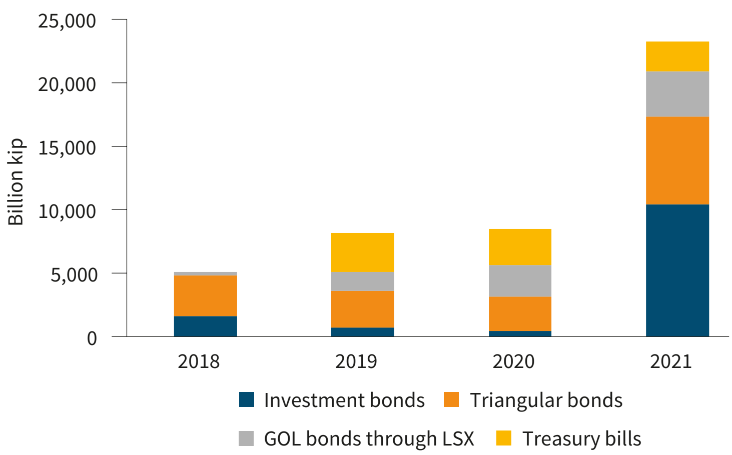
Table 2. Interest rates comparison
(Percent per annum)

	BOL USD bonds (2019)	BOL 6-month LAK bonds (2022)	MOF USD bonds sold on LSX (2022)	MOF LAK bonds sold on LSX (2022)	Banks (LAK deposit rate in August 2022)	Banks (USD deposit rate in August 2022)
Amount	500 (m USD)	5000 billion kip	50 (m USD)	1900 billion kip	-	-
6 months	-	20% (p.a)	-	-	-	-
1 year	5.0%	-	5.0%	5.0%	5.4%	3.8%
2 years	-	-	5.5%	-	6.4%	4.9%
3 years	6.0%	-	6.0%	6.8%	6.9%	6.0%
4 years	-	-	-	-	6.9%	6.8%
5 years	7.0%	-	7.0%	7.0%	7.0%	6.8%
7 years	-	-	7.5%	7.2%	-	-
10 years	-	-	8.0%	7.5%	-	-
15 years	-	-	-	7.0%	-	-
15 years	-	-	-	8.0%	-	-

Source: BOL, commercial banks, MOF

Domestic public debt increased sharply due to bond issuance to settle accumulated expenditure arrears. The domestic debt stock increased from 5 to 13 percent of GDP between 2020 and 2021 due to domestic bond issuance. The government reported 10 trillion kip of accumulated public investment arrears (5.5 percent of GDP), which had been constraining the balance sheets of contractors and banks. In response, the Ministry of Finance issued bonds amounting to 9.5 trillion kip (5.2 percent of GDP) in 2021 to repay most of these arrears. The remaining amount (423 billion kip) remains classified as expenditure arrears and is not accounted for the debt stock by the government.

Figure 35. Domestic debt composition



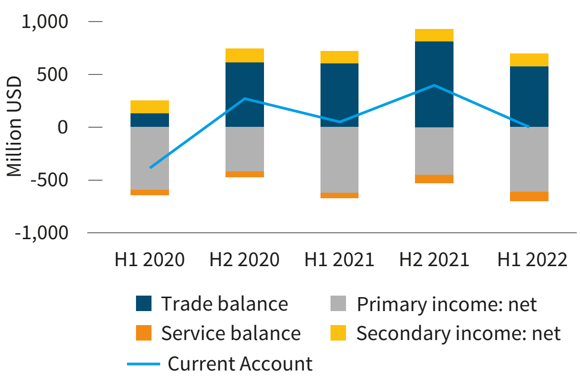
Source: Ministry of Finance.

2.7 External Sector

External imbalances persist amid high demand for imports and debt service payments

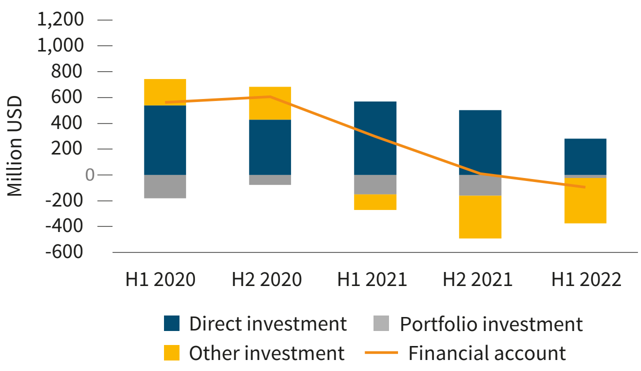
The current account deteriorated in the first half of 2022, partly because of higher imports. According to official statistics, the current account recorded a surplus of 2.4 percent of GDP in 2021, partly due to strong merchandise exports. However, the current account balance was estimated to be in deficit of about 2.9 percent of GDP when using statistics produced by trade partners, which reflect unrecorded imports. Despite interest payment deferrals, the officially reported current account surplus declined in the first half of 2022 when compared to the same period last year because exports grew less than imports. The main export drivers were gold, iron, rubber, cassava, and wood and paper products. Imports increased largely because of fuel and machinery, driven by higher fuel prices and the currency depreciation. Tourism revenues recovered slowly. Despite resilient exports and external debt service deferrals, gains were partly offset by faster growth in imports and high net income payments abroad.

Figure 36. Current account composition



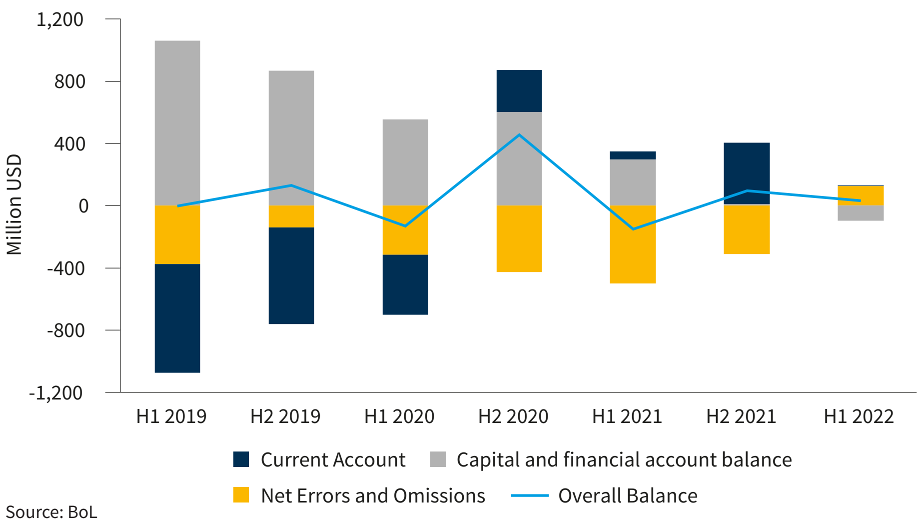
Source: BoL

Figure 37. Financial account composition



Source: BoL

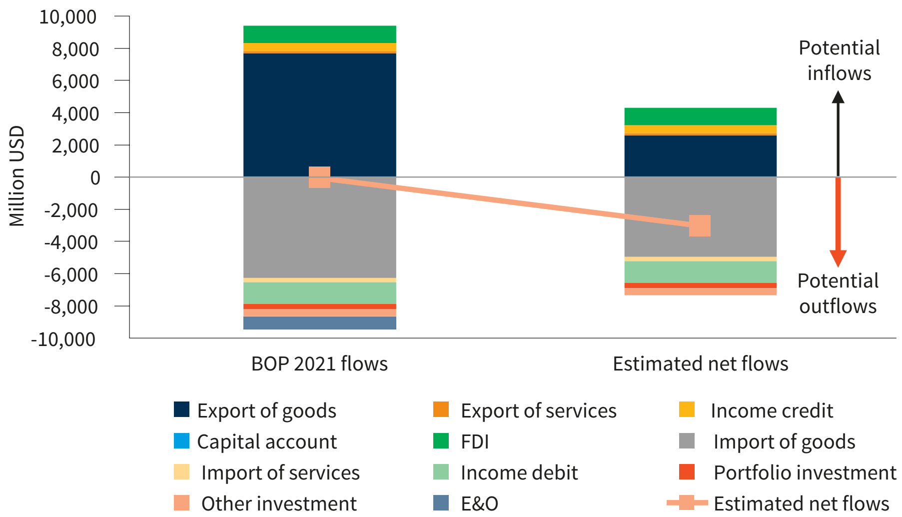
Figure 38. Balance of payments composition



Source: BoL

External imbalances have worsened, owing to a weaker current account and lower capital inflows. While the current account weakened, the financial account reported a net outflow in the first half of 2022. Net direct investment inflows declined by 51 percent year-on-year in the first half of 2022 when compared to the same period in 2021, as many large investment projects were completed in 2021. Portfolio investment net outflows declined as no bonds matured in the first half of 2022. However, other investment net outflows rose in the latter half of 2021 and continued into the first half of 2022. The combination of lower foreign exchange net inflows and high demand for foreign exchange for imports and debt service payment is likely to aggravate foreign currency liquidity constraints and possibly disrupt imports of essential goods. Potential net outflows are estimated to be much larger than officially recorded.

Figure 39. Indicative illustration of foreign exchange cash flows based on 2021 BOP



Source: WB staff assessment based on data form BOL, MOF and various other sources.

Note: Estimates of foreign exchange cash flows are based on the following assumptions: (i) goods export proceeds adjust for underreported exports, but only 33 percent of the officially reported amount flows back into the economy; (ii) goods import payments adjust for underreported imports but 37 percent of imports are financed by investment projects, (iii) net services trade and net primary and secondary income is as officially reported; (iv) net financial account is as officially reported and (v) errors and omissions are negligible after these adjustments.

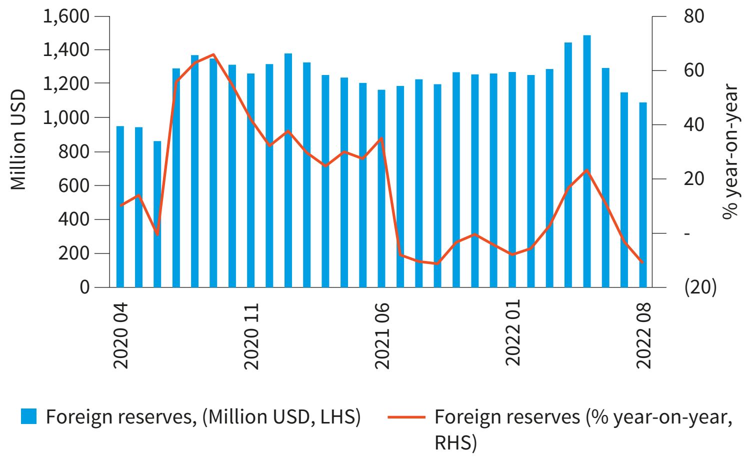
Reserve buffers remained inadequate, owing to a mismatch between the demand and supply of foreign exchange. Gross official reserves amounted to $1.1 billion in August 2022, covering less than two months of imports of goods and services[16] and were slightly higher than the debt service plan, if there were no deferrals.[17] Despite support from a swap arrangement with the People's Bank of China, foreign reserves were low partly because only 33 percent of export receipts entered the country through the banking system (see indicative illustration in Figure 39).[18] This large discrepancy is particularly high in the natural resource and informal trade sectors. A revised law on foreign exchange management has been recently approved by the National Assembly. The law is thought to contain repatriation requirements, instructing traders and investors to bring export proceeds and investment funds into the domestic financial system after external debt settlements. However, reforming the business environment remains critical to promoting investment and exports, while curbing tax exemptions can also increase inflows of foreign currency. Addressing financial sector vulnerabilities and improving the rule of law would help boost investor confidence.

[16] The reserves level rose in April 2022,but declined in June, possibly reflecting the foreign currency arrangement for fuel imports.

[17] External public debt service in 2021 declined due to debt payment deferrals and rollover of repayment to commercial banks, which will be paid in local currency.

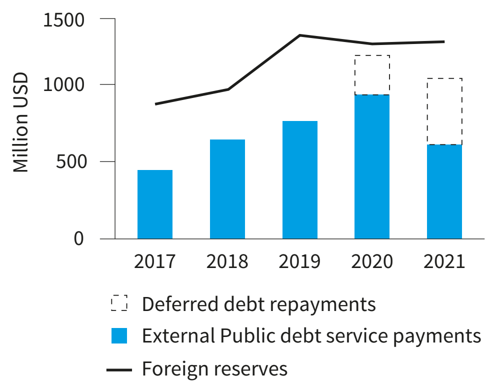
[18] Laotian Times. 2022. "Laos Economy Short-changed by Foreign Currency Outflows". Available https://laotiantimes.com/2022/05/19/laos-economy-short-changed-by-foreign-currency-outflows/

Figure 40. Foreign reserves



Source: BoL

Figure 41. Gross foreign reserves and public debt service



Source: BoL, MOF, WB staff estimate

2.8 Exchange Rate

The kip experienced a sharp depreciation, due to a stronger US dollar and limited foreign reserves

The kip has experienced a very sharp depreciation, owing to limited foreign exchange liquidity and a strong US dollar. The weakening of the currency reflects considerable external liquidity constraints (despite substantial external debt repayment deferrals) partly due to long-standing structural imbalances, including limited foreign exchange inflows and reserves,as well as depreciation expectations, which could undermine confidence in the kip. These were intensified by the strengthening of the US dollar against regional currencies. The Lao kip depreciated sharply between March and June 2022, adding to the already significant weakening in the second half of 2021. Although the pace of depreciation seems to be more gradual in recent months, the official exchange rate depreciated by 68 percent against the US dollar in the year to October compared to the same time last year. The parallel exchange rate weakened by 57 percent during the same period. The Lao kip also depreciated significantly against the Thai baht. The gap between the official and parallel rates has fallen to around 10 percent for the kip/US dollar, but remains high, while the kip/baht premium was about 6 percent in October 2022.

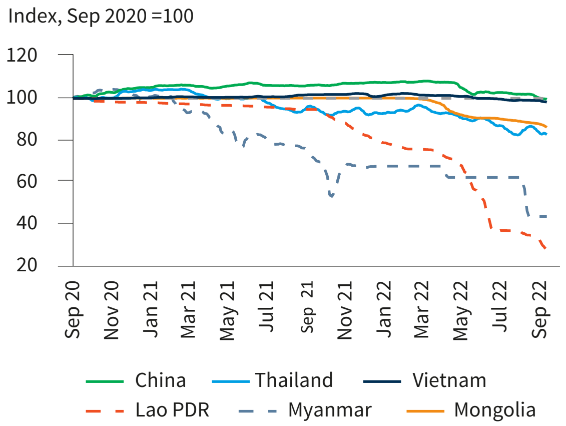
The Bank of the Lao PDR has undertaken policy measures to ease depreciation pressures. In June 2022, the central bank announced the issuance of savings bonds amounting to 5 trillion kip with a six-month maturity and an annual interest rate of 20 percent. The main objective of the issuance was to reduce kip liquidity and thus ease depreciation pressures. Nevertheless, the impact of these measures is likely to be temporary unless the underlying structural imbalances are addressed. The central bank also tightened exchange controls by placing daily limits on foreign exchange transactions, prioritizing importers of key goods (e.g., fuel), and only allowing exchange bureaus to trade with individuals (not companies).[19] The authorities also closed some unlicensed and non-compliant exchange bureaus. In October, the Bank of the Lao PDR (BOL) has allowed greater exchange rate flexibility by expanding the band within which commercial bank rates can deviate from the BOL daily reference rate to ±4.5 percent. This is the largest range of flexibility ever allowed by the BOL. At the same time, the regulation states that exchange bureau rates can move within ±3 percent of the reference rate.[20]

[19] Bank of the Lao PDR regulation on foreign exchange services and agent exchange bureaus. No. 449/BOL, dated 14 June 2022.

[20] According to BOL regulation No. 779 dated 11 October 2022, commercial banks can now deviate from the daily reference exchange rate by ±4.5 percent (compared to the previous ±1.5 percent) and the gap between the sell and buy rates for the USD increased to 1 percent (from the previous 0.5 percent). Foreign exchange bureaus are no longer authorized to sell foreign exchange, while their buying rate for the USD must be within ±3 percent of the reference rate.

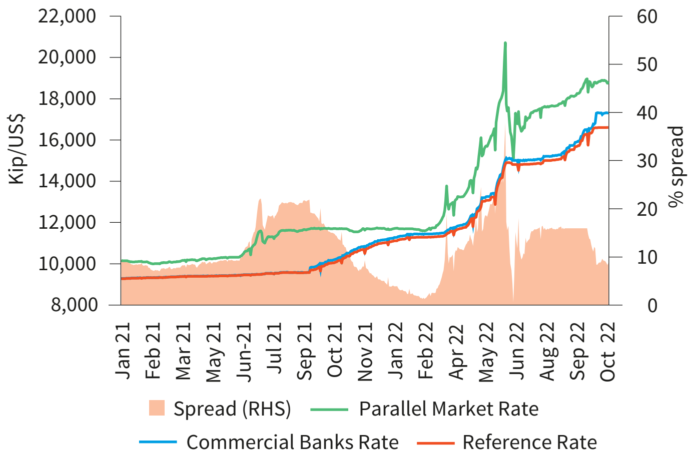
Figure 42. Exchange rate depreciation

(Local currency/US dollar, Index Sep 2020 = 100)



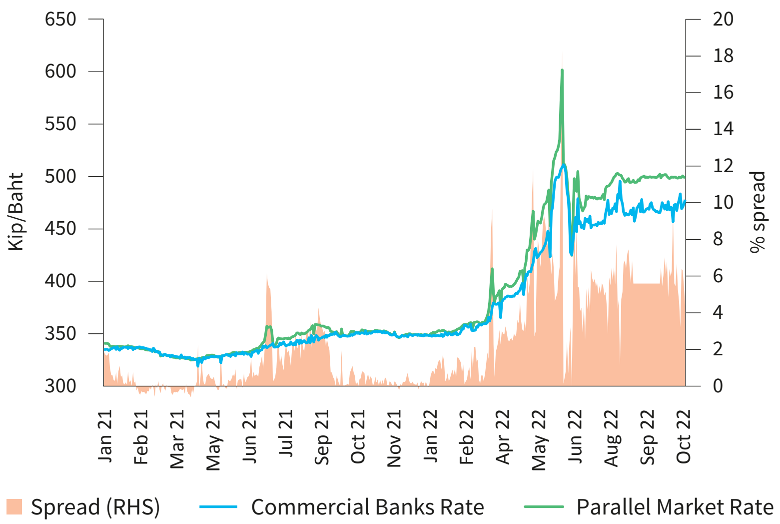
Source: Bank of Lao PDR, World Bank.

Figure 43. Kip/USD exchange rate



Source: Bank of Lao PDR.

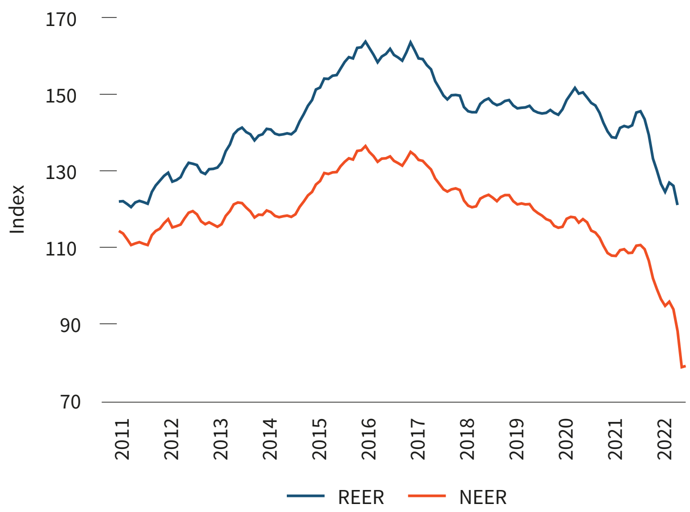
Figure 44. Kip/baht exchange rate



Source: Bank of Lao PDR, World Bank.

The real effective exchange rate (REER) depreciated in line with trends in the nominal rate. The REER depreciated by 14 percent during January-August 2022 compared to 7 percent in the same period last year. The depreciation of the REER, due to the depreciation of the nominal effective exchange rate, has reversed some of the appreciation observed before 2016, when there were large investment flows into the natural resource sectors. The REER depreciation can boost export competitiveness, although adequate productive capacities are required to seize emerging opportunities. On the other hand, depreciation makes imports relatively more expensive, particularly fuel and raw materials, which increases production costs and makes financial payments abroad relatively more expensive.

Figure 45: Real effective exchange rate



Source: Bruegel https://www.bruegel.org/publications/datasets/real-effective-exchange-rates-for-178-countries-a-new-database/

Note: An increase in the index indicates an appreciation of the home currency against the basket of currencies of trading partners. A decline in the index indicates the depreciation.

2.9 Monetary and Financial Developments

Financial sector vulnerabilities persist despite improvements in some aggregate financial soundness indicators

Monetary policy tightened in 2022 to reduce pressure on the kip. The authorities have pursued an accommodative monetary policy stance since 2020 to ease the economic impacts of COVID-19 by lowering policy rates and reserve requirements, expanding credit programs, and adopting forbearance measures. However, it is unclear if this policy stance was effective in supporting economic recovery, while there is growing evidence of deteriorating asset quality in the banking sector. In addition, depreciation expectations also contributed to more preference in holding foreign currencies. More recently, in response to depreciation pressures, the central bank has pursued monetary tightening by raising the short-term policy rate (from 3.1 percent to 6.5 percent) in October 2022. In addition, kip liquidity was reduced through the offering of savings bonds to individuals and business entities.[21] Real lending and borrowing rates have significantly declined, due to high inflation. While the lower real rate may be favorable for borrowers, it can affect saving decisions by households.

Domestic credit has been increasing considerably, partly due to the kip depreciation.[22] Broad money growth increased by 40 percent in the year to August 2022, mostly because of foreign currency deposits, which have seen their kip equivalent value increase due to the depreciation. Credit programs were established to support businesses during the COVID-19 pandemic, particularly for small and medium enterprises (SMEs). Credit to the economy reached 59 percent of GDP in August. [23] There has also been strong growth in lending to the government since 2021, reflecting public borrowing from the domestic banking sector due to limited access to international capital markets to meet public financing needs and higher holding of government bonds. Banks' increased exposure to public borrowing puts more pressure on bank balance sheets. As a result, domestic credit grew by 47 percent in the year to August 2022, although kip depreciation also had an important impact.[24] Private sector

[21] BOL Notice No. 263, dated 19 August 2022. As of August, 80 percent of BOL bonds, which is equivalent to about 4 trillion kip, was sold to individuals and business entities.

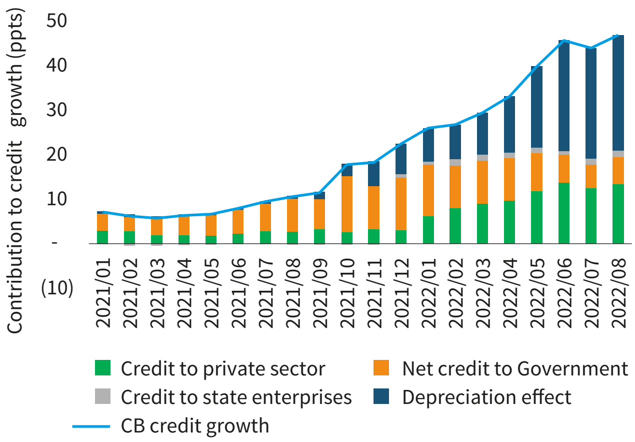
[22] Domestic credit covers credit from BOL and commercial banks

[23] This includes credit provided by the total banking sector.

[24] Domestic credit includes credit to private sector, state enterprises and the government.

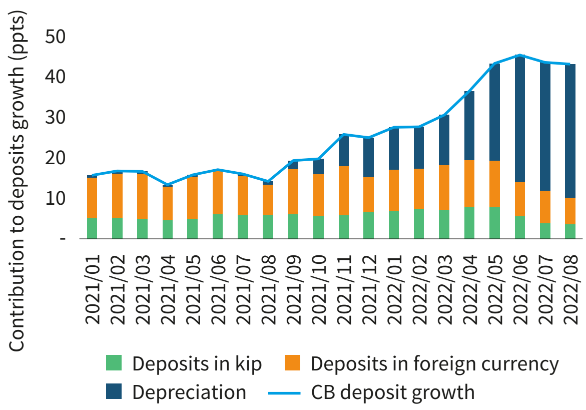
credit comprises mostly lending to industry, commerce, service and construction sectors. As inflation is rising fast, monetary and exchange rate policies are facing a dilemma between supporting the economic recovery and trying to reduce inflationary pressures.

Figure 46. Commercial bank credit



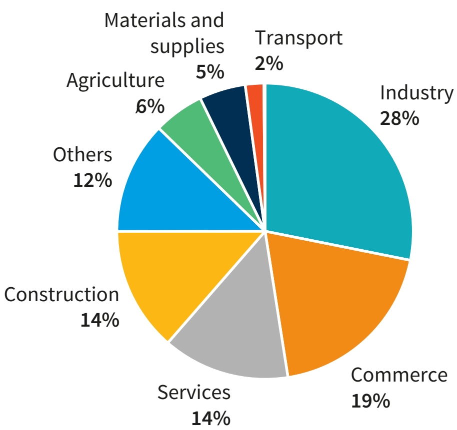
Source: WB staff estimate based on BOL data.
Note: This illustration only covers lending by commercial banks. It assumes a scenario of a more stable depreciation rate.

Figure 47. Deposits at commercial banks



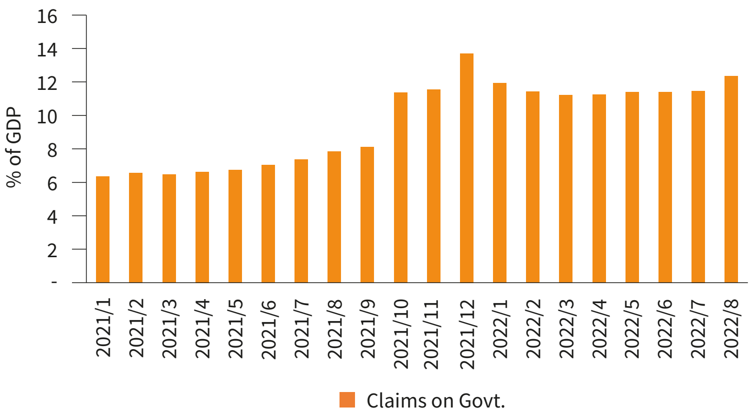
Source: WB staff estimate based on BOL data.
Note: This illustration only covers lending by commercial banks. It assumes a scenario of a more stable depreciation rate.

Figure 48. Share of credit by sector
(Percent share in total credit provided by commercial banks)



Source: Bank of Lao PDR.

Figure 49. Net claims on government by BOL and banks



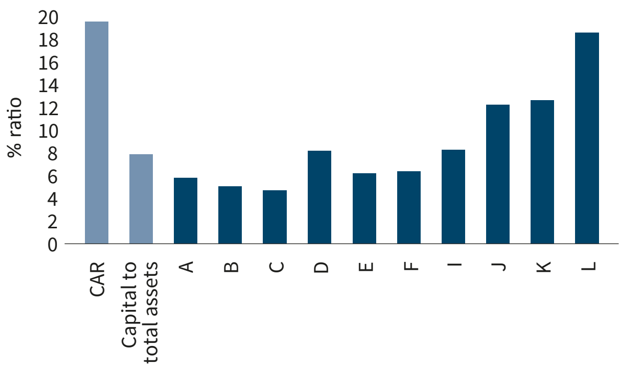
Source: Bank of Lao PDR.
Note: This includes net claims on government from both BOL and commercial banks.

Financial sector vulnerabilities persist despite improvements in some aggregate financial soundness indicators. The capital adequacy ratio (CAR) increased to almost 20 percent in the first quarter of 2022, while the capital to total assets ratio was reported at 7.8 percent. While aggregate indicators seem comparable to regional peers, they mask significant variation in capital buffers and asset quality across banks. Five out of the top-10 largest banks (in terms of assets), which account for approximately 80 percent of total banking system assets, have capital to asset ratios[25] below the average. The largest state-owned bank (Banque Pour Le Commerce Exterieur), which accounts for 38 percent of system assets, experienced a notable decline in the CAR to only 5.8 percent in June 2022, from 7.4 percent in December 2021, below the prudential minimum of 8 percent.[26]

Reported non-performing loans (NPL) slightly declined partly due to improved asset quality in restructured state-owned banks. However, the decline in reported NPL ratios also reflects faster credit growth and the COVID-19 forbearance policy. Forbearance measures (such as the freeze of loan classifications) and the ever-greening of loans may mask important risk and vulnerabilities. While many countries are making good progress in unwinding COVID-19 support measures, Lao PDR has yet to establish a clear timeline on phasing out forbearance measures amid continued economic challenges. This could undermine credit discipline and present risks to the financial system. Half of the top-10 banks (as measured by the size of their lending portfolio as of the end of 2021)

Figure 50. Capital to asset ratio as of 2022Q1[27]

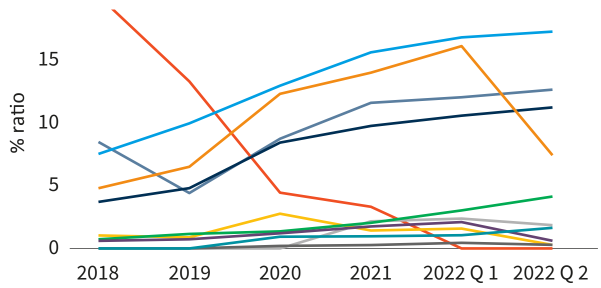
(Each bar represents a different bank, percent)



Source: WB staff calculation based on Bank information

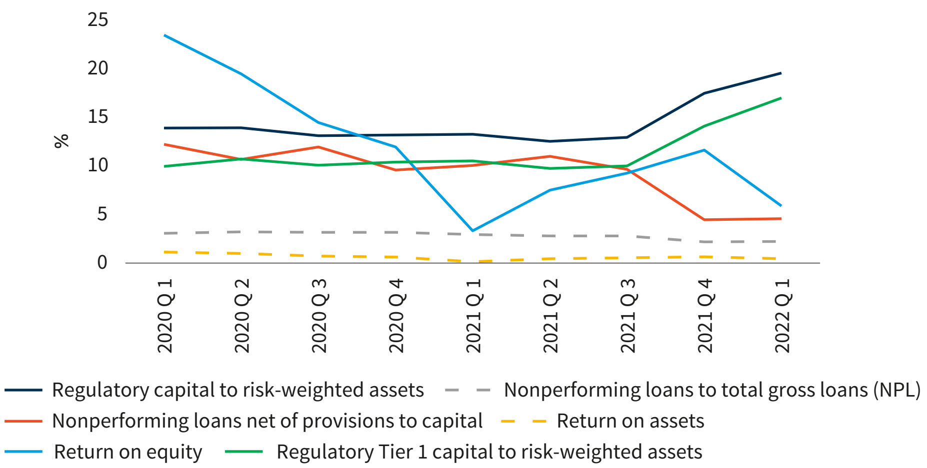
Figure 51. Accrual interest to loans[28]

(Each line represents a different bank, percent)



Source: WB staff calculation based on Bank information

Figure 52. Financial Soundness Indicators



Source: BOL .

[25] For commercial banks that do not publish capital adequacy ratios, total capital to asset ratios are used as a proxy for comparison.

[26] According to Interim Financial Information for the six-month period ended 30 June 2022. See https://www.bcel.com.la/bcel/bcelweb-datas/financial-info/half-year-rpt/en/bcel_web_file_14_c8ad51d484eb181f6e9caaeac683ec97.pdf

[27] The banks covered in the analysis are the top-10 banks in terms of their asset size as of end-2021. The capital-to-asset ratio is calculated as total capital divided by total assets as a proxy. In alphabetical order, these include BCEL, BIC Bank, ICBC, Indochina Bank, JDB, LDB, Lao-Viet Bank, Phongsavanh Bank, ST Bank and Vietin Bank. Information are drawn from their financial statements published on their websites.

[28] The banks covered in the analysis are top ten banks in terms of their loan size as of end-2021. In alphabetical order, these include BCEL, BIC Bank, ICBC, Indochina Bank, JDB, LDB, Lao-Viet Bank, Phongsavanh Bank, ST Bank and Vietin Bank. The declining ratios for some banks were due to fast credit expansion. Information are drawn from their financial statements published on their websites.

have incurred higher accrued interest (as a share of total loans) since 2019, suggesting difficulties in collecting payments. Some banks exhibit a lower ratio due to the increased lending. Sector profitability and liquidity have declined. Both return-on-equity and return-on-assets, which measure profitability, declined in the first quarter of 2022 and are lower than regional peers. Liquidity indicators (e.g., liquid assets to total assets and total liabilities) fell considerably, except for the ratio to short-term liabilities. In this context, balancing the phasing out of forbearance measures and the health of bank balance sheets is important to minimize vulnerabilities in the financial sector while supporting the economic recovery. Enhancing bank monitoring and supervision, establishing a crisis management framework, and developing a plan to unwind forbearance measures are among the top priorities to address sector vulnerabilities.

3. Outlook and Risks

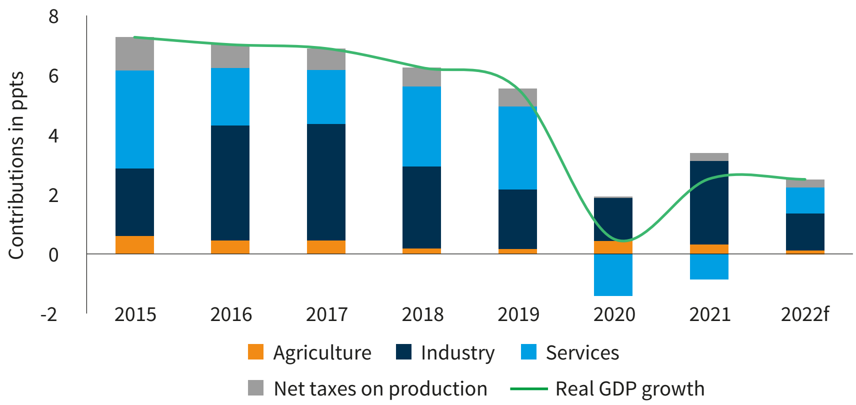
Box 1 Key assumptions for the baseline

Domestically, the outlook assumes no widespread outbreak of COVID-19 and no reinstatement of containment measures. Tourism gradually picks up, supported by a gradual improvement in domestic tourism, while international tourism will mostly benefit from visitors from neighboring countries – except China, due to its zero-COVID-19 policy. Improved logistics and railway operations will continue to boost transport services and trade flows. Externally, the outlook assumes debt repayment deferrals continue in 2022, providing vital temporary relief. However, higher US interest rates are expected to result in a stronger US dollar, which will place further depreciation pressures on the kip, and hence inflation. Price pressures are exacerbated by higher commodity prices and supply chain disruptions due to the war in Ukraine and global geopolitical conflicts.

In the medium term, the outlook assumes a gradual recovery in international tourism and exports, but is contingent on a successful conclusion of ongoing debt negotiations. Pressures from debt service payments are expected to persist unless there is a comprehensive agreement on restructuring with main creditors. The outlook does not incorporate assumptions on the accumulated debt payment deferrals yet due to uncertainty. Oil and food price rises are expected to moderate, bringing down inflation in the medium-term. Revenue collection gradually improves as revenue-enhancing measures are implemented and tax compliance improves. As debt service obligations remain high, expenditure adjustment policies continue to be considered to achieve fiscal consolidation in the medium-term.

The GDP growth forecast for 2022 was downgraded to 2.5 percent due to a larger-than-expected depreciation and inflation, amid a deteriorating global economic environment and slow domestic reforms. The gradual resumption of tourism, and the Lao-China railway will continue to support economic activity in the remaining months of 2022. However, the outlook is mostly shaped by negative domestic and external factors. The strong depreciation of the Lao kip has fueled inflation that is harming private consumption, while businesses are also struggling with higher costs. High fuel and input prices are expected to dampen growth prospects in agriculture, manufacturing, and construction. Depreciation pressures may reemerge since underlying structural weaknesses remain unaddressed, which could keep inflation high and contribute to supply shortages for some products, such as fuel.

Figure 53. GDP growth



Source: Lao Statistics Bureau and WB staff estimate

Table 3. GDP growth forecast

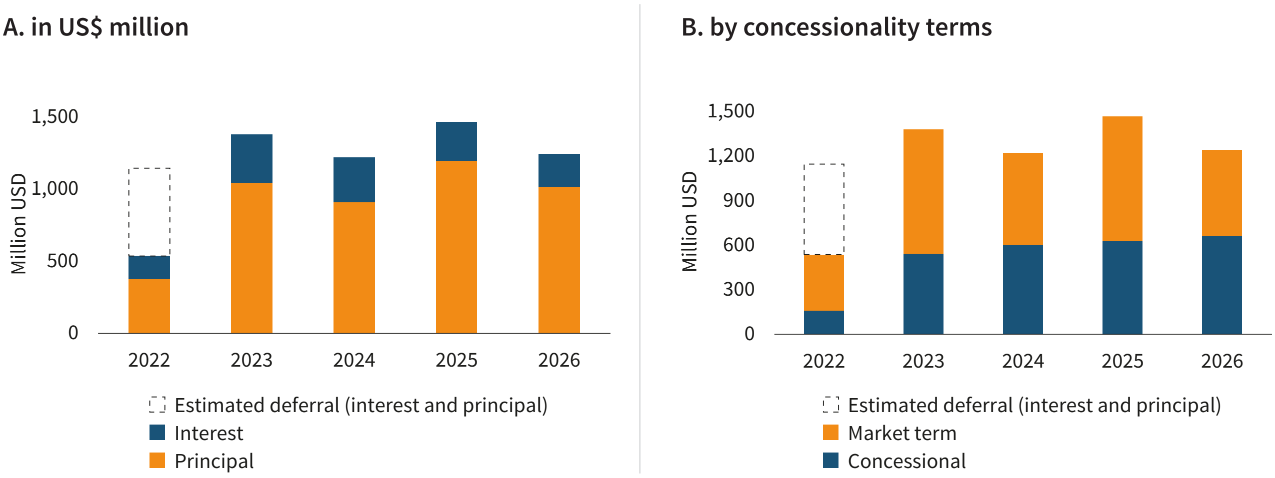
			April 2022 forecast	October 2022 forecast	
	2020	2021	2022	2022	2023
East Asia & Pacific	1.2	7.2	5.0	3.2	4.6
East Asia & Pacific (excluding China)	-3.6	2.6	4.8	5.3	5.0
ASEAN-5	-3.8	3.4	4.9	5.4	5.1
China	2.2	8.1	5.0	2.5	4.5
Indonesia	-2.1	3.7	5.1	5.1	5.1
Malaysia	-5.5	3.1	5.5	6.4	4.2
Philippines	-9.5	5.7	5.7	6.5	5.8
Thailand	-6.2	1.5	2.9	3.1	4.1
Vietnam	2.9	2.6	5.3	7.2	6.7
Cambodia	-3.1	3.0	4.5	4.8	5.2
Lao PDR	0.5	2.5	3.8	2.5	3.8
Mongolia	-4.4	1.6	2.5	2.4	5.5
Myanmar	3.2	-18.0	1.0	3.0	-

Source: World Bank EAP Economic Update September 2022.

Note: ASEAN-5 are Indonesia, Malaysia, Philippines, Singapore and Thailand."

Economic growth is projected to accelerate in the medium-term, provided that debt deferrals continue or a comprehensive debt agreement is reached. GDP growth is forecast to accelerate to around 4 percent in the medium term, supported by solid export growth and a gradual recovery of the services sector. However, it will still be below pre-pandemic levels owing to unaddressed structural constraints. With estimated debt service deferrals in 2022, the accumulated amount (covering 2020-2022) will likely reach 8 percent of GDP in 2022. While these deferrals have provided temporary relief, it remains unclear how these amounts will be treated as they are not included in the medium-term debt service plan, which is already very high. External debt service payments average $1.3 billion per year over 2023-2026, compared to a similar amount for official foreign exchange reserves in June 2022. Therefore, there is a need to reach a successful conclusion of ongoing debt negotiations with a view to creating fiscal space for critical growth-enhancing spending.

Figure 54. Public external debt service 2022-26 based on 2021 debt stock

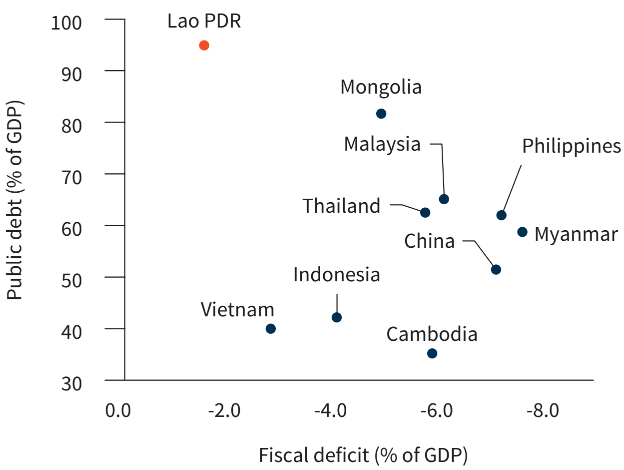


Source: MOF

Employment levels and earnings are expected to gradually recover to pre-pandemic levels. However, high food and fuel prices are eroding purchasing power and placing many households at risk of falling into poverty. Slow progress in poverty reduction will likely continue. The poverty headcount is expected to decline marginally to 31.3 percent in 2023.

High debt levels will continue to constrain fiscal space, jeopardizing development gains. Domestic revenues will increase slowly as a ratio to GDP, while grants will decline and expenditure will remain subdued. The outlook assumes that ongoing bilateral debt renegotiations will provide some form of debt relief, without which fiscal and external pressures would become insurmountable. A lower interest burden would likely result in a lower fiscal deficit. However, public debt as a share of GDP will increase in 2022 due to the sharp currency depreciation. Despite the lower fiscal deficit, financing needs will remain high due to debt amortization needs, exacerbated by the kip depreciation.

Figure 55. Fiscal deficit and public debt projection, 2022



Source: World Bank EAP Economic Update October 2022

Note: Assume debt payment deferral to key creditor in 2022. Public debt exclude public guarantees.

External imbalances are expected to persist in the absence of bold reforms to tackle structural weaknesses. The current account balance is expected to remain at a similar level to last year, assuming that external debt service deferrals continue in 2022. Reserves are expected to be at around $1.3 billion, covering less than two months of imports. Limited foreign exchange liquidity and high demand for foreign currencies (for imports and debt servicing) are expected to continue placing pressure on the exchange rate and keep the exchange rate gap high in the near term.

The outlook is subject to significant downside risks. The global economy is being undermined by the protracted war in Ukraine, rising geopolitical tensions, and tighter macroeconomic policies (e.g., rising interest rates and withdrawal of COVID-19-related support measures). Moreover, weaker growth prospects in key trading and investment partners, namely China due to its structural slowdown and zero-COVID-19 policy, are also weighing down on the recovery. These developments affect the Lao PDR through several channels, including lower external demand, higher commodity prices, and further exchange rate depreciation pressures. Domestic risks include challenges with refinancing external debts, slow progress with structural reforms, and a deterioration of bank balance sheets. In particular, the outcome of the ongoing bilateral debt renegotiation with key creditors will have strong implications for debt distress and macroeconomic instability. A fiscal adjustment alone, particularly through protracted expenditure curbs, will not be sufficient to improve debt sustainability without harming medium- and long-term growth prospects, as the debt overhang will undermine critical investments in human capital, crowd out private investment, and fuel macroeconomic instability.

4. Policy Options

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

- **Revise the Law on Investment Promotion to curb tax incentives and exemptions.** Broadening the tax base is critical to boost domestic revenue mobilization. The corporate income tax (CIT) gap – i.e., the difference between potential and actual CIT revenue – is estimated at nearly 90 percent, implying large foregone revenues from tax exemptions. Large capital-intensive investments in energy, mining, and transport infrastructure have benefited from generous tax incentives, which deprive the country from vital fiscal revenues and foreign exchange. International evidence shows that tax incentives do not encourage foreign investment. Replacing the current profit-based tax incentive system (based on tax holidays and reduced rates) by a cost-based tax incentive system (based on accelerated depreciation and additional tax deductions) would better link incentives to investment. CIT collection amounted to around 1 percent of GDP before Covid-19. If this amount is doubled, it could generate an additional $180-$200 million a year. In addition, it would be important to improve the monitoring of tax exemptions (through a more detailed tax return form) and undertake an assessment of the largest concession agreements (to estimate foregone revenues and evaluate the legal scope for revision).

- **Restore the value-added tax (VAT) rate to 10 percent and reduce VAT exemptions.** Revenue collection relies heavily on indirect taxes, particularly the value added tax (VAT) and excises. The VAT accounted for about 30 percent of total tax revenue in 2015-2019. In January 2022, the VAT rate was reduced from 10 to 7 percent – although it is unclear if this tax cut has been passed on to consumers. This rate is very low by regional and international standards, and further undermines revenue collection – the average VAT rate is 12 percent for Asia, 14 percent for Latin America, 16 percent for Africa, and 19 percent for OECD countries. Restoring the VAT rate to 10 percent could (immediately and efficiently) raise about $150 million a year. Part of this could then be earmarked to support the most vulnerable households (through the expansion of targeted cash-transfer programmes), so that the tax rate increase does not affect income inequality. Reducing VAT exemptions, such as those for large-scale agricultural activities, would help widen the tax base and thus support domestic revenue mobilization.

- **Reprioritize spending toward the social sectors.** Improving the allocative efficiency of public expenditure is particularly important given the current fiscal constraints. Development spending has been under pressure from declining revenues and rising debt service obligations. The combined public spending on education and health declined from an already low level of 4.4 percent of GDP in 2016 to 3.1 percent of GDP in 2021, likely undermining public service delivery. The level of spending in the social sectors (i.e., education, health, and social protection) is one of the lowest in the region and in the world. Interest payments on public debt will soon overtake the combined spending in the social sectors – in the absence of debt deferrals. Reprioritizing public spending towards education, health, and social protection would be critical to build human capital and thus improve economic growth prospects in the medium term. It would also make public spending more pro-poor, thus helping to reduce poverty and inequality. Without strong investments in human capital, the return on investment in physical capital will likely be limited. This may require a rebalancing from the prevalent focus on large-scale infrastructure.

- **Strengthen the governance framework for public-private partnerships (PPPs).** Governments can choose to finance public assets and services through a public-private partnership (PPP) model, which may enable investments that otherwise could not be undertaken. However, PPPs may turn out to be more costly than traditional procurement if they are not adequately designed. Therefore, it is crucial to enhance the current legal and regulatory framework by upgrading the Decree on PPPs to a law, and strengthen the institutional capacity to prepare, procure, and manage PPP projects. In that context, a high-level committee should be created to scrutinize and prioritize PPP project proposals to ensure that they are in line with existing public investment plans. Publishing documents relating to PPP projects (such as appraisals and fiscal commitments from contracts) would promote transparency. Improving project appraisal (by developing rigorous criteria, tools, and implementation guidelines to comprehensively assess economic and financial viability) and mandating transparent and competitive procurement would help maximize value for money. Implementing a robust framework to assess, approve, and manage PPP-related fiscal risks would limit the accumulation of contingent liabilities.

- **Pursue the restructuring of public debt.** Liquidity and solvency challenges are due to rapid debt accumulation, particularly in the energy sector, and limited revenue collection. This has been compounded by the impact of Covid-19, the depreciation of the Lao kip, and a deteriorating global macroeconomic environment. A high public debt burden constrains fiscal space, exerts pressure on the exchange rate, and jeopardizes banking sector stability. The current debt service schedule is not achievable without a socially damaging compression of public expenditure. Restructuring public debt would be vital to secure macroeconomic stability and support the economic recovery. Debt restructuring can be pursued through discussions with bilateral creditors or multilateral channels. The G-20 Common Framework aims to provide comprehensive debt relief for developing countries, while there are ongoing debt renegotiations with large bilateral creditors. Bringing ongoing bilateral debt negotiations to a successful conclusion, or applying for debt treatment under the Common Framework, would ease debt pressures, create fiscal space for growth-enhancing expenditures, and improve market confidence.

- **Enhance bank monitoring and operationalize emergency arrangements.** The recent economic downturn and the extension of regulatory forbearance measures negatively impact banks' balance sheets and threaten the sector's ability to fulfil its financial intermediation role to support the economic recovery. A bank failure could have considerable economic repercussions. The rapid depreciation of the Lao kip places an additional stress on the highly dollarized banking sector. The authorities should enhance bank monitoring with granular and frequent information on liquidity (including daily reports) given potential volatilities. As the government may need to mobilize liquidity facilities and emergency liquidity assistance (ELA) arrangements to manage weaknesses in the sector, it is critical to put in place regulations and procedures in case of need. These encompass eligibility criteria for the use of collateral, definition of haircuts, as well as detailed procedures related to steps to be taken by the various units of the Bank of the Lao PDR and instances to be involved in the process.

Additional priority reforms in the area of business environment and trade include:

- **Improving business registration processes and the operating licensing regime**
- **Fully implementing existing paperless trade systems.**

A detailed description of what those reforms entail is provided in Part B of this report.

Table 4. Key macroeconomic indicators

	2019	2020	2021	2022	2023	2024
					Projections	
Real Economy		Percent change year-on-year				
Real GDP growth	5.5	0.5	2.5	2.5	3.8	4.2
Agriculture	1.2	3.2	2.3	0.8	2.4	2.6
Industry	5.6	4.0	7.6	3.2	3.7	3.4
Services	7.0	-3.5	-2.2	2.4	4.4	5.7
Inflation (period average)	3.3	5.1	3.8	19.0	7.2	6.1
Fiscal Account*		Percent of GDP				
Revenues	15.6	12.7	14.9	14.6	14.9	15.1
Domestic Revenues	13.8	11.2	13.1	13.4	13.6	13.9
Taxes	10.9	9.2	10.1	10.7	10.9	11.1
Non-tax	2.9	2.0	2.7	2.7	2.7	2.8
Grants	1.7	1.5	1.8	1.2	1.2	1.2
Expenditures	18.8	18.0	16.1	16.1	16.8	17.2
Current expenditure	12.6	11.5	11.1	11.2	11.8	12.1
Wages	6.4	6.2	6.0	5.6	5.6	5.6
Non-wage, non-interest expenditure	4.5	3.8	3.9	3.6	3.6	3.9
Interest payment	1.8	1.5	1.2	2.0	2.6	2.6
Current expenditure without interest	10.9	10.0	9.9	9.2	9.2	9.5
Capital expenditure	6.2	6.5	5.2	4.9	4.9	5.0
Fiscal balance	-3.3	-5.2	-1.3	-1.5	-2.0	-2.0
Primary balance	-1.5	-3.7	0.0	0.5	0.7	0.5
Total Public Debt [1/]	59.0	62.3	76.6	94.9	96.4	97.7
Selected Monetary Accounts [2/]		Percent change year-on-year				
Broad money	18.9	16.3	24.0	42.9		
Credit to the economy	7.4	4.3	11.5	42.3		
Balance of Payments		Percent of GDP				
Current Account Balance	-12.1	-5.9	-2.9	-2.9	-4.6	-4.9
Trade balance	-7.9	-1.3	1.7	1.5	0.7	0.3
Export of G&S	37.6	35.2	42.1	55.5	60.2	62.6
Import of G&S	45.5	36.5	40.4	54.0	59.6	62.3
Primary and secondary income balances	-4.2	-4.6	-4.5	-4.4	-5.3	-5.2
Gross international reserves	997	1,319	1,263	1,278	1,314	1,329
Months of G&S import cover	1.4	2.3	2.0	1.9	1.8	1.7
Memorandum items						
Nominal GDP (Billion kip)	162,657	171,741	182,584	211,344	228,764	248,609

Source: Lao Statistics Bureau, Ministry of Finance, Bank of Lao PDR, Ministry of Industry and Commerce, World Bank Staff estimate and projections baed on inputs from Lao Authorities and trade partners' data as of September 2022.

Note: 1/ public debt exclude public guaranteed debt.

2/ Latest information upto September 2022 as available for selected indicators

PART B

Exports for Jobs

Key Messages[29]

- The Lao PDR grew rapidly over the previous two decades, but this resource-driven growth did little to create jobs or inclusive growth.
- The Lao labor market is characterized by agricultural workers facing seasonal fluctuations in labor demand, high informality, and a growing number of public sector jobs but declining non-farm private sector employment.
- Lao PDR needs more productive, internationally oriented companies to drive exports, boost productivity and create higher-quality jobs.
- Lao PDR could spread the labor market gains from exports more widely by focusing on (1) boosting and connecting exports to markets and people; (2) diversifying exports into labor-intensive sectors by eliminating policy-induced distortions that limit the efficient allocation of resources; and (3) better preparing the workforce by investing in their education and skills.

1. Introduction

Over the past two decades, Lao PDR recorded one of the highest rates of economic growth in Southeast Asia. This growth was largely driven by trade and investment in natural resources (mining and power). Between 2000 and 2018, Lao PDR's real GDP growth averaged 7.5 percent a year, with trade growing at an average annual rate of 17 percent.

Trade, growth and jobs typically go hand in hand, yet, in Lao PDR the highly-capital resource-driven growth model had little success in translating high growth rates into employment. Non-farm formal private sector employment dropped over the period 2012 to 2018, with salaried jobs mostly created in the public sector. The off-farm jobs creation was not enough to absorb the surplus agricultural workforce. As a result, the unemployment rate increased from 4.1 percent in 2012 to 15.7 percent in 2018. Poverty was reduced but more slowly than in comparator countries and principally driven by rising farm incomes. Today two million people still live on less than $3.65 a day (a lower-middle-income poverty line in 2017 purchasing power parity (PPP)).

While labor demand is subdued, in terms of labor supply Lao PDR has one of the youngest populations in the region. Jobless growth has prevented the economy from reaping a substantial demographic dividend. In the coming decades, the Lao PDR will need to create nearly 60,000 jobs a year to absorb its increasing population.

The high dependence on commodity exports also exposed the country to significant environmental and macroeconomic risks. Fluctuating commodity prices, large debt-financed public investments and more recently the COVID-19 crisis have exerted pressure on Lao PDR's fiscal and external balances with debt rising to critical levels.

In this context, measures to boost non-resource exports are an urgent priority to raise revenue and firm productivity and obtain better labor market outcomes.

2. High Growth but Few Jobs

Lao PDR's economic growth has been largely driven by its highly-capital intensive natural resource sector, which did not create many jobs. From 2012 to 2018, the hydropower sector alone grew by an average of 17.8 percent per year and in 2018, the mining and hydropower sectors accounted for 20.7 percent of GDP. Yet, that same year both sectors contributed less than 1 percent of total employment.

The resource-driven growth also limited the growth of the non-resource sectors, constraining their contribution to employment. The appreciation of the kip from 2005 up until 2017 reduced the competitiveness of manufacturing and agriculture exports in international markets, although trading businesses may have benefitted from cheaper imported inputs, with garment and agro-processing reporting the strongest impact (Nolintha and Jajri, 2015).

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[29] Lead Authors: Melise Jaud and Tanida Arayavechkit. It focuses on recent trends in job creation in Lao PDR and the role of trade in supporting productive employment. The chapter is based on the Country Economic Memorandum (CEM) published in June 2022.

Following large investments in mines, dams and transport infrastructure, the construction sector boomed in the 2010s but did not add net jobs over the period 2012-2018. The sector's large reliance on a foreign workforce is part of the story, with anecdotal evidence suggesting that in 2012, an estimated 100,000 skilled workers from Vietnam, China, and Thailand were employed on large hydropower and transport infrastructure projects (MOIC, 2012). By 2018, only 4 percent of overall employment worked in construction (120,000 workers).

Public investments in the resource sector, especially hydropower, also reduced fiscal space, with less resources available for investments in agriculture, education, healthcare, and other public services. All of these could have increased labor productivity and promoted more sustainable, inclusive growth. This resulted in Lao PDR experiencing jobless growth.

All sectors, except the public and a few manufacturing and services subsectors, experienced a net decline in employment in the six years after 2012

The non-farm private sector lost 150,000 jobs between 2012 and 2018. Around 74,000 in the manufacturing sector, more than half of which were wage jobs were lost. Hospitality services and, to a lesser extent, transport, created some jobs, but not enough to offset the jobs lost in wholesale and retail. Overall, the services sector lost close to 77,000 workers (Figure 56).

Figure 56 High growth but low job creation in Lao PDR, 2012 and 2018

Source: CEM (2022) using Lao Bureau of Statistics for GDP data, LECS 2012 and LECS 2018 for employment.

Jobs were created by the expanding public sector: 126,000 wage jobs. In 2018, the public sector employed 6.7 percent of the labor force, up from 3 percent in 2012. Although public sector employment contributes to overall job creation, it can crowd out jobs and investments in the private sector by exerting upward pressure on reservation wages and attracting scarce human resources away from private businesses. The average real public sector wage rose by nearly 10 percent each year during this period, higher than in almost all other sectors.

A handful of subsectors in manufacturing and services also recorded a net increase in employment. These included: textiles, apparel, and leather; electrical, machinery, and transportation equipment; and coke oven products. The agro-industrial sector lost jobs in net but it experienced an increase in wage employment and stronger wage growth than other sectors. The median real income of full-time paid employees in agro-industry increased by 13.5 percent each year between 2012-2018, higher than the all-sector average of 10.6 percent. In services, hospitality and transportation created about 35,000 self-employed jobs in tourism and FDI-related activities. These were principally in Vientiane and the northern region where large infrastructure projects were being implemented.

The industry and services sectors could not absorb the surplus agricultural workforce. Around 390,000 workers moved out of full-time farm employment between 2012 and 2018. Most switched to seasonal farming and substituted non-farm employment with remittances or informal jobs in Thailand between growing seasons.

As a result, the total unemployment rate rose from 4.1 in 2012 to 15.7 percent in 2018. The non-seasonal unemployment rate increased from 0.6 percent to 3.2 percent while seasonal unemployment surged from 3.5 percent to 12.5 percent over the period.[30] The labor force participation rate fell from 84.6 percent to 72.1 percent over the same period, suggesting that the unemployment rate understates the true share of the out-of-work population in the labor market.

The lack of job creation has also prevented the economy from reaping a demographic dividend. Lao PDR's workforce has expanded sharply since 1993. The ratio of the working-age population (those aged 15 to 64) to the non-working-age population increased from 1.1 to 1.8 in 2020. In developing economies, surplus labor typically moves from traditional agriculture or informal sectors to industrial, service, or formal sectors. In Lao PDR, the lack of non-farm job creation slowed the structural shift and the employment-to-population ratio declined from 81.9 percent in 2012 to 60.8 percent in 2018 (Figure 57). This is close to the average of 60.9 percent found in resource-rich peers, but lower than that of regional peers (71.5 percent). A higher share of the working-age population needs to enter the workforce for Lao PDR to reap the benefits of this demographic dividend. And for that, firms need to create jobs.

Figure 57. The lack of non-farm job creation slowed the structural shift
(million, 2012-2018)

Source: CEM (2022)

In the absence of new jobs, rapid economic growth did not bring an equally high rate of poverty reduction

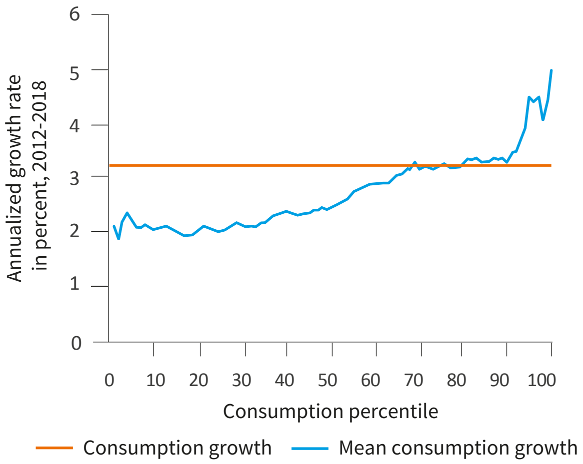
Poverty decreased, driven by rising farm incomes and migrant remittances. The poverty rate fell from 46 percent in 1992 to 23 percent in 2012 and to 18 percent in 2018. Since 2012, some agricultural households have moved from subsistence rice cultivation toward the commercial production of cash crops. And between 2013 and 2019, remittances from migrants became a source of income for nearly 15 percent of households, making up for lost non-farm income and accounting for 3.7 percentage points in poverty reduction.

The disappearance of off-farm private jobs has slowed poverty reduction. From 2012 to 2018, a 1 percent increase in GDP per capita generated a decline in the poverty rate of only 0.67 percent, half that of Vietnam at similar levels of GDP growth. Poverty also remains high among minority ethnic groups and fell less quickly among poorly educated households. In 2019, a poverty rate of 34.6 percent was observed among people living in households headed by someone with no formal education. This is ten times higher than among households headed by those who have completed secondary education.

[30] Seasonal unemployment includes those who are not seeking work but waiting for the busy season to work.

Inequality also rose driven by a widening consumption gap within regions between the very rich and the very poor. The Gini coefficient increased from 36.0 in 2012 to 38.8 in 2018, above that of regional peers, Vietnam (35.7), Thailand (37.0) and Indonesia (37.7). The ratio of the top 20 percent richest households to the bottom 20 percent household increased from 5.8 in 2012 to 6.6 in 2018, and the average consumption per capita of the top 10 percent richest households was ten times larger than that of the poorest 10 percent in 2018(Figure 58).

Figure 58. Consumption growth has been shewed towards rich households



Source: CEM (2022) using World Bank, Laos Poverty Assessment.

The COVID-19 outbreak has brought an unprecedented employment shock, adding pressure to the weak job market. A sharp drop in tourism has led to job losses in retail trade, transport, and hospitality, which together account for 11 percent of total employment. About 50 percent of workers in hospitality before the pandemic had either lost or changed their jobs by the end of Q2 2020. A protracted border closure, with all tourist visas and most international flights still suspended, meant few hospitality workers had returned to work by the end of Q2 2021. Between Q2 2020 and Q2 2021, the manufacturing sector also experienced widespread job loss, following a contraction in the sector's exports. By May 2022, most workers who had lost their jobs managed to return to employment or to move to other sectors.

Agriculture has also been more resilient, acting as a buffer by absorbing workers laid off in other sectors. Over 75 percent of households hold a family farm. By Q1 2021, 94 percent of these households had maintained normal farm operations. Anecdotal evidence suggests that farmers adjusted their choice of crop based on demand and prices during the pandemic (e.g., shifting from cabbage to cassava). A large share of workers who lost their jobs in manufacturing, construction and services as a result of the pandemic had moved back to the agricultural sector temporarily or permanently.

The decline in remittance flows combined with the slowdown in the non-agricultural sectors is expected to have slowed progress in poverty reduction. Prior to the pandemic, remittances were a source of livelihood for nearly 15 per cent of Lao households and contributed largely to poverty reduction during 2012-2018. Remittances dropped sharply due to the pandemic. Approximately 70 percent of remittances sent to Lao households are from abroad. But the pandemic has resulted in job losses among migrants, and many have returned home. The loss of income has created big challenges for those households who rely on remittance income to survive.

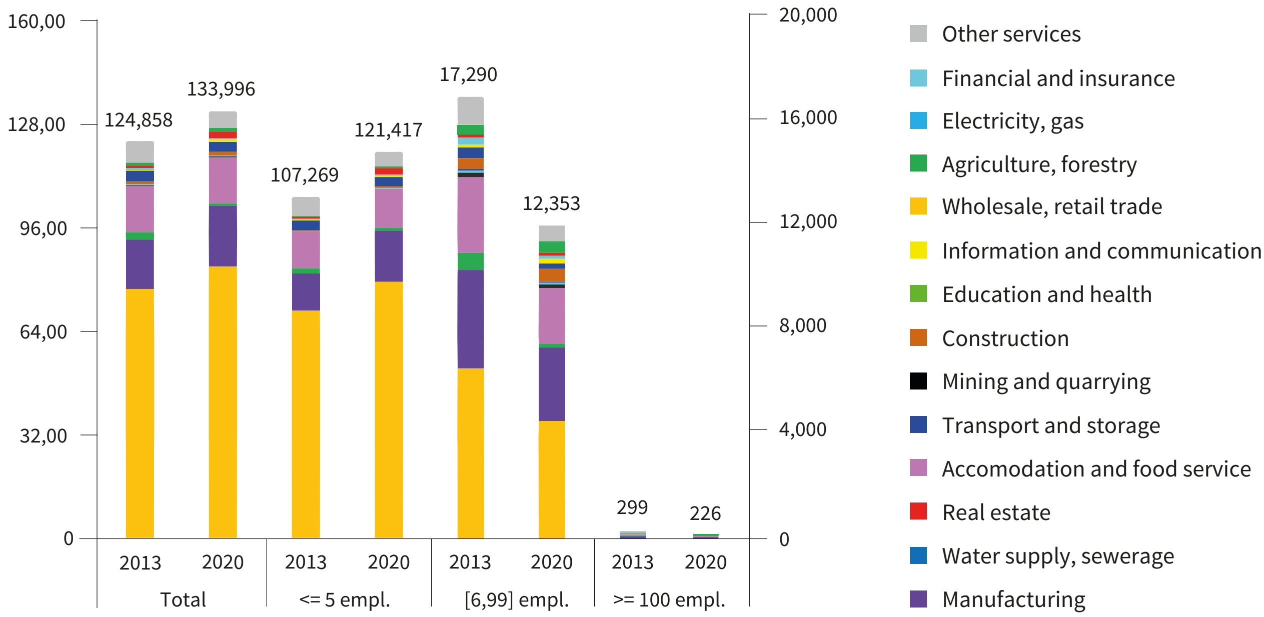
3. The Potential of Exports and International Value Chains to Improve Labor Market Outcomes

Jobs in the private sector, especially in the formal private sector, are the main way to a productive income and out of poverty. Understanding the economic conditions necessary to foster job and wage growth is critical for improving the standard of living of the Lao people.

The manufacturing sector remains small due to low productivity, while investment in the agriculture sector has declined

The formal private sector remains small and dominated by micro-enterprises. As in many developing countries, a large proportion of Lao workers are employed in the informal sector, with the sector accounting for 83 percent of total employment, compared to 7 percent in the formal private sector and 10 percent in the public sector (ILO, 2018). In the formal sector, 90 percent of the 134,000 registered businesses have five or fewer employees (Figure 59). Most businesses operate in the wholesale and retail sectors (63 percent), followed by manufacturing (14 percent) and hospitality (11 percent). The average business size fell from 4.2 employees in 2013 to 3.7 employees in 2020. The decline was even more pronounced in manufacturing, with the average number dropping from 7.8 to 5.9 employees.

Figure 59. Distribution of registered businesses by sector and size, 2013 and 2020



Source: CEM (2022) using Laos economic census 2013 and 2020.

Note: Between 2013 and 2020 firm size categories size. In 2013, microbusinesses include businesses with less than 5 employees, while in 2020 they include businesses with 5 or less employees.

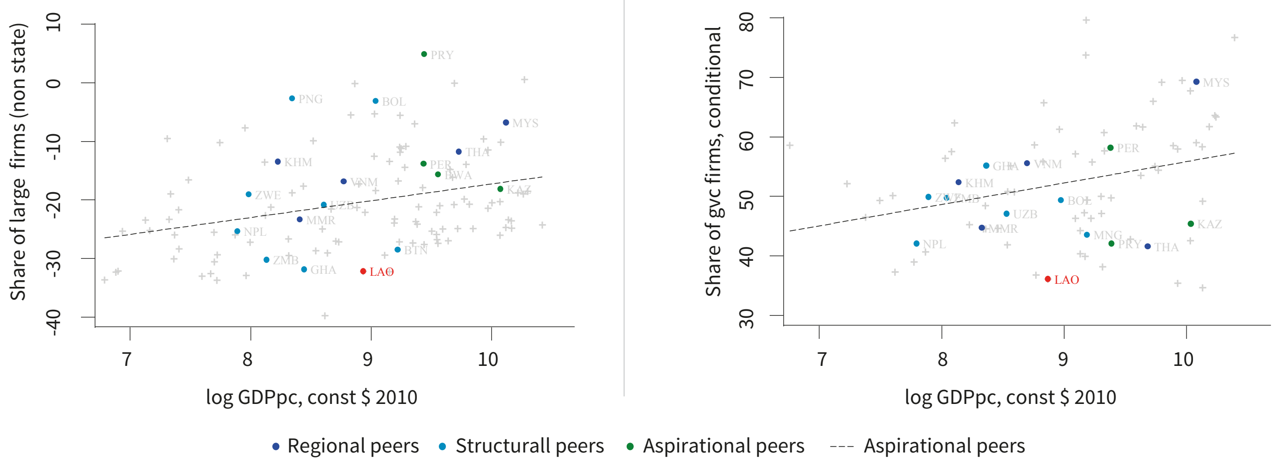
Lao PDR needs more productive, internationally oriented companies to drive exports, boost productivity and create jobs. Lao PDR appears to have fewer large manufacturing and global value chains (GVC) firms compared to peers at similar levels of income. This matters as those firms make a disproportionate contribution to job creation. Excluding micro-businesses, only 2 percent of Lao businesses (225 businesses) employ more than 100 workers, with most of these in manufacturing (43 percent in food processing, electronics, and apparel companies); construction (10 percent); and agriculture and forestry (8 percent). In 2018, just over 12 percent of businesses in the manufacturing and service sectors with more than five employees were either partially or fully foreign-owned.

A relatively small number of enterprises in Lao PDR engage in importing or exporting and survival is a major issue. About 23 percent of manufacturing companies with more than five employees are importing; 15 percent exporting; and 5 percent engaging in both trading activities (WBES 2018). This is considerably lower than the average for countries with similar income levels (Figure 60). In addition, the survival rate is low. More than a third of exporting businesses stop selling abroad after one year, and 87 percent after three years. GVC firms (firms that both export and import foreign inputs) account for 20 percent of trading firms, higher than the average of 15 percent in a large sample of countries. However, they contribute a smaller share of total trade.

Figure 60. Lao PDR lacks heavyweights at the top of the distribution, 2018

A. Share of large firms

B. Share of GVC firms



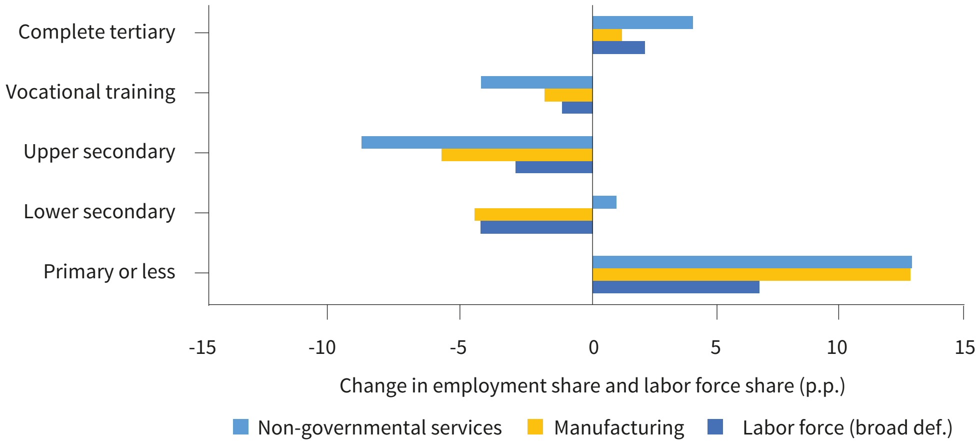
Source: CEM (2022) using World Bank Enterprise surveys latest available year for each country. 2018 data for Laos.

Note: Sample includes manufacturing firms with more than 5 employees. Large firms defined as businesses with 100 or more employees and GVC firms defined as businesses that both import and export. The relationship shown uses regression to control for population and the share of resource rents in GDP. The share of businesses shown on the vertical axis is the share of businesses adjusted for the effect of size and resource endowment.

During the decade prior to COVID-19, the competitiveness of Lao manufacturing businesses eroded, with most Lao manufacturing businesses recording lower levels of productivity than do counterparts in East Asia and Pacific regional neighbors. Between 2009 and 2018, the average labor costs per worker more than doubled, from $708 to $1,444. Rather than reflecting an improvement in workers' skills, the increase was likely driven by a wage demonstration effect from an expanding public sector, high wages in the resource sector and rising minimum wages. In fact, the skill composition of waged workers in the manufacturing sector barely improved between 2008 and 2018. And the share of workers who had completed secondary education or higher declined from 45 percent in 2008 to 37 percent in 2018. The unit labor costs (labor costs divided by value-added) increased, as labor costs were not matched by similarly fast rising productivity. This reduced firms' profitability and stalled employment. Estimates suggest that Lao PDR manufacturing businesses were on average 22 percent less productive than those in Cambodia and 65 percent less than those in Vietnam. In 2018, the unit labor cost in Lao PDR is estimated to be on average 20 percent higher than in Vietnam (WBES, 2018).

Manufacturing businesses shifted their employment largely toward low-skilled workers. Between 2012 and 2018, the proportion of workers in the manufacturing sector who had completed secondary school dropped, mirrored by an increase in the proportion of workers who had only completed primary school and a slight increase in the proportion of those who had completed tertiary education (Figure 61). With labor demand shifting toward low-skilled workers, the average rate of return to an additional year of education in the manufacturing sector declined from 5.8 percent in 2012 to 4.4 percent in 2018 (World Bank 2020).

Figure 61. Employment and the labor force shifted largely towards low skilled workers, 2012 and 2018



Source: CEM (2022) using LECS5 and LECS6.

Note: A broad definition of the labor force is adopted, defined as working age individuals excluding students and retired or disabled persons, so it includes potential discouraged workers. Service sector employment excludes public employees.

Businesses also replaced wage workers with self-employed workers. The textile and apparel industry grew marginally (2,500 new jobs created) but substituted half of its wage workers with self-employed workers (Figure 62, panel b, lower right quadrant). As wages increased, garment and footwear factories located outside Special Economic Zones (SEZs) might have attempted to remain competitive by reducing labor costs. More analysis on this is necessary. In contrast the electronic and electrical equipment sector, which mostly operates from within SEZs, almost exclusively created formal wage jobs, reflecting in part better access to inputs, infrastructure; proximity to borders and markets; and the provision of tax and non-tax incentives in the form of duty and tax exemptions. It may also be that those businesses comply more closely with national minimum wage regulations and international labor standards.

The service sector's average labor productivity grew, driven by a small number of high-productivity enterprises, but most businesses remain small. There are fewer than 100 service businesses with more than 100 employees, and fewer than 250 with more than 50. The average business in the sector saw its productivity increase by 17 percent per year, more than the 6.8 percent for the median business, suggesting the increase was driven by a small number of high-performing enterprises mostly in the wholesale and retail, transport and communication sectors where domestic demand increased.[31]

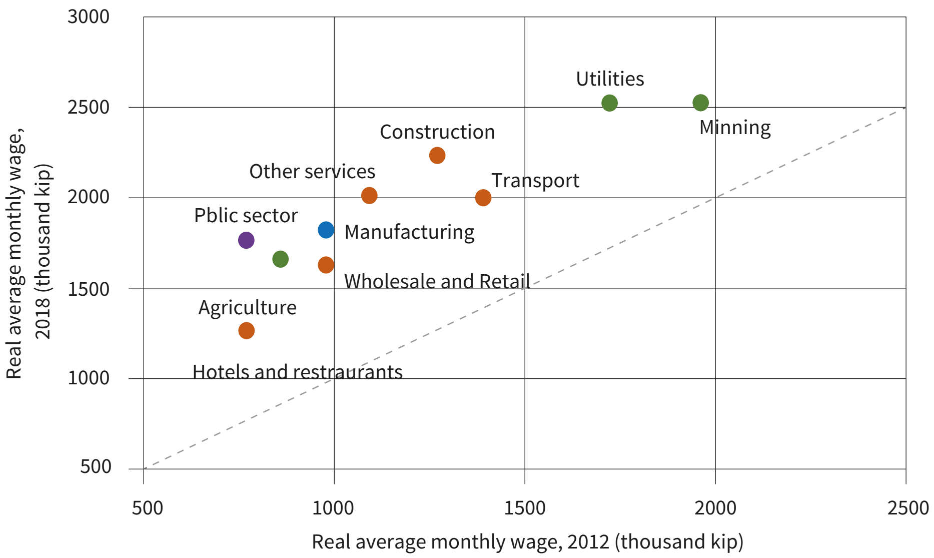
Agricultural productivity improved, albeit slowly, and remains lower than regional peers. Between 2000 and 2019, growth in the agricultural sector averaged 2.9 percent per year and was driven primarily by expansion of the land area under cultivation, rather than by productivity improvements. Only 30 percent of Lao PDR 650,000 farming households are engaged in commercial farming. The yields of some crops improved, including rice and roots and tubers, but overall productivity remains low with a value-added per hectare of $578, corresponding to 60 and 40 percent of that in Thailand and Vietnam respectively.

Overall investments in the sector remain limited, but the development of the Laos-China railway may change the dynamic, at least in the north. The share of the sector in total capital stock fell from about 15 percent in 2000 to less than 6 percent in 2017, contrasting with rising trends in regional peers. Over the period 2000-2014, only $480 of the $5,100 per capita investments in capital formation were invested in agriculture and credit to the agricultural sector is relatively low, about 8 percent of total credit, constraining productivity gains. In addition, weak enforcement of chemical and pesticide regulations constrains farmers' ability to meet quality standards and access export markets.

[31] World Bank Enterprise Surveys 2009 and 2018. The service sector includes wholesale and retail trade, hotels and restaurants, transport, storage, and communications.

Figure 62. Rising wages and labor demand in Laos, 2012-18

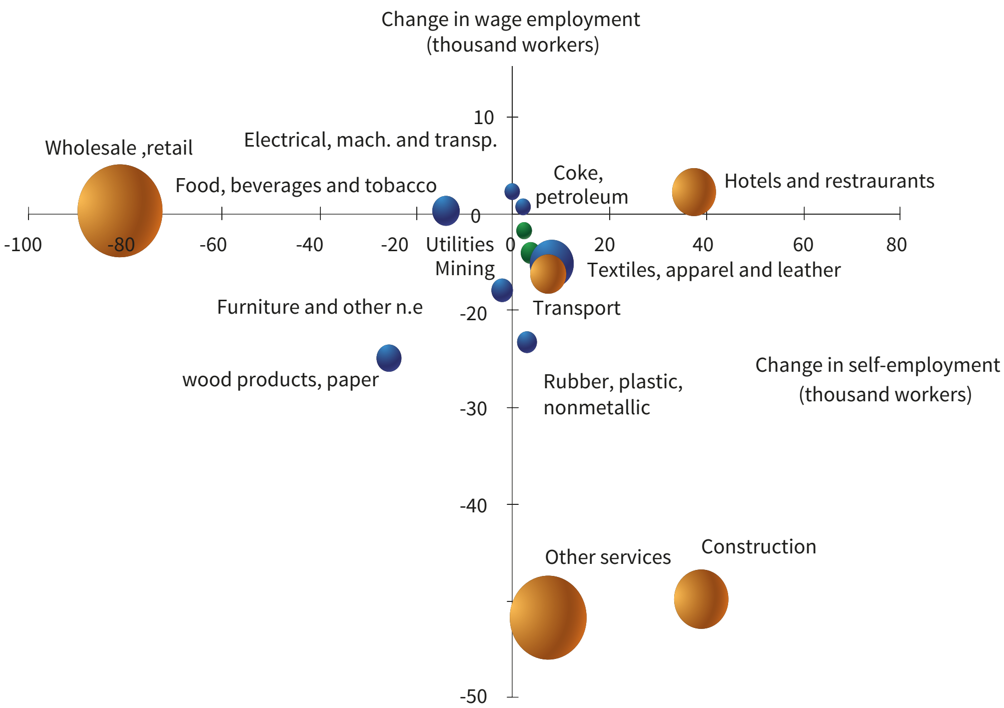
A. Change in real earnings by sectors, 2012 and 2018



Source: CEM (2022) using LECS 2012, 2018.

Note: Real wages are expressed in 2018 prices.

B. Change in wage and non-wage employment by sectors, 2012 and 2018



Source: CEM (2022) using LECS 2012, 2018. The size of the bubble is the share of the sector in total 2018 employment (wage and non-wage). For visibility the figure excludes agriculture and public sector.

The Lao PDR's resource-based growth model, combined with a complex business environment and challenging labor market conditions, did not support broad-based job growth

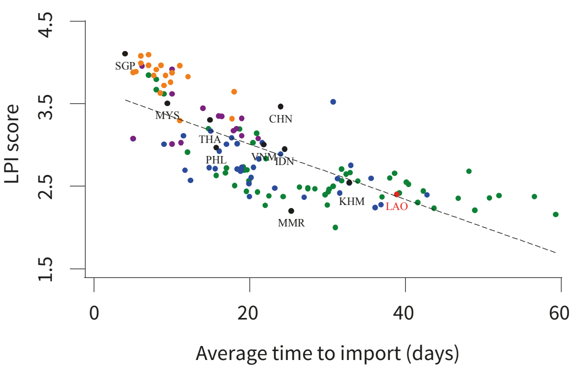
The country is more policy-locked than landlocked and the domestic business environment remains unpredictable and restrictive. Despite strong political commitment, the implementation of trade and business reforms remains slow. While it has recently become easier to start a business and to secure construction permits, Lao PDR still ranked in 154th place of 190 countries in the 2020 World Bank Group Doing Business Index, with a score of 50.8 out of 100. Burdensome administrative requirements are the biggest hindrances to competitiveness, placing Lao PDR at 139th among 141 countries in this specific area in the 2019 Global Competitiveness Index. The other major obstacles include weak institutions and macroeconomic instability. Regulatory frameworks to promote corporate governance and mitigate conflicts of interest are inadequate. Meanwhile, macroeconomic stability has deteriorated in recent years, aggravating risks and uncertainties faced by Lao businesses.

Regulatory complexity and discretion discourage new enterprises from entering and have led to the prevalence of informal business practices. More than half of informal businesses choose to remain informal to avoid the cost and difficulty of registration. Those that register do so to increase their access to finance, inputs and customers. Even among registered businesses informal practices are prevalent. Those that follow the rules incur higher costs and feel at a disadvantage compared to competitors that do not. In 2018, 17 percent of business managers cited informal practices of competitors as the biggest constraint on their business operations (2018 World Bank Enterprise Survey).

More than new reforms, it is important to ensure that existing reforms are fully implemented. In Lao PDR, there is too often a gap between the letter of reform measures and their implementation. For example, considering the time to clear exports through customs, a comparison of the data from the Ease of Doing Business survey (which show the time the process should take) and from the World Bank Enterprise Survey (which show the time it actually takes, as reported by entrepreneurs) shows that while Lao PDR performs relatively well in terms of the de jure requirements compared to other East Asian countries and even to middle-income peers, in practice there is much larger variability in implementation than in high income or efficient export-oriented peers such as Thailand (Figure 63).

Fig 63. GVCs thrive on predictable business environments

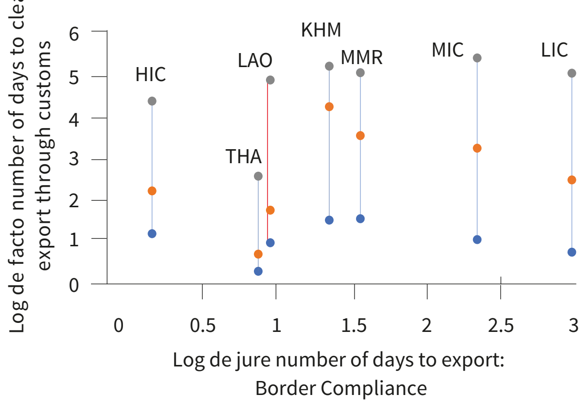
A. Logistics and connectivity matter for manufacturing GVC integration



Source: CEM (2022) using WEF and WDI data and WDR2020 GVC taxonomy.

Note: LPI score is the overall score. The index varies from 1= extremely poor to 5= extremely good.

B. And consistent policy implementation



Source: CEM (2022) using Enterprise Survey data latest available year (2018 for Laos, 2016 for Thailand, Cambodia and Myanmar). Doing business indicator data latest available year.

Note: Figure plots the 10th percentile, median, and 90th percentile de facto log policy implementation time in a given country-year reported by entrepreneurs surveyed by the World Bank Enterprise Surveys against the amount of time it should take according to the DB.

Educational attainment has improved over the past decade, but skills shortages remain a key constraint for firms and exporters. Between 2008 and 2018, the gross enrollment ratio increased from 54 percent to 77 percent for lower secondary education; from 34 percent to 54 percent for upper secondary education and from 44 percent to 67 percent for tertiary education. Still, Lao PDR lags behind its regional peers, including Myanmar, Cambodia, Vietnam, and Thailand, making it less attractive for FDI and reducing the competitiveness of Lao exporters. In 2018, 22 percent of Lao exporters cited an inadequately educated workforce as the most significant constraint on their business operations, compared to 10 percent of domestic firms.

The undersupply of both unskilled and skilled workers reflects the ease with which workers can migrate to Thailand to seek better-paid jobs. Between 200,000 and 300,000 Lao nationals are estimated to currently work in Thailand, although the number could be higher since accurate measurement is difficult (IOM, 2019). Most are employed in domestic work, construction, manufacturing, agriculture, and entertainment work, mainly in neighboring border provinces and larger cities. Wages in Thailand are much higher than in Lao PDR, even for the least skilled workers, such as agricultural day laborers. The minimum wage in Thailand is about 350 baht per day (equivalent to $9.3/day or 150,000 kip per day at the current exchange rate), more than three times the rate in Lao PDR.

The attractiveness of Thai wages is even greater given the depreciation of the Lao kip and higher cost of living in Lao PDR. Lao PDR's prices are inflated in part due to the high transportation costs resulting from its landlocked position. High dependence on imported goods and the recent rapid depreciation of the Lao kip has also driven prices higher. This has widened the real wage gap between Thailand and Lao PDR, making migrating and seeking jobs in Thailand more attractive.

Working conditions also discourage workers. Long working days and mandatory overtime are common in garment factories, often for untrained rural female workers, and many workers regard factory work as an interim strategy to build savings before they establish their own small business or find a better job elsewhere (World Bank, 2012). The high staff turnover rate (estimated at between 3.5 and 6 percent per month) in turn contributes to low-capacity utilization and low employer investment in workforce skills and training, both with a negative impact on productivity.

International trade can contribute to economic growth and job creation through both imports which can compete with local production and exports which can increase local labor demand

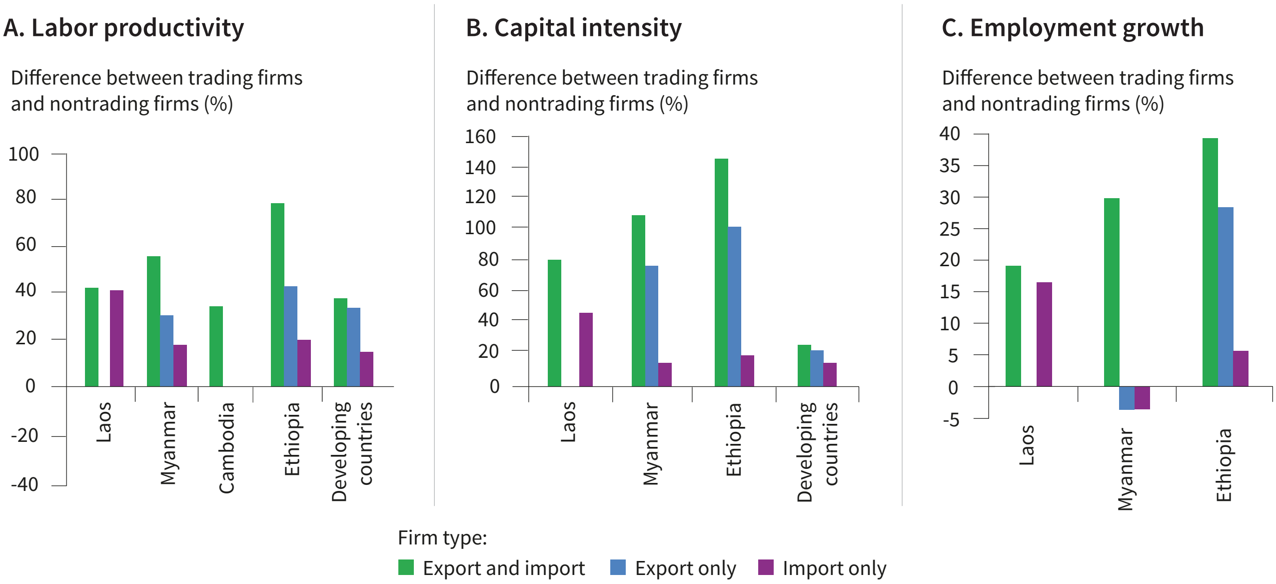
In East Asia especially, trade has been associated with very rapid economic growth. Recent empirical evidence shows that when developing countries participate in GVCs, this can accelerate inclusive growth. The businesses that participate in GVCs do not need to produce an entire product. Instead, they specialize in the production of simpler parts which enable them to exploit their comparative advantage. The fragmentation of production makes it possible for even small businesses to enter foreign markets at relatively low cost.

GVC trade is a more powerful force than traditional trade in terms of supporting growth and poverty reduction (WDR, 2020). The world market offers firms an opportunity to sell larger amounts and take advantage of economies of scale. Access to global inputs can help improve products and production processes that can make firms more productive, and higher productivity leads to growth and job creation. Exposure to foreign markets, through both imports and exports, also brings in new ideas for products and production processes that can also increase domestic productivity. And competition from foreign markets also imposes discipline on domestic firms and generates incentives to become more efficient. In turn, this boosts domestic income and employment, even when exports have lower domestic content.

Firms in manufacturing GVCs tend to be more productive, capital intensive and employ more workers. Even though production is becoming more capital-intensive and less job-intensive, firms that participate in manufacturing GVCs have higher levels of productivity, which allows them to expand output. This scale effect more than offsets the negative effect of using labor-saving technologies for production. In net, manufacturing GVCs create more jobs.

This holds true for Lao PDR. Controlling for capital, GVC firms engaged in manufacturing record higher levels of labor productivity than businesses that do not trade, by about 40 percent (Figure 64). They are also more capital-intensive and hire more workers than non-trading firms appear to do. On average, two-way traders utilize 80 percent more capital per worker than non-trading firms, with a 102 percent difference for export-only firms and a 19 percent difference for import-only firms. In addition, two-way traders increased their labor force at a rate 19 percent faster than non-trading businesses.

Figure 64. Firms that export and import are more productive, capital intensive and create more jobs



Source: CEM (2022) using WDR 2020 and World Bank's Enterprise Surveys data for Laos (2018), Myanmar (2016) see Jaud et al., (2020).

Results for Cambodia from Cambodia Economic Update 2020, for Ethiopia from Choi, Fukase, and Zeufack (2019) and from WDR2020 for the 81 developing countries.

Note: Labor productivity is log sales per worker, Capital intensity is log K per worker. Employment growth is the delta log N employee within firm. For Laos, GVC and exporters only are combined due to the lack of observations for GVC firms in the WB enterprise survey data. Lack of observations precludes including results for Laos for exporters only.

Lao PDR is mostly integrated in commodity global value chains, although its participation in light manufacturing other than garments has recently increased with some wage job creation

Lao PDR trade has grown at a fast pace over the past decade, but there is strong potential for further growth. Merchandise exports in proportion to GDP increased from 19 percent in 2013 to 31.5 percent in 2019. Imports grew from 25.5 percent to 34 percent over the same period. Service exports and imports both decreased to 5 and 6 percent of GDP respectively in 2018, although the services balance improved in absolute terms. Lao PDR still lags its comparators in terms of exports per capita. In 2019, Vietnam generated nearly $2,700 of exports per capita pre-COVID-19, more than three times the amount recorded in Lao PDR. In Cambodia that figure is at $1,200. Lao PDR's export base also remains smaller and more concentrated compared to regional comparators, with only 928 products exported in 2018, roughly the same number as ten years ago, and considerably less than the 3,793 products exported by Vietnam.

Lao PDR is not a typical landlocked country, with high transport costs. It is strategically located among major global economies, creating opportunities for trade. Lao PDR's five neighbors account for more than 17 percent of global GDP and over a fifth of the world's population. Most have developed, open economies, with booming markets, a high demand for labor and goods, and a high level of integration in global value chains, both as participants and leaders. Lao PDR can benefit from a strong demand for its exports, and from cheap sources of imports. These countries are also a source of FDI and opportunities for deeper integration into GVCs. These can help to pull Lao PDR's growth and to diversify its economy away from mining and hydropower. Indeed, Lao PDR is already reaping some of these benefits, particularly in its textile/garments and electrical equipment sectors.

Lao PDR can also benefit from the efficient trading infrastructure and services of its large, export-oriented neighbors. This partially compensates for its own less efficient trading systems. In addition, Lao PDR is unlikely to suffer detrimental effects associated with foregoing competitive sources of imports under regional trade agreement — the so-called trade diversion from participation in a preferential trade agreement (PTA). As its PTA partners are already some of the most efficient and low-cost producers in the world, Lao PDR experience only trade creation.

Lao PDR has mostly participated mostly in regional commodity GVCs. This is the export of natural resource-related products, power generation, copper ore, rubber and raw agricultural commodities that serve as inputs for other countries' exports. This reflects its endowment in natural resources as well as its location. However, its small domestic labor market, high labor and transportation costs, and often opaque and cumbersome regulations put it at a competitive disadvantage in terms of participation in light manufacturing GVCs. In 2019, Lao PDR's largest markets were Thailand (36 percent of all merchandise exports) consisting of energy (60 percent); copper products (16 percent); and electronics and electrical components (15 percent). China comes second (28 percent) dominated by copper ores and articles (33 percent), wood pulp and rubber (26 percent) and agricultural and food products (20 percent). Vietnam mostly imports foodstuff and agricultural produce (58 percent), rubber (11.3 percent) and some electrical energy (10.5 percent) and processed timber (5.3 percent).

Since 2013, exports have increasingly diversified, largely due to foreign investment in light manufacturing, primarily in electronics and electrical components. Thai-based Japanese investment has driven exports of electronics and electrical equipment, primarily video displays, recording and broadcasting accessories, more than 10 percent of goods exports in 2019 and up from 1 percent in 2013. Thai investments supported food and beverage exports which account for 10.4 percent of exports in 2019 against 5.8 percent in 2013. The garment sector has also shown a high degree of resilience, maintaining stable export volumes, mostly through the Generalized System of Preferences to the EU and Japanese markets. This shows the potential of these markets if constraints on the domestic environment and labor markets were eased.

Preliminary evidence suggests that these foreign investments in export-oriented manufacturing SEZs were associated with local economic development and job creation. Areas close to SEZs with a high share of export-oriented manufacturing and close to the Thai border experienced a greater increase in economic activity, as evidenced by the increase in night-light intensity between 2003 and 2020 (Figure 65). And between 2012 and 2018, the electrical, machinery and transportation equipment sector was one of the three manufacturing sectors that recorded net positive job creation, albeit on a limited scale.

While the evidence suggests that at least some SEZs have been successful, there is a need for a more careful evaluation of their impact on employment, productivity, and exports. In Lao PDR, anecdotal evidence suggests that not all SEZs have successfully driven job creation for the local population, particularly given the high proportion of foreign workers they employ. In 2018, of the roughly 20,000 workers employed in Lao PDR's 12 SEZs, close to 55 percent were foreign workers. If the government is to continue with its policies to leverage SEZs to drive export diversification and job creation, it is important to know what works and what does not and prioritize investment, particularly when fiscal space is tight.

Successful SEZs are those that can leverage the comparative advantages sought by investors, such as location, labor cost, skills and infrastructure, but also that display the good management and flexibility needed to adapt to an industry's needs. SEZs are often established to jumpstart manufacturing production and exports when getting the conditions right on a national scale to attract FDI is costly and takes time. However, evidence for their success is mixed (Farole, 2011). Even highly successful, labor-intensive SEZs in Bangladesh and Vietnam accounted for only 5 percent and 19 percent of national employment respectively in 2014, with backward linkages to the rest of the country generally remaining weak.

Expanding agricultural and food exports can also make a substantial contribution to poverty reduction. Between 2012 and 2018, poverty declined more rapidly in Lao farming households close to borders in the north and south. Expanding agricultural commercialization and cross-border trade would help secure jobs and formalize employment in the sector while raising productivity through capital deepening. However, constraints on production limit the scale and ability of farmers to join supply value chains.

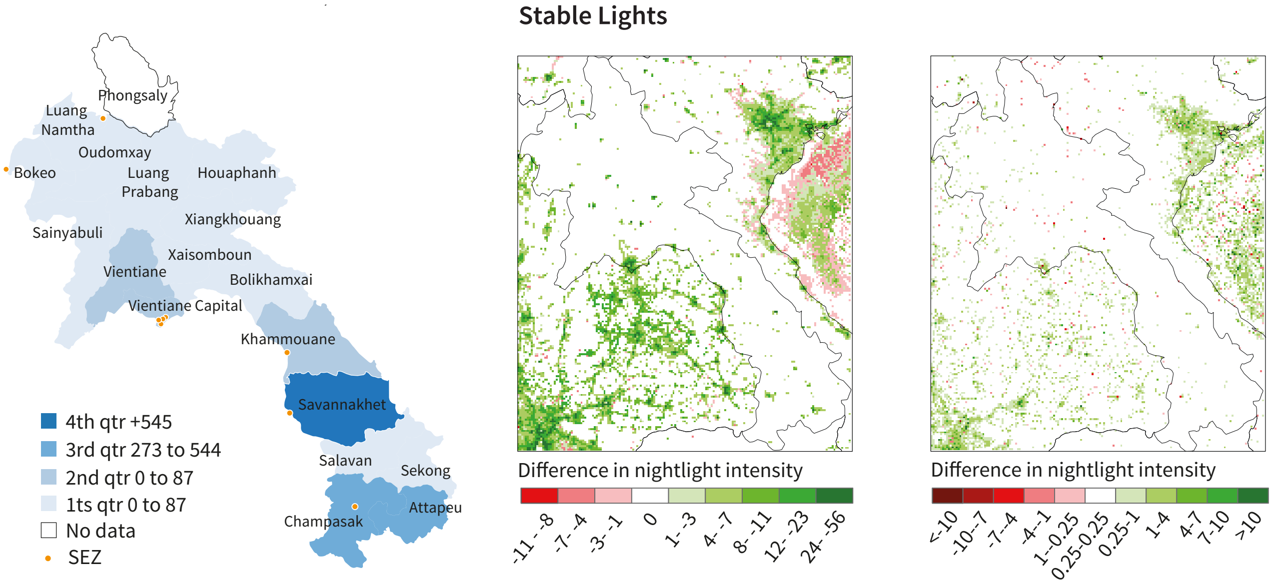
The development of new highways and the Lao-China railway should create opportunities for cross-border trade and linking the more isolated rural areas with industrial agglomerations and nearby international markets. For this to take place, constraints in logistics infrastructure and services need to be addressed to ensure that trade development along those corridors results in greater spread of economic activity and inland rural development.

Figure 65. Economic development linked to export-oriented manufacturing FDI, 2003-20

A. Total FDI in manufacturing since 2003, million USD

B. 2013-2003 Difference, DSMP-OLS F18 & F15 Stable Lights

C. 2020-2014 Difference, VIIRS vcmslcfg



Source: CEM (2022) using fDi Markets. 2003 and 2013 data from the DMSP-OLS F15 Stable Lights Cloud Free; 2014 and 2020: VIIRS vcm annualized. Image and data processing by Earth Observation Group, Payne Institute for Public Policy, Colorado School of Mines. DMSP data collected by US Air Force Weather Agency.

Note: Spots colored from green to red mark night lights of increasing intensity. A change in the satellite in 2013, makes the comparison of maps and scales between 2003-2013 and 2014-2020 non-comparable. The seemingly brighter map for the period 2003-2013 is a result of this change.

4. Policies to Spread the Labor Market Gains from Exports

Lao PDR could spread the labor market gains from exports more widely by focusing on (1) boosting and connecting exports to markets and people; (2) diversifying exports by eliminating distortions in production; and (3) better preparing the workforce by investing in their education and skills.

Policies to Boost and Connect Exports

Remove trade barriers and invest in infrastructure to increase the scale of exports. Measures to achieve this include:

- **Continue to simplify the tariff structure.** Eliminating nuisance tariffs, tariff so low that it costs the government more to collect it than the revenue it generates, would help simplify trade procedures and reduce the cost burden of implementing the tariff policy.

- **Implement fully paperless trade systems.** Implementing cross-border paperless trade is a top priority to reduce time consuming manual transactions, reduce trade transaction costs, increase trade volumes and in turn support the country's competitiveness in regional and global markets. Lao PDR has currently three systems for the submission, processing and clearance of trade-related information by government agencies, as well as payment of the relevant fees and taxes electronically. However, implementation of a fully paperless processing environment and the introduction of pre-arrival processing of declarations is slow due to a combination of internal inertia, lack of capacity, and budget constraints. Moreover, global experience strongly suggests that improvements in trade facilitation, achieved through more efficient targeting of high-risk cargo, results in increased revenue collection performance.

- **Enhance border management by targeting border controls on high-risk trade.** Introducing an integrated border risk management framework would allow Customs, cross-border agencies, and traders to electronically submit and exchange data and documentation and allow agencies to better target high risk cargo while facilitating low risk shipments. This would increase the efficiency and effectiveness of border procedures and help expedite the clearance of imports, exports and transits while ensuring community protection requirements and revenue collection objectives are met. However, border agencies still lack a sound process for inter-agency collaboration and integrated risk management as well as standard operating procedures to guide joint cargo inspection activities.

- **Streamline non-tariff measures to support exports.** Import tariffs have been reduced, but non-tariff measures (NTMs) remain highly prevalent. Almost all imported products are covered by at least one measure, often unrelated to product safety. Such NTMs act as export restrictions or quantity/price control measures. Improved transparency, harmonization, and mutual recognition of NTMs among trading partners would facilitate imports of key inputs, especially for manufacturing and agriculture (including seeds and fertilizer) and thus support exports from these sectors. Assisting businesses to comply with such standards would improve their access to larger higher-end markets and enhance their performance.

- **Improve domestic and regional connectivity to augment market size and to facilitate labor mobility.** Logistics and connectivity matter for manufacturing GVC integration. However, in Lao PDR organizing supply chains remains more costly and time consuming than in Thailand or Vietnam. There is room to improve infrastructure connectivity at both the domestic and regional levels. The challenge is not only to connect Lao PDR to the dynamic markets in China, Thailand and overseas, but also to connect remote areas within Lao PDR to trade corridors (World Bank, 2020a). It will be important to link local and remote areas with industrial agglomerations and nearby international markets. This requires a coherent approach to reduce bottlenecks in logistics infrastructure including by promoting investments to close the remaining infrastructure gaps, attracting foreign investment to modernize the local transport and logistics industry and to increase competition, and improving road connectivity, particularly along the National Road 2 corridor (through the development of access roads to major agriculture production areas). These investments will complement policy reforms to achieve seamless cross-border transit, and improved logistics and value chains.

Policies To Diversify into Labor-Intensive Exports

Remove policy-induced distortions that limit the efficient allocation of labor, capital, and land to enable more-productive firms both domestic and foreign to grow and create formal jobs. Measures to achieve this include:

- **Improve business registration processes and the operating licensing regime.** Firm registration procedures and operating licensing requirements are onerous in terms of cost and time which discourage formalization and limit firms growth. The current enterprise registration process is still largely manual-based and despite some recent improvement still requires significant documentary preparation, physical flows of documentary review, and decision making. The same holds true for obtaining operating licenses. Implementing an electronic business registration system and streamlining the licensing regime would facilitate entry and expansion of both domestic and foreign firms, which would in turn contribute to improving productivity and economic growth. The enterprise law that is currently being revised should include provisions allowing the move to digital business and operating licenses registration. Streamlining regulations to ensure transparency and consistency in the tax systems would also help curb informal practices.

- **Simplify and reduce entry conditions to attract foreign investment.** Attracting foreign direct investment requires an open, transparent, and dependable investment climate. The 2017 revision of the Law on Investment Promotion simplified entry conditions but re-introduced investment licenses requiring pre-screening for business activities included in a long ‘controlled business list’. Foreign investors still face stringent requirements including screening, limited ownership equity, and high minimum levels of capital. Adopting a more transparent regulatory framework, with clear information regarding the required steps and procedures would accelerate investment processes and help prevent regulatory capture. Implementing the 'one-stop-service' for investments established under the Investment Promotion Authority would provide adequate services for obtaining operating licenses. Investors also need protection of intellectual property rights and contract enforcement to reduce risks related to their investment.

- **Revise the law on investment promotion to curb tax incentives and exemptions.** Tax exemptions are widely used in Lao PDR to attract investment, supported by the Law on Investment Promotion 2009 and 2017. However, international evidence shows that tax incentives do little to encourage foreign investment. Some of the sectors which have benefited most from tax exemptions (hydropower and mining) are in Lao PDR for specific technical reasons. Replacing the current profit-based tax incentive system (based on tax holidays and reduced rates) by a cost-based tax incentive system (based on accelerated depreciation and additional tax deductions) would better link incentives to investment. In addition, it would be important to improve the monitoring of tax exemptions (through a more detailed tax return form) and undertake an assessment of the largest concession agreements (to estimate foregone revenues).

- **Facilitate links between SEZs and the domestic economy.** Enabling domestic businesses to compete with foreign entrants, as well as gain knowledge through imitation and learning would help raise their productivity and competitiveness. Ensuring that SEZs regulations do not discriminate against local supplier relationships would also support local employment. Facilitating worker movements from foreign to local businesses would encourage the dissemination of knowledge and skills, with positive impacts on productivity. Foreign companies could also help domestic businesses in the form of training; assistance with setting up production lines; management coaching, quality control and similar measures This would also help incentivize entrepreneurship and innovation. Taken together these measures would also ensure SEZs spearhead rather than substitute for broader business climate reforms.

Policies to Raise Skills of the Labor Force

Invest in skills and ensure a well-functioning labor market to prepare the workforce to handle the complexities of globalized production systems and in turn contribute to more inclusive growth.

- **Invest in human capital to stimulate economic diversification.** The most effective way to address the competitiveness challenges facing a country with low levels of human capital is to focus on basic education and to partner with the private sector to build industry-specific skills. To support firm productivity growth, it is crucial to expand access to education particularly in remote areas, increase enrolment rates so that secondary education completion becomes the norm, reform curricula to better align skills with the demands of the private sector, and upgrade the quality of teaching. Employers rarely recruit personnel from technical and vocational education training institutes. The matching and intermediation services are still largely undeveloped and would need to be built up to increase productivity and to incentivize businesses to recruit domestic workers. These services should be customized for vulnerable groups such as women and young people. Vocational training programs can also address skills shortages and mismatches if aligned with private sector needs and implemented on a sufficiently large scale. Lead global firms and those in industries that have good potential to contribute to employment creation should be involved. Building the stock of human capital will require more and better public spending, which may entail a rebalancing from the prevalent focus on physical capital.

- **Promoting skill retraining and geographically targeted-employment incentives.** Introducing youth internships and employment incentives such as tax allowances or wage subsidies could play a positive role in introducing target groups such as youth into the labor market, while also assisting enterprises to recover their productive capacity as rapidly as possible following the pandemic. This could support employment creation in areas with limited jobs and facilitate labor mobility to improve job matching.

- **Strengthening labor laws and their enforcement.** Measures to improve the protection of workers and the bargaining power of low-wage workers are important to ensure that vulnerable workers are protected, and their remuneration is commensurate with their contribution without jeopardizing business competitiveness.

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The World Bank Lao PDR Country Office,
East Asia and Pacific Region
Xieng Ngeun Village, Chao Fa Ngum Road,
Chantabouly District, Vientiane, Lao PDR
Tel: (856-21) 266 200
Fax: (202) 266 299
www.worldbank.org/lao

The World Bank
1818 H Street, NW Washington, D.C.
20433, USA
Tel: (202) 4731000
Fax: (202) 4776391

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