Managing Macroeconomic Balances to Sustain High Economic Growth

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LAO PDR RECENT ECONOMIC DEVELOPMENTS

SPECIAL POINTS OF INTEREST:

- **Strong economic performance in 2010.**
- **Rising food prices putting pressures on inflation.**
- **Decline in net foreign assets and international reserves posing macroeconomic risks.**

Lao PDR Economic Monitor - SEPTEMBER 2010 UPDATE is issued in Lao and English by the World Bank Office in Lao PDR. This update reports mainly on recent economic developments and medium-term outlook for the country. The paper was prepared by Somneuk Davading (Country Economist) and Keomanivone Phimmahasay (Research Analyst) under the overall supervision of Genevieve Boyreau (Senior Country Economist) and Mathew Verghis (Lead Economist). We are grateful to the Government for providing inputs. We would like to thank our World Bank colleagues: Vattana Singharaj, Boualamphan Phouthavisouk, Thalavanh Vongsonephet and other staff for designs, printing and dissemination of the Monitor.

"THE WORLD BANK TEAM APPRECIATES FEEDBACK ON STRUCTURE AND CONTENT OF THE MONITOR"

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GROWTH AND INFLATION

Lao PDR economic growth continues to be strong in 2010, against the backdrop of a fragile global recovery yet dynamic regional demand. Growth is projected at 8.5 percent in 2010, from 7.5 percent in 2009 — see Figure 1. The resources sector is projected to contribute about 4 percentage points of economic growth, of which electricity, water and gas about 3.2 percentage points. This increment is largely due to the start of NT2 operations (about 8 months of production this year), contributing 3 percentage points or $160 million, mining - mostly copper and gold – contributes about 0.8 percentage points, with a higher than anticipated extraction (especially copper: around 16 percent increase for Phubia (or to about 63,000 tons this year from 54,000 tons in 2009) and 4 percent for Sepon (or to 70,000 tons in 2010 from 67,000 tons in 2009; but with recent expansion Sepon’s copper output will rise by 14 percent in 2011 (or about 80,000 tons).

The non-resource sector is performing well in 2010, although agriculture may under-perform following weather shocks. In the non resource sectors, manufacturing (agro-processing, food and beverages, cement and metal) and construction (continued booms in infrastructure construction – roads and bridges, housing and other trade and entertainment/tourism related facilities) have performed well this year while garments started to rebound. However, growth in agriculture (especially rice production) is expected to slow in 2010 due to early draught and recent flood in some remote provinces, although the net impact on total production this year will depend on the yield of upcoming harvest in October/November. Services (mostly trade, banking and transport services) contribute 2.5 percentage points — see Figure 2. Tourism is likely to recover this year - the total number of tourist arrivals to the country increased by 26 percent during the first half of 2010 compared to the same period of last year (most importantly the number of visitors from Europe and America together rebounded by 64 percent while from Asia and Pacific region it grew by about 22 percent).
**RISING FOOD PRICES FUELED INFLATION IN RECENT MONTHS**

After a period of deflation in 2009, the headline inflation (y-o-y) has risen notably in the past months and was at nearly 8 percent in August 2010 due to rapid increase in food prices. Food prices grew by 14 percent y-o-y in August (or contributed about 5.7 percentage points to the total inflation) and core inflation (excluding food and energy) climbed slightly by 3.4 percent (or contributed around 1.7 percentage points) caused by sustained demand for consumption goods while fuel prices increase has slowed to 6.8 percent in August from 20.3 percent in May (or contributed only 0.5 percentage points). Among key food items, rice price (mainly sticky rice) contributed 8.8 percentage points (or increased most by 49.2 percent y-o-y), vegetables about 1.3 percentage points (or grew by 11 percent y-o-y) and the rest about 3.9 percentage points to food prices in August. Imported inflation, through the depreciation of the kip vis a vis the Thai Baht of 4.6 percent over the last 12 months and Thai inflation (3.3 percent in August), also contributes to higher prices. It is nevertheless expected that rice prices are likely to drop during the harvest season from October onward (See box 1).

**Box 1: Factors driving the increase of the price of glutinous rice**

*Local rice price in Lao PDR is more influenced by seasonal changes than global trends.* Unlike Thailand and Vietnam, Lao PDR produces mainly glutinous (sticky) rice (around 85-90% of total rice outputs in the rainy season) which is mostly produced for domestic consumption. The recent surge in the price of glutinous rise may be attributed to a combination of the following factors:

*Reduced “dry-season” harvest (April) and unfavorable prospects for the 2010 main “wet-season” crop about to be harvested.* The flood (2009) and drought (2010) in Champasack and Attapeu provinces have contributed to the much less harvest of glutinous rice. According to the department of meteorology and hydrology report, late rain resulted in 14.4% less of rainfall this year compared with normal rainfalls.

*Market coordination failures,* with reported withholding of stock of paddy by traders, anticipating higher prices;

*Official and unofficial rice exportations* to Vietnam, and reportedly China, contributing to a lower domestic supply;

*Sharp increase of the benchmark Thailand export price* for the same type of rice (White Glutinous rice 10%). Volumes of glutinous rice exported by...
Thailand in the first eight months of 2010 are much smaller than last year (121 k tons, compared to 206 k tons in Jan-Aug 2009) following a reduced crop in northeast and central provinces of the country where much of the glutinous rice is produced.

The rise of domestic fuel prices affects the rice price only to a limited extent. The average diesel price of this year is 8,200 kip per liter, compared to 6,500 kip per liter in 2009, i.e. a rise of 20%. This cost push inflation is likely to be marginal, and does not affect overall rice production. In upland areas, rice production is largely for subsistence and with very minimal use of fertilizers and other inputs. In low land areas, there is little use of fertilizer and other inputs for the rainy season crop.

Rice prices are expected to drop during the harvest season from mid-October onward. Anecdotal evidence based on rapid interviews of several rice millers in Vientiane in the end of September showed that un-milled sticky rice price offered by rice traders or middlemen has decreased very recently to 3,500 kip per kg from 4,000 kip in past months (Jul-Sep) and this declining trend is expected to continue in coming months. Nonetheless, improvement of rice sector coordination and management (with regard to reserve fund, rice production, stocking and distribution management, improving value chain to raise quality and value added) is critical for the GOL in order to ensure food security and maintain food price stability in the country.

It should be emphasized that food price dynamics and impact in Lao PDR differ from other countries in 2 main ways: First, consumption is largely based on subsistence agriculture and self-sufficiency in production in most provinces. The impact of rising food prices on households will vary considerably. Some households (net producers of food) may conceivably benefit from rising prices. Households involved in small-scale subsistence farming (who buy and sell only small amounts of food) are unlikely to experience a significant impact of rising prices. Clearly, the most vulnerable groups are landless rural households (a relatively small group) and poor or near-poor urban households that depend extensively on purchased food. About 40-60 percent of food consumed by rural households are self-produced whereas in cities just about 9 percent. These groups, estimated to be around 300-400,000 people, face significant risks. Second, although rising food prices comprise a risk to nutritional outcomes, a shortage of food is probably not going to further exacerbate malnutrition in Laos. Malnutrition is a significant concern in Laos. Recent surveys have found that between 40 and 50 percent of children under 5 are stunted--i.e. they are significantly shorter than they would have been if they had consumed adequate and appropriate food, in particular during the first two years of their lives. While food shortage and food insecurity are clearly contributing factors to malnutrition, evidence from Laos and internationally suggest that other factors, including breast-feeding practices, complementary feeding practices, and high incidence of diarrhea disease are more important.
The Government is taking steps to rein in the expansionary macroeconomic policy in place during the global crisis. First, it is expected that the fiscal deficit will reduce from 6.6 percent in FY2009 to 4.8 percent of GDP in FY2010 (about 2.7 percent of GDP from off-budget spending. Quasi-fiscal off-budget operations have continued into 2010, on the basis of 2009 commitments, while government has committed to stop any new lending). The GoL’s revenue collection for the first three quarters of this fiscal year has performed well, reaching 85 percent of the annual target (largely due to higher tax and customs revenue) and overall domestic revenue to GDP ratio is expected to increase to 14.6 percent this year from 13.7 percent in FY2009. Overall public spending will increase moderately to 23.6 percent of GDP in FY2010 from 22.4 percent in FY2009 mainly due to the new inclusion of non-project grants (about 2.5 percent of GDP) into the budget from this fiscal year. Wage spending share in GDP is expected to decline to 4.6 percent in FY2010 from 5.4 percent in FY2009. This relative decline is due to an only moderate increase in the nominal wage bill (with no change in the multiplier). While still appropriate by international standards, the level of the wage bill has generally increased over the recent years (due to adjustment of real wage, increase in allowances and the number of civil servants)1. Similarly, domestically financed capital expenditure is expected to decline to 5.7 percent of GDP in FY2010 from 6.6 percent in FY2009 as a result of prudent spending policy. An important element of the Government exit strategy out of the fiscal stimulus is to allocate part of capital spending to on-budget repayment of local projects financed out of off-budget BoL loans.

1/ For an analysis of the wage bill, please see the World Bank 2010 report “Civil Service Pay and Compensation Study”.

Source: MoF and staff estimates and projections (FY11).
EXTERNAL BALANCE

The current account deficit is expected to improve to 9.6 percent of GDP in 2010 from 13.8 percent in 2009, supported by strong export performance in the resource sector. The positive impact on the current account of high export earnings in 2010 is somewhat muted by (i) increased profit repatriation from mining this year projected at $336 million, as mining exports have performed well, and higher imports in the non-resource sector. Lao exports performed well in 2010 supported by increased regional demand, the operational start of new projects, and favorable commodity prices. Exports are projected to surge by about 38 percent this year with resource exports growing at 54 percent (electricity –NT2 by 150 percent and mining 40 percent). Non-resource exports, consisting mainly of agriculture, wood products, to a lesser extent garments and other manufactured goods, have started to rebound and are projected to grow by 11 percent in 2010, driven by demand from China, Thailand and Vietnam. The total export value is expected to increase to about US$2 billion in 2010. Imports are expected to grow by 9 percent this year driven by the non-resource sector (consumer and to some extent by investment related goods). Overall, the non-resource current account balance is expected to deteriorate in 2010 to 20.8 percent of GDP. Lao PDR exports not only metals and hydro-electricity, but also other products, such as garments, wood and wood products, and -- most recently -- agricultural products and imports investment goods (machinery and equipment, construction materials, etc.), fuel, raw materials for garment industries, agriculture and processing industries, and various consumer goods.

Figure 6. Exports by Sector ($ million)

Figure 7. Commodity Prices (index 2000 = 100)

Source: GOL, trading partners and staff estimates and projections.

Figure 8. Balance of Payments, 2006-10 (percent of GDP)

Source: Lao PDR authorities (BOL) and staff estimates/projections
Meanwhile, net capital inflows are projected to decline to 8.5 percent in 2010 from 12.5 percent of GDP in 2009, following a temporary drop in investments in the hydropower sector, mostly on the account of the completion of NT2 construction in 2009, and delays in Hongsa lignite coal-fired power project construction. FDI in hydropower will rebound in 2011, with projects starting construction. By contrast, FDI in mining and non-resource sectors started to rebound this year, in line with regional trends in investment inflows. The start of NT2 operations in 2010 without new operations starting this year implies a fall of FDI in the sector by $112 million. By contrast, net FDI in mining is rebounding this year, with planned expansion of operations, and will further increase in 2011 as Phubia mine is finishing repaying its debt. FDI in the non-resource sector is expected to follow the same trend, as a response to the strong regional demand and high commodity prices.

Meanwhile, net capital inflows are expected to fall to $631 million in 2010 from $771 million in 2009, on the account of (i) lower gross inflows and increased net debt repayments.

Figure 9. Disbursement of FDI in Lao PDR, 2006-2010 (US$ millions)

Source: Lao PDR authorities (MOIC) and staff estimates

Figure 10. Nominal and Real Effective Exchange Rates

Source: IMF, BOL and staff calculation.

MONETARY SECTOR

The Government is pursuing an exchange rate policy of stabilized exchange rate regime (with an objective of ± 5 percent of fluctuations vis a vis major currencies per annum) to maintain price stability. The authorities have been promoting a stable kip to contribute to low inflation, to build people’s confidence in the national currency and lower the dollarization rate of the economy. The Lao kip exchange rate has appreciated against the US dollar but depreciated notably against Thai baht in recent months. The Lao kip appreciated by 4.5 percent against the US dollar and depreciated by 4.6 percent against the Thai baht during the past 12 months, reflecting the GoL’s attempt to balance kip exchange rate fluctuations against these two major foreign currencies. Pursuing the policy will become increasingly challenging in the context of a weakening US dollar against other major currencies and further depreciation of the kip against the baht fueling inflation in the near future.

2/ FDI inflows from China and Vietnam have been rising rapidly in recent years, rivaling Thailand’s position as Lao’s largest source of FDI. Investments from China and Vietnam have been primarily in natural resources, such as hydropower and mining. The remainder of the investment flows to projects in agriculture, manufacturing, tourism/entertainment related businesses and construction infrastructure. There are indications that FDI from China and Vietnam will surge in the coming years as the two countries vie for influence and to secure raw materials (in mining and hydro power projects)
Net foreign assets and international reserves have declined, as a result of (i) high net imports growth in the non-resource sector, (ii) lower net capital inflows, and (iii) government efforts to support a stabilized exchange rate policy. Reserve levels dropped Q-to-Q by 12.3 percent and y-o-y by 7.3 percent by June 2010 (or about US$558 million in June from US$636 m in March 2010) while net foreign assets in the banking system declined by 11.4 percent and y-o-y by 27.2 percent. It is expected that the fall in reserves and net foreign assets levels will, as a response to credit growth slowdown, tightened public spending, and sustained inflows of exports stabilize by the end of 2010, with the continued slowdown of domestic credit expansion.

Credit growth is slowing down, mostly on the account of private credit deceleration, while BoL credit is expanding at a fast pace on the basis of previous 2009 commitments. The Government’s commitment to rein in credit growth seems to pay off, with credit growth decelerating y-o-y to about 60 percent in June 2010 from 90 percent in March. Credits to private sector grew by 52.6 percent in Q2 of 2010 (a notable decline from 86.5 percent in Q1). Nevertheless, lending to local projects (by the Central Bank grew by 84.4 percent (a moderate decrease from 98.3 percent Q1). Direct credit to local projects amounted almost half of the total credit disbursement during the second quarter of 2010. Credit growth is expected to slow further by the end of this year as a combination of (i) the phasing out of committed quasi-fiscal activities, (ii) a policy response to the decline in net foreign assets of the banking system and rising inflation; and (iii) tightened liquidity with banking sector’s loan to deposit ratio climbed to 76 percent by Q2.
of 2010. Monetary growth slowed during the first six months of 2010. Broad money (M2) growth slowed y-o-y to 26 percent by Q2 of 2010 from 28 percent in Q1 and 31 percent in end-2009. At the same time, total deposits grew y-o-y by 25.9 percent in Q2 of 2010 (compared to 29.7 percent in Q1). Demand for kip saving and time deposit doubled to LAK4,013 billion (USD487 million) yoy in June 2010 reflecting the increased confidence in the public in kip monetary holdings. Foreign currency deposits increased by a more moderate rate of 17 percent y-o-y over the same period (up to USD921 million). The dollarization rate (defined as the ratio of foreign currency deposits in banks over broad money) was 46 percent in June 2010 and has been on a decline trend over the last few years.

The credit deceleration is welcome, against the backdrop of relatively weak banking supervision. Total lending as percent of GDP amounted 21 percent of GDP in December 2009 while reported non-performing loans (NPL) dropped from approximately 10 percent at the end 2006, to approximately 3.7 percent in June 2010. In the context of rapid credit growth, it is not clear however whether these NPL reductions are coming from an improvement in the loan portfolios of banks or from a mechanic impact from new loans expansion. There are also concerns over the accuracy of NPLs measurement and the use of internationals standards. These risks are highlighted by a history of a lack of appropriate capacity for screening of borrowers. It will be important in the future to strengthen banking supervision and improve credit screening capacity in banks to prevent potential risks of defaulting in the banking sector.

Another encouraging development is the continuous decline in interest rate spreads. The spread in Kip reduced from 7.82 percent in 2008 to 5.14 percent in 2009 and 5 percent by mid-2010 compared to USD which declined from 7.56 percent to 5.33 percent in the last quarter of 2009. Lending rates in kip for the tenor of 1 year is 14.36 percent which is significantly higher than in US dollar of 8.54 percent, while 1 year deposit rates are 9.22 percent and 3.21 percent respectively.