

## Resource revenues underpin healthy long-term economic growth prospects

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Lao PDR, bordered by China, Vietnam, Cambodia, Thailand and Myanmar, is roughly 237,000 sq km in size. It has an estimated population of 6 mn, expanding at an average rate of 2.2% pa between 2000-2006, one of the highest in Southeast Asia. The population is relatively young, with 40% in the 0-14 year age group. Per capita income has risen substantially in recent years and was estimated at US\$656 in 2007 compared with just US\$329 in 2000. Over the past seven years, growth in per capita GDP has averaged 10.6% per year, a similar rate of expansion when compared with Vietnam of 10.8% per year and Cambodia of 11.1% per annum. Laos became a member of ASEAN in July 1997 and is working towards obtaining membership to the World Trade Organisation (WTO) by 2010.

## Comparative data, 2006

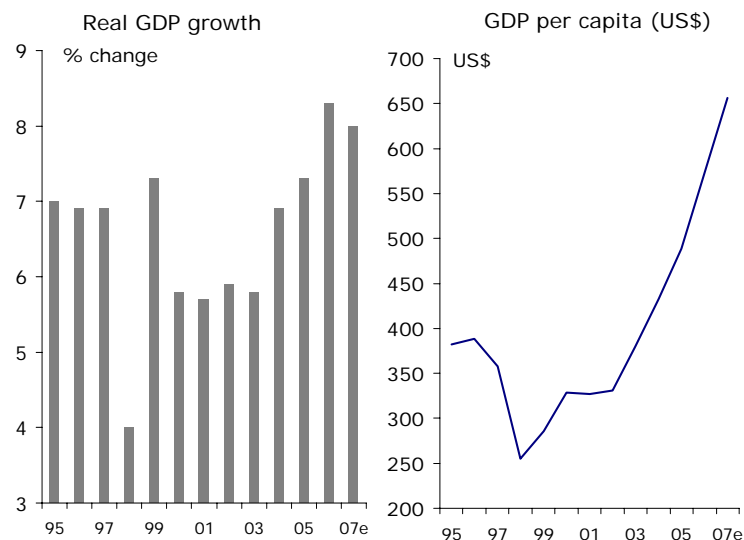
	Est. Pop. (mn)	Pop. growth 2000-06 (per yr) (%)	Pop age composition 0-14 yrs (%)	Per capita income <sup>+</sup> (US\$)
Lao PDR	6	2.2	40	656
Cambodia	14.2	1.8	37	600
China	1,315	0.6	21	2,461
Indonesia	222	1.3	28	1,925
Philippines	87	2.2	35	1,625
Vietnam	84.4	1.4	29	818

+: 2007 estimate

Sources: World Bank, International Monetary Fund

In this report, we provide a brief economic background and highlight some opportunities and challenges ahead for the economy. Economic growth has accelerated in recent years, to average 6.5% per year since 2000. The medium-term outlook is positive, boosted by the development of hydropower projects as well as its rich minerals resource base. Tourism is also an important contributor to growth and employment.

## Economy gains momentum



Sources: Asian Development Bank, International Monetary Fund

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## Economy powers ahead

Since 1986 when the government began to liberalise trade and investment, the economy has expanded by an average annual rate of 5.9% per year. More significantly, gross fixed capital formation as a share of GDP has jumped from just 6.9% in 1986 to 30.7% in 2006 according to UN data, laying the groundwork for the economy to generate a much stronger growth trajectory over the medium term. The healthy pick-up in economic momentum has lifted per capita income levels and helped alleviate poverty. Per capita income has caught up to Cambodia but is some 25% lower than Vietnam's.

In its sixth Socio-economic Development Plan 2006-2010, the government aims for the economy to expand by 7.5-8% pa with agriculture & forestry rising by 3-3.4%; industry by 13-14% and services by 7.5-8%. Real GDP rose by 8.3% in 2006 and estimates indicate that it grew by a healthy 8% in 2007. This compares well against the ASEAN average of 6.2% but remains below growth rates achieved by neighbours such as Vietnam and Cambodia of 8.5% and 9.5% respectively in 2007. While not immune to the slowdown in global growth, the outlook for 2008 is for another year of healthy growth with real GDP forecast to expand by around 7.7% according to the Asian Development Bank.

Agriculture dominates the economy, constituting 43% of GDP and close to 80% of the population are involved in this sector. Agriculture consists largely of subsistence farming, with rice being the staple crop. Development of commercial agriculture has, thus far, been impeded by the lack of equipment and infrastructure. There has, however, been investment in rubber tree and sugar plantations.

Share of GDP, 2006

Industry	Agriculture	Industry	Services
Lao PDR	42.7	32.0	25.3
Cambodia	29.6	30.2	40.2
Vietnam	18.7	41.0	40.3

Source: Asian Development Bank

The main growth potential for the Lao economy is industry, particularly the production of hydropower as well as gold and copper mining. The liberalisation of foreign investment, backed by the move towards a market economy, has seen large-scale investment, particularly in hydroelectricity generation. Laos aims to capitalise on its abundant rainfall, the Mekong river and its tributaries, to become the "battery of the region", having an energy generation capacity of 30,000 megawatts by 2020. Currently, it has a combined installation capacity of about 670 megawatts from 11 major and 40 medium-sized hydropower projects. A number of developments are underway including the Thai-backed Nam Theun 2, a US\$1.5 bn, 1,070 megawatt project that is scheduled for completion by end-2009. About 95% will be exported to Thailand, which would generate earnings for Laos of almost

US\$2 bn over 25 years. There are also several other Thai, Chinese and Vietnam-sponsored hydropower projects.

Laos is also rich in minerals such as gold, copper and gems. With commodity prices having accelerated sharply over recent years and expected to remain at elevated levels, although likely to soften in response to the current downturn in global economic growth, investment interest in exploration and extraction is expected to grow further.

The Lao Ministry of Trade and Industry data show that foreign investment has reached a cumulative US\$6 bn. Thailand was the main investor, putting US\$1.4 bn in 169 projects, followed by China with US\$1.14 bn in 237 projects and Vietnam with 120 projects worth US\$535 mn.

Hydroelectric and mining projects, however, tend to be more capital-intensive and less labour intensive although mining companies are employing a large number of people from the areas surrounding mine sites and local subcontractors. The government aims to set up Special Economic Zones to attract manufacturing investment in an effort to generate jobs and diversify the export base. Wages are competitive with the annual salary of a factory worker about 3.8 times lower than in China, based on estimates for wages in 2006.

### Low labour costs

Factory worker	Annual salary US\$ (2006)
Malaysia	3,910
Philippines	3,721
Thailand	3,686
China	2,795
Indonesia	2,793
India	2,728
Vietnam	1,109
Lao PDR	700-750

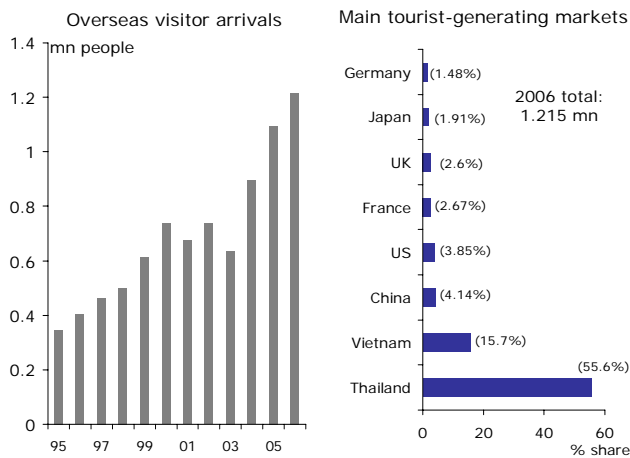
Source: International Monetary Fund

Within the manufacturing sector, the garment industry dominates. It is an important source of foreign exchange along with hydropower and tourism. It is, however, a tough market to compete in given large-scale manufacturing facilities in the region. This is compounded by the need to import raw materials and high transport costs. Nevertheless, the value of clothing exports has ticked up over the years. The outlook for the industry, however, is less favourable this year with US consumer demand expected to moderate.

Within the services sector, tourism-related industries also stand to make a more significant contribution to economic activity as they benefit from strong overseas visitor arrivals. Data shows that during January-September 2007, Vientiane welcomed 545,291 visitors, up 11% from a year earlier. The key tourist destination, Luang Prabang, saw a 32% YOY increase in the number of arrivals to 36,981 during January to October 2007. The Lao

National Administration of Tourism has projected 1.4 mn tourist arrivals this year, a significant increase from just over 600,000 in 2003.

**Strong outlook for tourism**



Sources: National Tourism Authority of Lao PDR; National Statistics Centre, Lao PDR

There are, however, several challenges ahead. By a number of economic and business surveys, Lao PDR has some catch-up to do in terms of lifting income, health and education standards and business conditions. Against the United Nations Development Programme’s Human Development Index 2007/08 (based on 2005 data), which is a comparative measure of life expectancy, literacy, education and the standard of living, Lao is ranked 130 out of 177, between Solomon Islands (129) and Cambodia (131). This ranking is a substantial improvement from 143 recorded in 2002 (based on 2000 data) but is still a relatively weak reading. Youth literacy rates are low with only around 79% of the population aged 15-24 years being literate compared with 98% for East Asia and the Pacific. Life expectancy at birth is just 62 years against 67 years for countries ranked within the “medium human development” group in which Laos is classified within.

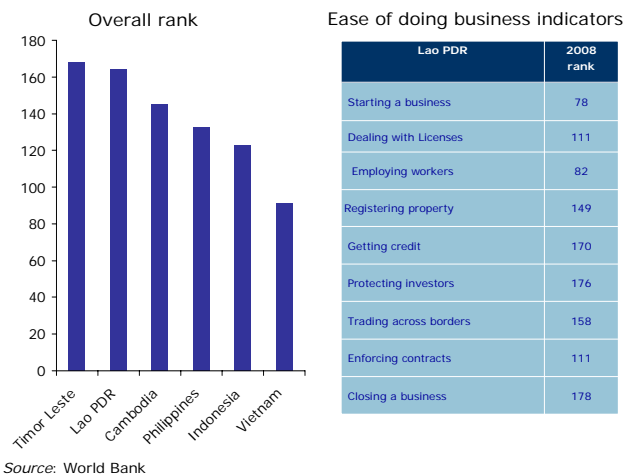
**Human Development Index**

	HDI rank 2007/08	HDI rank 2006
Vietnam	105	109
Lao PDR	130	133
Cambodia	131	129
Timor Leste	150	142

Source: UNDP

Surveys which monitor the cost of doing business, transparency and corruption levels indicate that Lao lags its neighbours. According to the latest World Bank “ease of doing business” survey, Laos ranked 164 out of 178 countries, between Timor-Leste (168) and Cambodia (145). Starting a business, for instance, can take 103 days compared with 86 in Cambodia and 50 days in Vietnam.

**World Bank “ease of doing business” survey, 2008**



Source: World Bank

Expansion of transport infrastructure is much needed, scope for broader telecommunications networks is compelling and electricity is limited to some urban areas.

**Infrastructure constraints**

	Telephones*		Cell subs.*	
	1990	2005	1990	2005
Lao PDR	2	13	0	108
Cambodia	-	3	0	75
Vietnam	1	191	0	115
East Asia & Pacific	18	223	-	301

\*: per 1,000 people  
Sources: UNDP

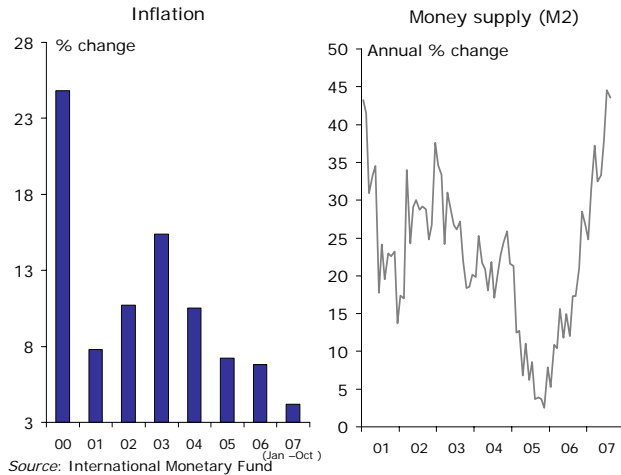
Issues such as corporate governance, legal requirements and concerns over property rights are also factors that are a constraint to more active private sector participation and foreign investment. Further reform towards streamlining operations, greater transparency and infrastructure development will go a long way in improving the investment climate and long-term economic growth potential. In addition, further economic integration with the rest of its ASEAN neighbours as well as membership to the WTO, once obtained, offer vast medium-term growth opportunities that would enable Laos to lift income levels and reduce poverty further.

**Inflation has improved but upside risks remain**

Consumer price inflation has moderated in recent years. For the first ten months of 2007, inflation was 4.2% higher than the same period in 2006. This compares favourably against 7.2% in 2005 and 6.8% in 2006. However, like its Asian neighbours, Laos is expected to feel the impact of higher fuel and food costs. Commodity prices are likely to stay elevated in coming months but the global downturn is likely to lead to some softening in prices towards the second half of 2008 and into 2009. The increase in capital inflows has the potential of exerting

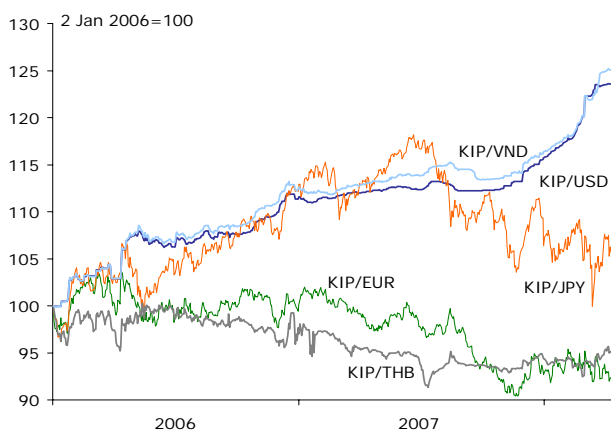
upward pressure on prices as money supply accelerates. Growth in money supply (M2) rose by some 44% over the year to August 2007, matching growth rates last seen in 2001. According to the IMF, inflation is forecast to pick up to between 6-7% pa in 2008 and 2009.

### Upside risks to inflation



Laos operates a managed exchange rate. There has been a gradual strengthening of the Kip (LAK) against the US dollar in recent years but this year has seen a much sharper appreciation, with the Kip gaining 7.1% since the start of the year. Against major trading and investment partners like Thailand and Vietnam, the Kip's performance has been mixed, appreciating by some 7.8% against the Vietnamese dong while staying flat against the onshore Thai baht since the start of the year. Against the euro and yen, the Kip has softened, largely reflecting the major currencies' gain against the US dollar. In the next few months, the Kip is likely to receive further upside support as the US dollar is weighed down by weaker domestic demand and uncertainty over the health of US financial institutions. However, a gradual recovery in the US dollar is expected in the second half of this year and into 2009, which could lead to some retracement of the Kip.

### Currency trends



Source: Bloomberg

Despite the Bank of Lao's best efforts to promote use of the freely-tradable local currency, particularly

in the major urban area of Vientiane City, the US dollar and the Thai baht are the most favoured currencies. Events of the recent past have left some doubts in the local currency as a savings vehicle and there is still a preference to hold cash in foreign currency. This is despite the recent strengthening of the Kip against the US dollar and more favourable interest rate differentials with LAK credit interest rates higher than Thai and US rates.

On the fiscal side, the government is committed towards fiscal consolidation over the medium term. The budget deficit has ranged between 3-4% of GDP in recent years and is likely to narrow in coming years to around 2-3% in FY2006/07 and FY2007/08 (fiscal year ending 30 September). Resource revenues are expected to stay strong and continue to help contain the budget shortfall. However, non-resource receipts are relatively low reflecting, in part, inefficiencies in tax collection. The government has also made efforts to contain expenditure. The budget gap is funded mainly through external financing and grants. Public sector debt has been declining from close to 100% of GDP in 2002 to under 70% of GDP estimated for 2007. External debt comprises the bulk of public sector debt.

### Wide trade deficit but balance of payments in surplus

According to the IMF, the current account is likely to remain in deficit of the order of around 20% of GDP in 2008, including official transfers. Mining and hydropower-related export earnings are likely to expand by around 20-25% in 2008 and accelerate further over the medium to long term as capacity expands. Other exports, such as clothing, wooden products and coffee, which comprise around 36% of total exports, are likely to grow at a slightly more modest pace than in 2007 given the slowdown in external demand. However, imports are likely to outpace export growth as demand for capital goods and raw materials stay strong. In addition, Lao's oil import bill remains large. Tourism receipts are expected to pick up but the income deficit could widen as interest payments, dividends and profits are sent offshore.

Nevertheless, the current account deficit has been more than offset by the surplus in the capital account, thanks largely to investments in hydropower and mining projects. This has led to a strengthening in international reserves (excluding gold) which stood at US\$511 mn as at October 2007, up 57% from end-2006 and representing slightly over 3 months of goods imports.

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