LAO PDR ECONOMIC MONITOR

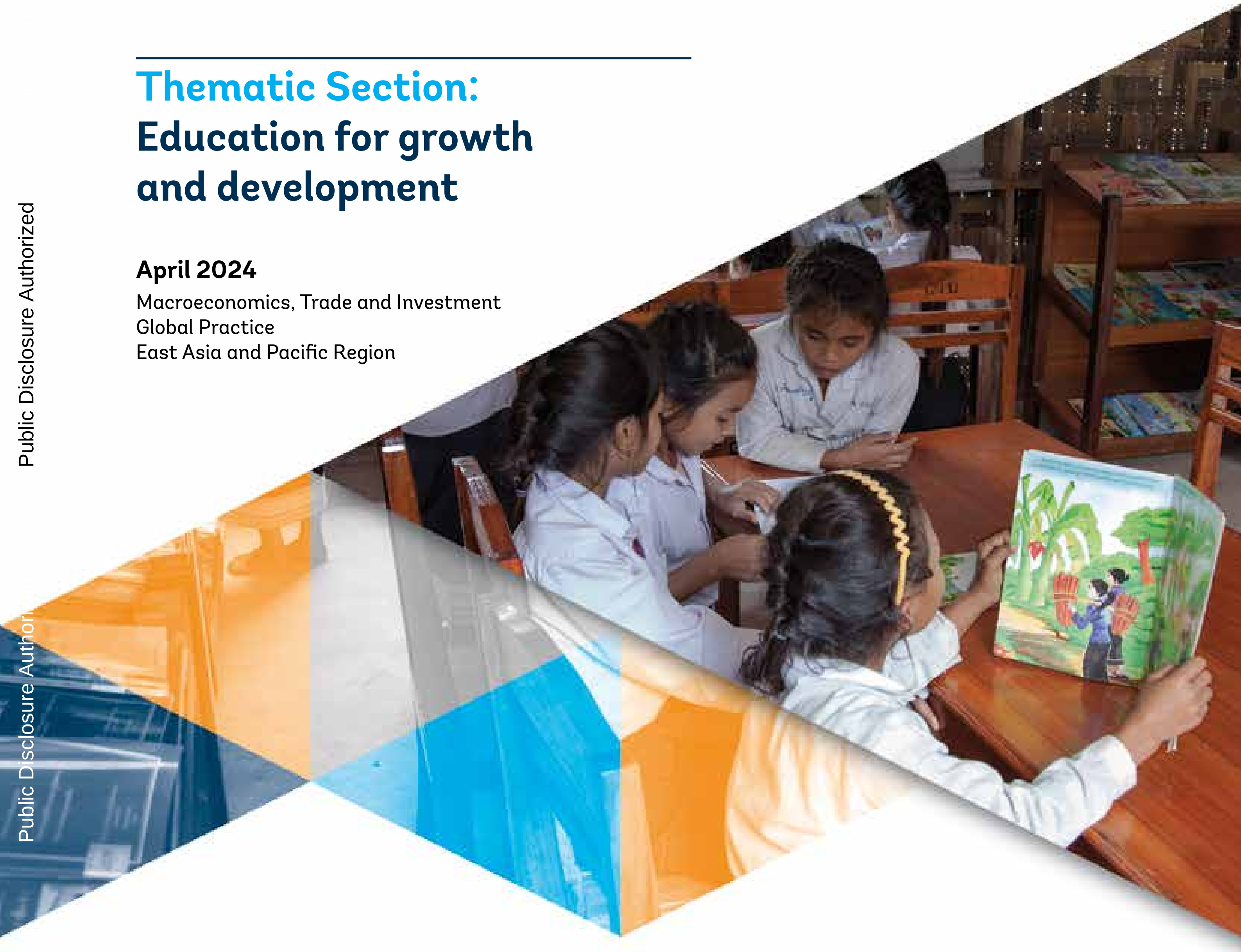
Accelerating Reforms for Growth

Thematic Section:
Education for growth and development

April 2024

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

Public Disclosure Authorized



Public Disclosure Authorized

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

LAO PDR ECONOMIC MONITOR

Accelerating Reforms for Growth

Thematic Section:
Education for growth and development

April 2024
Macroeconomics, Trade and Investment Global Practice
East Asia and Pacific Region

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Layout: Paul Bloxham.

Photos: Cover: World Bank/Bart Verweij; Page 1: Shutterstock/Phoutthavong Souvannachak; Page 26: Shutterstock / Matyas Rehak.

Contents

Figures

Tables

Boxes

Abbreviations

ASLO	Assessment of Student Learning Outcomes
BCEL	Banque Pour Le Commerce Exterieur Lao Public
BOL	Bank of the Lao PDR
CAR	Capital adequacy ratio
CIT	Corporate income tax
EAP	East Asia and Pacific
EDL	Electricité du Laos
LTGM	Long-term growth model
MOES	Ministry of Education and Sports
MOF	Ministry of Finance
NPL	Non-performing loan
NTM	Non-tariff measures
PPG	Public and publicly guaranteed
PPP	Public-private partnerships
PTR	Pupil-teacher ratios
SOE	State-owned enterprises
VAT	Value added tax

Acknowledgements

The **Lao PDR Economic Monitor April 2024** was prepared by a team led by Keomanivone Phimmahasay (Economist), Pedro Martins (Senior Country Economist) and Somneuk Davading (Senior Economist). This report comprises two parts. **Part A: Recent Economic Developments and Outlook**, was authored by Keomanivone Phimmahasay (Economist), Pedro Martins (Senior Country Economist), Somneuk Davading (Senior Economist), and Tanida Arayavechkit (Senior Economist). **Part B: Education for Growth and Development** was authored by Tara Beteille (Lead Economist, Program Leader), Johannes Norman Wolff (Consultant), Nicholas Travis (Consultant), Elena Georgieva-Andonovska (Senior Public Sector Management Specialist), Lars M. Sondergaard (Lead Economist), Cristian Aedo (Practice Manager). The team received useful inputs from Konesawang Nghardsaysone (Economist), Ergys Islamaj (Senior Economist), Daisuke Fukuzawa (Economist), Duong Trung Le (Economist), Kim Alan Edwards (Program Leader), Michael Corlett (Senior Financial Sector Specialist), Vidaovanh Phounvixay (Financial Sector Specialist), Alounny Vorachakdaovy (Consultant) and Phetnidda Ouankhamchan (Consultant). We gratefully acknowledge the production and dissemination assistance provided by Boualamphan Phouthavisouk (Team Assistant) and Aiden Glendinning (External Affairs Officer).

The team worked under the guidance of Mariam Sherman (Country Director), Alexander Kremer (Country Manager), Sebastian Eckardt (Practice Manager,) and Cristian Aedo (Practice Manager).

The team would like to express its gratitude to the Government of the Lao PDR, particularly the Ministry of Finance, Bank of the Lao PDR, Ministry of Planning and Investment (including the Lao Statistics Bureau), Ministry of Industry and Commerce, Ministry of Energy and Mines, Ministry of Education and Sports, Lao Academy of Social and Economic Sciences (Macroeconomic Research Institute), line ministries, the Lao National Chamber of Commerce and Industry, several business associations, businesses and banks for sharing their valuable views and inputs.

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: laos@ worldbank.org

Executive Summary

Part A: Recent Economic Developments and Outlook

Economic growth remains below pre-COVID-19 levels, mainly owing to protracted macroeconomic instability. Economic growth is estimated at 3.7 percent for 2023, with positive contributions from the services sector (for example, tourism, transport, and logistics) and mining. Electricity generation, mostly from hydropower plants, was tempered by low rainfall. Meanwhile, foreign investment increased substantially, linked mainly to the electricity and mining sectors. In contrast, public spending and household consumption remained constrained by limited fiscal space and high inflation. Merchandise export growth was limited, affected by supply-side constraints (for example, labor shortages) and subdued external demand.

Amid limited foreign exchange liquidity and high external debt service obligations, depreciation and inflationary pressures persist. In 2023, the annual average official kip/US dollar exchange rate weakened by 31 percent, while the average parallel rate depreciated by 27 percent. The parallel exchange rate premium was about 13 percent in March 2024. Depreciation appears to coincide with periods of large public debt service repayments, usually between March and September. Given the high import dependence, depreciation brings changes in domestic prices. Headline inflation averaged 31 percent in 2023 and remained at about 25 percent for eight consecutive months from August 2023, with food, transport, hotel, and restaurant price increases the main contributors.

Persistent depreciation and inflation continue to erode household real incomes. Average household incomes improved in 2023, but more than one-third of households saw their nominal income growth lag behind inflation, implying a loss of purchasing power. High food inflation has undermined food security, particularly among urban families, which rely mostly on purchased food. About one-third of households, especially low-income households, reduced their spending on health and education.

The sharp currency depreciation has incentivized out-migration and shifts in the domestic labor market. The number of registered Lao migrants in Thailand rose by 15 percent to 252,000 between June 2023 and February 2024. Higher wages and better employment opportunities in Thailand were key 'pull' factors, while sharp currency depreciation and high inflation in Laos exacerbated 'push' factors. Domestic labor is switching from non-tradable service sectors toward agriculture and some manufacturing sectors. Workers are also shifting from formal wage jobs and unpaid family work to self-employment and family businesses, implying a widened wage differential. Sectoral and occupational shifts, coupled with migration, have contributed to labor shortages in some labor-intensive sectors.

On the fiscal front, improved revenue collection offset increased public spending, but gross financing needs remained high. While the government ran a primary surplus (without all interest payments) estimated at 1.5 percent of GDP in 2023, the overall fiscal balance (including interest payments) was estimated at a deficit of 0.2 percent despite deferrals of some interest payments. Limited fiscal space has constrained the government's ability to invest in human capital. Gross financing needs amounted to almost 8 percent of GDP in 2023 (after debt service deferrals) or about 13 percent (without debt service deferrals).

Public and publicly guaranteed (PPG) debt remains at critical levels, while financing sources are limited. Total PPG debt is estimated to have remained above 110 percent of GDP in 2023, largely reflecting the kip depreciation. If domestic expenditure arrears and the swap arrangement with the People's Bank of China are included, total PPG debt increases to over 130 percent of GDP. The energy sector, primarily through Electricité du Laos (EDL), has been a significant driver of PPG debt accumulation, accounting for about 45 percent of external PPG debt in 2022 (45 percent of GDP).

Total external public debt repayments (interest and principal) rose considerably despite deferrals from China. Deferrals of principal and interest owed to China amounting to about $2 billion (over 15 percent of GDP in 2023) provided temporary relief between 2020 and 2023. Nevertheless, residual interest and principal payments still amounted to 5 percent of GDP in 2023, driven by maturing bonds and the amortization of bank loans, followed by repayments to multilateral creditors. Access to international capital markets has deteriorated since the loss of access to the Thai bond market in September 2023. The government relies on a combination of a primary surplus, on-lending repayments collected from state-owned enterprises (SOE), bond proceeds, and commercial bank loans to meet debt service payments. Combined lending to the government from commercial banks and the central bank also increased, indicating more reliance on domestic financing sources.

External imbalances persist despite the sharp currency depreciation, tightened monetary policy, and stricter foreign currency management. The official balance of payments data shows net foreign exchange inflows of about $250 million in the first three quarters of 2023, supported by a strong current account surplus and large investment inflows. Official data underreports imports and does not reflect unremitted export proceeds. When compared to trade partners' mirror data, imports of goods were underreported by almost 30 percent in 2023. At the same time, actual foreign exchange inflows relating to Laos' exports accounted for less than half of the total recorded export values. In practice, these two factors contributed to limited foreign exchange inflows, which caused foreign exchange shortages against a backdrop of high foreign exchange demand for imports, external debt repayments, and business profit repatriation. This, in turn, continued to put pressure on the exchange rate, fuel the parallel market, and feed domestic inflation.

In a bid to stem foreign exchange shortages, the Bank of the Lao PDR (BOL) has started to implement repatriation and surrender (i.e. conversion) requirements. In March 2024, the authorities began to enforce partial repatriation and conversion of export proceeds from key sectors (mining, power, agriculture, and services). These measures may bring more foreign currency into the economy in the short term, but they may be counter-productive in the medium term if they deter future investment or lead to misreporting. Gross reserves (including the currency swap) reached $1.7 billion in December 2023, covering two months of goods and services imports. Nevertheless, net reserve buffers (excluding the currency swap) remain low and a source of concern.

In 2024, real GDP is projected to grow by 4 percent as potential growth will remain constrained by structural challenges. This outlook assumes no new debt service deferrals in 2024 and beyond, while deferrals accumulated during 2020–2023 would continue to be deferred. Economic activity is expected to benefit from recovered performance in tourism, transport and logistics services, and investment in the power sector and some special economic zones. Despite the slight uptick this year, economic growth will remain below pre-COVID levels, weighed down by macroeconomic instability and structural constraints such as a shortage of skills, both in quality and quantity, and a challenging business environment.

Reflecting persistent depreciation pressures, inflation is expected to remain above 20 percent, continuing to exert pressure on real incomes. Depreciation pressures will continue to feed into domestic inflation. This will affect household real incomes, weighing on consumption and restraining progress on poverty reduction.

Fiscal space will remain constrained by elevated debt repayment obligations, which are expected to put additional pressure on domestic financing sources. The baseline projects a primary surplus in 2024, implying a headline fiscal deficit of about 1.4 percent of GDP in 2024, reflecting full interest payments (i.e. no further deferrals for 2024 repayment obligations). Gross financing needs are projected to reach almost 9 percent of GDP in 2024, as the expected primary surplus will only partly offset higher debt repayments in 2024 and beyond. External debt service obligations average $1.3 billion per year over 2024–2027 (about 9 percent of GDP annually), half of which is owed to China. As access to international capital markets is likely to remain constrained until 2025, when external debt service obligations peak, pressure on domestic funding sources is expected to intensify. In the absence of further debt service deferrals, meeting these obligations will be challenging and may require using more domestic revenues in foreign currencies, SOE repayments on on-lending, and domestically issued bonds (in kip and foreign currencies). While these options could generate short-term liquidity, debt restructuring would immediately and effectively relieve strong macro-fiscal pressures while the government implements critical revenue reforms.

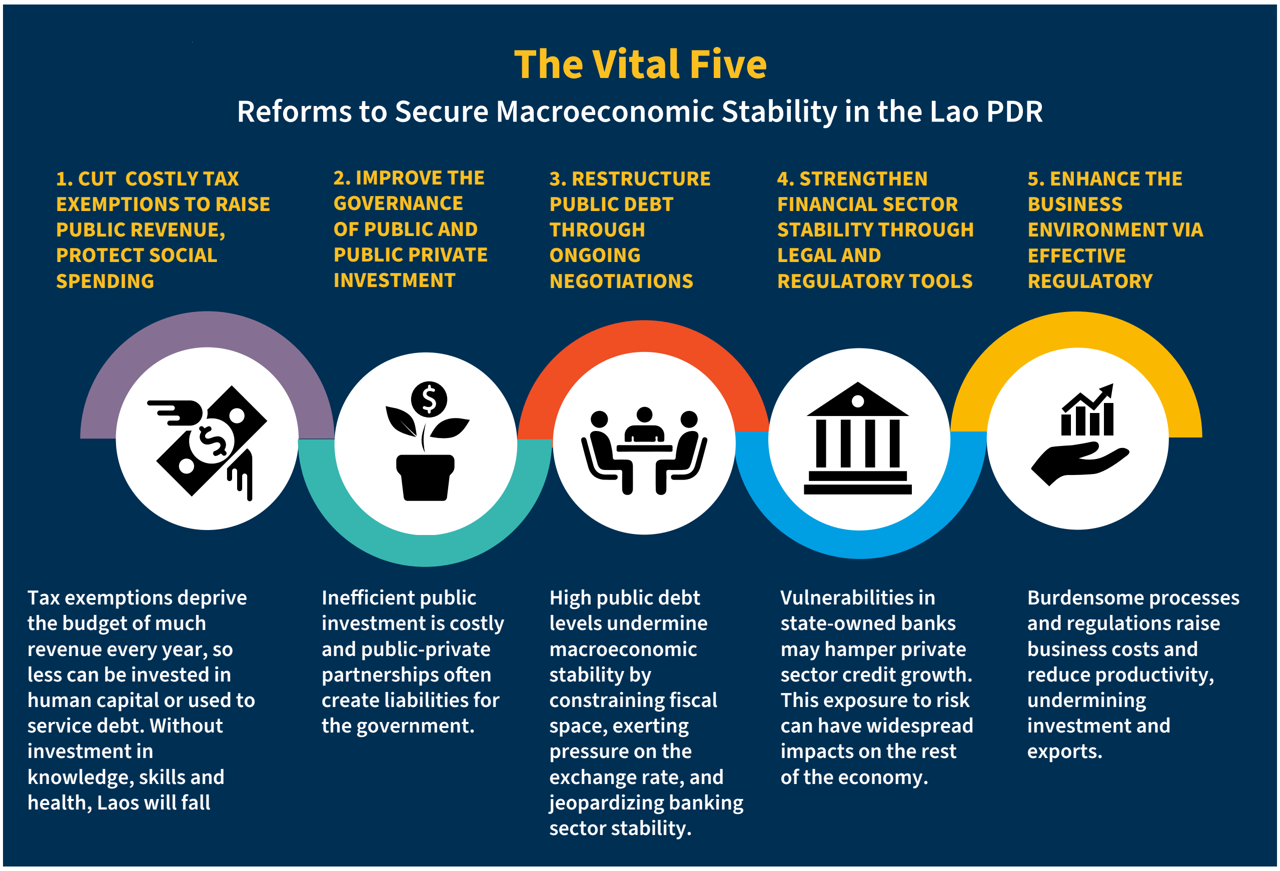
The outlook is subject to significant domestic and external uncertainty. Structural imbalances associated with limited foreign reserves, high public debt, and a high import bill will continue to put pressure on the kip and thus inflation. Worker shortages are weakening labour-intensive sectors. Lower global and regional economic growth would weaken external demand and thus exports. Domestic risks include tight foreign exchange liquidity to refinance external debt (particularly given limited access to international capital markets), slow progress with structural reforms, and deteriorating balance sheets in some large banks. The outcome of ongoing bilateral debt negotiations will have significant implications for both debt sustainability and macroeconomic stability.

Restoring macroeconomic stability requires a strong commitment to five critical reform areas: (i) implementing the restored VAT rate of 10 percent, curbing tax exemptions, and reforming excise taxes (for example, tobacco, alcohol, sugar-sweetened beverages, and fuel) to boost spending on social sectors; (ii) expediting ongoing debt renegotiations and strengthening public debt management; (iii) managing risks from contingent liabilities related to state-owned enterprises and public-private partnerships; (iv) strengthening financial sector stability; and (v) improving the business environment to promote investment and exports. In addition, improving data availability, timeliness, and quality is essential for informing evidence-based policy making.

Table 1. Summary of key economic indicators

	2020	2021	2022	2023	2024	2025
					Projections	
Real GDP growth (% change)	0.5	2.5	2.7	3.7	4.0	4.1
Inflation (period average, % change)	5.1	3.8	22.7	31.2	21.2	14.7
Fiscal balance (% of GDP)	-5.2	-1.3	-0.2	-0.2	-1.4	-1.5
Current account balance (% of GDP)	-5.9	-2.9	-1.7	-1.3	-2.9	-3.5

Sources: Lao Statistics Bureau, Ministry of Finance, Bank of the Lao PDR, Ministry of Industry and Commerce, World Bank staff estimates and projections based on inputs from Lao authorities and trade partner data as of March 2024.



Part B: Education for Growth and Development

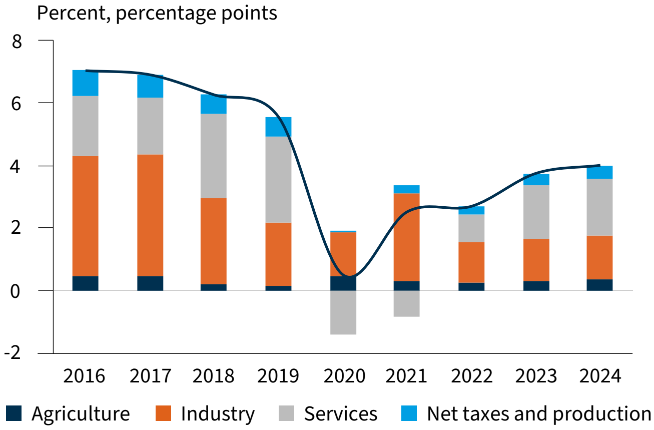
Strong human capital and education are fundamental to putting Laos on a sustainable high-growth trajectory. Human capital constitutes only 57.2 percent of the country's total wealth compared to 63.3 percent of the total wealth of nations globally. Education — and the skills it confers — is fundamental to improving human capital and thereby individual well-being as well as economic growth. Learning, especially in early childhood, is important in building skills. Since learning is cumulative, weak foundational skills in early life mean low skills in later life. However, primary education is no longer universal in Laos as an increasing number of students are dropping out and those students who stay are not learning. A 2019 Grade 5 learning outcomes assessment showed Lao children lagging behind those in neighboring East Asian countries in math, reading and writing. This has follow-on effects for subsequent education levels, with enrolment rates measurably below benchmarks while dropout rates are high and increasing. Most secondary students score below expected levels across subjects, with pronounced knowledge gaps in mathematics and science in particular.

Successful school systems require effective teachers and adequate financing. In Laos, teachers lack content knowledge as well as pedagogical skills. While approximately 85 percent of teachers report having completed preservice training/vocational degrees, various assessments indicate that teachers do not appear to have received the kind of pre-service training that would equip them for successful teaching in class. In-service training is ad hoc and inadequate. An imbalance in the distribution of teachers across education levels, geographical locations, and schools causes further inefficiencies in resource allocation and use. Moreover, adequate financing – both in total and in composition – is essential for schools to offer the needed teaching quality. However, the combined impacts of deprioritization and fiscal consolidation have caused an unprecedented decline in public education funding, which is now very low in real terms and relative to GDP and total government spending. This reflects a de-prioritization of the sector compared to other government spending. In real terms, actual expenditure fell by 22 percent between the 2018 peak and the latest available expenditure data from 2021. Budget allocations have since seen a further decline of 22 percent, according to the latest publicly available State Budget Plan for 2023. This amounts to a sharp reduction in real terms of 38 percent between 2013 actual spending and the 2023 budget allocation. The decline has been driven in part by a downsizing of the teaching workforce. Cuts to the education budget have also resulted in a very significant decline in operational spending, including on teacher support functions, such as in-service teacher training. In real terms, non-wage recurrent spending declined by 56 percent between 2018 and 2022.

For learning outcomes to improve, sector funding and teacher skills must improve. The education sector needs urgent re-prioritization, with increased budget allocations in real terms and with the right mix of inputs as a basis for quality teaching. This includes higher and more efficient investment in teacher training, learning, and teaching materials. In parallel, the education sector should prioritize service delivery (vis-à-vis administrative functions) and balance the allocation of teachers across education levels and schools. While addressing these critical supply-side issues, Laos must also create incentives in the form of jobs and entrepreneurship opportunities for households to enroll their children, ensure they stay enrolled, and demand quality education services.

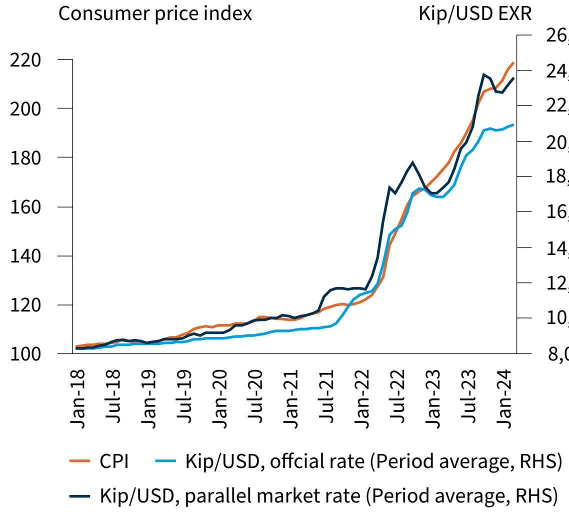
Lao PDR: Key Macroeconomic Indicators at a Glance

Growth recovery is restrained by protracted macroeconomic instability



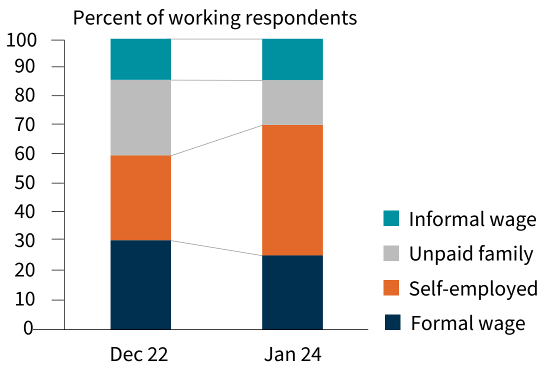
Source: Lao statistics bureau/World Bank staff estimate.

Persistent depreciation has continued to fuel domestic inflation



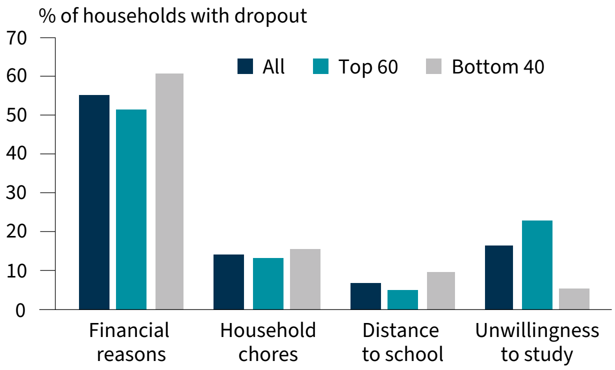
Sources: Bank of the Lao PDR.

Persistent inflation is eroding real household incomes, fueling out-migration and labor shifts



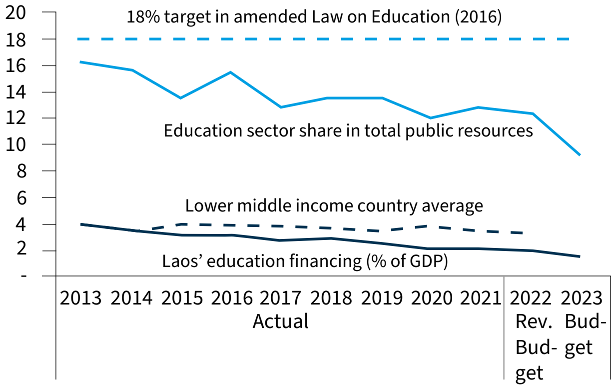
Source: World Bank rapid phone survey January–February 2024

Households' financial difficulties contribute to rising school dropouts



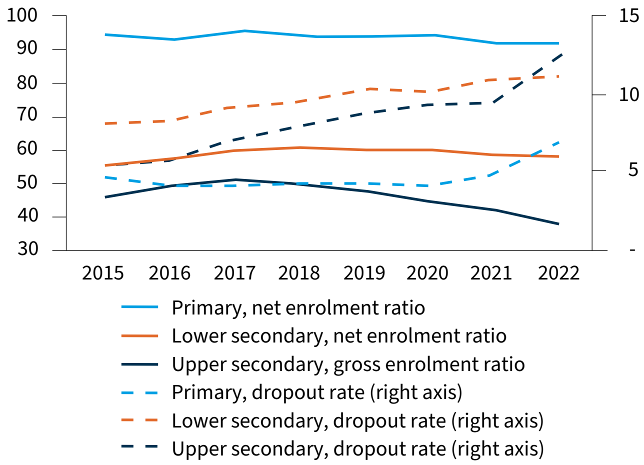
Source: World Bank rapid phone survey January–February 2024

De-prioritization and fiscal consolidation have caused decline in public education funding



Sources: Amended Law on Education 2016, State Budgets, State Budget Implementation Reports, World Bank staff estimates.

Enrolment rates across education levels: dropout rates are high and increasing



Source: World Bank staff estimates based on Laos Annual School Census, UN Population Data, and UNESCO UIS.

Note: Data from the Annual School Census collected at the end of each calendar year (i.e., 2022 data collected in late 2022 for school year 2022/23).

PART A

Recent Economic Developments and Outlook

1. Regional Economic Context

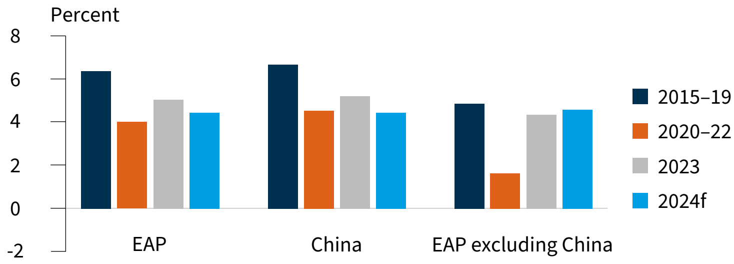
Regional growth prospects in EAP remained favorable.

Most economies in East Asia and Pacific (EAP) are growing faster than in the rest of the world, albeit slower than before the pandemic (Figure 1). China's economy grew by 5.2 percent in 2023, up from 3 percent in 2022, as the economy benefited from a strong post-COVID rebound in early 2023. However, China's growth momentum has slackened due to a slowdown in infrastructure and real estate development and high debt levels. The rest of the region grew by 4.4 percent in 2023, down from 5.8 percent in 2022, owing to slower trade growth and tight financial conditions.

The region's economic performance is influenced by external and domestic developments. Key external factors include slower global trade growth due to more trade-distorting measures imposed in 2023, and the high interest rates introduced to contain inflation in developed countries. Goods and services trade grew by only 0.2 percent in 2023, while almost 3,000 new trade-distorting measures were imposed in 2023, three times more than in 2019. Key domestic factors include elevated public and private debt levels, a constrained fiscal and monetary policy stance, and increased policy and political uncertainty in some countries.

Regional growth is forecast to ease to 4.5 percent in 2024, from 5.1 percent in 2023, reflecting more moderate growth in China. China's growth is forecast to slow to 4.5 percent in 2024 from 5.2 in 2023 due to near-term issues (high debt levels and property sector weaknesses) and longer-term structural factors (for example, population aging and trade protectionism). However, the rest of the region (excluding China) is expected to grow by 4.6 percent in 2024 from 4.4 percent in 2023. The anticipated recovery of global trade and easing global financial conditions are expected to boost external demand, which will help offset the impact of China's economic slowdown.

Figure 1. Regional GDP growth



Source: World Bank EAP Economic Update April 2024.
Note: EAP: East Asia Pacific; EMDE: emerging markets and developing economies

2. Recent Developments in the Lao PDR

2.1 Real Sector

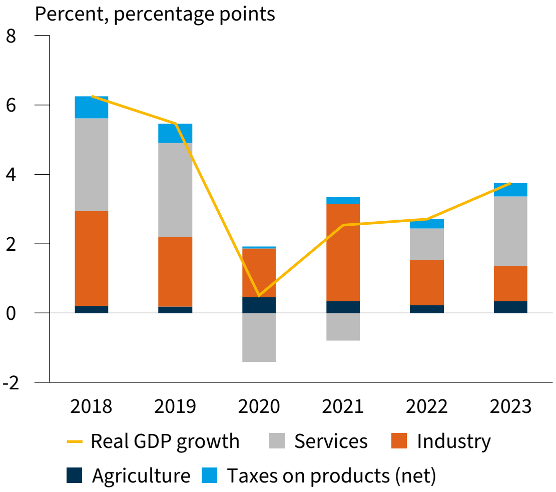
Economic growth in Laos remains significantly below pre-Covid-19 levels, mainly due to protracted macroeconomic instability.

Persistent macroeconomic instability has undermined Laos' post-pandemic economic recovery. The limitations of a resource-driven growth model and accumulated structural imbalances were exposed by the COVID-19 pandemic and a deteriorating global economic environment. A history of high fiscal deficits and large public investments in the power sector have led to an unsustainable debt burden. External debt service payments have risen due to the rapid accumulation of non-concessional debt (with higher interest rates and shorter maturities), which in turn has increased the demand for foreign exchange. At the same time, generous tax incentives for foreign investors have eroded foreign exchange revenues. These factors, coupled with high import demand in the context of low foreign reserves, have contributed to a significant foreign currency demand-supply mismatch and hence kip depreciation. A weaker kip aggravates the public debt burden and increases domestic inflation. High debt service obligations constrain the fiscal space available for investments in human capital, which are crucial for improving labor productivity and thus long-term growth. Slower economic growth, coupled with inflation, undercuts people's incomes and living standards.

Economic growth is estimated at 3.7 percent in 2023, largely benefiting from the services sector recovery (Figure 2).[1] Tourism, transport and logistics services, and mining supported economic growth in 2023. Meanwhile, low rainfall weighed down electricity generation, which is heavily dependent on hydropower. Foreign investment picked up substantially, largely in the power sector.[2] However, limited fiscal space and high inflation constrained public spending and household consumption, respectively. Merchandise export growth has been marginal, as increased mining exports were offset by lower growth in some manufacturing exports, which were affected by labor shortages and lower external demand.

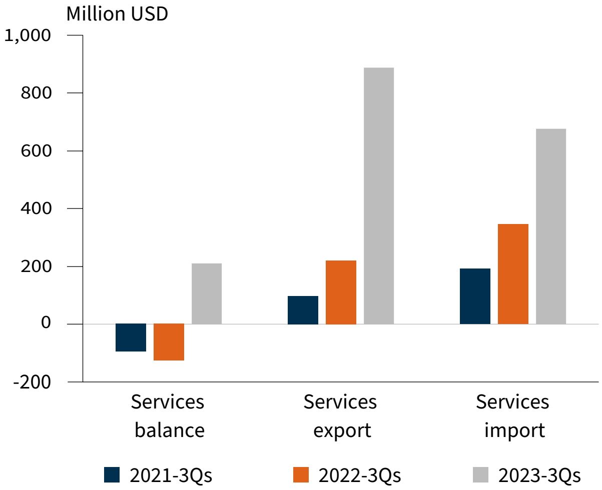
The services sector, which accounts for one-third of GDP, is estimated to have grown by 5.5 percent in 2023. The number of foreign visitors, mostly from the region, more than doubled to 3.4 million in 2023 compared to 1.3 million in the previous year. However, that was still only about 70 percent of pre-pandemic levels. Transport and logistics services have benefited from increased railway and dry port operations. Service exports tripled to about $880 million in the first nine months of 2023 compared to the same period a year ago (Figure 3). Wholesale and retail sales growth was supported by tourism but remained constrained by high inflation.

Figure 2. Real GDP growth



Sources: Lao Statistics Bureau and World Bank staff estimates.

Figure 3. Services trade



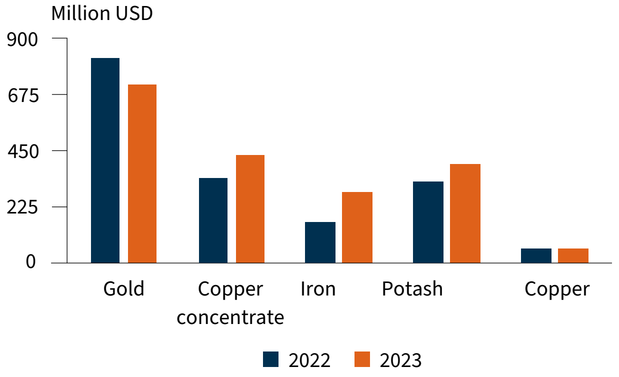
Source: Bank of the Lao PDR.

Industrial sector activity is estimated to have expanded by 2.6 percent in 2023, driven by mining, while electricity and manufacturing output was subdued. The mining sector saw output growth in copper concentrate, iron ore, and potash, while gold output slightly declined as existing pits are gradually depleted and new sources are at an early stage of development (Figure 4). Electricity generation, which accounts for 10 percent of GDP, was constrained by low rainfall. Manufacturing sector performance was mixed (Figure 5). An increase in food and beverage output was partly offset by lower growth in other manufacturing, such as wood pulp, paper products, and electronics, which were partly affected by lower external demand. Meanwhile, low wages in Laos, exacerbated by the recent depreciation and high inflation, have contributed to increased worker migration to Thailand, where average wages are about three times higher. This trend is challenging for most labor-intensive sectors, such as garment manufacturing and hospitality, which are facing increasing labor shortages.

[1] Lao Statistics Bureau estimated 2023 growth at 4.2 percent. https://www.lsb.gov.la/en/home/ (Accessed 29 March 2024).

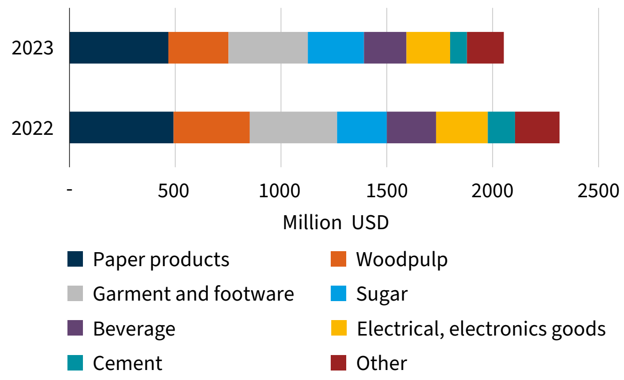
[2] A large proportion of the investment inflows into the power sector are financial transactions related to the EDL-Transmission joint venture.

Figure 4. Mining exports



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

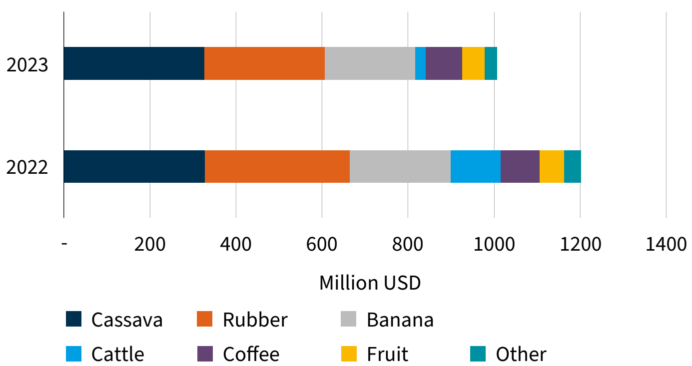
Figure 5. Manufacturing exports



Sources: World Bank staff calculations based on Ministry of Industry and Commerce and trading partners' customs data.

The agriculture sector grew by an estimated 2.4 percent in 2023, driven by rice production. Global prices for agriculture inputs eased, but the costs of imported inputs remained high, owing to the continued depreciation of the kip. Increased input costs have partly translated into higher local food prices. Nevertheless, an increase in rice production partly offset the decline in key agricultural exports (Figure 6). Livestock exports also declined significantly, particularly cattle, due to limited supply-side capacity. The main agriculture exports in 2023 were cassava, fruits, rubber, and coffee. In response to difficult economic conditions, more households turned to farming and agricultural businesses, which offered relatively better returns than wage employment (see Household section).

Figure 6. Agricultural exports



Sources: World Bank staff calculations based on Ministry of Industry and Commerce and trading partners' customs data.

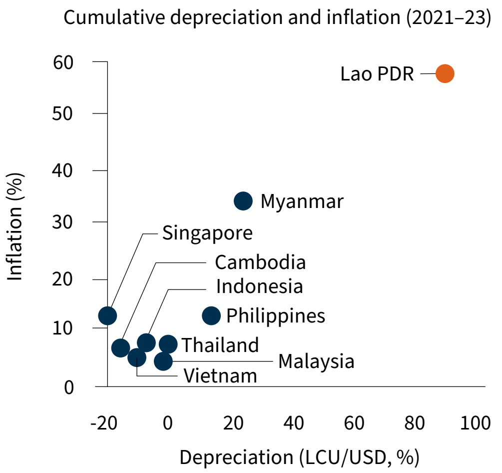
2.2 Inflation

Persistent depreciation has continued to fuel domestic inflation.

Consumer price inflation accelerated in 2023, driven by increases in food, transport, and hotel and restaurant prices. Average annual consumer price inflation reached 31 percent in 2023, compared to 23 percent in 2022. Food, transport, restaurant, and hotel prices rose by 38, 26 and 35 percent, respectively in 2023. Although headline inflation moderated since the 41 percent peak in February 2023, it remained high at about 25 percent between August 2023 and March 2024. Inflation in Laos remained much higher than in its regional peers, reflecting sharp depreciation of the kip in 2023 (Figure 7). Core inflation reached 27 percent in 2023 and remained at this level in the year to March 2024, largely driven by rising prices in restaurants and hotels, clothing, and housing (Figure 8).

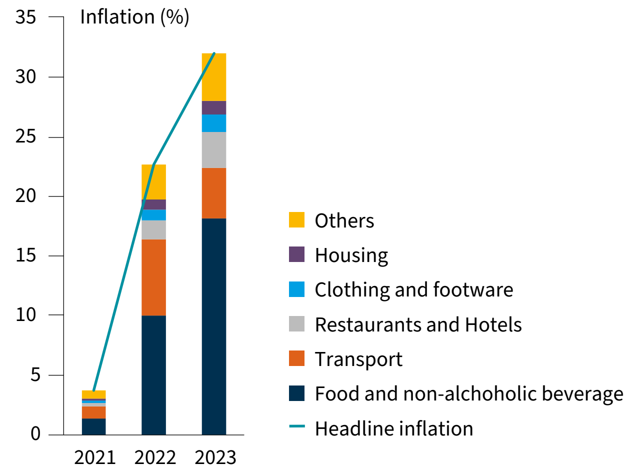
High inflation was largely driven by the kip depreciation, particularly in the parallel market. On average, a 1 percent depreciation of the Lao kip increased consumer prices by 0.5 percent.[3] However, the inflation rate has been closer to depreciation levels in recent times, suggesting a higher passthrough, especially from the parallel rate. Markets tend to price goods and services based on parallel rates, as many businesses anticipate further depreciation and thus set prices higher to cover the exchange rate risk. Tackling inflation will require exchange rate stability.

Figure 7. Inflation among regional peers



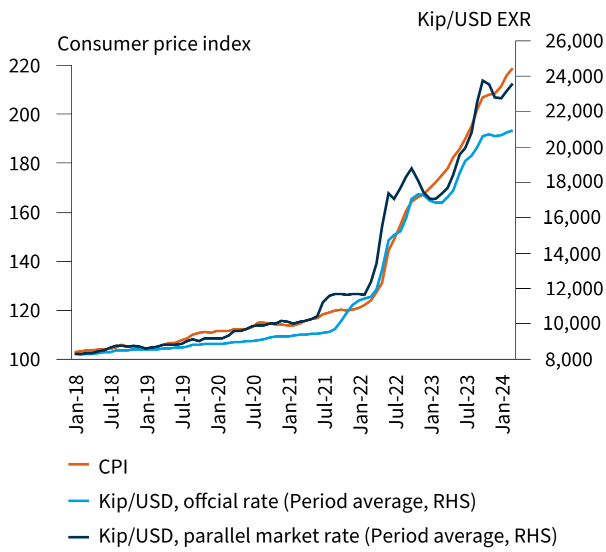
Sources: Lao Statistics Bureau and, International Monetary Fund International Financial Statistics IMF IFS (August 2023)

Figure 8. Consumer price inflation



Sources: Lao Statistics Bureau and World Bank staff calculation.

Figure 9. Inflation and exchange rates



Sources: Lao Statistics Bureau and Bank of the Lao PDR

[3] See International Monetary Fund Article IV 2023. https://www.imf.org/en/Publications/CR/Issues/2023/05/22/Lao-People-s-Democratic-Republic-2023-Article-IV-Consultation-Press-Release-Staff-Report-533636 (Accessed 15 March 2024).

2.3 Households

Persistent depreciation and inflation is eroding real household incomes, while fueling out-migration and labor shifts from non-tradable to tradable sectors.

A protracted period of high inflation has changed the labor market situation. The latest World Bank phone survey shows that 93 percent of respondents reported working in January 2024, up from 90 percent in December 2022.[4] However, high inflation and a sharp currency depreciation have incentivized workers to switch from non-tradable service sectors toward agriculture and manufacturing (Figure 10). The share of working respondents employed in the services sector notably declined from 52 percent to 42 percent. Workers moved from wage employment and unpaid family work to become self-employed, as the latter offered better returns. The share of self-employment rose from 29 percent to 45 percent between December 2022 and January 2024.

Average household income improved in 2023, but more than one-third of households still saw their nominal income growth lag behind inflation. Income growth varied by source. While nominal wages grew at 13 percent in the year to December 2023, average profit rose by 17 percent for family businesses in the non-farm sector and 26 percent for those in the agricultural sector. Average household income per capita rose by almost 25 percent in the year to December 2023, in line with the year-on-year inflation rate of 24 percent. However, this improvement masks the distributional consequence of persistent inflation. Despite the increase in average incomes, more than 40 percent of households still saw their income lag behind inflation and suffered from elevated living costs.

Workers have migrated domestically and internationally to seek higher wages and better employment opportunities. A sharp currency depreciation and high inflation have exacerbated 'push' factors to migrate to other countries (for example, Thailand and Korea) and domestically to fast developing special economic zones. In February 2024, the number of registered Lao workers in Thailand stood at 252,000, up from 215,000 in June 2023 (Figure 11), while the total number (including unregistered migrants) is estimated to range between 300,000 and 400,000, more than one-third of non-farm employment in Laos.[5] Higher wages and better employment opportunities are the main reasons for migration. The kip depreciation has widened the wage gap between Thailand and Laos. Despite the increase of the minimum wage to 1.6 million kip (about $79 per month) in October 2023, the minimum wage in Thailand was about three times higher than in Laos.

Sectoral and occupational shifts, coupled with migration, have contributed to labor shortages in labor-intensive sectors. The shift of workers to the agricultural sector and self-employment has reduced the workforce available for non-farm businesses. Out-migration has also depleted the labor force in Laos. Around 80 percent of migrants had been working in manufacturing and services before migrating to Thailand.[6] Almost 60 percent of Lao migrants in Thailand work in the services sector, followed by manufacturing (20 percent), agriculture (16 percent) and construction (7 percent).[7]

High food inflation has undermined food security, particularly among urban families, which rely mostly on purchased food.[8] Food inflation remained high at 24 percent in the year to March 2024. Overall food security slightly improved between December 2022 and January 2024, with the share of food insecure households declining from 33 percent to 29 percent (Figure 12). However, there is significant variation across groups. Food security improved among rural and low-income families but not among urban and better-off families. The former tends to engage in farming activities and rely more on self-produced food, while the latter rely mostly on purchased food.

---

4 World Bank Rapid Monitoring Phone Survey of Households Round 8, conducted during January-February 2024. Employment is defined as those who worked at least an hour in the last seven days before the interview date.

5 International Organization for Migration. 2021. An Analysis of Migration Trends of Lao Migrants for Lao People's Democratic Republic in Two Selected Provinces: Sanvanakhet and Xayaboury. https://publications.iom.int/system/files/pdf/Analysis-MIG-Trends-Lao.pdf/ (Accessed 13 March 2024).

6 International Organization for Migration survey, December, 2022.

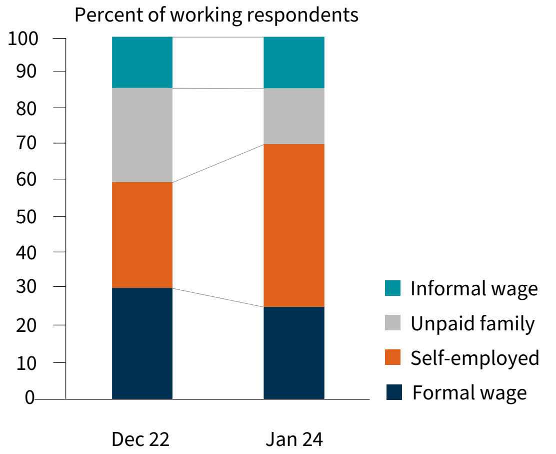
7 Department of Employment, Government of Thailand.

8 The level of food insecurity is determined using the method developed by FAO for the analysis of Food Insecurity Experience Scale (FIES) data. More information about FIES methodology https://www.fao.org/policy-support/tools-and-publications/resources-details/en/c/1236494/ (Accessed 13 March 2024.

Nevertheless, the prevalence of moderate to severe food insecurity remains higher among rural and low-income families.

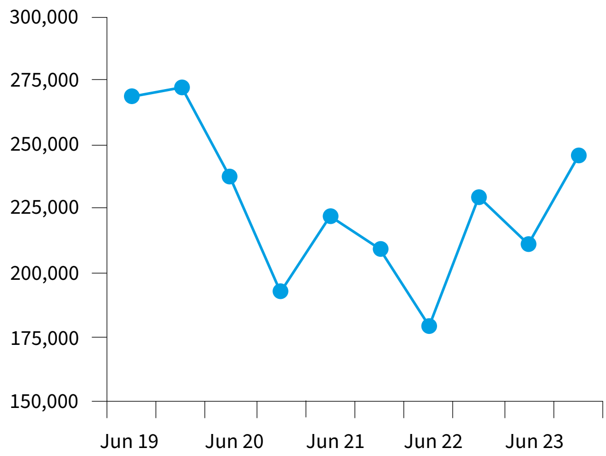
Households have adopted various coping strategies in response to high inflation, some of which could be detrimental to human capital development. Scaling up own-food production, switching to cheaper food, and reducing food consumption are among the most common strategies. While the proportion of households reducing food consumption to cope with high food inflation declined across all socioeconomic groups in recent months, it did not decrease for low-income households. Moreover, more than one-third of households reported reducing education spending because of inflation, and this reduction was most common among low-income families. Nearly 5 percent of school-aged children (aged 6–17) dropped out of school in the past year, with more than half of households with school dropout citing financial reasons as the main cause for school dropouts (Figure 13). Coupled with low government spending on the social sectors, investments in human capital are being hampered, which can severely undermine the economic prospects of an entire generation.

Figure 10. Employment



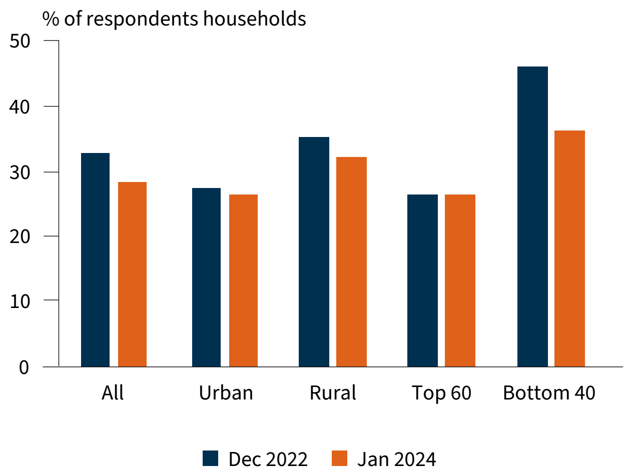
Source: World Bank rapid phone survey January-February 2024

Figure 11. Registered Lao workers in Thailand



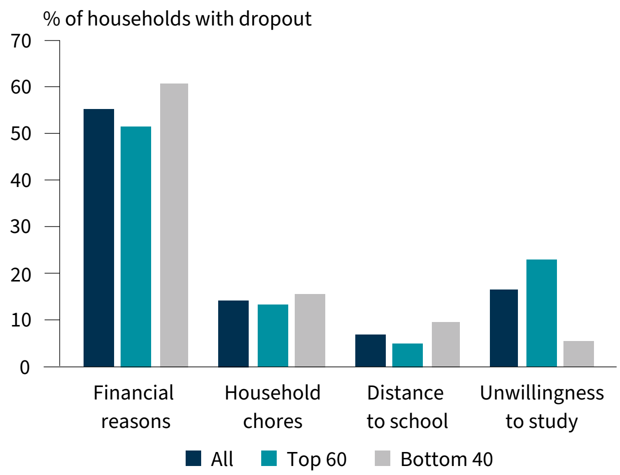
Source: Ministry of Labour, Government of Thailand

Figure 12. Food insecurity prevalence rates



Source: World Bank rapid phone survey January–February 2024

Figure 13. Reasons for school dropout



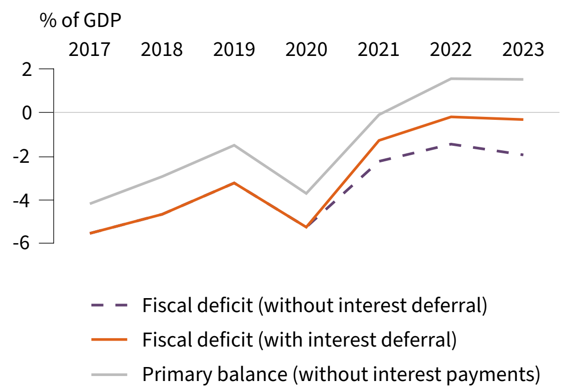
Source: World Bank rapid phone survey January–February 2024

2.4 Fiscal Developments

The fiscal deficit remained stable, supported by improved revenues and limited expenditure growth.

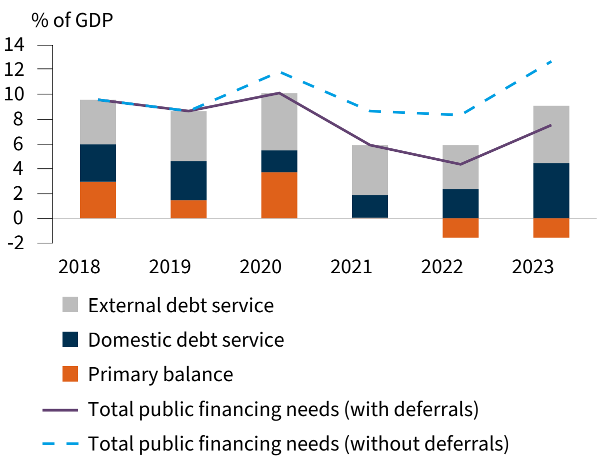
The fiscal deficit remained at an estimated 0.2 percent of GDP in 2023, as improved revenue collection was offset by increased public spending (Figure 14).[9] The primary balance (which excludes interest payments) is estimated to have slightly increased to 1.5 percent of GDP in 2023, supported by better revenue collection and limited growth in non-interest expenditures. Nevertheless, total financing needs amounted to almost 8 percent of GDP in 2023, as debt repayment, exacerbated by the impact of the weakened kip on external debt service, significantly exceeded the primary surplus (Figure 15). Without deferrals, financing needs would have reached 13 percent of GDP. The government met its financing needs largely through a combination of fiscal revenues in foreign currency, on-lending repayments collected from state-owned enterprises (SOEs), bank loans and bond issuances in the domestic capital market (both in foreign and local currencies).

Figure 14. Fiscal performance



Source: Ministry of Finance, World Bank staff estimate

Figure 15. Total public financing needs



Source: Ministry of Finance, World Bank staff estimate

Domestic revenue improved in 2023, supported by higher economic activity as well as price and exchange rate effects. Domestic revenue recovered to an estimated 14.2 percent of GDP in 2023 owing to resource taxes, fees, and the value added tax (VAT) (Figure 16). Excise revenue was relatively stable, as higher volume sales, price increases, and some rate increases were offset by lower fuel excise rates. The sharp kip depreciation and general price increases have benefitted revenue collection, compensating for the lower VAT and fuel excise rates. The VAT tax base expanded, with more VAT-eligible taxpayers joining the VAT system through the TAXRIS system.[10] Despite this improvement, Laos' revenue performance still lags behind most regional peers (Figure 17).

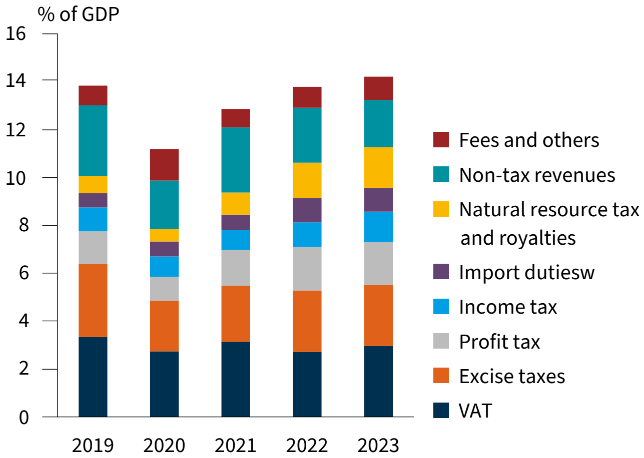
Untargeted tax cuts and generous fiscal incentives have resulted in large foregone revenues. To ease the impacts of soaring international fuel prices in 2022, exacerbated by the strong kip depreciation, fuel excise rates were significantly reduced in mid-2022. Similarly, the VAT rate was reduced from 10 to 7 percent in January 2022, aiming to support households, improve tax compliance, and expand the tax base. Estimates suggest that these rate cuts have resulted in large foregone revenues: about 0.9 percent of GDP for fuel excises and about 1 percent for the VAT. These measures have predominantly benefited wealthier households since they consume more products subject to VAT and excise taxes compared to the poor. In addition, reported fuel imports are lower than trading partners'

[9] The fiscal data are based on data from January-September 2023 and preliminary World Bank's estimates based on information available as of March 2024.

[10] Under the National Agenda, one target under the revenue pillar is to improve compliance to value added tax. MOF aims to increase 14,000 eligible units in the VAT system by 2023, of which 12,000 have already joined.

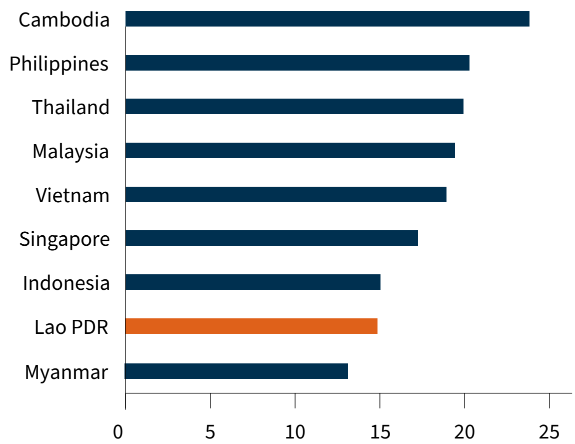
reported exports to Laos (for example, from Thailand and Vietnam). This suggests that a significant amount of fuel is not being taxed. In addition, corporate income tax (CIT) collection remained at around the 2022 level (as a share of GDP), still very low by regional benchmarks. Only about 10 percent of the potential CIT revenue base is actually collected, which implies very large foregone revenues from tax exemptions and evasion.[11]

Figure 16. Domestic revenues



Source: Ministry of Finance, World Bank staff estimate

Figure 17. Total revenues (% of GDP in 2022)



Source: International Monetary Fund, Fiscal Monitor October 2023.

To boost revenue potential, the government introduced several tax policy reforms. New measures included higher excise taxes on alcohol, vehicles, and tobacco (October 2023), introducing new and higher export duties (August 2023), and restoring the VAT rate back to the original 10 percent (March 2024).[12] However, some of these measures may not result in significant additional revenues in the short-term owing to generous tax incentives granted under investment agreements, which severely undermine the tax base.[13]

Public expenditure is estimated to have increased slightly in 2023, owing to higher capital spending, and transfers despite containment of the wage bill and interest payment deferrals (Figure 18). Total expenditure rose to an estimated 15.2 percent of GDP in 2023, but it remained below pre-pandemic levels and most regional peers (Figure 18, 19). Wages and salaries spending declined, owing to limited wage growth and lower net recruitment despite more benefits.[14] Capital spending increased, likely due to exchange rate effects on external loan-financed project disbursements. Some projects have either been cancelled or postponed, as the focus is on meeting the financing needs of ongoing or completed projects. High prices reportedly affected the construction costs of some public investment projects and the purchase of goods and services. In addition, domestic expenditure arrears continue to pose a challenge for expenditure management and domestic debt. Interest payments remained stable, supported by continued debt service deferrals in 2023.

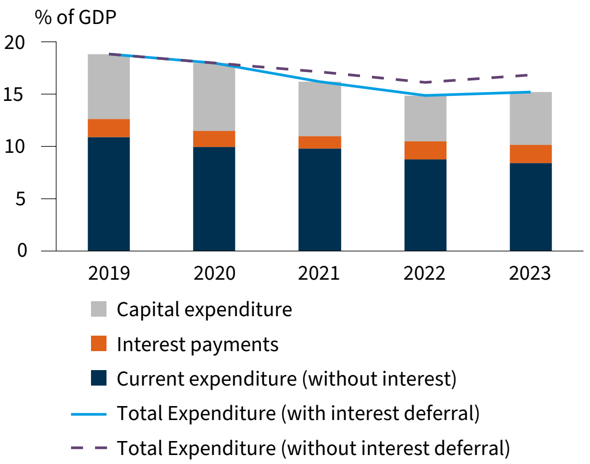
[11] World Bank. 2023. Public Finance Review - Forging Ahead: Restoring Stability & Boosting Prosperity. https://www.worldbank.org/en/events/2023/12/03/public-finance-review-fiscal-incidence-analysis-lao-pdr-2023 (Accessed 13 March, 2024).

[12] The relevant regulations are Presidential Ordinance on the Revision of Excise Rates on Selected Products, No. 003/P, dated 9 October, 2023; Presidential Ordinance on Natural Resource Taxes; and Presidential Ordinance on the VAT Rate To Return to 10%, dated 19 March 2024. https://laoofficialgazette.gov.la/ (Accessed 13 March, 2024).

[13] Despite tax reforms introduced in January 2024, new revenue is expected to amount to less than 0.02 percent of GDP because lower tax rates applied under investment agreements. See more in World Bank. 2023. Health Taxes in the Lao PDR - Technical Note. https://www.worldbank.org/en/country/lao/publication/health-taxes-in-the-lao-pdr-technical-note (Accessed 13 March 2024).

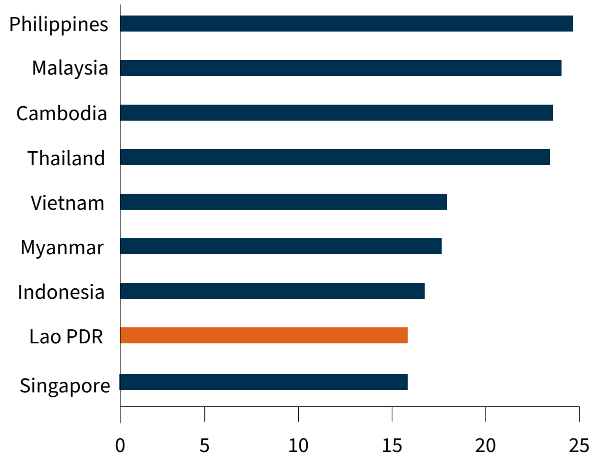
[14] Laotian Times. 2023. Lao Government Increases Living Allowances for Civil Servants. https://laotiantimes.com/2023/01/09/lao-government-increases-living-allowances-for-civil-servants/ (Accessed 13 March 2024).

Figure 18. Total expenditure



Source: Ministry of Finance, World Bank staff estimate.

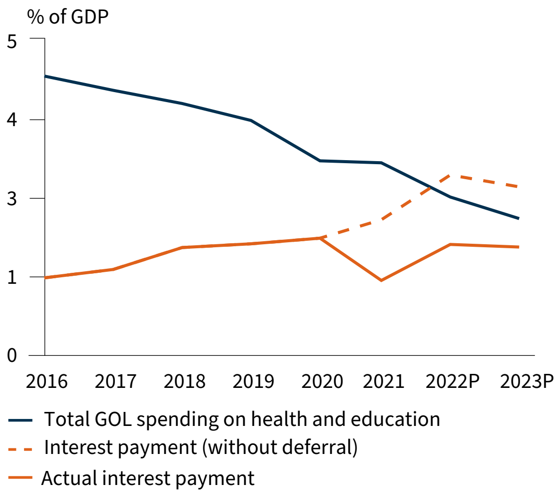
Figure 19. Expenditure (% of GDP in 2022)



Source: International Monetary Fund, Fiscal Monitor October 2023.

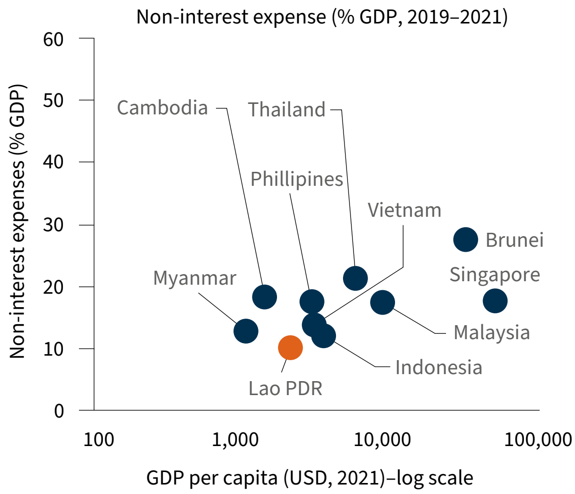
Expenditure increased slightly but is still low for human capital spending and non-interest expenditures, which are crucial for the provision of essential public services. Although debt service deferrals have shielded Laos from more drastic fiscal pressures in recent years, there has been limited support to poor households severely affected by rising living costs. The combined spending on education and health declined from 4.9 percent of GDP in 2013 to an estimated 2.3 percent in 2023 (Figure 20). Meanwhile, non-interest expenditure remained very low, especially when compared to in other countries with similar incomes and regional peers (Figure 21).

Figure 20. Human capital spending (% of GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 21. Non-interest expenditure



Source: International Monetary Fund Government Finance Statistics.

2.5 Public Debt Dynamics

A weakened kip has significantly increased the public debt burden, with sustainability largely contingent on the outcome of ongoing debt negotiations and revenue reforms.

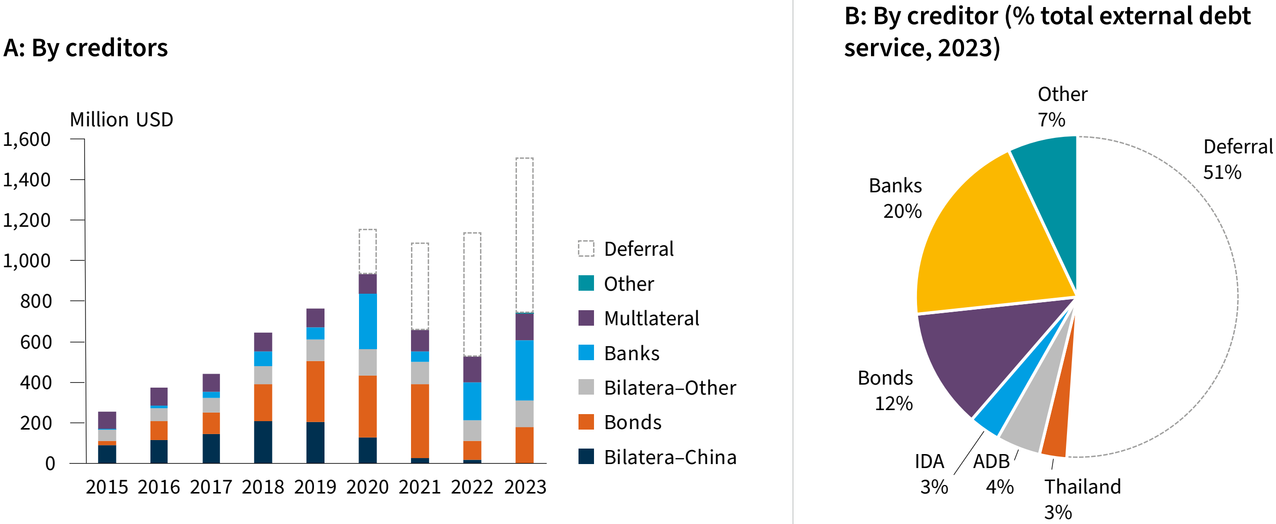
Unsustainable public debt threatens macroeconomic stability and development prospects. Laos is facing considerable liquidity and solvency challenges owing to a high debt burden, low foreign currency reserves, and limited financing options.[15] Total public and publicly guaranteed (PPG) debt is estimated to remain above 110 percent of GDP in 2023, reflecting the kip depreciation. If domestic expenditure arrears and the currency swap arrangement with the People's Bank of China are included, total PPG debt rises above 130 percent of GDP.[16] State-owned enterprises account for 49 percent of external PPG debt in the form of on-lending or guarantees, with the remaining 51 percent being government owned-debt.[17] The energy sector, primarily through Electricité du Laos (EDL), has been a significant driver of PPG debt accumulation, accounting for about 45 percent of external PPG debt in 2022 (45 percent of GDP).

PPG debt service payments are highly exposed to exchange rate risk. Debt denominated in US dollars accounts for more than half of total external public debt, followed by Special Drawing Rights, Thai baht, and Chinese yuan.[18] Therefore, the continued depreciation of the Lao kip against major foreign currencies in 2023 has had a considerable effect on the debt burden. In addition, interest rate increases during 2023 are expected to have some impact on debt service, as about 15 percent of total PPG debt was contracted on variable interest rates.

The domestic public debt stock is estimated to have increased in 2023 with the issuance of treasury bills and bonds to clear expenditure arrears. The domestic debt stock is estimated to have risen above 12 percent of GDP in 2023, mainly due to the issuance of government bonds to pay for domestic expenditure arrears, issuance of treasury bills, and advances from the Bank of the Lao PDR to finance the budget. Public expenditure arrears remained large, with a reported amount of 23 trillion kip (11 percent of GDP in 2022). These arrears are under the process of audit and verification.[19]

Public debt repayments are estimated to increase in 2023 (Figure 22). Total external public debt service rose considerably, despite deferrals of repayments to China. This was driven by maturing bonds and the amortization

Figure 22. External public debt repayment due



Source: World Bank calculations based on Ministry of Finance data.

Source: World Bank calculations based on Ministry of Finance data.

[15] The latest IMF-WB Debt Sustainability Analysis (May 2023) assessed Laos to be in debt distress with an unsustainable outlook.

[16] The upcoming 2023 Public Debt Bulletin will be reflected in the next Lao PDR Economic Monitor.

[17] Laos uses the currency criterion, which means that external debt comprises all debt denominated in foreign currencies, irrespective of where it is issued. Domestic debt comprises all kip-denominated debt.

[18] See Lao Economic Monitor November 2023 for more details on PPG debt stock in 2022.

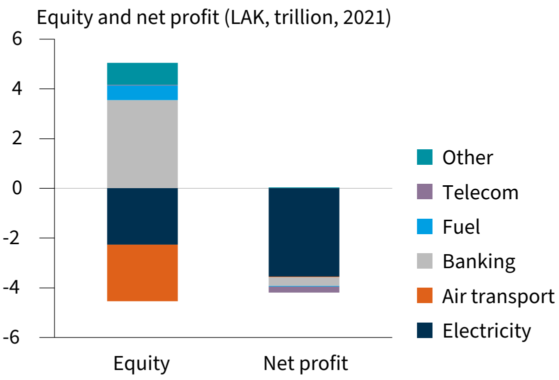
[19] According to the 2022 Public Debt Bulletin, arrears are not yet considered to be PPG debt under the Public Debt Management Law. These only become a debt if (and when) settled through a bond issuance. The government reported completed public works (relating to capital investment) of about 33,000 billion kip, of which 23,000 billion kip is currently undergoing an audit and inspection process by relevant agencies. The amounts verified and approved as arrears might be cleared through a combination of domestic bond issuances and future budget allocations.

of bank loans, followed by repayments to multilateral creditors. While the specific terms of the deferrals are not known, they had accumulated to about $2 billion by the end of 2023 (nearly 16 percent of GDP). Domestic debt repayments also rose slightly, as more treasury bills matured. Total debt service (i.e. principal and interest on domestic and external debt after deferrals) account for almost 40 percent of domestic revenue. Without deferrals, total debt service would be as much as domestic revenues in 2023.

Laos relies increasingly on the domestic financial market to meet debt service obligations, as access to international capital markets has been further restricted. The August 2023 bond issuance in Thailand was significantly undersubscribed, while in September the TRIS ratings agency downgraded Laos' sovereign credit rating to BB+ with a negative outlook. This implies that further bond issuances in Thailand are unlikely to take place before 2026.[20] The government turned to the domestic capital market to finance the deficit and repay its debts, issuing Thai baht bonds (for the first time), US dollar bonds, and kip bonds on the Lao Securities Exchange (amounting to 3 billion baht, $100 million, and 3 trillion kip). Baht bonds were fully subscribed (mostly by banks) and mostly with a one-year maturity, while the subscription of US dollar bonds was lower. Claims on the government by banks also increased (see the Financial Sector section).

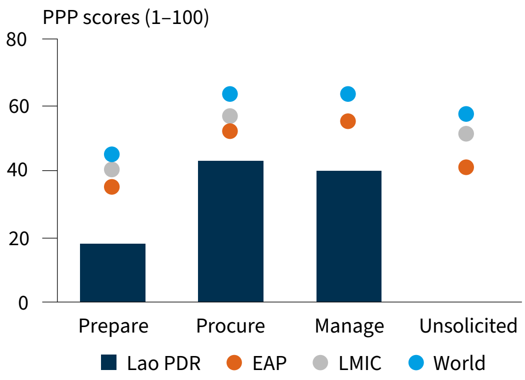
The operations of state-owned enterprises and public-private partnerships pose fiscal risks through additional contingent liabilities. In 2022, SOE debt accounted for 49 percent of total external PPG debt (in the form of on-lending and public guarantees), of which 42 percent was held by SOEs in the power sector (namely, EDL and Lao State Holding Enterprise). According to the World Bank's 2023 Public Finance Review, the electricity sector has negative equity and generates large losses (Figure 23). Kip depreciation has significantly affected EDL, which earns revenues in kip but has to repay its debt and import power in foreign currencies.[21] While PPPs have brought some benefits to the local economy, they are often complex arrangements that can create significant fiscal costs and risks. The 2023 Debt Sustainability Analysis indicates that public debt is most sensitive to a contingent liabilities shock. Meanwhile, the regulatory quality for Lao PPPs is relatively low compared to in peer countries, especially in terms of project preparation (Figure 24).

Figure 23. SOE performance by sectors



Sources: World Bank Public Finance Review, 2023

Figure 24. PPP regulatory quality



Source: World Bank Public Finance Review, 2023

[20] The downgrade reflected a significant deterioration in the serviceability of public debt, weak economic fundamentals, and the kip depreciation. Total bond stock was $1.1 billion in 2022, of which the majority were issued through the Thai bond market. The government planned to issue 3.6 billion Thai baht in the Thai bond market in August 2023 (about $100 million), but actual subscription was only 22 percent of the planned amount.

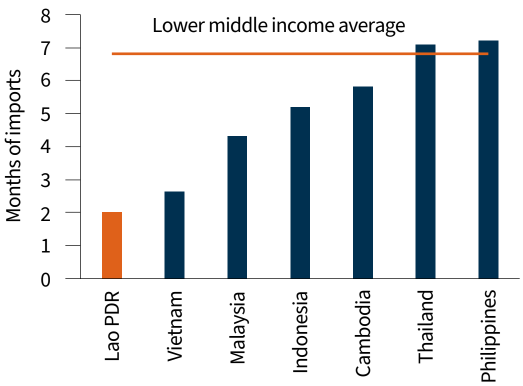
[21] In February 2024, 24 percent of EDL-GEN's shares was transferred from Phongsubthavy Group (PGL) back to EDL. The transfer could have implications on the PPG debt level. https://edlgen.com.la/uploads/lsx/2024/en/Transfer_of_24_EDL-Gen_Shares_from_Phongsubthavy_Group_(PGL)_to_Electricite_Du_Laos_(EDL)_(EN).pdf (Accessed 13 March, 2024).

2.6 External Sector

Persistent external imbalances continue to pressure the exchange rate.

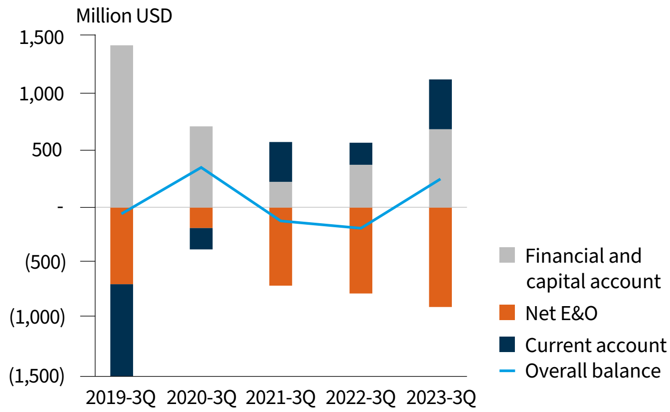
External imbalances persist, leading to foreign currency demand-supply mismatches, which put pressure on the exchange rate. The official balance of payments data shows net foreign exchange inflows of about $250 million in the first three quarters of 2023, supported by a strong current account surplus and large investment inflows (Figure 26). Official data underreports imports and does not reflect unremitted export proceeds (Figure 27). Imports of goods were underreported by almost 30 percent in 2023 when compared to trade partners' mirror trade data.[22]

Figure 25. Reserves in months of imports



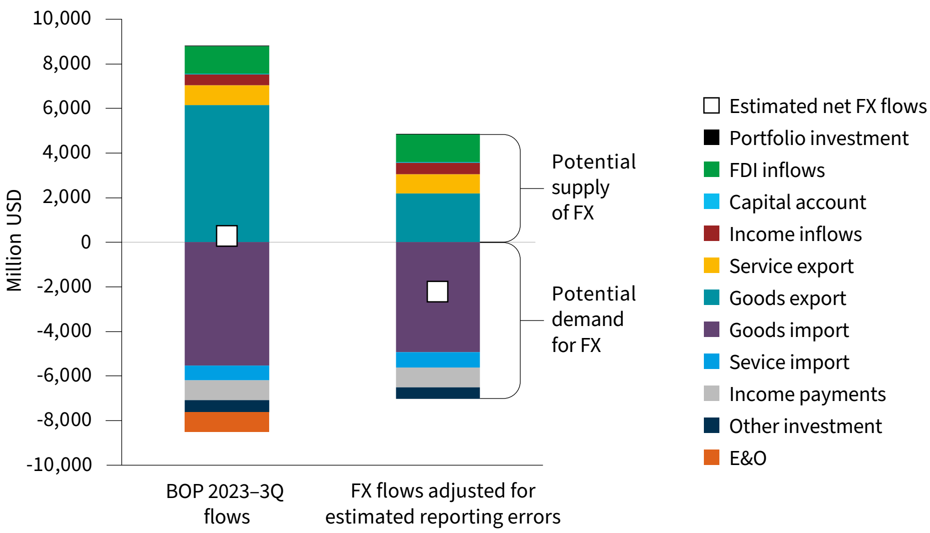
Source: World Bank World Development Indicators.

Figure 26. Balance of payments



Source: Bank of the Lao PDR.

Figure 27. Indicative scenario of potential foreign exchange supply-demand imbalances on balance of payments by end of Q3 2023



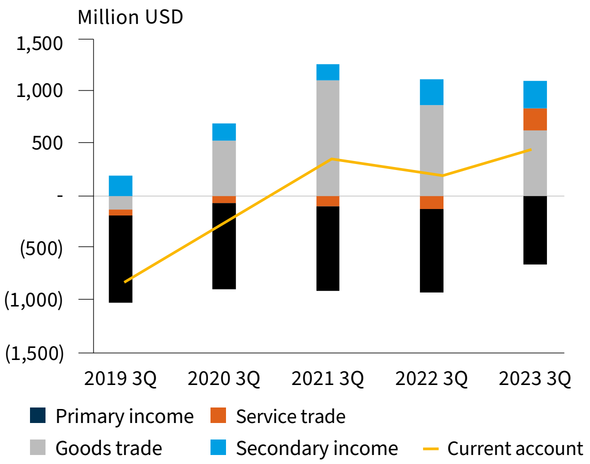
Source: World Bank staff assessment based on data from the Bank of the Lao PDR, Ministry of Finance, and other authorities and trade partners.

Note: FX denotes foreign currencies. Estimates of net foreign exchange flows are based on the following assumptions: (i) 41 percent of officially reported export proceeds are remitted back into the economy in three quarters of 2023; (ii) goods imports adjusted for underreported imports and imports already financed by investment projects, (iii) the underreporting of imports and unremitted exports are captured in errors and omissions, and (iv) errors and omissions are negligible after these adjustments.

[22] Official statistics is based on Ministry of Industry and Commerce https://laotradestat.moic.gov.la/estat/home (Accessed 13 March, 2024). Trade partner statistics are based on the International Monetary Fund Direction of Trade Statistics.

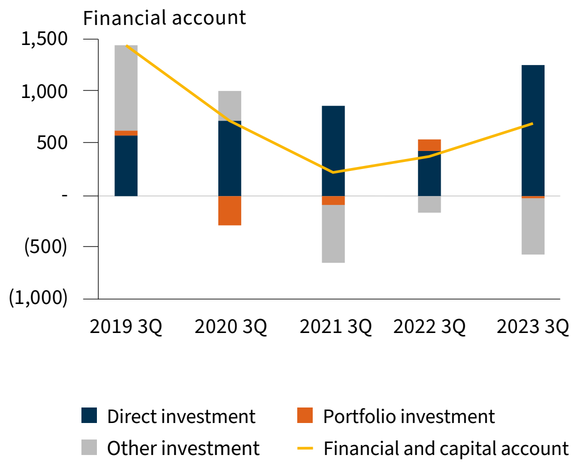
At the same time, actual foreign exchange inflows relating to Laos' exports accounted for less than half of the total recorded official export values. In practice, these two factors contributed to limited foreign exchange inflows, which result in foreign exchange shortages in the economy, against a backdrop of high foreign exchange demand for imports, external debt repayments, and business profit repatriation.[23] This, in turn, continues to put pressure on the exchange rate, fuel the parallel market, and feed into domestic inflation.

Figure 28. Current account balance



Source: Bank of the Lao PDR.

Figure 29. Financial account balance



Source: Bank of the Lao PDR.
Note: positive value denotes an inflow

Official statistics show an improved current account balance owing to an improved trade surplus and lower net income payments abroad. According to official data, the net trade surplus in goods and services reached $830 million in the first three quarters of 2023, a 12 percent year-on-year increase, supported by strong service exports (tourism and transport), which partly compensated for a lower trade surplus for goods. Goods export growth was marginal in the first three quarters, as higher mining exports offset declines in electricity, manufacturing, and agriculture exports. Imports grew by 3 percent year-on-year in the first three quarters of 2023, driven by machinery equipment, vehicles and parts, and construction materials. Net primary income payments abroad declined by 18 percent in the same period due to continued interest expense deferrals on public debt and lower interest payments and profit repatriation by the private sector. Net secondary income slightly increased, partly supported by remittances and personal transfers. However, the current account is estimated to be in deficit when taking into account underreported imports as reflected in trade partners' data and unremitted export proceeds.

Official statistics mask persistent external imbalances in foreign currency flows, which put pressure on the exchange rate. Actual foreign exchange inflows related to exports are still much lower than those presented in official data because only 41 percent of total export proceeds were repatriated by the third quarter of 2023. This contributed to limited foreign exchange liquidity in the economy. Most unremitted export proceeds are reflected in large errors and omissions in the balance of payments statistics. In addition, net primary income payments abroad remained high despite the recent decline. In practice, the current account balance remains significantly negative on a cashflow basis. Coupled with low foreign exchange reserves, even after the currency swap, foreign liquidity shortages place significant pressure on the exchange rate.

Financial account net inflows increased in the first three quarters of 2023, owing to higher direct investment. Net inflow to the financial account reached almost $700 million by the end of the third quarter of 2023, almost double the level in the previous year, as strong foreign direct investment offset net outflows on other

[23] The underreporting of imports and unremitted exports are captured in errors and omissions in the balance of payments.