

Tiny, Poor, Landlocked, Indebted but Growing:
Lessons for Late Reforming Transition
Economies from Laos

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(1) INTRODUCTION

The world's major development challenge: Collier's the 'bottom billion', least developed countries.

Convergence not evident; prevailing catch-up pessimism.

'Development traps': conflict, natural resources, land-locked, poor governance.

Globalization only works if have the 'pre-requisites', able to participate in global production networks, policy credibility, etc.

Danger that this pessimism become the new development orthodoxy.

Can examine these issues with reference to cross-country econometrics or very detailed case studies. This a study of Laos, the poorest ASEAN member. Very unfavourable 'initial conditions': colonial neglect; awful conflict, lost about 3/4 quarters of skilled population in 1970s, highest unexploded ordnance per capita; land-locked; high debt.

Yet, when embarked on largely conventional economic reforms - macro, trade, etc - achieved moderately fast growth.

Laos case study illustrative of dangers of this 'development pessimism'; also indicative of the challenges in transition from plan to market.

(2) AN OVERVIEW: THE LAO DEVELOPMENT RECORD

(2.1) The Historical Backdrop

Shares border with five countries (map), part of French colonial empire, colonial neglect, governed from Hanoi, independence in 1953. From 1960, deeply enmeshed in Vietnam War.

Became communist state in 1975, Lao PDR. Lost about 3/4 of its educated elite, terrible bombing legacy. Attempted to introduce agricultural collectivization, connected to Comecon Bloc.

Disappointing results, imminent implosion of USSR, followed Vietnam's reform with the 'New Economic Mechanism' (NEM), 1986, cautious liberalization.

1987 - removed most price controls, trade reforms commenced.

1988 - unification of exchange rates, began SOE reforms, aid flows resume.

1990s - further trade reform; joins ASEAN in 1996; temporary loss of macro control in 1997-98, partly linked to AFC; reform slows.

2000s - renewed reform, beginnings of resource boom.

Very little political liberalization.

(2.2) Economic Recovery and Growth

Figure 1: Laos the poorest ASEAN country, both pci and HDI.

Figure 2: National accounts from about 1990; averaging about 6% growth; so pci doubled since reforms commenced; first sustained growth episode. Less affected by AFC, mainly real sector cf financial contagion.

Figure 3: Accompanied by structural change.

Agriculture sector shrinking, but growing quite fast - crop diversification rural investments, reduced inter-provincial trade barriers.

Rapid industrial growth, including manufacturing, utilities (electricity exports), mining (major exports emerging).

Also services, broad-based - trade freed up, tourism, telecoms, etc.

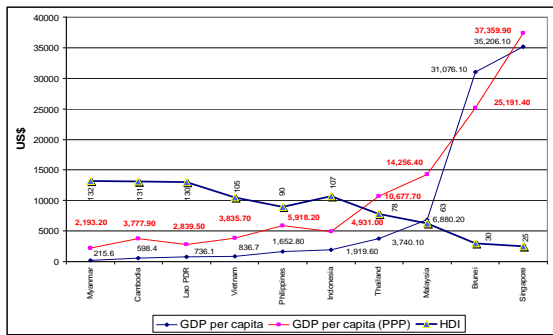
External accounts - three main features:

a) Rapid increase in all forms of international transactions, trade/GDP share doubled 1990-2006, 37-78%.

b) Very large deficits, fiscal, BoT, CAD; funded by aid and FDI.

Eg. CAD 10-20% of GDP; aid 6-10% of GDP; imports generally 50% larger than exports. So very high external debt (inc. USSR era), about 90% of GDP; but mainly concessional, long-term, IFI's.

Figure 1: Southeast Asia: Economic and Social Indicators, 2006



•Note: HDI – Human Development Indicators by rank, 1 is highest.
 •Source: ASEAN Secretariat, World Development Report 2007

Figure 2: Economic growth, 1990-2006, Laos and Neighbours (% growth rate)

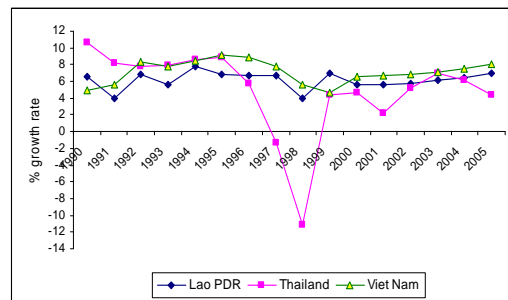
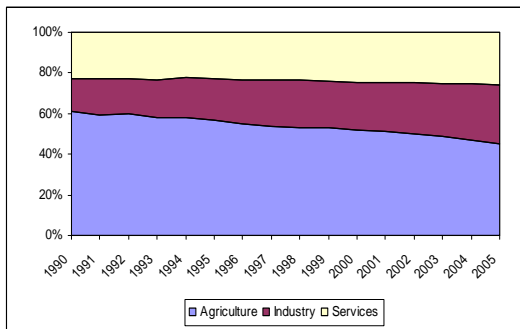


Figure 3: The Structure of the Lao Economy, 1990-2005 (% of nominal GDP)



c) Forex earnings surprising diversified for tiny economy. Eg, substantial earnings from garments, tourism, mining, electricity, remittances, each at least \$100 million. Facilitates macro management, durability of growth. Also diverse impacts and management issues.

Eg, garments and tourism, range of drivers: low costs, special market access, open trade & FDI (garments); natural attractions, high-growth neighbours (tourism). See Figures 4 & 5.

(2.3) Social Progress

Broadly tracked economic growth, translating into improved social indicators, owing to low inequality. But ethnic minorities out of the mainstream, missing out?

Table 1: Summary of limited social indicators data, one population census, three rounds of LECS.

Poverty incidence fallen from 1/2 to 1/3, both head count and severity measures. Growth-poverty elasticity not very high.

On track to meet MDGs, unless impact of GFC severe (so far not).

See Engvall on determinants of poverty, serious pockets, ethnicity v/s associated characteristics.

Rapid improvement in non-monetary indicators since reform. Eg, LE increased by a decade, IMRs halved, literacy risen substantially, etc.

Figure 4: Garment exports, 1995-2006 (US\$ millions)

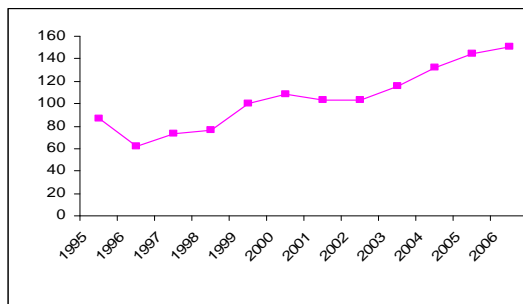


Figure 5: Tourism, 1990-2006 (d) Visitors (in 000s on LHS) and estimated revenues from tourism (in US\$ million on RHS)

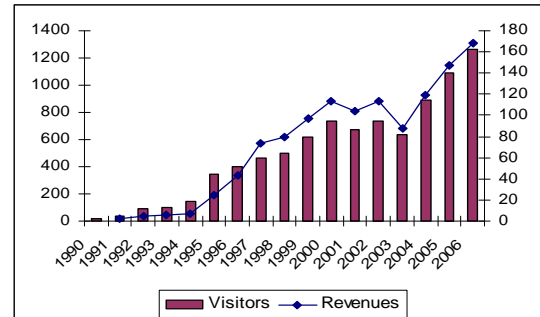


Table 1: Lao Social Indicators, 1990-2005

| Indicator | 1990 | 1995 | 2005 |
|------------------------------------|------|------|------|
| • Infant mortality rate (/1,000) | 120 | 104 | 70 |
| • Life expectancy at birth (years) | 50 | 51 | 61 |
| • Adult literacy (%) | 57 | 60 | 73 |
| • Primary school enrolment (%) | 63 | 69 | 84 |
| Poverty: | | | |
| • Incidence (head count, %) | 46 | 40 | 33 |
| • Gap (index) | 11.3 | 10.3 | 8.0 |
| • Severity (index) | 4.2 | 4.0 | 2.8 |
| • Gini ratio (expenditure) | 0.29 | 0.36 | 0.33 |

Notes and sources: Extracted from ADB (2006) and UNDP (2006). Poverty and inequality data refer to years 1992/93, 1997/98 and 2002/03. See sources for original source material and additional notes.

(3) DEVELOPMENT CHALLENGES: FROM PLAN TO MARKET

Consider macro management, trade policy, microeconomic reform.

(3.1) Macroeconomic Management

Fiscal policy: Major challenges from indebtedness, weak revenue base, weak fiscal policy framework, partially reformed SOEs and SOBs, limited macro policy credibility.

Specific fiscal policy challenges: fragmented/decentralized tax collection, limited buoyancy; proliferation of tax incentives undermining revenue base; weak tax administration, falling trade taxes erode revenue.

But progress: fiscal consolidation, increased mining royalties, VAT.

Figure 6: fiscal deficits falling; MT debt reduction strategy, increasing aid independence.

Inflation/ER policy: Transition economies often inflation prone, soft budgets, weak central banks.

For Laos, a major challenge, serious inflationary episodes (Figure 7), explained by cost-push and fiscal deficit factors, eg, 1998, 2003.

But general trend lowering inflation, development of MP instruments.

Figure 6: Fiscal Deficit and Public Debt, 1997-2006 (% of GDP)

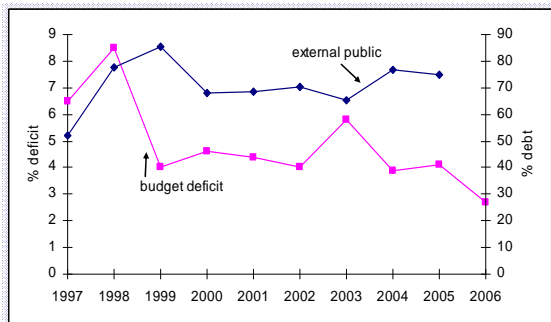
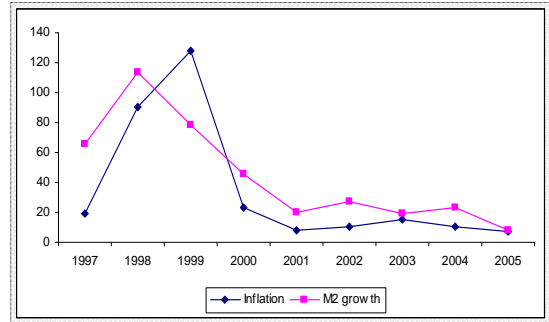


Figure 7: Inflation and Money Supply, 1997-2005 (%)



Lao ER/MP settings unusual: abolished parallel market, aims to target a stable Kip/Baht rate, as main nominal anchor. Can't control MS, so uses OMOs.

Widespread foreign currencies, about 50% of notes, 60% of bank deposits. Official ambivalence, occasional attempts to eliminate, but mainly pragmatic acceptance, provides a MP discipline. Is a case for dollarization, especially as labour market is flexible and fiscal policy much tighter. But political opposition. Hence 'muddling through' (Menon), providing acceptable macro outcomes.

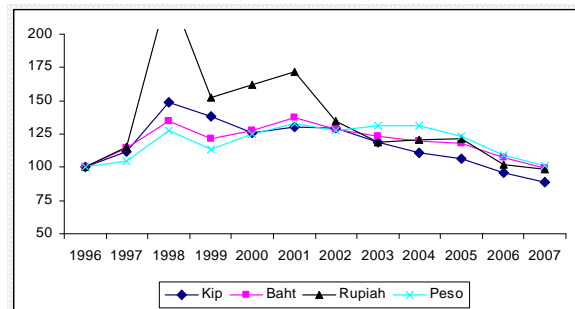
Managing resource booms: Major booming sector issue, both mining and electricity generation, but limited policy instruments (Warr).

PV of gold/copper exports & hydro exports each >100% of current GDP; 3% points of growth; 15%+ of govt revenue; 5-6% of GDP in BoP.

Competitiveness/inflation effects so far blunted: rising ToT, debt payoff, some exports (garments, tourism) not very ER sensitive, surplus labour. Various estimates of REER; see Figure 8. Large nominal depreciation in late 1990s, some real also; then gradual appreciation.

Subject to the qualification of measuring the REER with multiple currencies.

Figure 8: Real Exchange Rates, 1996-2007, Laos and Neighbours (1996 = 100)



(3.2) Trade Policy

Major issue in transition economies, both technical and political economy. Also land-locked issue, and many trade agreements.

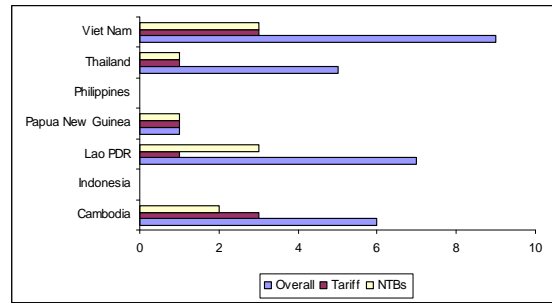
Trade reform: Steady trade reform (Fane), narrower tariff bands; converting NTBs to tariffs; capped anyway by smuggling. But still significant reform agenda:

Significant trade barriers still present (Figure 9), NTBs in a range of 'strategic' industries, combined with opaque customs administration. Informal cartels operate in sectors with SOEs (eg, cement). Need to coordinate trade and fiscal policy.

Trade policy making dispersed across ministries. Many firm-specific duty exemptions, eg, effective tariff rate less than half the simple average tariff. Rules for exemptions unclear. Hangovers from central planning era, including allocation of import quotas; often not commercially convenient.

Regional and international trade agreements: Complex layers of trade agreements tax very limited administrative capacity. WTO application proceeding for several years; difficult process.

Figure 9: IMF Index of Trade Restrictiveness, Laos and Neighbours



Membership of AFTA being phased in, but introduces complex set of agreements, in practice beyond the administrative capacity of Lao bureaucracy, especially ROOs. In principle might have dual trade regime, but in practice virtually impossible. So only feasible strategy is multilateralization of AFTA concessions, but this politically unacceptable. Also needs to marry WTO commitments, AFTA commitments, various transit good arrangements, with least developed country facilities, which Laos can avail of.

Land-locked a problem? General presumption in (mainly African) literature is that complicates trade liberalization and export performance. Generally not serious for Laos: in a region of export-oriented economies; ASEAN membership contributes to harmony; foreign truckers allowed entry, increased transport efficiency; and able to negotiate transit goods arrangements with Thailand and Vietnam. For Vientiane garment firm, found to similar to a Bandung garment factory.

Though some complications: Agreements work OK for firms on main transport corridors, but less well for more remote exporters, so a 'geographic dualism'. And more difficult for SME exporters that don't have the scale to consolidate shipments, pay for customs post, etc.

(3.3) Governance and Enterprise Reform

These often the most difficult in transition economies (Pomfret): SOE reform, bureaucracy, etc, danger of overdoing FDI/export incentives. Absence of data complicates evaluation.

Governance indicators: Table 2 - generally the lowest for SE Asia.

Regulatory regime: Two detailed firm-level surveys (ADB-WB, GTZ) provide approx indication of challenges. See Figure 10. Predictable responses on infrastructure and macroeconomic uncertainty. But also regulatory complexity, especially for SMEs, uneven application of laws. **Doing Business** rank 159/175; very low for time to start a business. Tax administration and transparency a major issue. New investment law an improvement, but still maintains 'positive list' mentality, and reporting procedures cumbersome.

Finance sector reform: One of the most complex in transition economies. Figure 11: Lao system shallow, SOB dominated, high spreads, lack trust. Though improving with new entrants, tighter supervision, better macro management; also recourse to Thai banks across the border. But still command lending, NPLs, collateral problems for SMEs.

Table 2: Governance Indicators: Regional Comparisons, 2007

| Country | Voice and Accountability | Political Stability | Government Effectiveness | Regulatory Quality | Rule of Law | Control of Corruption |
|----------------|--------------------------|---------------------|--------------------------|--------------------|-------------|-----------------------|
| 1. Philippines | 43.3 | 10.1 | 56.4 | 50.5 | 33.8 | 22.2 |
| 2. Indonesia | 42.8 | 14.9 | 41.7 | 43.7 | 27.1 | 27.1 |
| 3. Malaysia | 31.3 | 52.4 | 82.9 | 67.0 | 65.2 | 62.3 |
| 4. Thailand | 29.8 | 16.8 | 61.6 | 56.3 | 52.9 | 44.0 |
| 5. Viet Nam | 6.7 | 56.3 | 41.2 | 35.9 | 38.6 | 28.0 |
| 6. Cambodia | 24.0 | 28.8 | 20.9 | 30.6 | 13.8 | 8.2 |
| 7. Lao PDR | 6.3 | 42.8 | 21.3 | 15.0 | 17.1 | 13.0 |

*Note: 2007 data the latest. Percentile ranking is interpreted as follows: Laos has a rank of 6.3% for voice and accountability. This means that the Lao score for this category is higher than 6.3% of the 212 countries included in the indicator, or conversely about 93.7% of the 212 countries have a higher score.

*Source: World Bank, 2008.

Figure 10: Establishments Identifying Problems as "Major" or "Very Severe" Obstacle to Growth (% of firms)

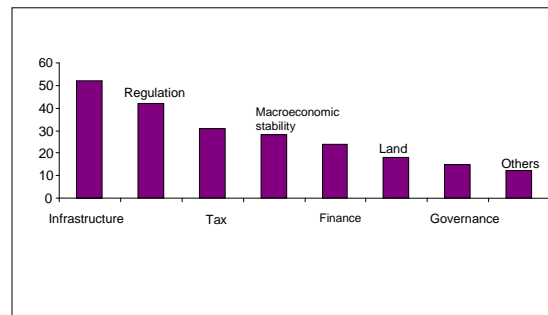
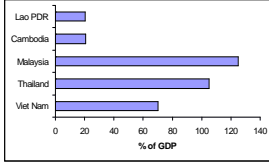
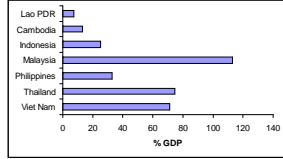


Figure 11: Comparative Financial Indicators: Laos and Neighbours

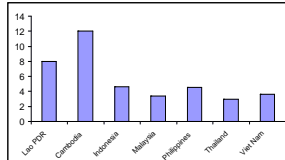
A. Broad Money Supply as a % of GDP



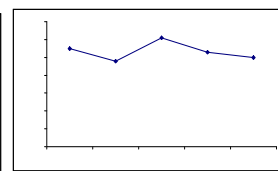
B. Domestic Credit to the Private Sector as % of GDP



C. Average Interest Spreads of Loans Over Deposits



D. Kip Interest Spreads Since 2003



Sources: Central banks, various countries. Average interest spreads refer to local currency lending rates over deposits rates.

Enterprise structure and dynamics: Difficult to assess, no economic census. GTZ (2006) survey the most extensive, found considerable enterprise dynamism, many firms graduating from household to micro to SME. See Table 3. Encouragingly, most of the growth domestic private firms.

Also difficult to estimate firm-level productivity. See Figure 12 for one set of estimates, internationally comparable, standardized product (men's shirt). Labour productivity increasing, catching up to Thai levels, with wages 1/3-1/4 that of Thailand.

Table 3: Change in Enterprise Size

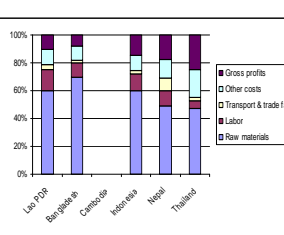
| Firm size | Size Before Survey in 2005 | | | | Total in 2005 survey |
|---------------------|----------------------------|-------|--------|-------|----------------------|
| | Micro | Small | Medium | Large | |
| Total prior to 2005 | 135 | 198 | 43 | 14 | 390 |
| Large | 0 | 1 | 11 | 8 | 20 |
| Medium | 2 | 31 | 26 | 5 | 64 |
| Small | 55 | 161 | 6 | 1 | 223 |
| Micro | 78 | 5 | 0 | 0 | 83 |

Firms measured by employment

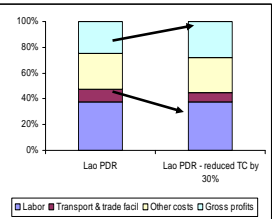
Source: 2005 Enterprise Baseline Survey, GTZ, Vientiane, published May 2006

Figure 12: Distribution of FOB Prices of Men's Cotton Shirts Produced in Similar Garment Factories

A. Composition of FOB Prices



B. Impact on Profit Margins from a 30% cut in Transaction Costs



Note: The estimates are indicative only

Source: Chart A: fieldwork estimates for Lao PDR, Cambodia, and Indonesia. World Bank estimates for Bangladesh, Nepal and Thailand, from various diagnostic trade studies.

(3) CONCLUSIONS AND SOME LESSONS

Very poor, latecomer, transition economies with unfavourable initial conditions can grow if get a few key economic policies 'right'. The international literature may have overstated the handicaps for these economies. The international economy provides diverse niches. Landlocked barrier may also have been overstated. Small size, LDC status, also facilitates international market penetration.

Lao experience illustrates these propositions, eg, garments, tourism, mining, electricity, remittances. Success creates a reform momentum. Some policies may be 'unorthodox' but effective, eg, multiple currencies. Two factors worked to Lao advantage, but shouldn't overstate importance of domestic reforms:

Surrounded by high-growth neighbours, emulating Vietnam. But geography alone insufficient, eg, case of Myanmar.

Very large aid flows. Useful, though effectiveness conditional on good policies. Also major management issues for very small economies dealing with many donors, multiple modalities, priorities, etc.