Brief economic outlook for 2019

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"It's difficult to make predictions, especially about the future" goes the famous quote that probably originates from a Danish proverb.

Macro-economic forecasting is a precarious endeavour that has not yet been really mastered, even not by major forecasting agencies. Volatility or variance (standard deviation) are often underestimated and particularly in times of abrupt changes like crises or recessions predictions are often wrong.

Nevertheless we want to briefly look at several recent developments and their likely impact in 2019. Since this article is not supposed to become a book it will look at only a limited number aspects, conceding that the following assessment will not be comprehensive and omit a good deal of details.

The views presented are based on figures and analysis from international sources, such as the IMF, World Bank etc., leading economic magazines and think tanks as well as Lao government sources and on our own observations.

The World

Competition between the great powers has increased in 2018 and there is a good chance that this trend will continue in 2019. The relationship between USA and China might become more tense and, with waning arms control treaties, the arms race between the China, Russia and USA is likely to reignite. So is the potential for conflict in the South China Sea and so is increased competition in cyberspace. For many "middle powers" the situation in 2019 will most likely become more complex and uncomfortable, a bit like squaring the circle, being caught between the desire to maintain a tight security relationship with the US and expand business relationships with China.

Against this backdrop the geopolitical risk for international business has increased and this risk will probably further unfold in 2019. On one hand we notice China's intention to have a more prominent place in the world order and to economically catch up, on the other hand OECD countries, not least due to US pressure, will erect higher barriers for Chinese investment and for economic engagement with China. In 2016 the Obama administration spoiled the sale of the German company Aixtron to China's Fujian Grand Chip Investment Fund. In September 2017 the European Commission proposed an investment screening instrument based on concerns for national security and public order; one year later the European Parliament called for its swift adoption. France is worried about the purchase of its vineyards by Chinese investors, Germans are uneasy about certain Chinese takeovers and have increased the barriers.

The West's resistance will be met by countermeasures from Beijing which could lead to a spiral towards an ever tenser situation.

A stalemate situation at the WTO, particularly in the field of trade dispute settlement, and a less multilateral approach to international business could force nations into seeking more bilateral agreements that make the international business environment more volatile and less predictable.

The global economic outlook for 2019 is gloomier than the one for last year. The main causes are raised tensions in international trade, weaker performance in emerging and developing economies and waning cross-border investments. The World Bank forecasts a global growth of 2.9%, slightly lower than 2018. Advanced economies are predicted to grow by 2% - the Euro area by 1.6%, down from an estimated 2% in 2018. South Asia, led by India, will see the strongest growth (7.1%), followed by Asia Pacific (6%) with China probably at about 6.2%.

Against this backdrop, *The Economist* points out that globalisation has in the last couple of years changed its character and by most measures slowed down over the last years – a trend that might well continue in 2019. Trade stood at 61% of GDP ten years ago, now it is down to 58%. Cross border bank loans stood at well over half of global GDP – now it is not much more than a third. Foreign Direct Investment (FDI), 3.5% of GDP in 2007, has plummeted to 1.3% last year. In 2018 alone global FDI fell by about 20%, partially due to a drastic fall of new Chinese engagement in the USA and Europe. The odds are that global FDI will shrink further in 2019.

The impact on international inequality has been dramatic – measured by PPP p.c.[1] about 88% of the emerging economies ten years ago were catching up with the rich countries– now it is a mere 50%. Disenchantment in the populations of several OECD countries, which can be underpinned by figures reflecting individual income and which have resulted in increasing relevance of populist movements, are at least partially results of increasing inequality on national levels and the feeling of certain social groups to be "left behind".

There are several reasons for this development – the financial crises of 2008-09 made banks more reluctant to finance trade or overseas ventures; transport cost and tariffs have barely fallen in the last decade, while the return of multinational investment has dropped significantly. Politics also play a part: the attitude of the Trump administration has further contributed to the slowing of globalisation.

As the global economy shifts to services, their international trade will grow, but if the past is an indicator, many services are much harder than goods to trade across borders and, not least in the high-tech sector, more vulnerable to political intervention: India has last year passed regulations that deny Amazon and Walmart to own inventory; China is sticking to its adverse approach to certain foreign digital firms.

In future globalisation may take more the pattern of regionalization. The OECD reckons that international supply chains are becoming more regional, when inputs are measured by value added. This means for instance that the EU and Asia trade more in their respective regions than between each other. Similar trends are visible in FDI flows.

[1] Purchasing Power Parity per capita

In technology the most important aspect will most likely be the roll-out of 5G telecommunication in developed countries – another field of potential conflict where two of the major players, the Chinese companies Huawei and ZTE, are facing bans on sales of their electronic infrastructure in the domestic markets of the US and several other OECD countries.

Europe

The outlook for Europe is mixed – at best. Brexit is becoming evermore unpredictable and, in part, resembles a bizarre, though interesting TV series. Italy's populist government and its fragile banking sector remain a threat to the integrity of the Eurozone. Macron's reform politics in France faces opposition from the street in a country where the political center seems to be increasingly hollowed out. The shrinking of the political center is also visible in Germany, albeit on a lesser scale.

Germany's economic growth prospects has been downgraded to 1.8% with, being a strong exporter, disruptions in international trade seen as greatest risk to the economy. Other risks are expected wage increases of about 3% in 2019 and 2020, induced by low unemployment. On the positive side wage rises will outstrip inflation, which probably will not be higher than 2%, so that a rise in consumption is likely.

The French economy, the second biggest in Europe, will most likely grow by about 1.6% to 1.7% with unemployment at about 9% and the current account deficit – which has dropped last year – as some of the major challenges.

Elections for the European parliament I n May might result in a more fragmented body, lead by pro-EU parties facing strong Eurosceptic and nationalist groups. Challenges to the EU institutions will also come from Eastern European countries like Poland, Romania and Hungary.

China

The peak of Chinese GDP growth seems to be well over. In 2018 its economy grew officially by 6.6%, the lowest since 1990 and down from 6.9% in 2017. The fourth quarter of 2018 saw only 6.4% growth. Some analysts say that even these figures could be significantly inflated. This year, according to World Bank estimates, it might reach only (but still a significant) 6.2%.

China's economic growth showed signs already of structurally slowing before the trade war with the US had begun, which has impacted so far probably less directly China's international trade than its business confidence. Some of the reasons are rooted in domestic policies – in a (very necessary) effort to clean up the environment, highly polluting production facilities have been closed down, particularly in the "rust belt" of China's Northeast. There was a crack-down on shadow banking in order to reduce systemic financial risk which led to a cooling of private economic activities and a debate about the role of private business in the economy.

Exports have been falling and while consumption is robust and the service sector is performing well, retail figures are stable, car sales, parts of manufacturing and the real estate sector outside of tier 1 cities are weakening. Private sector investment has grown whereas the growth in fixed investment, particularly investment in infrastructure, has slowed considerably. Industrial profits grew by 10.3% in 2018, less than half the figure of 2017. These are overall not very favourable trends as the government tried to rebalance its economy to a more consumer driven one and to address other structural imbalances (regional and social) as well as rising debt levels. However, due to the structural peculiarities of Chinese borrowing (most of it is done by state owned enterprises and local government investment vehicles), it is unlikely that China will experience a catastrophic “Minsky moment” in 2019.

It is very likely that economic growth in China will further decelerate this year as the economy restructures; Chinese officials expect 6 to 6.5%. For the government social stability – cemented by a high and increasing level of official control – and employment are paramount. There is some risk that, if the government cannot deliver on growth and employment, alternative and perhaps more dangerous measures will be taken to promote cohesion, such as promoting patriotism and a more assertive foreign policy which could have the inherent potential to lead to heightened geopolitical tensions.

On the other hand Beijing seems to undertake efforts to moderate the trade dispute with the US. It announced for instance to replace or amend the Made in China 2025 strategy by giving foreign companies greater access to its domestic market. At home, Keynesian measures such as fiscal and monetary stimuli and boosting domestic consumption will be rolled out in 2019 to improve the countries growth. On January 29th the State Council issued a notice to promote growth in consumption, which aims at expanding markets in areas like automobiles, home appliances and tourism. It is unlikely though that Beijing’s stimulus measures will be as massive as what had been rolled out after previous global economic crises.

In order to secure new markets, China will most likely increase its efforts related to the Belt and Road initiative although Chinese private banks have shown some restraints recently when it comes to lending to related projects and some countries have started showing resistance to the initiative.

While China and the USA negotiate to avoid a further escalation of the trade war, other issues often receive less attention than they deserve. One example is that China defines itself in the World Trade Organisation (WTO) as a “developing country” which gives it, among other, more leeway in implement agreements or limiting market access. Since the WTO leaves it to the countries themselves to define them as developing countries (or not), this raises tension, especially with the US.

ASEAN

With a GDP of more than 2.5 trillion USD ASEAN is the 6th largest economy in the world. It has been growing steadily at an average rate of about 5% per year. To continue that rate of growth, infrastructure needs have to be addressed. This is where the Chinese Belt and Road Initiative comes into the regional picture. The centerpiece is the Pan-Asia Railway Network which fundamentally consists of three major lines, all starting in Kunming. The Eastern line is designed to pass through Vietnam and Cambodia into Thailand, the Central and most expensive line through Laos, Thailand, Malaysia to Singapore and the Western line through Myanmar into Thailand. Another major project is the Digital Silk Road.

Although a boost in infrastructure is welcome, criticism of the project is rising in the region, mainly focusing on lack of transparency and inclusivity – according to the East Asia Forum almost 90% of the contractors are Chinese – and the risk of a debt trap. This has pushed some ASEAN member states like Malaysia and Myanmar to start re-negotiations with Beijing.

As for ASEAN-EU political relations there is a good chance that they will become closer. In the EU-ASEAN Ministerial Meeting on January 21st it was agreed to work closer together, to promote free and fair trade and rules-based multilateralism and, in principle, to upgrade the relationship between the EU and ASEAN to a Strategic Partnership. There is also the ambition to establish a EU-ASEAN Connectivity Partnership and the parties are moving closer towards a Comprehensive Air Transport Agreement.

Business relations between EU and ASEAN are strong and will most likely become even stronger – the EU is the biggest provider of FDI into ASEAN and its second largest trading partner. The European investment stock in ASEAN totals over 263 billion Euro, exports to ASEAN stood 2017 at 91 billion Euro, imports from ASEAN at almost 135 billion Euro. 99% of European enterprises in ASEAN which were surveyed by the EU-ASEAN Business Council in 2018 plan to maintain or expand trade and investment in the region over the next five years.

Lao PDR

Developments in Laos are much harder to predict when relying on published figures. According to the online available statistics of the Enterprise Registration and Management Department, total investment in Laos was 2017 about 9.9 billion. USD, in 2018 approximately 18 billion USD. The latter figure means that investment would almost have doubled and now roughly equal the country's GDP which is hard to imagine. GDP is defined as the sum of investment, consumption, government spending and exports minus imports. This means if investment would equal GDP, all other figures would basically either be zero or add up to zero, e.g. an export deficit that would be equivalent to government spending plus consumption. If the export deficit would be equal to government spending, there would be no money left for consumption. So nobody would buy food or drinks or pay rent, so we would all starve in the open (unless we own our accommodation, then we would die sheltered). FDI inflow in 2017, looking at the same source, would have been approximately 2.4 billion USD, whereas the World Bank only records 1.6 billion USD – about 0.65 billion USD more than in 2015.

On the positive side GDP is currently forecasted to grow by 6.6%, slightly more than in 2018 but less than previous projections assumed. To keep the economy growing, investment of 44,347 billion. LAK or almost 27% of GDP is foreseen for 2019, with almost 10% of the amount coming out of the national budget.

Sovereign debt remains with over 60% at an unhealthy and risky level for an LDC. The Lao Government has apparently taken warnings to this effect from World Bank and IMF seriously and plans to massively reduce the budget deficit and reduce borrowing to cover state expenditures by 2020. This leaves the government with two alternatives: severe cuts in spending or raising domestic revenue. For 2019 the government plans to reduce the public deficit to 4.28%, (i.e. slightly below 7.1trn. LAK) down from 5.3% in 2017. In order to increase domestic revenue the government's focus will be on improving the business environment and on investment in tourism, infrastructure, and processing industries.

It is crucial for Laos to improve its business environment for domestic *and* foreign investment in order to remain internationally competitive. Efforts are ongoing to improve the country's ranking in the World Bank's Ease of Doing Business Index.

Deficits in education are a significant obstacle to economic development in the Lao PDR that have to be addressed. So has the shortage of skilled and unskilled labour which is aggravated by emigration – about seven years ago it was reported by the Lao authorities that about 200,000 Lao nationals were working in Thailand – meanwhile that figure might have easily doubled.

In international trade Thailand, followed by China and Vietnam are the most important partners, a situation that is unlikely to change fundamentally in 2019.

SMEs, which in Laos are mainly very small companies and self-employed people, lack the capacity to raise money, to innovate and thus to make a significant contribution to the country's growth.

The informal sector – which according to estimates from the World Bank comprises between 60 and 80% of total employment - and its unfair competitive advantages in comparison to the formal sector is increasingly perceived as problematic.

Mining is still important, particularly for earning export revenues, but reduced demand, among others from China, and the volatility of copper price are issues – although the later has recovered from its low in 2015 it has dropped again since the middle of 2018. In 2017 the growth rate of the mining sector fell by 4.3% on a year-on-year basis. In 2019 the overall mineral production is assumed to fall by almost 2%.

Electricity generation, mainly through hydropower plants, remains of great importance for the Lao economy. By the end of 2018 the country had 61 hydropower plants with an installed capacity of 7,207 MW. Hydropower generation is supposed to increase massively in the future, but the tragic collapse of a dam in Southern Laos in June 2018 has cast a shadow on the vision to develop Laos as the "battery of South East Asia". Still, according to the Lao Government, there are currently 36 hydropower plants in various stages of construction, of which in 2019 at least 12 are supposed to become operational.

The Lao garment industry, with about 26,000 workers (90% of whom are women) the most important processing industry of the country, is facing problems which will most likely not change significantly in 2019. Issues are the lack of domestic raw materials, high transport cost and the chronic shortage of skilled labour. The garment industry is currently short of about 10,000 workers, partially because Thai garment factories are in a position to pay significantly higher wages than many – though not all - Lao garment factories, and attract Lao labour which then is missing on the domestic market. The situation is definitely a threat to the industry and some factories already had to close because of lack of workers. Due to this and other reasons the number of garment factories in the PDR has fallen from 92 to 78 over the past three years. It is not unlikely that this trend will continue, which will not be the end of this industry but result in a "survival of the fittest", means of those factories that are productive enough to pay regionally competitive wages.

Construction is expected to grow by more than 10% this year according to estimates of the National Institute for Economic Research. Still, there are reasons for concern - many construction companies suffer from deferred payments (particular in public sector projects) and have difficulties servicing their debts and getting access to loans.

Tourism, which supports directly and indirectly about 384,000 jobs according to the World Travel and Tourism Council, has endured significant declines in tourist arrivals and tourist revenues in 2016 and 2017. 2018 was better due to a rise of international tourist arrivals of 8.2%, but the actual number of arrivals still fell massively short of the target – 4.18million instead of the targeted 5million. Most tourists come from Thailand, followed by Vietnam and China; last year an increased number of Thai (+7%) and Chinese (+26%) tourists were recorded, but there was a 3% decline in Vietnamese tourist arrivals. There is a chance that the latter development maybe somewhat misleading since it is assumed that a sizeable number of Vietnamese did enter Laos in the past not exactly for touristic purposes but to seek employment. Stricter controls at immigration may have deterred Vietnamese nationals looking for jobs in Laos.

In 2019 Laos will apparently focus on Chinese visitors with its "Visit Laos-China Year 2019". The number of Chinese tourists increased 2018 to over 800,000; 2019 the government hopes to attract 1 million Chinese visitors. However, official estimates still reckon that 2019 will see a drop of revenue earned from foreign visitors by about 2.6% to 876mln. USD.

Official Development Aid (ODA) will lose some of its importance, as can be expected for a country that intends to graduate from its LDC status over the next few years to a Middle Income Country. The government expects to receive 7.1 trillion LAK in ODA in 2019 (about 4.3% of GDP), about 0.9. trillion less than what was planned for 2018

ECCIL

Though ECCIL does not necessarily have all the answers to global economic challenges, the chamber will try to improve the business environment in Laos, promote European-Lao business links and offer more valuable services to members and other clients.

In particular we will focus on advocacy, the provision of services and information as well as direct promotion of business links between the Lao PDR and Europe.

In advocacy we will tackle cross-cutting issues, here primarily the Ease of Doing Business issues, but also industry-specific issues, for instance in tourism.

In services we will deepen and broaden our offer of seminars and workshops and also try out new formats; we will have a job fair in May, we will compile and disseminate as much information as possible about the economy and its legal framework and respective changes. Last not least we will have networking events, some of them in a new format.

Vientiane, February 2019