

# PERSPECTIVE

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## **Laos's High-Speed Railway Coming Round the Bend**

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### **EXECUTIVE SUMMARY**

- A US\$6 billion high-speed railway line that will run through much of northern Laos is reported to be 78 per cent completed, with the first trains due to run in 2021.
- The railway will link Kunming in the Chinese province of Yunnan with north-eastern Thailand, and is a key part of China's Belt and Road Initiative (BRI) in Mainland Southeast Asia.
- This project has faced concerns over the debt implications for the host country, and whether the project makes good economic sense for Laos.
- Nonetheless, the Laotian government has ardently supported the railway project as a crucial part of its long-held desire to turn Laos from landlocked to land-linked.
- One legitimate worry is that the modest Laotian corporate sector is not yet well positioned to take advantage of the new railway's potential economic returns. Identifying and implementing new business opportunities that leverage the high-speed railway will be central to the ultimate significance of the project for Laos.

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## CONTEXT AND HISTORY

Latest reports suggest that an ambitious high-speed electrified railway track running through Laos and connecting Kunming in China's southwestern province of Yunnan with north-eastern Thailand is now 78 per cent complete. All the bridges, tunnels and other structures have been completed; what remains to be done is to lay the track, and to install the signalling and the other 'mechanics' necessary for operations. The first trains are expected to use the line approximately two years from now. Formally announced in 2015, the railway is part of China's Belt and Road Initiative (BRI), and is widely seen as a major step in the Laotian government's long-held desire to turn the country from being land-locked to land-linked.<sup>1</sup> For China, completion of the railway will not only link Yunnan directly to Thailand but also connect it to the Malaysian peninsula further south and ultimately to Singapore.<sup>2</sup>

The 420-kilometer north-south line cuts through a large part of northern and central Laos, starting at Boten on the Laos-China border, passing through Luang Namtha province, then wending its way roughly south through Oudomxay, Luang Prabang and Vientiane provinces, before terminating at a station most likely to be built close to the country's capital, Vientiane.<sup>3</sup> Its construction has been a colossal undertaking, requiring more than 70 tunnels and 150 bridges. Indeed, the line will run through tunnels for almost 200 kilometres.) It will have ten stations in Laos, including one at the former royal capital of Luang Prabang. It will thus allow domestic passenger and freight use. The line will also have some 20 'crossing loops' to allow trains to pass each other on what will be largely a single-line railway.<sup>4</sup>

This is not the first railway project in Laos. In the 1890s, the French built a small, seven-kilometer-long railway in the colony's southern panhandle, close to its border with Cambodia. The purpose of that line was essentially to allow for river-boat traffic further up the Mekong River and into Laos, despite the natural obstacle presented by the Khon waterfalls.<sup>5</sup> Operation of that line halted in 1941, following Japanese occupation of French Indochina.

More recently, in 2008 and after years of discussions, the governments of Thailand and Laos agreed to build a three-kilometre-long railway across the Friendship Bridge – the first such bridge across the Mekong River – to connect Nong Khai on the Thai side to a station at Thanaleng on the Laotian side. The governments of Australia and Thailand funded the project. There had been expectations that the line would ultimately run a further 20 kilometres, to Vientiane itself, possibly with French funding, but this never transpired.<sup>6</sup> The result is that a small passenger train runs a few times each way each day, requiring riders to get off at both ends to go through immigration check-points. There have also been vague plans to construct a 220-kilometre-long railway running roughly east-west through Laos's southern panhandle and, connecting north-eastern Thailand with central Vietnam.<sup>7</sup>

For China, the economic and geo-strategic attraction of the new high-speed railway is considerable. It will allow the shipment of goods from southern and south-western China to the markets of Mainland Southeast Asia, without having to depend on aviation or long shipping routes. As in the case of the proposed railway connecting Yunnan to Rakhine State on Myanmar's west coast, and thus to the Indian Ocean, the China-Laos railway will give the former country significantly greater transportation and logistical options in reaching markets and economies to its south and west.

It appears that the new railway will terminate at Vientiane, and not run on to the station at Thanaleng, though the latter could serve as a single trans-shipment point for cargo heading to and from Thailand. In either case, cargo will have to be trans-shipped at least once between Vientiane and Nong Khai, as the gauges of the new line and of that crossing the Friendship Bridge are different.<sup>8</sup> Seamless cargo traffic from Kunming to Bangkok will therefore not be possible, at least for some time, although it has been widely reported that the Thai government is also planning a high-speed railway to link Bangkok and Nong Khai, again with loans from China. If this project does go ahead, it will probably not be operational before 2026 at the earliest.<sup>9</sup>

## **ECONOMIC CONCERNS**

The cost of the China-Laos railway project is probably the matter that has attracted greatest international attention. That cost is around US\$6 billion, of which 60 per cent or US\$3.5 billion in the form of borrowing from the Export-Import Bank of China. A further 40 per cent, amounting to US\$2.4 billion, is being funded with equity in the form of a special purpose vehicle. This concern is a joint venture company among three Chinese state-owned firms and one Laotian state-owned enterprise. The latter enterprise holds a 30 per cent stake in the new concern. To fund that stake, the Laotian government has committed US\$250 million from the national budget and taken a second loan of US\$480 million from the Export-Import Bank of China. The country's combined debt exposure to that for the railway project is therefore more than US\$1.5 billion.<sup>10</sup> This is a considerable sum for a country with a nominal GDP of around US\$20 billion, and official foreign exchange reserves of around US\$1.1 billion. For the railway to make economic sense, the revenue that it generates will need to be sufficient to permit Laos to service these loans.

In January 2017, the International Monetary Fund cautioned that “the risk of Lao PDR facing external debt distress has risen from moderate to high”, and in its latest ‘Article IV’ report on Laos, released in August 2019, the same organization noted that “the risk of debt distress remains elevated”.<sup>11</sup> More recently, a Lowy Institute study on the impact of the BRI on various countries’ debt levels noted that the total debt that Laos owed to China stood at around 45 per cent of the former’s GDP. This figure exceeded those for all other countries considered in the study, including Cambodia, the Democratic Republic of the Congo, and other African and Pacific island states.<sup>12</sup> Laos actually has very little private sector external debt, around 13 per cent of total external debt as of 2015. But it has higher levels of multilateral debt, 23 per cent of the total, and of bilateral debt, 64 per cent. Around 60 per cent of this debt is denominated in US Dollars, with smaller amounts in Yuan, Yen, Euros and Baht.<sup>13</sup>

When the Laotian government first debated the high-speed railway project in 2013, the same year that China announced the BRI, some reports intimated that Laos would provide “underground mineral reserves” as collateral for the loan financing. Thus, if the revenues from the railway were not sufficient to service the debt, the lender would presumably have rights to mineral extraction as an alternative means of securing repayment.<sup>14</sup> Whether or not this is included in the financing terms of the railway, which is not backed by a sovereign guarantee, it has raised the spectre of the kind of debt default seen in other countries. Such default has resulted in China taking ownership of strategically important physical assets.<sup>15</sup>

One widely reported example of this outcome has been the Hambantota port project in Sri Lanka, also funded using China Eximbank loans.

In Laos itself, greatest domestic concern over the high-speed railway has probably been around the issue of adequate compensation for the communities adversely affected by this giant construction project.<sup>16</sup> Another point of contention has been the number of Chinese working to build the line, and conversely the lack of Laotian companies and workers contracted to take part in its construction. As in a number of other Mainland Southeast Asian countries close to China, there is growing worry in Laos about the burgeoning economic clout of the ‘Middle Kingdom’ and the extent to which the economy is being subsumed by that of the powerful neighbour to the north. The increased presence of Chinese nationals in northern border areas of Laos also brings concerns. But, as China is the largest investor in the country’s modest economy, pragmatism dictates that Laos find ways to absorb and harness Chinese capital, even without considering the close ideological ties between the two leaderships.

## **FINDING THE OPTIMAL STRATEGY**

If the downside risks of this railway project for Laos — largely in the form of excessive debt — are known, what potential upside economic opportunities does it offer the country? The World Bank appears broadly optimistic. In a recent report it suggested that the railway was “expected to bring significant economic benefits to Lao PDR if important complementary economic reforms are undertaken in tandem.” But the report also cautions that it “remains to be seen how economically profitable the railway will be and how the operating costs will be funded once construction is complete”.<sup>17</sup>

A key determinant of the railway’s commercial viability will be the extent to which it can generate new traffic, both cargo and passenger traffic, and particularly transit traffic between China and Thailand. A simple migration of extant traffic and cargo from roads to the new railway line is unlikely to be sufficient. But the generation of new traffic will in turn require infrastructure and logistics planning to ensure that the railway is well served by roads, cargo hub points and other platforms to allow Laotian companies can take advantage of the railway. There is a need for policy-makers to start thinking about economic corridors, and how best to leverage the new railway line to benefit the provinces through which it will run. There may even be a need to re-think some existing development plans; this process will also entail discussions with Laos’s development partners. Considerable lessons can be learnt, both good and bad, from other trans-border railway projects and from other infrastructure projects about how to ensure that countries through which they run also benefit. Forecasts of the likely passenger and cargo figures for the railway vary. Some critics argue that the figures used in the feasibility study for the railway are too bullish. However, a recent analysis using a geographical simulation model suggests that Laos will benefit from the railway mostly through passenger traffic, service provision for passengers, and ‘transit-oriented development’.<sup>18</sup>

The extent to which ‘soft infrastructure’ like customs clearance can be made smooth and reliable will also determine the attractiveness of the railway. In the latest iteration of the World Bank’s “Doing Business” report, Laos scores relatively well in ease of trading across borders. Its rank of seventy-eighth in that area is its highest rank across the ten “Doing

Business” measures; its overall ranking is one hundred and fifty-fourth.<sup>19</sup> The World Bank’s Logistics Performance Index shows a broadly similar picture, ranking Laos eighty-second overall, with clear potential for improvement in areas such as customs, tracking, timeliness of shipments, quality of logistics providers, and others.

It is also important that the Laotian corporate sector adopt a proactive stance in preparing for the railway’s entering into operation, and scoping out the business opportunities that will arise from it. Having largely missed out on participation in its construction, domestic firms should not adopt a wait-and-see approach to its operation. Further, these opportunities need not only concern large companies, of which Laos has relatively few. They may also create numerous openings for small and medium-sized firms, if they can identify possible new market demand. A lack of prior experience of large-scale railway development may hamper Laotian firms, and it might be difficult to envisage what will transpire. But it does not require too much imagination, innovation and long-term planning to come up with business plans focused on harnessing the impact of the new railway service.

Regardless of one’s opinions of the high-speed line’s intrinsic merits, opportunity costs and not inconsiderable risks, its arrival is now beyond question. The train, as they say, has definitely left the station. The priority now for Laos is to try and capitalise on it, and to derive the best possible return on the investment and debt commitments that it has made. With the right kind of strategic approach, on the part of both the public and private sectors, the railway could prove to be a fillip for the economy of Laos, which has for too long been overly dependent on just a few business sectors, as well as the largesse of development partners. Laos needs to be on board to leverage the railway’s operations as a means to diversify the economy into new areas of business — areas of business that were not feasible or commercially viable before. But that will not happen organically. It will require planning and execution.

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<sup>1</sup> In April 2013, the *Financial Times* reported that the Laotian leadership gave approval to commence negotiating a loan with China to underwrite the railway project. See “Laos high-speed rail: China’s ticket to southeast Asia and beyond”, *Financial Times*, 9 April 2013 (<https://www.ft.com/content/8fd5ed45-ca71-3f42-a513-0152c749e2b4>, downloaded 12 November 2019).

<sup>2</sup> For a good overview of the project, see “Landlocked Laos on track for controversial China rail link”, *Nikkei Asian Review*, 24 June 2017 (<https://asia.nikkei.com/Politics/International-relations/Land-locked-Laos-on-track-for-controversial-China-rail-link>, downloaded 12 November 2019).

<sup>3</sup> The precise location of the station is still not in the public domain, but it is expected to be somewhere to the south of the capital, and possibly close to a proposed new airport.

<sup>4</sup> Probably the most thorough analysis of the railway project to date is Scott Morris, “The Kunming-Vientiane Railway: The Economic, Procurement, Labor, and Safeguards Dimensions of a Chinese Belt and Road Project”, Center for Global Development, Policy Paper 142, 17 May 2019 (<https://www.cgdev.org/publication/kunming-vientiane-railway-economic-procurement-labor-and-safeguards-dimensions-chinese>, downloaded 12 November 2019).

<sup>5</sup> For further details, and some remarkable photos of boats being transported on the railway, see “The Mysterious Khon Island Portage Railway”, *Historic Vietnam*, 14 June 2014 ([www.historicvietnam.com/the-mysterious-khon-island-portage-railway](http://www.historicvietnam.com/the-mysterious-khon-island-portage-railway), downloaded 12 November 2019).

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<sup>6</sup> See ‘Thai-Laos Rail Link’, *Railway Technology* n.d. (<https://www.railway-technology.com/projects/thai-laoslink>, downloaded 12 November).

<sup>7</sup> A build and operate contract for this project was signed in late 2012, but it has not led to construction. There are, however, a privately owned ‘dry port’, bonded warehouse and logistics hub in Savannakhet.

<sup>8</sup> It is perhaps worth noting that on the Trans-Mongolian railway, the ‘bogies’ of the trains are changed at the Sino-Mongolian border, because of the differing gauges. Passengers may remain on the train, as the carriages are lifted into the air, and the bogies swapped over.

<sup>9</sup> Malaysia’s planned high-speed railway project, first announced in 2010 and meant to run down the peninsula to Singapore, is currently postponed, following the recent change in government. The principal reason for this postponement is Kuala Lumpur’s concern over the elevated costs.

<sup>10</sup> The loan terms are believed to be for 35 years, with a five-year grace period, and an interest rate of 2.3 per cent.

<sup>11</sup> International Monetary Fund “Lao People’s Democratic Republic: 2019 Article IV Consultation” country report, 8 August 2019

(<https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Lao-Peoples-Democratic-Republic-2019-Article-IV-Consultation-Press-Release-Staff-Report-48577>, downloaded 12 November 2019).

<sup>12</sup> Roland Rajah, Alexandre Dayant and Jonathan Pryke, “Ocean of Debt? Belt and Road and Debt Diplomacy in the Pacific”, Lowy Institute, 21 October 2019

(<https://www.lowyinstitute.org/publications/ocean-debt-belt-and-road-and-debt-diplomacy-pacific>, downloaded 12 November 2019). A recent report by the Center for Global Development suggested that eight BRI recipient countries are at an elevated risk of debt distress: Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan, and Tajikistan; “Belt and Road Initiative Heightens Debt Risks in Eight Countries, Points to Need for Better Lending Practices”, Center for Global Development Press Release, 4 March 2018 (<https://www.cgdev.org/article/chinas-belt-and-road-initiative-heightens-debt-risks-eight-countries-points-need-better>, downloaded 12 November 2019).

<sup>13</sup> International Monetary Fund, “Lao People’s Democratic Republic: Debt Sustainability Analysis”, 6 January 2017 (<https://www.imf.org/en/Publications/CR/Issues/2017/02/15/Lao-People-s-Democratic-Republic-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-44669>, downloaded 12 November 2019).

<sup>14</sup> See “Laos ruling party agrees to pursue China rail loan”, *Radio Free Asia*, 2 April 2013 (<https://www.rfa.org/english/news/laos/rail-04022013200531.html>, downloaded 12 November 2019).

<sup>15</sup> One press report suggested that the US\$480m loan is “guaranteed by the railway’s future income as well as two mining concessions”; “Laos on a fast track to a China debt trap”, *Asia Times*, 29 March 2018 (<https://jclao.com/laos-on-a-fast-track-to-a-china-debt-trap/>, downloaded 12 November 2019). There do seem to be precedents for this kind of arrangement. It was reported that in 2009 Laos ‘repaid’ China for building a new stadium for the Southeast Asian Games with 300 hectares of land on the outskirts of the capital. “Laos and China come to terms on loan interest rate for railway project”, *Radio Free Asia*, 4 January 2016 (<https://www.rfa.org/english/news/laos/laos-china-come-to-terms-on-loan-interest-rate-for-railway-project-01042016163552.html>, downloaded 12 November 2019).

<sup>16</sup> See “Chinese railway project in Laos leaves farmers in the lurch”, *Radio Free Asia*, 10 January 2019 (<https://www.rfa.org/english/news/laos/lao-farmer-railway-01102019160842.html>, downloaded 12 November 2019).

<sup>17</sup> The World Bank, “The Belt and Road Initiative Network: Lessons from the Lao-China Railway Project”, *East Asia and Pacific Economic Update, October 2019: Weathering Growing Risks*,

October 2019 (<https://openknowledge.worldbank.org/handle/10986/32482>, downloaded 12 November 2019).

<sup>18</sup> See Souknilanh Keola, “Geographical Simulation Analysis of the Lao-Chinese High-Speed Railway”, pp. 47-63 in Daisuke Hiratsuka, *EEC Development and Transport Facilitation Measures in Thailand, and the Development Strategies by the Neighbouring Countries*,” BRC Research Report, Bangkok Research Center, JETRO Bangkok/IDE-JETRO, 2019 ([https://www.researchgate.net/publication/333263367\\_Chapter\\_3\\_Geographical\\_Simulation\\_Analysis\\_of\\_the\\_Lao-Chinese\\_High-Speed\\_Railway/link/5ce51548a6fdccc9ddc4c813/download](https://www.researchgate.net/publication/333263367_Chapter_3_Geographical_Simulation_Analysis_of_the_Lao-Chinese_High-Speed_Railway/link/5ce51548a6fdccc9ddc4c813/download), downloaded 12 November 2019).

<sup>19</sup> The World Bank, “Ease of Doing Business in Lao PDR”, 2019 (<https://www.doingbusiness.org/en/data/exploreconomies/lao-pdr> , downloaded 15 November 2019).

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