Laos: Once an Economic Miracle, Now a Debt-distressed Country

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Key Words

Land-locked; Resource-rich; Economic Miracle; Debt-distress; Liberalization; Privatization; Dollarization

Abstract

Laos, a landlocked, yet resource-rich country in the center of Southeast posted an annual average growth in its gross domestic product (GDP) of more than 7.0% between 1985 and 2019. That indeed meant that Laos experienced an 'economic miracle' during that long period of more than three decades. Considering that Laos is a landlocked country, that was indeed an admirable socioeconomic performance. It looked as if it was becoming the 'Battery of Southeast Asia' was charging on all cylinders. However, since 2019 the country's economic growth has petered out not only due to the outbreak of Covid-2019 but also due to the country's huge debt overhang. Laos badly needs a short and simple liberalization program. The liberalization program should be three-pronged: privatize the economy; remove most, if not all, the controls on the country's external trade and capital flows; and finally, and most importantly, dollarize the economy. More than anything else, dollarization would hugely boost confidence in the economy from both domestic and foreign investors.

Laos: Once an Economic Miracle, Now a Debt-distressed Country

1. Introduction

Laos, a landlocked, yet resource-rich country lies in the middle of Southeast Asia. The country's sociopolitical model resembles that of China – a country that relies on market-based economic policies but at the same time maintains a high degree of political control with a single party rule. For a long time before the outbreak of the Covid-19, that model had enabled the resource-rich Laos to post strong economic growth and modest social progress.

Between 1985 and 2019, Laos posted an annual average growth in its gross domestic product (GDP) of more than 7.0%. That indeed meant that Laos experienced an 'economic miracle' during that long period of more than three decades (Madhur and Madhur, 2024, 14 January). At the same time, the country's poverty rate plunged from 46% in 1993 to 18% in 2019 (UNDP, 2022, p. 6). As early as 2011, the World Bank had upgraded the country from low income country to a lower middle income country.

In terms of the Human development Index (HDI), published by the United Nations Development Program (UNDP), the figure for Laos rose from 0.408 in 1990 to 0. 610 in 2019; In 2022 – the latest year for which data are available – the figure stood at 0.620. The country's ranking in terms of the human development remained posted a marginal increase from140 out of 193 countries in 2019 to 139 out of 193 countries in 2022 (UNDP (2024, 13 March; UNDP 2024, 29 March). In terms of the latest available Social Progress Index (SPI) (that basically excludes per capita income from the Human Development index), Laos is ranked 124 out of 170 countries, higher than Myanmar (127), although lower than most other ASEAN countries, say, Cambodia (120), and Vietnam (66) (Social Progress Imperative, 2024).

Considering that Laos is a landlocked country, that was indeed an admirable socioeconomic performance. It looked as if it was becoming the 'Battery of Southeast Asia' – a key objective of the Laos' policymakers -- to develop the country by exporting electricity to its neighbors. The huge thermal power generation capacity of the country was its great asset. That worked for the country's advantage for quite a while, as it attracted foreign investments, especially to its power sector. However, since 2019 the country's economic growth has petered out not only due to the outbreak of Covid-2019 but also due to the country's huge debt overhang.

This Essay attempts to explain the extent of the debt overhang and how Laos got into a debt-crisis of this proportion and what it means for the country and its people (Section 2), the government's response to the debt-distress (Section 3), the near term outlook and policy options that the government will have to seriously consider going forward (Section 4). Section 5 sums up the key conclusions of the paper.

2. The Economic Fall and the Debt Overhang

Laos' major strengths lie in its abundant natural resources and the huge hydroelectric power. However, the country's major weakness is its unsustainable external debt and all the attendant economic evils that go with it -- persistent current account deficit, low foreign exchange reserves, huge depreciation of the national currency (the kip), a spiraling of inflation, and growing food insecurity, and more! In recent years, the country's weaknesses have taken over its strengths by a wide, and still widening, margin. With a GDP of around $14 billion in 2023, Laos has the smallest economy among the ASEAN-10 countries (https://www.statista.com/statistics/796245/gdp-of-the-asean-countries/).

The size of the economy has continuously shrunk from about out $18.7 billion in 2019 to $14.1 billion by 2023 (ADB, 2024, February). During the same period, the country's per capita GDP declined from $2600 to $1858. Meanwhile, annual inflation has skyrocketed from about 3.0% in 2029 to 31.2% in 2023. For a third consecutive year in 2023, annual inflation ran above 20%. Kip – the country's currency – depreciated from less than 14,000 per a U.S. dollar ($) in 2021 to 24,000 in 2023. Indeed, inflation accelerated from 23% in 2022 to a whopping 31.2% in 2023.

In June 2023, Credendo, a European trade credit insurer, lowered Lao's political risk rating to the lowest risk category, 7/7. It made this downward adjustment citing the country's "unsustainable external debt ratios and challenging future debt service repayments amid poor liquidity and tightened global monetary conditions have brought Laos closer to sovereign debt default" (Credendo 2023, 16 June).

The Insurer emphasized the sharp increase in the country's public debt from 69% of GDP in pre-Covid years to 128.5% in 2022. As a result, interest payment charges are 24% of government revenues, whereas that figure was less than 10% in 2019. Moreover, 85% of Laos' debt is owed by the country's public sector. To boot, public revenues remain by far too low as they amount to an average of 12.5% of GDP in 2020-2022 (Credendo, 2023, 16 June). All these indicators point towards an ominous future for the country over the medium term.

Costlier commodity imports have raised the cost of living, even leading to the shortage basic goods. By now, the foreign exchange reserves are too little to pay for a few months' imports of necessities. "As in Sri Lanka and Pakistan, the shortage of foreign currency has led the central bank to prioritize the use of foreign currencies for essential goods. The liquidity stress is happening in a context of a too expensive market access to refinance commercial bonds (on the Thai market) amid tighter global financing conditions" (Crdendo 2023, 16 June). In February 2024, Moody's rated the sovereign credit of Laos far below the investment grade (https://www.theglobaleconomy.com/Laos/credit_rating/).

The Washington Post put it bluntly : “China’s promise of prosperity bought Laos debt – and debt distress… no country in the world with a higher amount of debt exposure to China than Laos. It is a very, very extreme example …. Laos went on a borrowing spree and got in over its head….in a country where virtually everything is imported, the statistics translate into sacrifice: farmers who can no longer afford fertilizer, children who have dropped out of school to work and families cutting back on health care” (Washington Post (2023, 12 October). Other experts also agree on such an assessment: “Laos is spiraling toward a debt crisis as China looms large” (Chandaran 2023, 8 November). “China strengthens hold on its struggling neighbor” (Tostevin 2024, 1 February). Moreover, “fears grow that the ‘World Heritage Site of Laun Prabang’ could be hugely harmed, as a result of the dam built across Mekong River on borrowed money harm” (Associated Press 2024, 31 January). If this situation continues, Luan Prabang could even lose its World Heritage Site title.

Citing the country’s difficulties in servicing its external debt, half of which is owed to China’s lenders under its Belt and the Road Initiative (BRI), the International Monetary Fund’s 2023 Article IV Consultation Report gave its verdict: Laos is in debt-distress. (IMF 2023, 22 May). In a similar vein, in April 2024, the Asian Development Bank in its annual flagship publication - Asian Development Outlook - rightly highlighted that resolving the country’s huge debt overhang should be a top policy priority for Laos (ADB 2024, April, pp.194 -197).

BTI - a German institution that does periodical socioeconomic reviews of countries around the world, had this to say in its 2024 Laos’ report: “One underlying cause of the crisis over debt servicing and critically low foreign reserves was previous overborrowing for as-yet unproductive hydropower assets. The debt crisis pushed the country to the brink of default, only being avoided by debt deferrals and other agreements, mainly with China… Moves toward economic reforms and the implementation of ‘rule of law’ principles continued to be touted publicly but were slow to materialize” (BTI 2024).

An earlier report by UNCTAD put it without mincing words: “The poor governance standards, including high political corruption, further adds to the economic vulnerability” (UNCTAD 2022). The report then went on to say that even the success registered by the country in attracting foreign investment and driving exports are not trickling down into: “dividends in terms of fiscal revenues, jobs growth, economy-wide productivity improvements and structural transformation – i.e. it has too weak an impact on what matters most to the Lao citizen. The vulnerability profile also underscores the poor economic linkages and value addition potential that exists between the mining and hydropower generation sectors with the wider economy” (UNCTAD 2022, p. 60).

Thus, it is not surprising that the 2023 Transparency International Corruption Perception report placed Lao at 136 out of a total of 180 countries ranked, lower than Pakistan (133) and Sri Lanka (115) (https://www.transparency.org/en/cpi/2023/). Indeed, among the ASEAN countries, Laos' corruption level, as measured by the Corruption Index, is only lower than that of Myanmar.

These worsening macro indicators have translated into severe pressures on the poor and the vulnerable sections of the society; of all the things, food insecurity has worsened, causing hunger and deprivation to the poor. According to the May 2023 Joint-IMF-World Bank Report: "43 percent of households have experienced a decline in real incomes since the onset of the pandemic. Inflation has been highest on essential goods, resulting in cuts to food consumption, education, health care. Poverty rates have increased" (World Bank, 2023 May, p. 9)

Both the ADB and the World Bank had also emphasized that the huge debt overhang, combined with an unfriendly monsoon, was causing food insecurity in the country. It was accompanied by huge stunting among the country's children (World Bank 2024, 5 March; ADB 2024, April). The high level of malnutrition among the children is estimated to cost Laos about 2.6% of the country's annual GDP. Undernutrition has caused stunting and underweight among the children. About 32.8% of the children under five years are stunted and 24.3% percent are underweight (World Bank 2024, 5 March).

3. Government's Response

Resolving the country's debt-distress is of utmost importance to the Cambodian policy makers. The Laotian government too recognizes the need to reduce the public debt in its 9th Five-Year Plan and the National Agenda for addressing economic and financial difficulties.

"The authorities have established a Public Debt Management Committee led by the Deputy Prime Minister. All borrowing (by central and provincial governments, SOEs, Public-Private Partnerships (PPPs)) must be approved by the National Assembly and the Ministry of Finance negotiates all loans. To improve the legal and regulatory framework, the government has implemented a decree which mandates SOEs to report debt data to the Ministry of Finance and to consult the ministry before a significant borrowing" (World Bank May (World Bank (2023, May, p. 3).

The government has addressed debt arrears by issuing domestic bonds, but there still exists a risk of domestic expenditure arrears going forward. "Given significant fiscal pressures and limited progress in terms of enhancing budget formulation, implementation, spending controls and monitoring, further domestic expenditure arrears are a risk going forward" (World Bank 2023, May P. 6))

“External debt repayment deferrals have taken place in 2020, 2021 and 2022: debt servicing to China was deferred during the past three years (US$ 220 million in 2020, US$ 450 million in 2021, and US$ 610 million in 2022), and US$150 million of deferred principal is supposed to be repaid in 2023. The deferred principal payments in 2020 and 2021 are included in 2021 debt stock in the debt bulletin. Staff includes the suspended interest payments (US$ 130 million in 2021 and US$ 190 million in 2022) in the debt stock for this Debt Sustainability Assessment (DSA)” (World Bank 2023, May P. 6))

On top of these responses, on 14 July 2023, Laos’ Prime Minister signed a seven-page order requiring the country’s exporters to route their foreign exchange earnings through the country’s banking system; this conditions apply to foreign investors in tp the country as well Laotian Times (2023, 19 July). Currently, a little over 30 percent of export receipts in Laos enter through the country’s banking system.

As part of these response measures, the government: (i) ‘ordered’ the Bank of Lao PDR (BOL) to improve its electronic payment system, (ii)instructed the Ministry of Finance to collect taxes and revenues from businesses and exporters in foreign currencies, in case these businesses generate income in foreign currencies; (iii) asked the Ministry of Industry and Commerce to develop an electronic system that enabled the sharing of data with BOL; (iv) instructed importers and exporters to compulsorily hold bank accounts; (v) insisted that exporters who want to keep their earnings in foreign currencies abroad should seek prior permission from the BOL; and (vi) anyone other than a foreign experts and expat employees, are banned to receive their salaries in foreign currencies.

Not just that. The Prime Minister required government officials to keep supervising that these measures are implemented without fail. If one were to summarize these measures, one could simply say that the government imposed a set of draconian capital controls on the country’s external current as well as capital accounts.

4. Near-Term Outlook and Policy Options

The near-term future looks gloomy, with the growing external debt hang on the economy. “Debt vulnerabilities remain severe in some middle-income countries as well as low-income countries. It is critical that creditor countries provide the necessary debt treatments to restore the debt suitability of these countries” -- remarked the Japanese Finance Minister at the annual meeting of Asian Development Bank (ADB) held in May 2024, in Tbilisi, Georgia. (https://www.adb.org/sites/default/files/annual-meeting/2015/statements/AM2024-JPN.pdf; p.4). By any stretch of imagination, it is difficult not to include Laos in this set of countries with debt vulnerabilities.

In its 2023 Economic Monitor on Laos, the World Bank had cautioned: "To restore macroeconomic stability, a strong commitment to ambitious reforms in five crucial policy areas is essential: (i) raising public revenues to protect spending on education, health, and social protection; (ii) improving expenditure allocation and efficiency; (iii) expediting debt negotiations; (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 key to effective evidence-based policymaking" (World Bank 2023, May)

According to the Joint IMF-World Bank Report, a moratorium on new capital expenditure by the government allows only existing projects to be completed. That said, interest payments are expected to shoot up in the next few years, driving a rebound in overall government expenditure (World Bank 2023, May p.12)

Encouragingly, the 2023 Joint IMF-World Bank Report also mentioned that the "government recognizes the need to bring down public debt in its Ninth Five-Year Plan and the National Agenda for addressing economic and financial difficulties. … The government has reached a small primary surplus, following substantial fiscal consolidation driven equally by expenditure tightening" (World Bank (2023, May P.22). With the public sector tightening its belts, growth will have to be the key source of growth in the near term. However, private firms in the country is held back by bureaucratic red tape, inadequate access to credit, and labor market mismatches. The Joint IMF-World Bank Report went on to say that firms on their part have to improve their internal governance structures.

According to a May 2023 report by the Lowy Institute, China has so far provided Laos with substantial near-term debt relief, deferring repayments equivalent of about 8% of the country's 2022 GDP (Cooray 2023, 2 May). That said, the report sounds a note of caution that "given the approach China has taken previously, it may offer short term relief, but only that" (Cooray 2023, 2 May).

Somewhat similar recommendations have been put forth by another expert (Barney 2024, 24 January). Barney considers three options for Laos: (i) securing more debt repayment extensions from Chinese banks through to 2027 or beyond, (ii) debt restructuring and economic reforms done in consultation with the IMF, World Bank, and the Asian Development Bank, so as to receive concessional funding accompanied by conditionalities though; (iii) privatizing more state assets to reduce debt loads and hopefully raise some new capital (Barney, Keith (2024, 24 January).

Barney then goes on to add that the second and the third options would not be politically palatable, with even the thought of privatization of electricity-generation being "an anathema to the Leadership" (Barney, Keith (2024, 24 January). Thus, the first option of, debt-deferral could perhaps be the most plausible path. "Yet this option could also lead to a 'lost generation', with tightly compressed expenditures on human capital and high levels of youth emigration for many years. Laos' political economy would have some further space to run, but the country would remain excluded from global private credit markets and struggle to attract reputable private investors" (Barney 2024, 24 January).

Barney then suggest that the "deferral approach could leave Laos trailing far behind in the 21st century knowledge economy as disinvestment in education and health undermines human capital. In its broader socio-economic implications, the first option could be the worst of the three, as it just temporarily dilutes the debt burden, and would suggest an unwillingness to address the underlying problems" (Barney 2024, 24 January).

Laos could and should take the current economic crisis as an opportunity to implement a simple yet meaningful set of deep economic reforms. It is indeed ironic that the government responded to the current economic crisis by introducing more and more controls on both the domestic economy and the country's external trade and capital flows (Madhur 2024, 31 May). At the present juncture, the country indeed needs exactly the opposite – a set of liberalization measures to link this small land-locked country with the rest of the world. If the policy makers are serious about saving the economy from further destruction and its people from further deprivation, they could and should implement a three-pronged liberalization and reform measures.

The three-pronged reform program should comprise: privatize the economy; remove most, if not all, the controls on the country's external trade and capital flows; and finally, and most importantly, dollarize the economy. The country could and should implement this three-pronged reforms as quickly as possible.

In terms of the 2024 Index of Economic Freedom, Laos's score is 50.6, with a ranking of 142 out of 184 countries. Although its rating has increased by 0.3 point from 2023, among the 10 ASEAN countries, Laos is ranked just above Myanmar. The 2024 report on Economic Freedom also underscores the need for the country to undertake 'deeper institutional reforms'. The 2024 Index of Economic Freedom Report went on to say: "As low scores for property rights and freedom from corruption indicate, the legal framework is inefficient and lacks transparency. Corruption and political interference undermine the rule of law. The transition to a more market-friendly economy has been slow. Despite some progress, the underdeveloped labor market does not provide dynamic employment opportunities for the growing supply of labor. The government influences many prices through state-owned enterprises and utilities. Deeper institutional reforms are needed in many areas of the economy to encourage broad-based long-term development" (https://www.heritage.org/index/pages/country-pages/laos).

Encouragingly, on 21 November, 2023, Laos' Ministry of Industry and Commerce hosted the 21st Trade and Private Sector Working Group (TPSWG) meeting. The event provided a platform for the Government of the Lao PDR, the private sector, small and medium enterprises, and development partners to discuss collaboration to improve the business environment and increase private sector investment in Lao PDR. The Deputy Minister made an encouraging statement: "Over recent years we have made several reforms to improve the environment for business. However, much more needs to be done to promote economic diversification and reduce our dependence on the resource sectors as main growth drivers". All that said and done, one better wait and see!

In the area of external trade and capital flows, the seven-page order issued by Laos' Prime Minister on 14 July 2023, simply imposed draconian controls. Perhaps, one could see that the government is still in the 'fire-fighting' stage on this front. Putting out the fire, rather than 'fire-proofing' the country seems to be the policy response. That said, there is huge merit in the government undertaking deeper liberalization of the country's external trade and capital flows regime, once the economic situation stabilizes.

Let me move on to the third, and the lynchpin of the policy measure that Laos should consider seriously. Laos badly needs more , not less, dollarization. Not realizing the need for this currency reform, the kip, the country's currency, will continue to be a liability rather than an asset for the country. As I have emphasized in my article in the Diplomat, dated 31 May, Laos simply does not need to have the luxury of a national currency (Madhur 2024, 31 May). Currency need not follow the flag, as the number of nations have simply grown in the postwar era.

Laos, being a small economy with inadequate human capital, is an ideal candidate for more, not less, dollarization. It has two options to consider. It could go for *de jure* dollarization, under which dollar formally replaces the kip. If it is not politically palatable to do away with the kip, then the second option could be *de facto* dollarization. Under this system, the government could keep the kip but then maintain a dollar-kip parity, so that the kip remains as a unit of account, but not as a medium of exchange and a store of value. Rather than using its scarce human capital in managing a national currency, BOL would then would have more time on its hands to effectively implement its regulatory and supervisory functions over the country's financial system.

Nearer home to Laos, Cambodia has used *de facto* dollarization well since the early 1990s. Along with Cambodia's highly open economic policies, the *de facto* dollarization has contributed to Cambodia's own sustained period of economic growth. The country's financial system allows banks to accept dollar-denominated deposits as well as to make dollar-denominated loans. Laos thus has a good example in one of its neighbors that has done well socioeconomically by adhering to *de facto* dollarization. More than anything else, the *de facto* dollarization had boosted confidence in the Cambodian economy from both domestic and foreign investors.

If all this evidence does not convince Laos to dollarize its economy at this crucial stage of its debt crisis, it is hard not to imagine the country simply traversing from the current crisis to another. The country's day of reckoning has come. The country badly needs more dollarization, whether *de jure* or *de facto*.

5. Summing Up

The paper has taken a closer look at Loas' miracle-like growth and development for decades before the outbreak of Covid-19, the subsequent economic fall and the debt overhang that has now strangled the economy and caused deprivation to its people. In response, the government has imposed draconian controls on domestic economic activities as well as the country's external trade and foreign capital flows – at a time when exactly the opposite policy measures were warranted.

After reviewing the many credible policy measures suggested by many experts on the subject, this paper proposes a simple, three-fold policy liberalization program: privatize the economy; remove most, if not all, the controls on the country's external trade and capital flows; and finally, and most importantly, dollarize the economy. The country could and should implement this three-pronged reforms as quickly as possible. If it does implement this three-pronged reform program, it still has a reasonable chance to be the 'battery of Asia' – a major policy objective of the government of this small land-locked country in the center of Southeast Asia, with substantia natural resources and source of hydropower. The lynchpin of this reform program is the country's dollarization, *de jure* or *de facto*.

If the country fails to implement these reform Program, there is a high probability that the country will be traversing from the current economic crisis to another. In that possibility, instead of the country becoming the 'battery of Southeast Asia, the country may continue to stagnate. The country may then become closer to what David Hut had once paraphrased: "…the most hermitage of Southeast Asian countries... Its diplomatic reach extends only to its immediate neighbors and they have little experience of engaging in sensitive issues, not least because the international community cares so little about Laos that is rarely troubled by events abroad" (Hut 2023,15 September).

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