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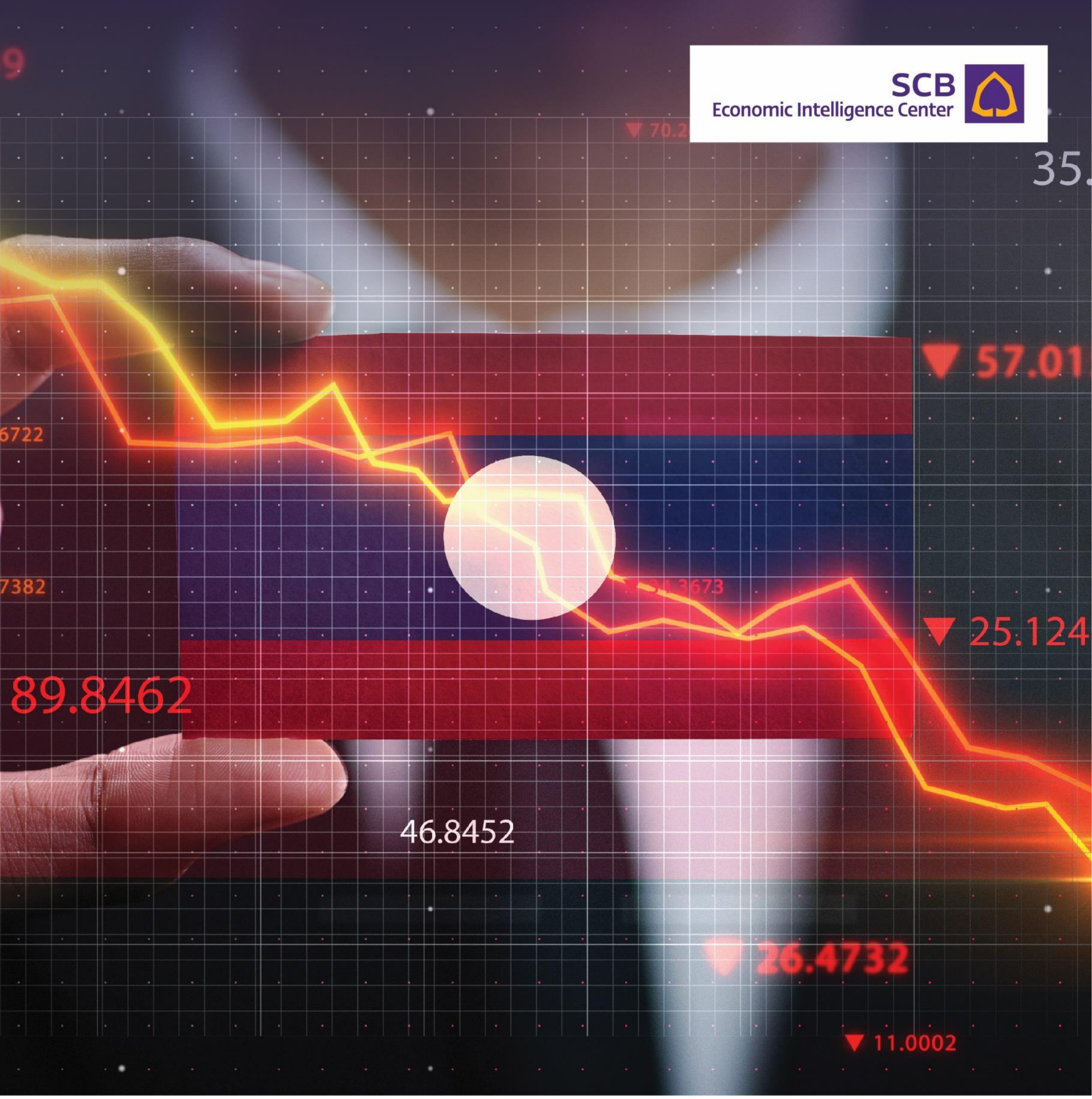

A Closer Look into Laos' Currency Crisis
and its Implication for the Thai Economy

9 August 2022

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Laos is facing a rapid depreciation of the kip in tandem with inflation surges.

As of August 8th, 2022, the Lao kip already tumbled to 15,000 LAK/USD—seeing a 57% drop against the greenback and 44% against the Thai baht since September 2021, marking the largest depreciation among regional peers. Driving forces behind the kip crumble were tightening global financial condition, inflationary pressures from the ongoing Russia-Ukraine war which sent commodity and oil prices soaring, and the global supply chain bottleneck—all of which threatened Laos' economy that highly relies on imports. Against this backdrop, Laos' inflation has been on the rise, resulting in US dollar inadequacy and goods shortages nationwide, particularly fuel oil.

The crisis primarily stemmed from a fragile economic structure.

Recent developments in the global economy—notably monetary policy tightening among major central banks—took a heavy toll on the Lao economy, which already grappled with long-running fiscal deficits and public debt overload from large infrastructure investments to buttress growth. Aside from that, Laos' financing options became limited given rising costs of funds after its sovereign credit rating was slashed to a speculative grade. Foreign reserves buffers also remained low, owing to persistent current account deficits. These were downward pressures on the kip and looming risks to external debt service and imports of staple goods.

In our view, the situation in Laos is unlikely to follow a crisis-ridden Sri Lanka since Laos still secures financing options and leeway for debt renegotiation.

Despite a spiraling public debt stock, the debt figure in Laos remained lower while international reserves in terms of imports and short-term external debt were higher than those of Sri Lanka. Besides, Laos still secure some funding channels from (1) Issuing bond in foreign financial markets such as Thailand—Laos recently issued government bonds worth THB 5 billion in March 2022; (2) Loans from international organizations; and (3) Economic restructuring through the privatization of under-performing state-owned enterprises while encouraging investment and private sector engagement in order to attract foreign investment and bolster exports. Until now, Laos' fiscal and monetary policies were primarily focused on supporting the economy. Yet these measures do not address the root causes of problems, and could worsen an already-fragile economic stability. Looking ahead, debt renegotiation, especially with China, should be a priority for the Lao government to stave off a debt default. As a dominant creditor, China will likely take the offer considering Laos' strategic position in its ambitious Belt and Road Initiative to gain influence over the ASEAN region.

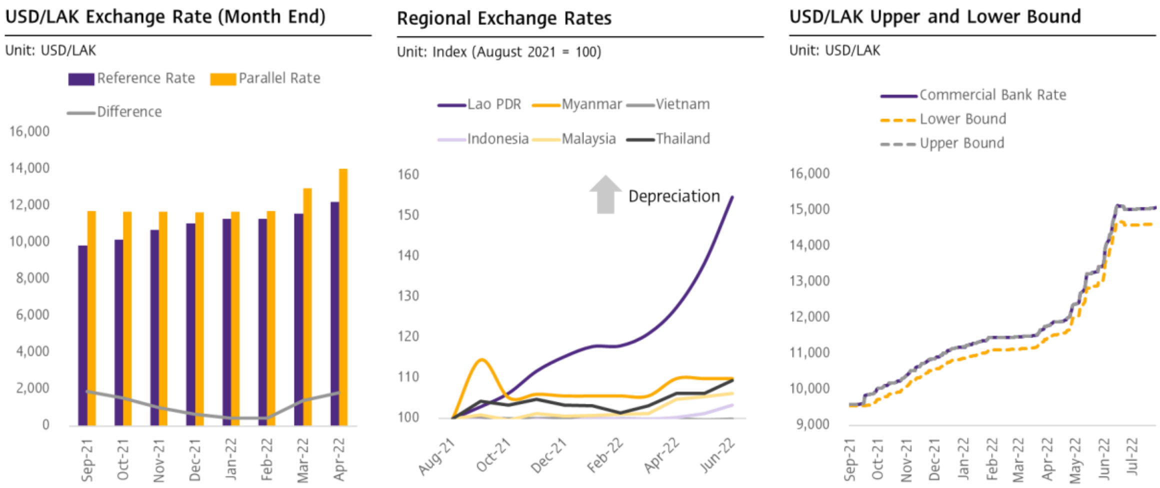
Adverse impacts on Thailand should be limited, albeit remains risks that warrant monitoring.

EIC assesses that the crisis will affect Thailand's economy through four channels: exports, tourism, Thailand's direct investment (TDI), and the financial sector. First, Thai exports might suffer from an economic slowdown in Laos followed by shrinking demand. But overall exports still see a rosy outlook buoyed by rising prices of refined oil—a major export product to Laos. Secondly, incoming tourists from Laos are confronted with risks from eroding purchasing power on the back of the weakening kip. Yet, the number of Lao visitors should pick up after Thailand's full reopening. Thirdly, TDI inflows to hydropower projects in Laos should be heedful of a possible delay of electricity payment from Laos, which could affect future sentiment. Although Laos' financial stability is relatively strong, it could become more vulnerable going forward. Still, we expect that overall impacts on Thailand should be limited since the major buyers of Laos' power are also Thai enterprises, and there are signed PPAs in place.

What's happening in Laos?

Laos has been facing a financial storm due to a rapid depreciation of the kip since September 2021. As of August 8th, 2022, the reference rate of the Lao kip weakened by 57% against the greenback and 44% against the Thai baht, compared to September 1st, 2021. The reference rate is stipulated by the Bank of the Lao PDR (BOL). Notably, in recent years, we observed a widening spread between reference and parallel exchange rates (Figure 1, left). Based on the diagram below, all regional currencies have experienced a downtrend but the Lao kip witnessed a more significant slump, particularly when compared with historical data (Figure 1, center). One of the reasons behind the sliding kip was the BOL announcement on September 15th, 2021, that expanded the band of exchange rate spreads at commercial banks and exchange bureaus to $\pm$ 1.5% of the daily reference rate published by the BOL, up from the previous cap at $\pm$ 0.25%. Based on our findings (data from Banque Pour Le Commerce Exterieur Lao Public—a government bank), exchange rates offered in the market always moved along the upper bound (Figure 1, right).

Figure 1: Lao kip saw the sharpest drop among regional currencies.

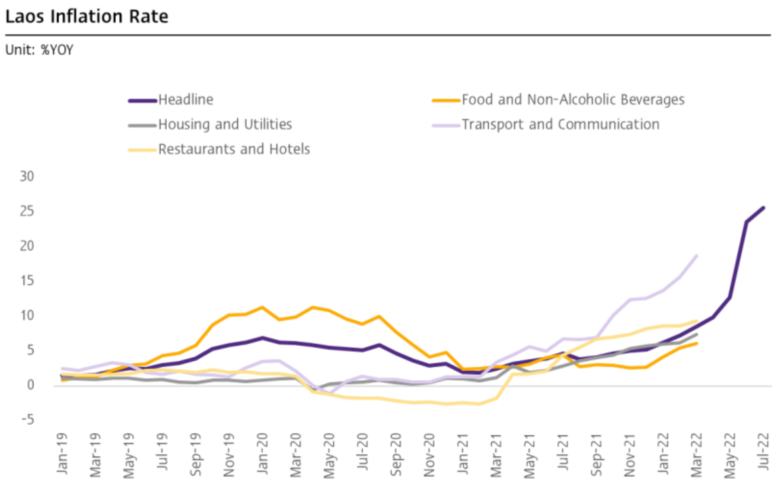


Source: EIC analysis based on data from BOL, BCEL, and CEIC

The rapid depreciation of the kip drove inflation higher and resulted in goods shortages.

The latest figure showed that the headline inflation surged to its 22-year high at 25.6%YOY in July (Figure 2). Price spikes were evident in nearly all products—including fuels, food, and public utilities—and primarily driven by accelerating global commodity prices due to the ongoing Russia-Ukraine war and global supply bottleneck. The weakening kip also added strain to the price rise, making imports more expensive in terms of local currency. Furthermore, high demand for foreign currencies to cover imports thus ensued foreign liquidity crunch and goods shortages. In particular, Laos is hit by acute fuel shortages. Many gas stations started to close down in late 2021 or imposed a fuel quota cap, disrupting economic activity in many sectors. Nonetheless, the situation started to improve somewhat in June 2022 after the government supported fuel importers through a Letter of Credit[1] issued in USD.

Figure 2: Inflation surge was broad-based across various products.



Source: EIC analysis based on data from Lao Statistics Bureau and BOL

[1] A document from financial institutitions verifying that sellers of fuel to Lao importers will receive full payment in a timely manner.

As the Thai and Lao economies are closely linked in many aspects, EIC thus conducted an in-depth analysis to find the root causes of the economic crisis in Laos and present possible solutions as well as implications for Thailand's economy and businesses.

What caused the currency crisis in Laos?

Both external and domestic economic elements triggered the currency crisis in Laos: 1) Global economic developments—including the COVID-19 pandemic, soaring commodity prices prompted by supply chain bottlenecks and the Russia-Ukraine war, and monetary policy tightening around the world—which resulted in the sliding Lao kip and inflation spikes; 2) Structural issues in Laos' economy from high public debt, long-running fiscal and current account deficits, and depleting foreign reserve buffers.

1. Global Economic Developments

Over the past three years, the global economy has been threatened by diverse challenges that also disrupted Laos' economic stability. The COVID-19 crisis and countrywide lockdowns during 2020-2021 have aggravated fiscal vulnerability in Laos through economic slowdown followed by a somber outlook, rising fiscal expenditure but lower revenue collection owing to tax relief measures to buttress an economy and foreign-currency income loss in the absence of international tourists. Furthermore, COVID-19 outbreaks have provoked supply chain bottlenecks in various industries and inflation spikes. Despite a stronger start in early 2022, the global economy was hamstrung by the Russia-Ukraine war, which elongated the supply chain crisis and prompted global commodity price surges—particularly fuel oil that Laos largely relies on imports. To tackle galloping inflation, the US Federal Reserve announced massive policy rate hikes, which sent the greenback to its historic high in 20 years. The soaring US dollar triggered capital flights from Laos and the falling Laotian kip—thus making it an alarming factor that exacerbates the kip depreciation and the risk of external debt default.

2. High public debt and long-running fiscal deficits

Ballooning public debt and persistent fiscal deficits are the major causes of the currency crumbling in Laos (Figure 3). Over the past years, with the ambitious target to become the "Battery of Southeast Asia" that supplies electricity throughout the region and the "Land-linked country" that serves as a regional logistics hub, the Lao government has actively involved in large-infrastructure building projects such as dam and hydropower plants, electricity grids, and high-speed railways connecting Laos and China. But given fiscal constraints due to long-running fiscal deficits, the government then sought loans from overseas, which added to the woes of the public debt load. During 2010-2019, 75 hydropower dams in Laos started their commercial operation (including the power plants owned by EDL[2]-Generation, IPP[3],

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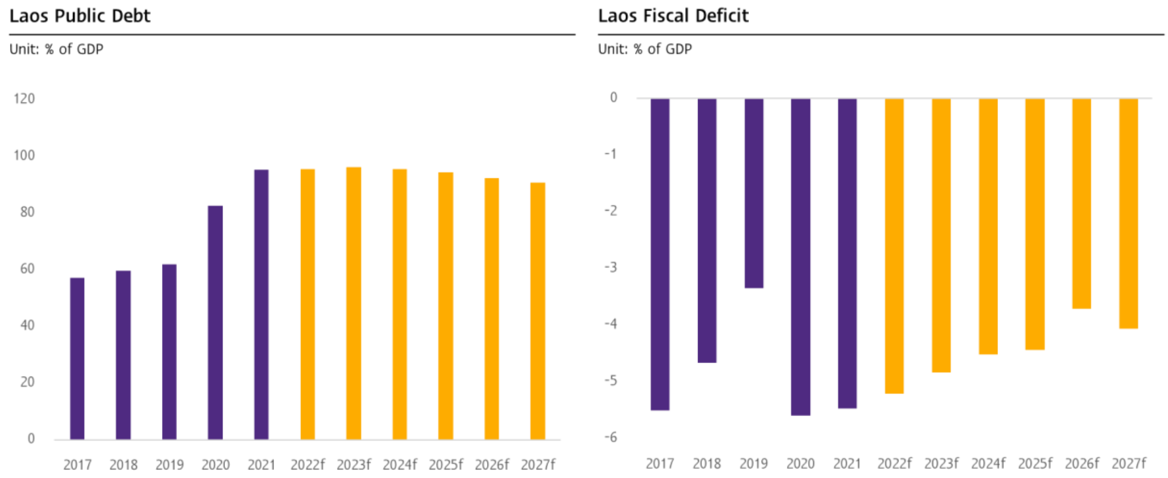
2 Electricite du Laos (EDL)

3 Independent Power Producer

and SPP[4]) and contributed nearly 80% of total power generation installed capacity. Meanwhile, AidData—a development finance research house—reported that the Laos-China railway cost Laos about USD 1.9 billion worth of public debt.

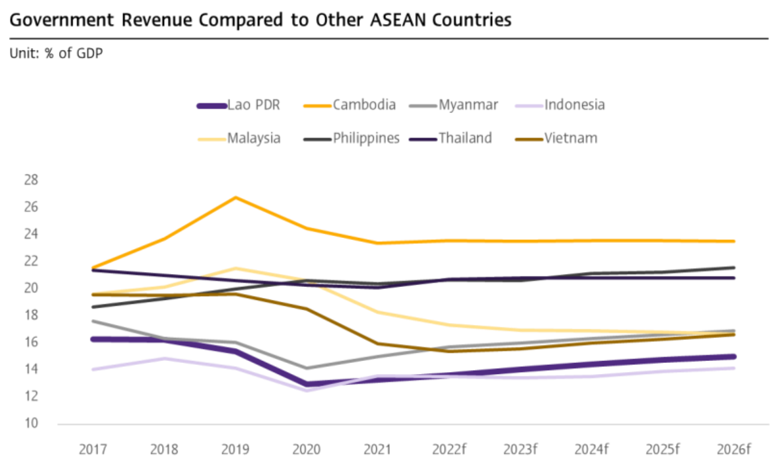
Figure 3: Laos' public debt has risen amidst long-running fiscal deficits.



Source: EIC analysis based on data from IMF World Economic Outlook (April 2022)

The large infrastructure-building investment helped bolster economic growth, but has yet to yield valuable returns to Laos in the short term, as evident in a steady economic slowdown since 2013. Many hydropower projects remained unprofitable and faced numerous challenges such as flood and drought that severely affected both farms and hydropower plant operation, and a deadly dam collapse in 2018 which prompted a temporary halt of other project construction. These major infrastructure investments also failed to spur significant FDI into other economic segments. Meanwhile, the fiscal revenue collection to GDP ratio tended to fall further (Figure 4) despite being relatively low among ASEAN peers. This partly stemmed from Laos's large informal economy and limited tax base.

Figure 4: Fiscal revenue in Laos was relatively low compared to ASEAN peers.

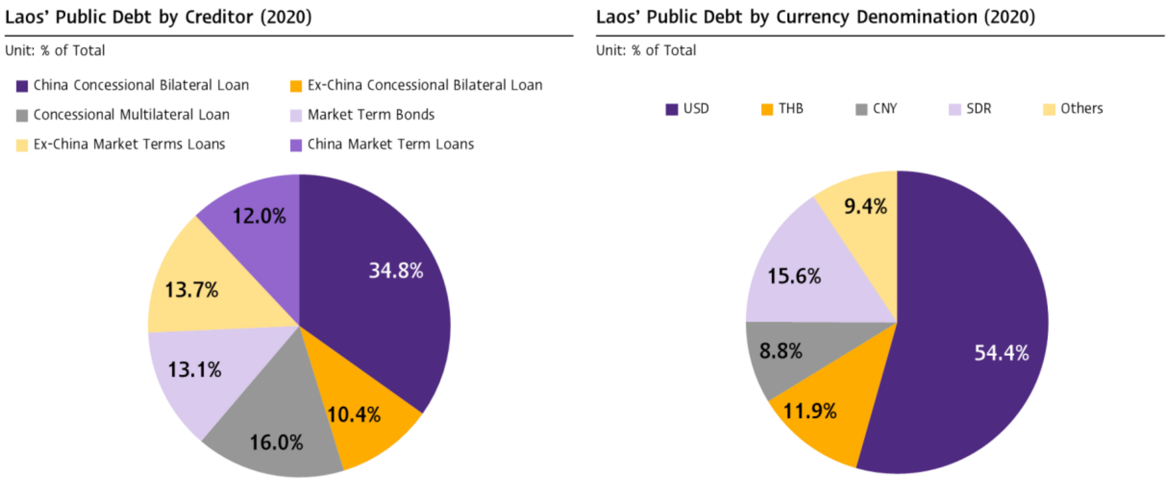


Source: EIC analysis based on data from IMF World Economic Outlook (April 2022)

4 Small Power Producer

Laos' public debt piles were dominated by external debt. And that ensued higher demand for the US dollar to cover maturing debt obligations and downward pressure on the Lao kip. In 2020, foreign-denominated debt was equivalent to 93.2% of total public and publicly guaranteed debt in Laos—most of which were in US dollar, special drawing rights (IMF's international reserve assets with values based on a basket of major currencies), Thai baht, and Chinese yuan, respectively. China remained Laos' largest debtor, followed by bilateral lenders and Thailand (Figure 5).

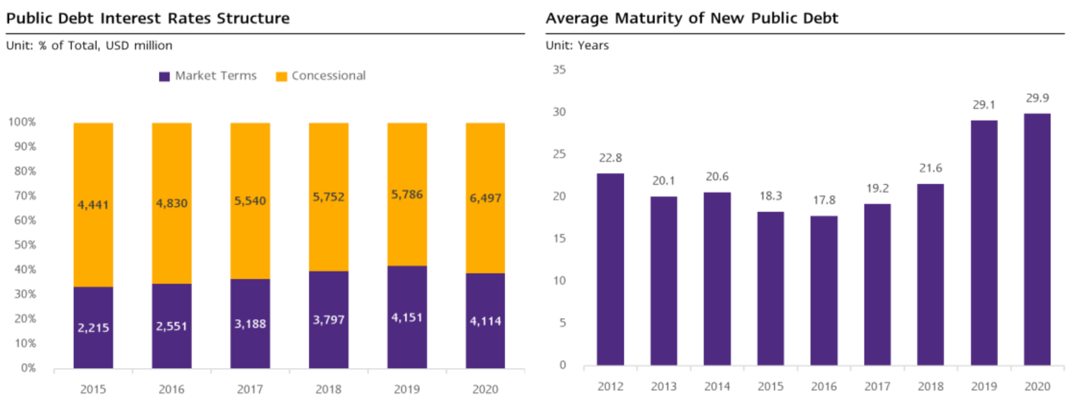
Figure 5: Laos' public debt breakdown in terms of creditor and currency



Source: EIC analysis based on data from Ministry of Finance of the Lao PDR

Over recent years, Laos has increasingly banked on market loans, compared to concessional finance. The share of market-term loans rose from 33% in 2015 to 39% in 2020 (Figure 6, left). This could fuel risks of financial distress in an era of rising rates since market loans generally charge higher interest rates and offer less room for debt restructuring. The other two credit risks came from (1) The share of variable rate loans which are more exposed to higher market rates than fixed-rate loans, and (2) Loan maturity—the shorter the maturity, the higher the default risks. Nonetheless, Laos still have these two risks under control, considering the share of variable rate loans at 17.4% in 2020 and an average maturity of new loans at around 22 years during 2012-2020, according to the World Bank (Figure 6, right)

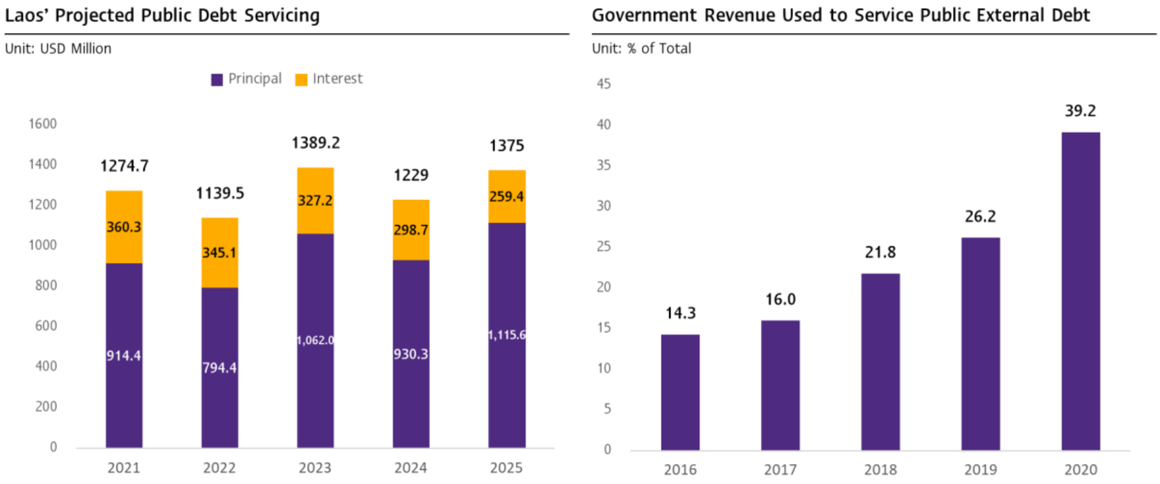
Figure 6: Composition of loan interest rates and an average maturity of external debt



Source: EIC analysis based on data from Ministry of Finance of the Lao PDR and World Bank

From now until 2025, Laos' annual debt-service obligations would be over USD 1 billion, which is substantially high compared to its foreign reserve buffers, whereas the share of government revenue allocated to finance debt payments has been increasing (Figure 7). As of March 2022, Laos has about USD 1.29 billion worth of reserve buffers—equivalent to only 1.9 months of imports (below the 3-month threshold)—while an estimated debt obligation was as high as USD 1.14 billion (estimation by Laos' Finance Ministry in 2020). Still, the actual reserve buffers should be lower than reported since the USD-1.29-billion figure encompassed the currency swap agreement of USD 300 million with China's PBOC. The amount was set solely for the purpose of covering Chinese imports and thus unable to service debt. Meanwhile, swelling public debt and steady low revenue collection sent the ratio of government revenue to service debt climbing from 14.3% in 2016 to 39% in 2020—another risk undermining Laos' public debt serviceability.

Figure 7: Laos has a relatively high debt burden, considering its foreign reserve buffers and fiscal revenue.



Source: EIC analysis based on data from Ministry of Finance of the Lao PDR

3. Funding constraints against the backdrop of tightening global financial condition

Given the risks mentioned above, credit rating agencies decided to downgrade Laos' sovereign credit rating to a speculative grade or an equivalent of a junk bond. Moody's and Fitch Ratings slashed Laos' rating to Caa3 and CCC, respectively, signaling high financial distress risks (Table 1). With credit rating at a speculative grade, borrowing options from the financial market became more costly for Laos. Recently, the BOL issued BOL bills of up to LAK 5 trillion with 20% annual yields and 6-month maturity. Nonetheless, looming default risks might thwart investor sentiment on Laos bonds, particularly when the global financial condition has become increasingly tightened with lower liquidity. This was evident in the Laos government postponing its dollar bond issuance, citing an unfavorable market environment. **All things considered, Laos is facing higher funding costs in tandem with constrained financing options to roll over its maturing debt.**

Table 1: Laos' sovereign credit rating compared to other countries with high default risks.

End-Year	TRIS	Moody's	Fitch
2018	BBB+		
2019	BBB		
2020	BBB	Caa2	CCC
2021	BBB-	Caa2	CCC
2022 (July)	BBB-	Caa3	CCC*

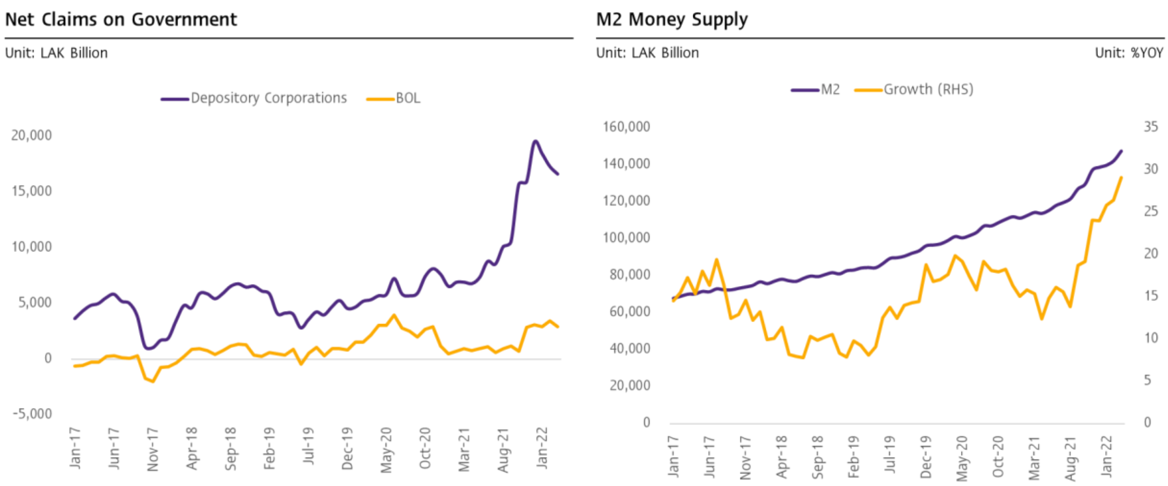
Latest	Moody's	Fitch
Ukraine	Caa3	C
Sri Lanka	Ca	Restricted Default
Pakistan	B3	B-
Argentina	Ca	CCC
Tunisia	Caa1	CCC

Note: *Fitch placed on Under Criteria Observation (UCO) on final sovereign rating criteria

Source: EIC analysis based on data from Tris Rating, Moody's, and Fitch

Given limited funding options in the international market, the Lao government increasingly relied on monetary financing from commercial banks and the Bank of the Lao PDR—another factor that prompted accelerating inflation and weakening Laotian kip. In 2021, the net credit to the government from commercial banks and the net claims on the government from the BOL saw a rapid increase. These financing options do not take a toll on fiscal deficits but could intensify risks of inflation surges and further kip depreciation since they indirectly inject money supply into circulation (Figure 8). Furthermore, commercial banks, as the government debtor, could face alarming credit risks that jeopardize financial stability in the long term if the government fails to meet its debt obligations. In contrast, if the government continues to bank on the BOL, Laos could fall under the threat of fiscal dominance, in which the central bank loses abilities to curb inflation via a policy rate hike as it also affects the public debt burden. Under such circumstances, Laos might witness inflation deeply entrenched in the future economy.

Figure 8: Laos' government increasingly relied on monetary financing from commercial banks and BOL.



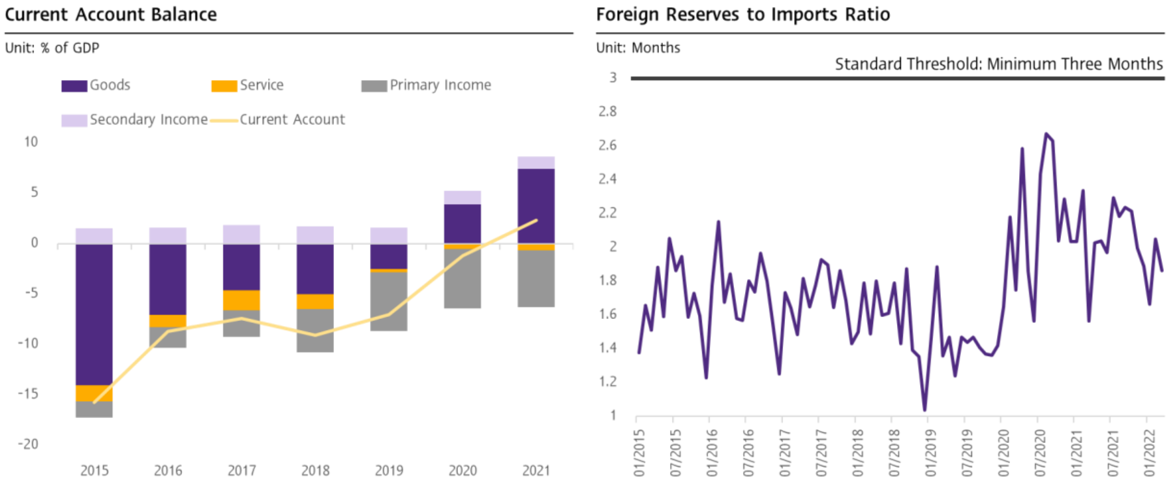
Source: EIC analysis based on data from BOL

Thailand's bond market is another financing option available for Laos, yet the borrowing costs are higher than the debentures of Thai companies with similar credit ratings. In May 2022, Tris Rating—the major rating agency in Thailand—maintained Laos' sovereign credit rating at BBB- and revised the outlook upward from negative to stable. The rating was higher than those of Moody's and Fitch Ratings, so the cost of funds in the Thai market for Laos was lower than in other financial markets. In March 2022, Laos' Finance Ministry issued baht bonds worth THB 5 billion in the Thai market with an interest rate of 5.8% and 6.4% for 3-year and 4-year maturity, respectively. Still, the **Laotian bonds need to offer higher yields than debentures issued by non-financial Thai corporations** with similar credit ratings and bond maturity (3 years), of which the average return rate was around 5.4%. The higher rate somewhat reflects growing concerns among Thai investors over Laos' debt default.

4. Current account deficits and low foreign reserve buffers

Another force behind the sliding kip was a long-running current account deficit (Figure 9), which primarily stemmed from two factors: 1) Trade deficit and 2) Net primary income deficit. First of all, the trade deficit resulted from a deterioration in the terms of trade. Given Laos' limited production capability, the nation imported a large number of consumer goods such as refined oils, beverages, livestock, cars and parts—most of which were finished products with higher prices compared to Laos' major exports: electricity and raw materials such as copper, farm products, and pulp of wood. With imports payment dwarfing export earnings, the terms of trade fell off and became downward pressures on the Lao kip. Besides, soaring prices of global refined oils and economic slowdown in major trade partners would undermine Laos' trade outlook this year. Laos bounced back as a net exporter during 2020-2021 thanks to improving external demand and a slower domestic rebound. Nonetheless, the former BOL governor announced that Laos had earned only 33% of export revenue in the first four months of 2022, whilst the remainder was kept in foreign bank accounts, thus deterring Laos' overall revenue in foreign currencies. Secondly, the net primary income fell into deficits due to substantial payments to foreigners: wage payments to foreign labors in Laos, such as Chinese workers in high-speed railway construction, and profit and dividend payout to foreigners investing in Laos, such as infrastructure-building projects. Both are factors that constrained Laos' foreign reserve buffers and threatened economic sentiment, thus pressuring the kip to weaken further.

Figure 9: Laos' current account was running on deficits, with low foreign reserves.



Source: EIC analysis based on data from BOL, IMF, and CEIC

Given these structural fragilities, Laos' economy eventually fell into the currency crisis on the back of rampant inflation.

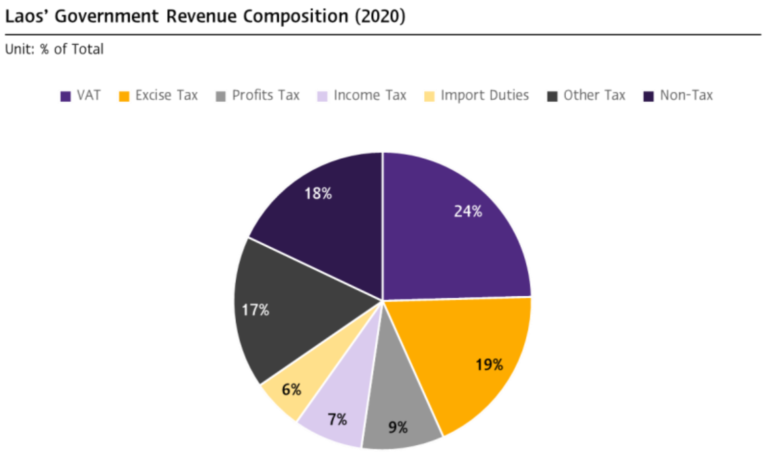
Implications for Laos' fiscal and monetary policies ahead

For fiscal policy, the Lao government has implemented various relief measures to alleviate the impacts of rising living costs and soaring inflation. Some measures are:

1. Reduction of excise tax from 21% to 0% for diesel fuels and from 31% to 5% for gasoline, effective for three months from May 2022
2. Letter of Credit in the foreign currency provided to fuel importers to help ease liquidity crunch—the amount should be sufficient to cover fuel purchases during July-August; the government has also begun talks with Russia over fuel imports to increase domestic supply, as Russian petroleum is cheaper than global market prices due to sanctions from western countries.
3. VAT reduction from 10% to 7%, effective from the starting of 2022, in order to bolster economic growth
4. Minimum wage hike to LAK 1.2 million per month (around USD 80 or THB 2,900), effective from August 2022, from the previous LAK 1.1 million per month (around USD 75 or THB 2,700)

Nevertheless, the above measures only address the symptom rather than the root cause. Hence, we expect limited outcomes from these remedies, and in a worse case, they might further weaken Laos' fiscal position. In 2020, revenue collection from excise tax and VAT accounted for 43.9% of total government revenue in Laos (excluding foreign grants). Should the tax revenue dwindle due to the above tax reliefs, the Lao government must seek additional financing options, thus adding burden to an already-high public debt load on the back of tightening global financial conditions and higher borrowing costs (Figure 10).

Figure 10: VAT and excise tax were primary sources of Laos fiscal revenue.



Source: EIC analysis based on data from BOL

The monetary policy in Laos has become more stringent on currency exchange services, and the BOL kicked off its policy rate hikes, albeit gradually. In 2021, the BOL announced the new instruction that mandates all currency exchange bureaus to register as representatives of local commercial banks. The mandate aims to narrow a gap between reference exchange rates and parallel market rates since the commercial bank rates are mostly similar to the official reference. Then in June 2022, the BOL implemented a capital control measure to maintain the stability of the Lao kip by limiting daily currency exchange to LAK 15 million (around USD 1,000) per person for individual customers. Meanwhile, legal entities or organizations are permitted to receive currency exchange service only at licensed domestic commercial banks, with priority given to importers of necessary products. The measure has effectively kept the Lao kip steady since late June 2022. In addition, the BOL hiked its policy rate[5] to 3.1% from the previous 3.0% in May, and increased the kip reserve requirement ratio to 5% from 3% in order to put inflation and exchange rate under control.

In the short term, Laos' fiscal and monetary policies will struggle to choose between domestic stability and economic growth target. A sustainable solution would hinge on economic restructuring to improve fiscal revenue and the nation's capability. The fiscal austerity measure—minimizing fiscal expenditure and enhancing tax collection—seems to be a practical plan to battle a crisis. Yet, its policy effectiveness remains a subject of intense scholarly debate since such measure could substantially derail economic growth and thus pressure government revenue collection. Meanwhile, deeper economic scars—such as poverty and economic inequality—would undermine Laos' potential economic growth and might spiral into political and social risks ahead. Similarly, over-tightening monetary policy could jeopardize an already-fragile economy while adding an interest burden on households and businesses. In our view, Laos will need to endure slower growth in the short term, in

5 Short-term (< 7 days) lending rate that BOL offers to commercial banks with inadequate liquidity. BOL recently abolished the policy rates for lending of more than one week and of 2 weeks to 1 year in May 2022.

order to prop up an economy when debt restructuring negotiations with major creditors make progress. In the long term, Laos should urge an economic restructuring and strengthen domestic organizations to attract foreign investment into high-potential industries—such as power generation, mining, and logistics. These would be sustainable solutions to secure a flow of foreign currency revenue over a longer horizon.

Potential financing options and debt service solutions

Finding alternative financing channels will give Laos a leeway to navigate through this storm. Based on our examination, EIC came up with five potential financing options for Laos:

1. **Restructuring China-owed debt:** Since China has been Laos' largest creditor, cooperation with China would be the top crisis exit strategy. According to the Overseas Development Institute[6]—a research house on global affairs, the best possible approach to debt relief for China's concessional loans is debt restructuring via forbearance and maturity extension, while negotiating a lower interest rate would be rather difficult. As for market-rate loans, a repayment deferral is a viable option, but maturity extension and interest rate cuts are unlikely. EIC expects China to approve such debt reliefs, considering Laos' significant presence in China's Belt and Road Initiative (BRI) and that China's decision on Laos would affect ASEAN overall sentiment. Still, we expect to see China's assistance as a combination of debt restructuring, joint venture, and equity financing. China already took some steps in 2021 with the establishment of Electricite Du Laos Transmission (EDL-T), the joint venture between China Southern Power Grid and EDL. In addition, China could agree to an international currency exchange settlement that allows the Lao government to service debt in foreign currencies.
2. **Thailand's financial market:** For Laos, the Thai financial market is among the affordable funding channels that are less costly than global markets. In May 2022, Tris Rating made an upward revision on Laos' credit outlook from negative to stable, citing a better prospect of Laos' debt serviceability thanks to improving economic conditions: narrowing fiscal and current account deficits, healthier growth, and secured access to various funding channels—such as domestic financial market and debt restructuring. Laos recently gained another financing option as EDL-Gen got a greenlight from Thailand's Finance Ministry to issue baht bonds until January 31st, 2023. Nonetheless, higher default risks could hamper investor sentiment over the Lao bonds.
3. **State-owned enterprise reform:** Privatization of state-owned enterprises (SOEs) is among the government's urgent plans to improve revenue and reduce the public debt burden. According to the Vientiane Times, there were 178 SOEs in Laos, and nearly all of them were running on deficits because of inefficiencies. SOE privatization will benefit both Laos' government and SOEs

6 Rudyak, M. and Chen, Y. (2021) China's lending landscape, approach to debt and the Common Framework. ODI emerging analysis. London: ODI (www.odi.org/en/publications/chinas-lending-landscape-and-approach-to-debt-relief)

themselves. The government would raise revenue from asset selling while private organizations—with better experience and expertise—could help revitalize under-performed SOEs, thus contributing to improving the economy, employment, and tax collection.

4. **Bilateral loan:** In case Laos' economy is on the brink of debt distress, the government might resort to loans from international organizations such as IMF, World Bank, and Asian Development Bank (ADB). Still, EIC views that such case is less likely since bilateral loans usually come with strict conditions on country reform which are unfavorable to the Lao government. This was evident in Laos' absence from the G20 Debt Service Suspension Initiative. Besides, seeking bilateral loans might impair Laos' diplomatic tie with China.
5. **Economic restructuring to increase foreign revenue:** In the short term, Laos should enhance the capability of exports and the tourism sector, which will be vital sources of foreign-currency income. This could be in the form of promoting international shipment through the China-Laos high-speed railway or a tourism campaign targeting visitors from neighboring countries. Moreover, international remittances are expected to thrive in line with Thailand's improving growth this year, thus becoming another potential foreign revenue channel. In the long term, Laos should broaden its coverage of the taxation system to increase fiscal revenue while efficiently allocating fiscal spending to projects with high profitability. Apart from that, the Lao government should nurture a business enabling environment, particularly an easing registration process, to attract foreign investment into the nation's compelling industries.

Will Laos default on its debt and become the next Sri Lanka?

In our view, Laos has yet to reach the same point where Sri Lanka went into crumbling, thanks to the nation's financing alternatives. Aside from that, Laos' economy also differs from Sri Lanka in two significant aspects:

Table 2: Comparing public debt sustainability across countries

GDP Growth (%YOY)	2017	2018	2019	2020	2021	2022f
Lao PDR	6.9	6.3	4.7	-0.4	2.1	2.5
Sri Lanka	3.6	3.3	2.3	-3.6	3.6	2.6
Pakistan	4.6	6.1	3.1	-1.0	5.7	6.0
Argentina	2.8	-2.6	-2.0	-9.9	10.4	4.0
Tunisia	2.2	2.5	1.5	-9.3	3.1	2.2

Public Debt (% of GDP)	2017	2018	2019	2020	2021	2022f
Lao PDR	57.2	59.7	62.0	82.6	95.2	95.6
Sri Lanka	77.9	84.2	86.8	101.2	107.1	108.6
Pakistan	60.9	64.8	77.5	79.6	74.0	71.3
Argentina	57.0	85.2	88.8	102.8	80.6	74.4
Tunisia	69.1	74.8	69.0	82.9	82.0	87.3

Foreign Reserves (Months of Imports)	2017	2018	2019	2020	2021	2022f*
Lao PDR	2.2	1.7	1.9	3.0	2.4	2.3
Sri Lanka	4.0	3.3	4.0	3.9	1.6	1.2
Pakistan	3.2	1.8	3.2	3.8	2.7	1.5
Argentina	9.0	10.9	9.6	9.6	6.7	4.2
Tunisia	3.1	2.9	3.7	5.5	4.5	3.7

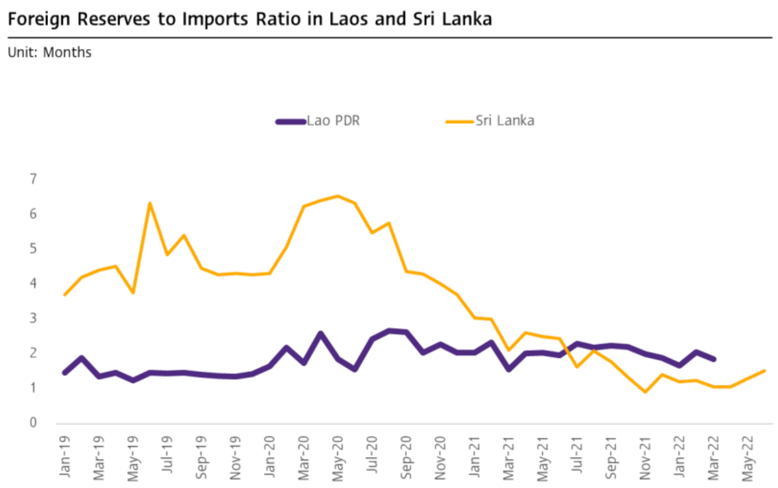
Short-Term Debt (% of Reserves)	2017	2018	2019	2020	2021	2022f
Lao PDR	66.2	41.2	52.7	70.7		
Sri Lanka	100.7	118.2	110.4	148.2		
Pakistan	77.6	116.4	100.1	81.3		
Argentina	100.3	102.3	149.3	108.1		
Tunisia	121.4	143.0	144.3	108.4		

Note: *the latest quarterly data

Source: EIC analysis based on data from IMF, World Bank, and CEIC

1. **Public debt in Laos was not much below that of Sri Lanka, but foreign reserve buffers in months of imports were considerably larger** (Table 2). Based on IMF estimation as of April 2022, Laos' public debt would be equivalent to 95.6% of GDP in 2022, still below Sri Lanka's expected debt burden of 109%. World Bank 2020 data also pointed in the same direction. In 2020, short-term external debt in Laos and Sri Lanka added up to 70.7% and 148.2% of total foreign reserves, respectively. The figure reflected Laos' higher serviceability of short-term external debt, whereas reserve buffers in Sri Lanka failed to cover short-term debt service. Furthermore, the latest quarterly data in 2022 showed that reserve buffers in Sri Lanka only covered about 1.3 months of imports, lower than 1.9 months of Laos. Another benchmark is Moody's External Vulnerability Indicator[7]—in which a higher figure implies higher vulnerability. As for Laos, the indicator was 229.4 in 2022 and 246.8 in 2023, compared to 503.4 in 2022 and 567.4 in 2023 for Sri Lanka. The indicators reflected a higher vulnerability in Sri Lanka, which came primarily from depleting foreign reserve buffers (Figure 11).

Figure 11: Foreign reserves in both countries remained low, but Laos witnessed higher stability.



Source: EIC analysis based on data from CEIC

2. **Since most of Laos' public debt was owed to China, successful negotiation for debt restructuring is highly anticipated, unlike in Sri Lanka, where the creditor base was more fragmented.** EIC views that China will offer debt reliefs in the form of maturity extension or equity financing to Laos' enterprises. To China, Laos is not only a debt recipient but also shares the same border. So if Laos falls into default, China could also feel the impact. Besides, Laos' financial distress would only hurt China's reputation among ASEAN peers, who might consider seeking country development loans from China. Not to mention that ASEAN is by far a buffer

7 Calculation formula: (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves

in US-China power rivalry. Laos' debt default could also halt the China-Laos high-speed railway, a major BRI project which recently opened to traffic in late 2021, and thus affect other regional BRI construction in the pipeline, such as Bangkok-Nakhon Ratchasima-Nong Khai high-speed rail link that will later connect with the China-Laos railway.

Implications for the Thai economy and businesses

The currency crisis in Laos would fuel risks of debt distress. With high public debt—most of which was dominated by foreign currencies, a continued depreciation of the Lao kip would add to the woes of future debt burden. Hence, Laos' economy has a higher risk of debt distress, given the already-fragile economic structure such as low international reserves, long-running fiscal and current account deficits, and financing options that have become limited or more costly. Nonetheless, Laos should be able to find short-term solutions to weather this crisis, with partial debt relief from China and secured access to financing alternatives. On a longer horizon, Laos' economic outlook will primarily hinge on global economic developments—such as global commodity and oil prices, the ongoing Russia-Ukraine war, China's zero-Covid policy—as well as debt reliefs and forbearances from foreign creditors, and regional economic prospects.

Laos' economy will likely witness lower-than-expected growth this year. EIC revised down our growth forecast for the Lao economy from 4.0% to 2.5%, as rampant inflation and goods shortage have weakened private consumption, whereas thin fiscal space constrained government consumption and investment. Furthermore, on the back of rising default risks, foreign investors might adopt a wait-and-see strategy and delay investments until the economy regains its firm footing. Nonetheless, tailwinds remain from the country reopening to foreign tourists and robust exports, buoyed by the high-speed railway service and the kip depreciation. Aside from economic risks, political uncertainties following a weaker economy would be another issue that warrants close monitoring. In response, the Lao government appointed the new BOL governor in June and reorganized the cabinet to solve the current economic crisis.

Adverse impacts on Thai exports and visitors from Laos should be limited, albeit facing higher downside risks. The domestic demand slowdown in Laos—pressured by elevating inflation—might hamper Thai exports, particularly high-priced durable goods such as cars and parts. Nonetheless, overall impacts are unlikely to be significant since exports of refined oils—which accounted for 26.5% of total exports in 2021—will benefit from rising global oil prices and consistently high demand in Laos. Also, exports to Laos are partly financed in Thai baht and thus helped ease Laos' burden from the US dollar shortages. Meanwhile, incoming tourists from Laos will expand gradually after Thailand's full reopening, possibly reinforced by Laotian tourists looking to buy cheaper products across the border. Nonetheless, lower purchasing power due to the kip depreciation might pressure on tourism revenue per head.

We also expect limited impacts on Thailand's direct investment in Laos in the short term, yet there remain economic uncertainties that warrant monitoring. Thailand's direct investment (TDI) to Laos might see a slight deceleration, owing to higher economic risks and disruptions in some internal economic activities from goods shortages, but overall we expect consistent TDI inflows. The electricity generation industry—the largest TDI sector in Laos—should observe limited impacts since the major share of commercial power supply was purchased by the Electricity Generating Authority of Thailand (EGAT), who is less likely to suffer from Laos' currency crisis. Also, the revenue stream from electricity is secured as the power purchasing agreement (PPA) has already decided on the amount of electricity to be supplied, negotiated prices, and currencies used in the transaction. Furthermore, the electricity generation sector has been a vital revenue channel for the Lao government through concession fees and corporate income tax, implying that the industry would see steady support from the government going forward. Still, risks that warrant monitoring include (1) Possible delayed or incomplete payments for power projects that sell electricity through EDL due to the US dollar shortage, and (2) Exchange rate fluctuation, particularly for enterprises that are contingent on revenues in kip. Nonetheless, such risks remain under control thanks to a very low rate of kip in holdings among Thai enterprises.

Financial stability is another issue that warrants monitoring. Based on the European Stability Mechanism's study on the relationship between sovereign debt default and financial crisis[8], EIC assessed that the crisis would affect Laos' and Thailand's economies via four channels:

1. **Balance sheet channels:** As mentioned above, the Lao government increasingly relied on loans from BOL and commercial banks. Hence, a debt default would damage the bank's asset quality and profitability.
2. **Macroeconomic channels:** Disruptions in domestic economic activities might undermine banks' revenue and profits, thus exposing them to risks. Such circumstances could prompt lower domestic lending, affecting both enterprises and households and possibly leading to a credit crunch.
3. **External sector channels:** Sovereign rating downgrade could trigger massive capital outflows and make financing options in the foreign market more costly.
4. **Risk channels:** Economic crisis would ensue the rise of non-performing loans (NPL) while eroding sentiment on financial markets might eventually result in a deposit run.

As of Q1/2022, Laos' financial position remained sound, backed by a low NPL ratio, while the capital adequacy ratio and Tier-1 ratio positioned above their minimum standards (Figure 12). Nonetheless, Laos' financial stability remained a critical issue that warrants monitoring through the remainder of this year since the above three figures could worsen should the Lao government end up defaulting on its debt.

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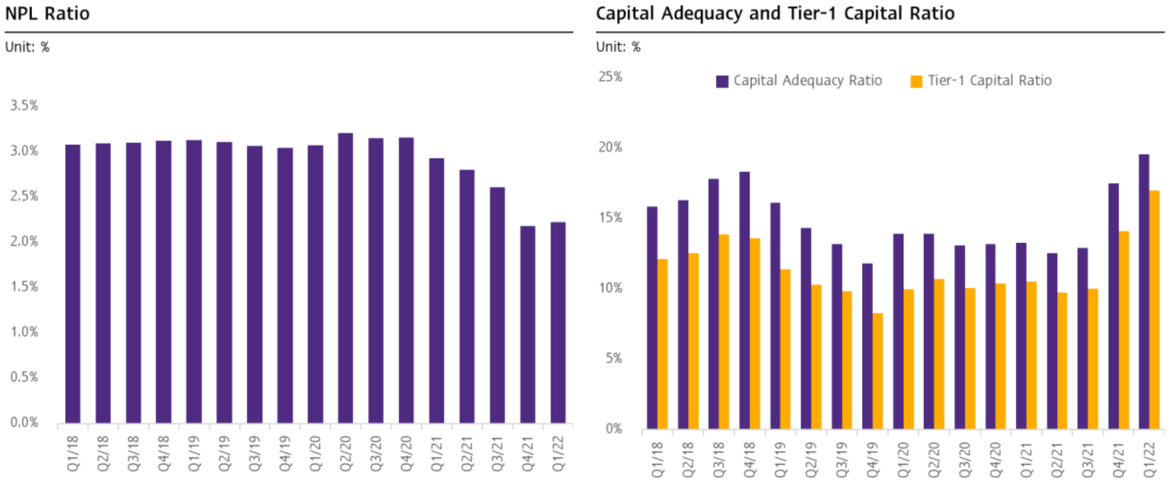
8 Balteanu, I. and Erce, A. (2017) Linking Bank Crises and Sovereign Defaults: Evidence from Emerging Markets. Working Paper Series 22. European Stability Mechanism (https://www.esm.europa.eu/sites/default/files/wp_22.pdf)

Figure 12: Laos financial position remained sound.



Source: EIC analysis based on data from BOL

Author

PUNN PATTANASIRI (punn.pattanasiri@scb.co.th)

ANALYST

ECONOMIC AND FINANCIAL MARKET RESEARCH

SOMPRAWIN MANPRASERT, Ph.D.

First Executive Vice President, Chief Economist at Economic Intelligence Center (EIC), Siam Commercial Bank and FEVP, Chief Strategy Officer at Siam Commercial Bank.

CHINNAWUT TECHANUVAT, Ph.D.

HEAD OF ECONOMIC AND FINANCIAL MARKET RESEARCH

WACHIRAWAT BANCHUEN

SENIOR ECONOMIST

POONYAWAT SREESING, Ph.D.

SENIOR ECONOMIST

ASAMA LIAMMUKDA, Ph.D.

ANALYST

JONGRAK KONGKUMCHAI

ANALYST

NICHANAN LOGEWITOOL

ANALYST

PUNN PATTANASIRI

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