Forging Ahead

Restoring Stability & Boosting Prosperity

PUBLIC FINANCE REVIEW

1. Macroeconomic Performance

Lao PDR 2023

THE WORLD BANK
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1. Macroeconomic Performance

The macroeconomic situation has become critical, with urgent reforms and public debt restructuring needed to stabilize the economy and stimulate growth. Economic growth has steadily decelerated since 2013, highlighting the limitations of a growth model that has been capital-intensive, resource-based, and debt-fueled. Poverty has been reduced, but at a slower pace than in regional peers, while inequality has increased. Pre-existing macroeconomic vulnerabilities have been exacerbated by the COVID-19 pandemic and a deteriorating global economic environment. Fiscal, external, and financial imbalances have fueled macroeconomic instability, with a sharp exchange rate depreciation and high inflation severely affecting households and businesses. The Lao kip depreciated, from about 9,700 to over 20,000 kip per US dollar between September 2021 and September 2023, while consumer price inflation reached 41 percent in February 2023. Public debt levels have risen rapidly, putting a considerable strain on public finances and the broader economy. Public and publicly guaranteed (PPG) debt surpassed 100 percent of GDP in 2022, one of the highest levels in the world. Large external public debt service obligations (averaging 9 percent of the 2022 GDP during 2023–2027) pose considerable fiscal and external risks. Contingent liabilities associated with state-owned enterprises (SOEs) and public-private partnerships (PPPs) are a major concern. Poor revenue collection and rising debt service payments have eroded fiscal space, leaving the country vulnerable to economic, health, and environmental shocks. External imbalances have led to foreign currency shortages, which have triggered a sharp currency depreciation and, thus, high inflation. The banking sector is highly vulnerable to risks associated with public sector liabilities. Unsustainable public debt levels, limited fiscal space for development spending, and a fragile banking sector are, in turn, undermining economic growth, private sector development, job creation, and poverty reduction. Navigating domestic and external challenges requires a positive outcome from ongoing debt renegotiations and the implementation of ambitious reforms to increase domestic revenue, enhance the quality of public spending, strengthen financial sector stability, and improve the business environment.

Main recommendations: (i) negotiate a credible and transparent debt restructuring plan to restore debt sustainability and create fiscal space for growth-enhancing spending; (ii) enhance revenue mobilization, improve spending efficiency, and curb fiscal risks to secure the sustainability of public finances; (iii) develop a medium-term fiscal framework and approve a revised Law on Public Debt Management to improve fiscal and debt management; (iv) adopt supportive monetary and exchange rate policies to help reduce macroeconomic vulnerabilities; and (v) enhance bank monitoring and operationalize emergency arrangements to boost crisis preparedness.

Chapter structure: The chapter starts with an overview of the current macroeconomic framework and key policy objectives. It then assesses the main challenges to economic growth and stability, including long-standing structural imbalances. The remainder of the chapter is devoted to fiscal and debt sustainability, analyzing recent trends and discussing different scenarios to frame policy options for the future. The chapter concludes by summarizing the evidence and providing key policy recommendations.

1.1 Background

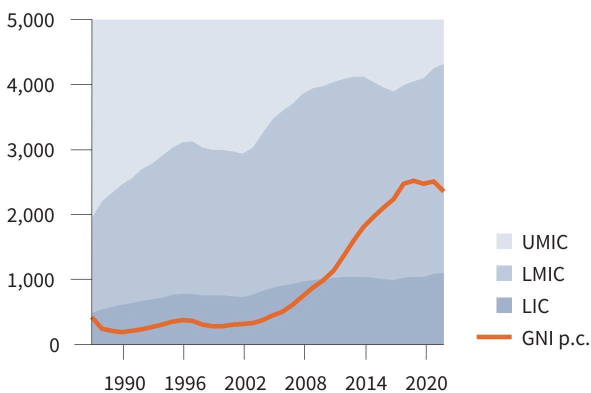
Policymakers have announced several macroeconomic targets in key national plans and strategies. The Ninth National Socio-Economic Development Plan (NSEDP) covers the period 2021–2025. Among the NSEDP's key targets is an average GDP growth rate of (at least) 4 percent, which is significantly lower than pre-pandemic levels. To secure fiscal and monetary stability, the NSEDP sets targets for revenue (at least 17 percent of GDP), expenditure (at most 18 percent of GDP), and the budget deficit (average of 1 percent of GDP).[10] The NSEDP also calls for restructuring public debt, limiting inflation to 6 percent, limiting money supply growth to 20 percent, keeping the exchange rate within a ±5 percent band against the US dollar, and increasing foreign exchange reserves to cover three months of imports. More recently, the National Agenda on Addressing Economic and Financial Difficulties (NAAEFD), which covers the period 2021–2023, was adopted to tackle macroeconomic vulnerabilities jeopardizing the country's development prospects.[11] Among its key targets is a ceiling on public debt (64.5 percent of GDP).

[10] Additionally, domestic revenue should be (at least) 15.8 percent of GDP, capital expenditure 5.6 percent of GDP, and the budget deficit should not exceed 2 percent of GDP.

[11] The National Agenda aims to avert a severe economic crisis and support the achievement of the NSEDP.

Progress toward the achievement of most targets has lagged, owing to limited reform efforts and significant macroeconomic instability. Stated policy objectives are consistent with restoring fiscal and debt sustainability, but the achievement of NSEDP and NAAEFD targets is largely off-track (with several reversals).[12] For instance, gross national income per capita (measured in US dollar terms) declined in 2022, owing to the weakening of the Lao kip (Figure 1.1). GDP growth and fiscal deficit are on track to meet the NAAEFD 2023 targets, although the growth target is arguably low at 4 percent (Figure 1.2). Domestic revenue, current account, foreign reserves, and exchange rate premium are lagging, while public debt increased significantly rather than declined. There are also concerns over financial sector stability indicators (e.g., nonperforming loans and capital adequacy ratios), as regulatory forbearance measures mask vulnerabilities in the banking system. Macroeconomic instability and slow progress on structural reforms have jeopardized progress toward the achievement of many targets. The World Bank and the Asian Development Bank have recently produced a Reform Roadmap to support the implementation of the NAAEFD.[13]

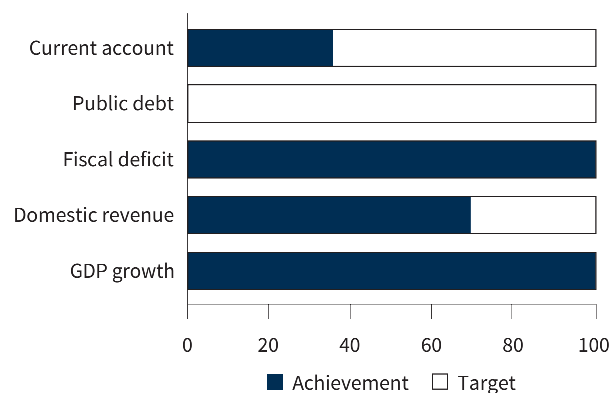
Figure 1.1: GNI per capita (Atlas method, USD)



Source: World Bank.

Note: UMIC upper middle-income country, LMIC lower middle-income country, and LIC low-income country.

Figure 1.2: Achievement of NAAEFD targets (%)



Source: Bank of the Lao PDR and World Bank staff calculations.

Note: Values are the ratio of current progress (difference between 2022 data and baseline) to expected progress (difference between the target and baseline).

Macroeconomic stability is an essential precondition for accelerating economic growth and enhancing living standards. Macroeconomic stability requires sustainable fiscal and external balances, manageable debt levels, and a sound financial sector, all of which are key to supporting a stable exchange rate and low inflation. Hence, stability relies on good macroeconomic management and supportive structural reforms that strengthen the functioning of important markets and sectors. Macroeconomic stability is known to be a necessary condition for sustained economic growth, which underpins improvements in the well-being of the poorest and most vulnerable people. In contrast, persistent macroeconomic instability can jeopardize development gains by reducing real incomes and increasing inequities. Macroeconomic imbalances, financial sector vulnerabilities, high inflation, and disruptive currency depreciations have negative impacts on job creation and other economic opportunities by raising uncertainty, disincentivizing investment, and undermining the efficient allocation of resources across the economy.

Fiscal policy has undermined macroeconomic stability, mainly through high budget deficits and large debt accumulation. Fiscal policy can promote economic growth, stability, and equity through targeted measures within the limits of fiscal prudence. The Ministry of Finance plays a central role in defining and executing Lao PDR's fiscal policy, although the Ministry of Planning and Investment oversees tax incentives and the capital budget. Over time, generous tax exemptions have been granted to large foreign investments, which has considerably undermined the revenue base. Poor revenue performance contributed to large fiscal deficits, while external borrowing (including on-lending to state-owned enterprises) also added to fiscal pressures. Coordination and consistency between fiscal and monetary policies have been low, with an unsustainable fiscal policy stance undermining financial sector soundness (through a growing exposure of banks to the public sector) and exchange rate stability. Recent fiscal consolidation

[12] An evaluation of performance against past five-year plans showed that the country met only one-third of the targets set under the Seventh NSEDP (2011–2015) and one-fourth set under the Eighth NSEDP (2016–2020). See the World Bank's Country Economic Memorandum.

[13] The Reform Roadmap is focused on five critical policy areas: (i) domestic revenue mobilization; (ii) expenditure efficiency; (iii) public debt management; (iv) financial sector stability; and (v) business environment.

efforts have been centered on expenditure controls, which will likely damage medium-term growth prospects. Current fiscal rules include a ceiling on the annual budget deficit (5 percent of GDP) and outstanding total debt (60 percent of GDP), although these are not strictly obeyed.[14] Overall, fiscal policies have largely been inconsistent with their stated objectives.

Monetary and exchange rate policies have been shaped by the consequences of fiscal policies, while their effectiveness is hampered by persistent structural imbalances. The stated objectives of monetary and exchange rate policies are to secure price stability and stimulate economic growth. These policies are managed by the Bank of the Lao PDR (BoL) with the stated goal of reaching GDP growth of 7 percent (or higher) and maintaining single-digit inflation below the GDP growth rate.[15] The monetary policy framework is a mixed regime of monetary targeting and an exchange rate anchor.[16] The BoL influences the money supply by setting policy and reserve requirement rates, issuing bonds, buying government bonds, and providing credit to the public sector. Nonetheless, the effectiveness of monetary policy measures is often hindered by weak transmission mechanisms. While the 'de jure' exchange rate regime is a managed float, the BoL operates a 'de facto' crawl-like arrangement in an effort to keep the Lao kip within a narrow margin relative to the US dollar (±5 percent of the previous year's average). Commercial banks are currently required to keep their buying and selling rates for Lao kip to US dollar transactions within 7.5 percent of the daily reference rate, while foreign exchange bureaus have been closed.[17] De facto exchange rate restrictions have increased, including the rationing of access to foreign exchange and hard ceilings on transactions. Recent efforts to stabilize the exchange rate and reduce inflation have been hampered by persistent structural imbalances (fiscal and external).

1.2 Economic growth

The Lao PDR was one of the fastest-growing economies in the world until the COVID-19 pandemic, despite a steady deceleration since 2013. The Lao PDR experienced rapid economic growth in the 2000s and 2010s (Figure 1.3). GDP growth averaged 7.2 percent per year in the period 2000–2019, making it one of the fastest-growing economies in the East Asia and Pacific (EAP) region and in the world (Figure 1.4). Nonetheless, growth gradually decelerated from 8.0 to 5.5 percent between 2013 and 2019, largely due to emerging structural constraints. GDP growth fell to 0.5 percent in 2020, its slowest pace in three decades, because of the economic impacts induced by the COVID-19 pandemic.[18] Growth recovered to 2.5 percent in 2021 and 2.7 percent in 2022, but it is not expected to return to pre-COVID-19 levels in the medium-term.

Economic activity has been notably driven by the mining and electricity sectors, with related services also playing an important role. The mining sector attracted considerable foreign investments in the 2000s owing to high global demand for copper and other mineral exports (e.g., gold). Meanwhile, the electricity sector also benefited from significant investments in power generation, which aimed to exploit the country's hydrological resources. As a result, mining and electricity have been the key drivers of economic growth, with positive spillovers for construction and some related services (Figure 1.5 and Figure 1.6). Construction also benefited from large investments in transport and logistics infrastructure (e.g., Laos–China railway and Thanaleng Dry Port) to facilitate trade. From an expenditure perspective, growth has been predominantly driven by investment and exports. However, new sources of growth need to be found, particularly given the declining potential of mining and hydropower.[19]

[14] Fiscal rules constrain policy (by setting limits on budgetary aggregates) to secure fiscal discipline and debt sustainability. These can comprise budget balance, debt, expenditure, and revenue rules.

[15] The central bank is not independent from the government. According to the 2018 amendment of the Law on the Bank of the Lao PDR, BoL is a state agency equivalent to a ministry. BoL serves as the secretariat of the government for the areas of monetary stability, supervision of financial institutions, and payment systems. Central bank independence typically enhances policy credibility (and thus effectiveness) by ensuring that decisions are based on economic, rather than political, considerations.

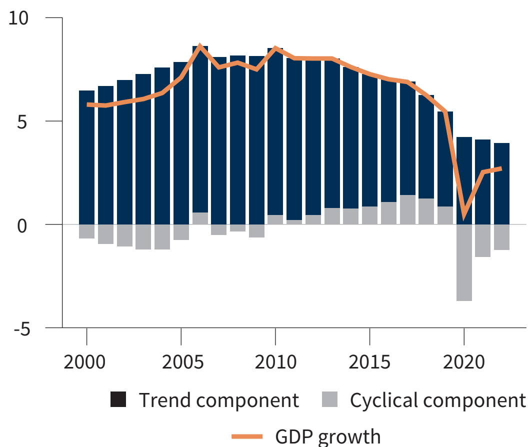
[16] See IMF 2021 Annual Report on Exchange Arrangements and Exchange Restrictions.

[17] In 2021, the US dollar exchange rate band was ±0.25. The 'official' exchange rate is calculated as the weighted average of the previous day's interbank rates and rates of commercial banks, and this rate is used to set the daily reference rate.

[18] The values for 2020–2022 are World Bank estimates, which differ from those published by the authorities.

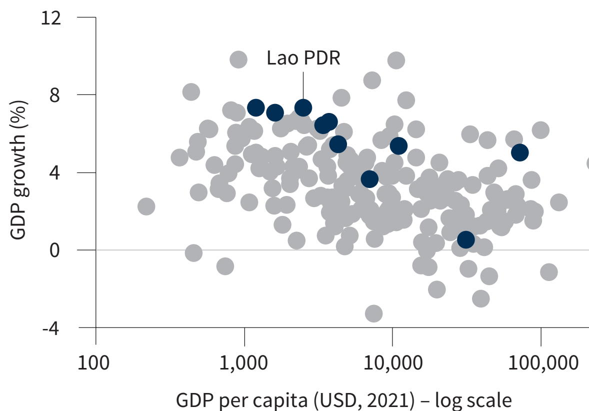
[19] Even if external demand for power increases, further investments in the electricity sector are increasingly constrained by limits to the amount of power technically recoverable (and the related social and environmental costs). Known reserves of minerals (particularly copper and gold) are also thought to be depleting.

Figure 1.3: GDP growth (% and contributions)



Source: Lao Statistics Bureau and World Bank staff estimates.

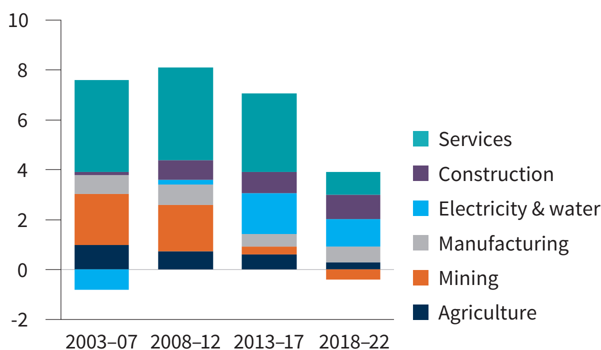
Figure 1.4: GDP growth (%, 2010–19)



Source: World Bank and staff calculations.

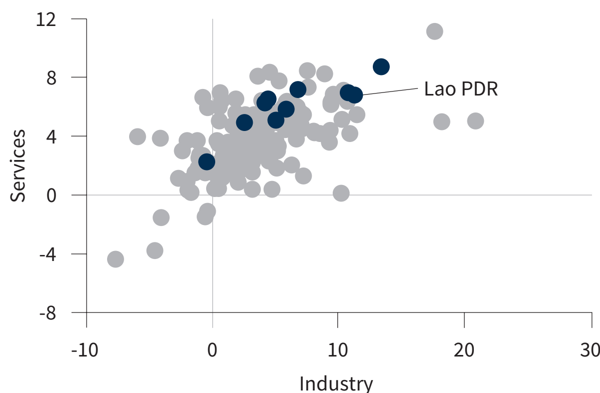
Note: Blue dots represent ASEAN countries. Vertical axis restricted to -4 to improve readability.

Figure 1.5: Contributions to real GVA growth (%)



Source: Lao Statistics Bureau and World Bank staff estimates.

Figure 1.6: Value added growth (%, 2010–19)



Source: World Bank and staff calculations.

The current growth model has clear limitations, as reflected in the large accumulation of public debt, limited job creation, and rapid depletion of natural resources. The steady deceleration of GDP growth underscores the limitations of the Lao PDR's capital-intensive, resource-based, debt-fueled growth model, which has proven to be economically, socially, and environmentally unsustainable.[20] The mining and electricity sectors are capital intensive and thus not able to generate significant employment, while the domestic private sector outside these sectors has been hampered by an unfavorable business environment. Economic growth has created limited job opportunities, undermining structural transformation, which is essential for sustained and inclusive growth. Unemployment rose from 4 to 16 percent during 2012–2018, while migration increased (especially to Thailand). Growth also came at a high environmental cost, as the construction of hydropower dams damaged river ecosystems and negatively impacted agriculture, fisheries, and biodiversity. Finally, (foreign) public debt levels increased considerably, partly to support investments undertaken by the state-owned power utility company (Électricité du Lao).[21] The Lao PDR has struggled to transform its natural wealth into sustained prosperity, as it is not drawing adequate benefits from its mineral, water, and forest resources to invest in human capital.

[20] The World Bank's Systematic Country Diagnostic (SCD) argues that key risks to macroeconomic stability, the inclusiveness of growth, and environmental degradation have materialized in the past few years.

[21] Revenue collection has underperformed, despite the potential for considerable natural resource revenues, owing to generous tax incentives. This has also contributed to foreign exchange shortages, as foregone revenues deprive the country of valuable foreign currency (and budget resources).

The poor quality of economic growth has weakened progress in reducing poverty and achieving shared prosperity. Increases in average incomes have not been commensurate with the pace of growth, partly because growth has not been inclusive.[22] The proportion of the population living under the national poverty line declined from 25 to 18 percent between 2012 and 2018, but it remains high. Meanwhile, income inequality increased and became one of the highest in the EAP, as rapid growth has been mostly jobless. The poverty headcount ratio using the $3.65 per day international poverty line was at 33 percent in 2018, which is much higher than regional peers.[23] Over the period 2012–2018, a 1 percent increase in GDP per capita was associated with a 0.52 percent decline in the poverty rate, less than half the impact Vietnam experienced during the same period. Gains in household income and consumption were modest, especially at the lower end of the distribution. Poverty improvements were mainly driven by rising incomes in the agricultural sector and migrant remittances rather than jobs in the manufacturing or modern services sectors, which are typically associated with structural transformation. A more inclusive growth pattern is required to improve development outcomes.

COVID-19 and high inflation have further undermined living standards, highlighting the economy's vulnerability to shocks. COVID-19 containment measures (e.g., internal movement restrictions and border closures) severely impacted the services sector and disrupted supply chains during 2020–2021. International commodity prices increased considerably in early 2022 when Russia invaded Ukraine. High fuel and fertilizer prices have undermined the economic recovery, with high inflation (mostly driven by exchange rate depreciation) having a considerable negative impact on living standards. Given limited fiscal space, the authorities have not been able to provide much-needed support to households and businesses affected by these shocks.[24] In the absence of an adequate social protection system, economic shocks will continue to undermine private consumption.

1.3 External and monetary sectors

Balance of payments

The current account deficit has narrowed since 2015 as an improving trade balance more than offset rising primary income outflows. The current account balance has improved considerably in recent years, partly supported by electricity exports, but rising debt repayment obligations intensify external imbalances. Exports of goods and services rose steadily during 2013–2019, reaching 56 percent in 2022 (Figure 1.7). This was driven by electricity and mining, as well as manufacturing and agriculture, but also the sharp depreciation of the Lao kip in 2021–2022. Imports of goods and services increased during 2007–2015, supported by the construction of large FDI projects, but subsequently eased as some of these were completed. The COVID-19 pandemic led to a severe contraction in imports (e.g., fuel, steel, and travel) in 2020, but the economic recovery and higher import prices raised imports to 50 percent of GDP in 2022.[25] The trade balance (of goods and services) improved considerably, from a deficit of 16 percent of GDP in 2015 to a surplus of 5 percent in 2022 (Figure 1.8). However, the primary income deficit deteriorated from 1 to 8 percent of GDP during 2014–2022, reflecting rising interest payments on loans.[26] The deficit would have been even higher in the absence of considerable deferrals on external public debt service since 2020. The significant improvement of the current account balance masks imbalances, as only about one-third of export proceeds enter the domestic banking system.

The financial account balance has deteriorated considerably since 2015, owing to a reduction in all types of investment. Lao PDR's vision of becoming the 'battery of Southeast Asia' and a 'land-linked country' has drawn large investments to hydropower and connective infrastructure. However, net foreign direct investment (FDI) declined from 10 to 4 percent of GDP during 2017–2022, albeit with some volatility (Figure 1.9). This partly reflects the completion of some large investment projects (e.g., expressway and railway) and perhaps a lower appetite for

[22] Moreover, the exchange rate appreciated by 26 percent between 2005–2013, likely improving the purchasing power of households. This suggests that the impact of economic growth on poverty reduction might have been even more limited than usually thought. The forthcoming Lao Expenditure and Consumption Survey (LECS) will shed further light on this, given the recent depreciation.

[23] This poverty line (measured in 2017 power purchasing parities) is the standard for lower-middle-income countries.

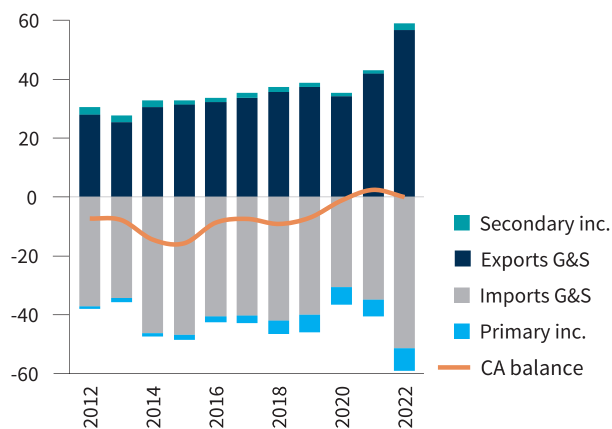
[24] Government efforts relied primarily on monetary and financial instruments. The BoL reduced policy and reserve requirement rates and instructed financial institutions to defer principal and interest payments, restructure debt, and provide new loans to affected enterprises. More recently, fuel excise and VAT rates were reduced.

[25] The Covid-19 pandemic led to a sharp decline in tourism and workers' remittances, despite an improvement in the goods trade balance (as imports declined faster than exports).

[26] Interest payments relate to public, SOE, and private debt. Income repatriation (e.g., FDI dividends) is comparatively smaller.

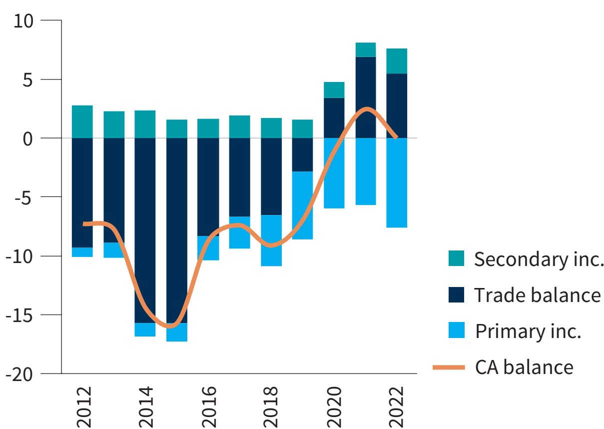
additional electricity projects. Net portfolio investment inflows (which are mostly associated with debt securities) were positive and significant until 2018, after which they became either negative or negligible. This partly reflects limited market access (for new bond issuances) and the repayment of maturing bonds. 'Other investment', which mainly includes other debt instruments (e.g., lending) and mostly relates to banks and government, has also been volatile but showing a clear downward trend. Overall, the financial account has steadily recorded lower net inflows. This has likely had an impact on economic growth, which decelerated during this period, as well as the supply of foreign exchange, thus contributing to exchange rate pressures.

Figure 1.7: Current account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.

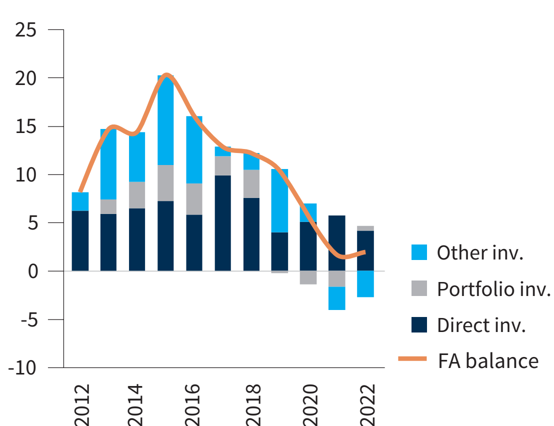
Figure 1.8: Current account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.
Note: Trade balance includes goods and services.

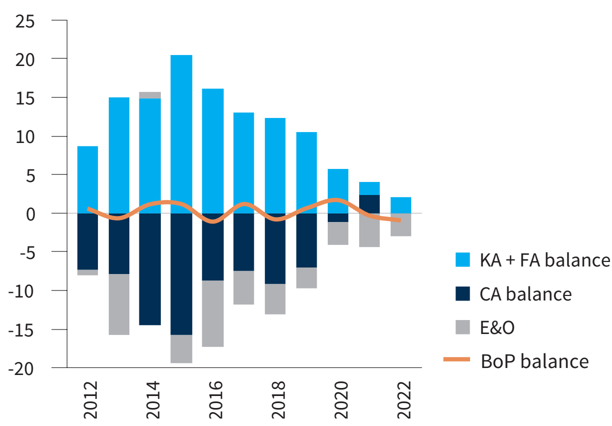
The balance of payments position has been volatile, while large errors & omissions suggest large unaccounted outflows. Net financial inflows have progressively declined from 20 to 4 percent GDP during 2015–2022, while the current account deficit improved from 16 to virtually 0 percent of GDP during the same period (Figure 1.10). In recent years, lower FDI, external borrowing, and tourism-related service exports have reduced the supply of foreign exchange. Errors & omissions have been consistently negative and sizable, suggesting large unreported outflows. The improved current account balance has led to recent balance of payments surpluses, but this data masks deeper structural imbalances. A large proportion of exports proceeds are retained abroad (depriving the country from vital foreign currency), while imports are likely underestimated (according to mirror data from trade partners).[27]

Figure 1.9: Financial account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.

Figure 1.10. Balance of payments (% GDP)



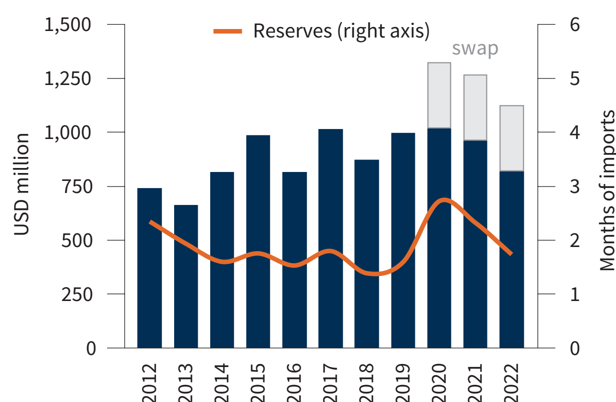
Source: Bank of Lao PDR and World Bank staff calculations.

[27] The BoL estimated that only 33 percent of total export proceeds came to the Lao PDR. The gap for electricity exports was much larger than for mining. Errors & omissions likely capture export proceeds retained abroad, informal transactions (e.g., trade and remittances), and illicit financial flows.

Reserves

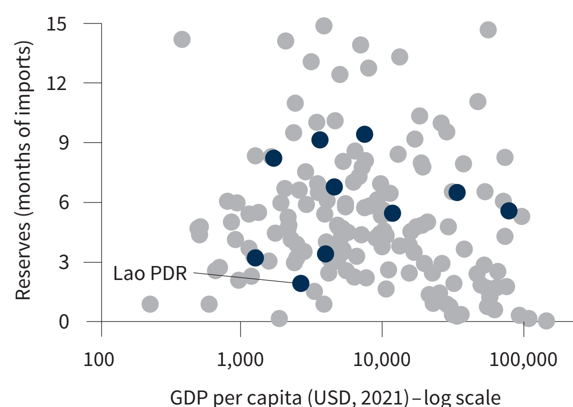
Official reserves are very low and cannot adequately cover import needs or debt service obligations. Gross foreign exchange reserves have been gradually depleted since 2007, as measured in months of imports, although a swap line with the People's Bank of China (PBoC) provided a boost in 2020 (Figure 1.11).[28] Reserves stood at $1.1 billion in December 2022, below two months' import cover, which is considerably below prudent thresholds (Figure 1.12).[29] Growing primary income outflows (e.g., interest payments) and lower investment inflows have had an impact on foreign exchange availability, while an improving trade balance has not fully offset these trends. Despite strong export performance, most export proceeds do not enter the domestic banking system as they are retained abroad. Low reserve levels limit the central bank's ability to support the exchange rate and banks with weak dollarized balance sheets, while constraining the government's capacity to meet external debt service obligations.

Figure 1.11: Reserves (USD and import cover)



Source: Bank of Lao PDR and World Bank staff calculations.

Figure 1.12: Reserves (months of imports, 2018–21)



Source: Bank of Lao PDR and World Bank staff calculations.

Exchange rate

The Lao kip appreciated significantly until the mid–2010s, mainly because of large capital inflows targeting natural resources. A resource-based growth model triggered a steady nominal exchange rate appreciation against the US dollar between 2005 and 2013, which undermined the development of labor-intensive activities outside the resource-based sectors (Figure 1.13). Between 2003 and 2016, the real effective exchange rate (REER) appreciated by about 80 percent (Figure 1.14).[30] This appreciation was mainly driven by large capital inflows to exploit natural resources, such as mining (e.g., copper and gold) and electricity (i.e., hydropower). Foreign exchange inflows mainly comprised foreign investment and external debt, and to a lesser extent official grants and workers' remittances. Large foreign exchange inflows tend to produce a 'Dutch disease' effect, whereby the appreciation of the real exchange rate (usually linked to the development of natural resource exports) undermines the development of traditional exports (e.g., manufacturing) by making them less competitive. This constrains their growth and partly explains why a large and diversified manufacturing base has not developed.[31]

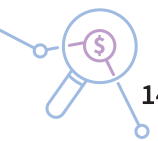
The kip has depreciated rapidly in recent years, predominantly due to external imbalances. The Lao kip has been weakening against most currencies since 2016, with a sharp depreciation experienced since mid-2021 (Figure 1.13). Between September 2021 and September 2023, the kip depreciated by 106 percent against the US dollar and 71 percent against the Thai baht (using average commercial bank rates). This has been largely due to structural

[28] In 2020, PBoC and BoL agreed to a three-year swap arrangement amounting to 6 billion Chinese yuan (about $900 million). Monetary data implies that about $300 million were disbursed in 2020, which are counted as gross reserves. Given the lack of details published (e.g., information on whether funds are earmarked for specific purposes), there is some uncertainty about how to accurately account for it in terms of reserves and public debt.

[29] A standard rule of thumb is to maintain reserve levels at about 3 months of imports, but a prudent reserve adequacy level for the Lao PDR might be even higher given its level of development and existing vulnerabilities. It should be noted that BoL calculates reserve coverage by excluding FDI-related imports.

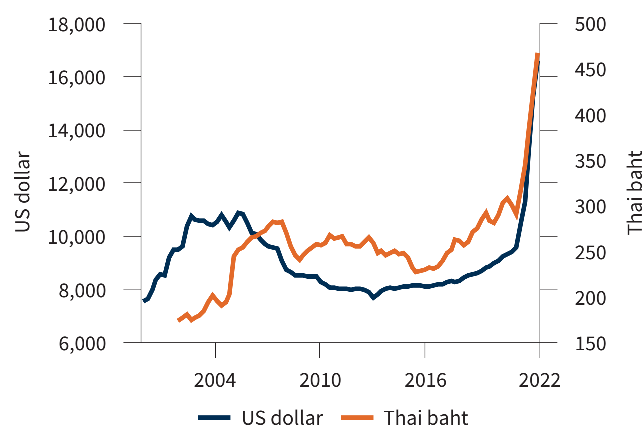
[30] The REER measures the value of the kip against the currencies of major trading partners (as a weighted average) in real terms.

[31] The share of manufacturing in total GDP stagnated at about 9 percent compared to an average of 20 percent for regional peers. Manufacturing only accounts for 20 percent of exports by value, and this lack of export diversification exacerbates the country's vulnerability to volatile commodity prices. The sector has been shedding jobs, with employment mostly driven by public sector jobs.



factors (e.g., high financing needs, limited availability of foreign currency, and low reserve buffers) and, to a lesser extent, the strengthening of the US dollar against most world currencies.[32] The BoL attempted to stem depreciation pressures by using monetary policy instruments to support the value of the kip (e.g., issuing kip-denominated savings bonds, raising interest rates, and increasing reserve requirements), while widening the exchange rate band (thus allowing greater exchange rate flexibility). The BoL has also closed foreign exchange bureaus and revised the foreign exchange management law (which includes repatriation and surrender requirements) in a bid to attract more foreign exchange to the formal banking system. However, the recent depreciation can be seen as an inevitable adjustment, as the kip appeared to be significantly overvalued.[33] Meanwhile, the sharp depreciation has fueled inflation (through higher import prices), increased external debt servicing costs, and exacerbated currency mismatches on bank balance sheets.[34] Persistent external imbalances will continue to put pressure on the exchange rate. Lack of confidence in the kip can potentially accentuate the dollarization of the economy.

Figure 1.13: Exchange rate (kip per foreign currency)



Source: International Monetary Fund and Bank of Thailand.

Note: Quarterly data up to 2022-Q4.

Figure 1.14: Effective exchange rate (index)

Source: Bruegel.

Note: Monthly data up to December 2022. Index equals 100 in December 2007.

Inflation

High consumer price inflation has undermined living standards and negatively impacted businesses. Inflation was relatively low and stable from 2004 until 2021, but the recent exchange rate depreciation and high commodity prices (e.g., fuel and fertilizers) have increased domestic prices (Figure 1.15 and Figure 1.16). Average consumer price inflation reached 23 percent in 2022, and it is projected to be above 30 percent in 2023. Given the significant reliance on imports, food and transport prices rose considerably. However, domestic price increases have been broad-based, also affecting non-tradable goods. The government reduced tax rates in 2022 and attempted to enforce price controls on several basic goods (e.g., rice and pork).[35] Additional depreciation pressures, a possible monetization of the deficit, and supply shocks could sustain domestic inflation in the medium-term. High inflation affects the purchasing power of households, especially the most vulnerable, as well as business costs and public expenditure (e.g., through higher procurement prices).[36] Real interest rates are strongly negative, which creates a disincentive to hold kip and thus supports dollarization. Inflation has contributed to an increase in domestic revenue (in nominal terms), but it has made the purchase of goods and services more expensive.

[32] The parallel market rate started to depreciate considerably in June 2021, with the parallel market premium rising to about 30 percent in September 2021. At this point, the BoL widened the US dollar exchange rate band from ±0.25 to ±1.5 percent, which enabled a faster adjustment that reduced the premium. This band was subsequently increased to ±4.5 percent in October 2022, and ±7.5 percent in June 2023.

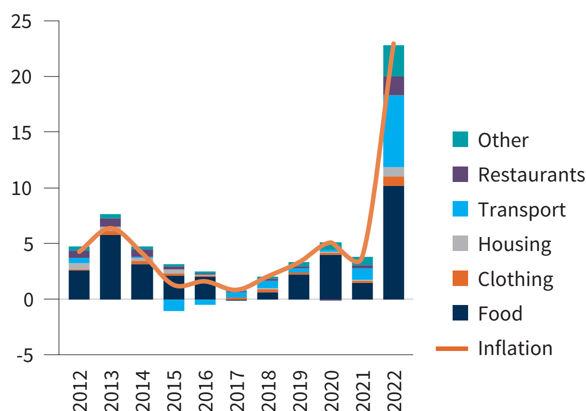
[33] The real effective exchange rate was estimated to be overvalued by 44 to 49 percent at the end of 2016 (IMF 2017 Article IV report). Nonetheless, evidence suggests that exchange rate movements tend to have asymmetric impacts on exports, partly because a depreciation will only promote export competitiveness if adequate productive capabilities and a favorable investment climate are in place.

[34] The strong exchange rate depreciation has considerably increased the kip value of liabilities denominated in foreign currency (e.g., public debt, corporate debt, and bank liabilities).

[35] Tax cuts tend to benefit the non-poor and create large foregone revenues, which undermined fiscal sustainability. Targeted social protection would be a more efficient and effective policy response. There were nationwide fuel shortages in April-June 2022, owing to a combination of fuel price caps and limited foreign exchange availability at the official rate.

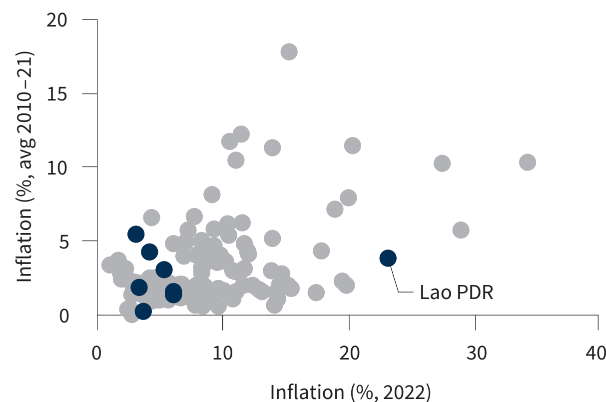
[36] The World Bank's Rapid Monitoring Phone Surveys indicate that 43 percent of households experienced declines in real incomes, and thus had to reduce spending on food, education, and health care. Poverty levels may have increased.

Figure 1.15: Consumer price inflation (%)



Source: LSB and World Bank staff calculations.

Figure 1.16: Consumer price inflation (%)



Source: World Bank and staff calculations.

Financial sector

Monetary policy has been tightened, but weak transmission mechanisms undermine its effectiveness. Money supply (M2) growth gradually decelerated from about 30 percent in 2011–2012 to 8 percent in 2018. However, M2 growth has accelerated rapidly since then, reaching 37 percent in 2022, although mostly due to the revaluation of foreign currency deposits. BoL has recently raised the policy rate, increased reserve requirements, and issued kip-denominated savings bonds to stem the currency depreciation and, thus, inflation pressures. The policy rate was reduced from 4 to 3 percent at the outset of COVID-19 (March 2020), but it was subsequently increased to 6.5 percent in 2022 and 7.5 percent in early 2023.[37] Despite these recent changes, commercial bank interest rates have remained broadly unchanged (likely due to excess liquidity), and real interest rates deeply negative. During 2022–2023, reserve requirements were increased to 8 and 10 percent for the kip and foreign currencies, respectively.[38] Finally, the BoL issued kip-denominated savings bonds in 2022–2023 (with a maturity of 6 months and interest rates of 15–20 percent per year) to reduce kip liquidity and thus shield the value of the local currency. However, these measures have had a limited impact on exchange rate trends.

The financial sector is relatively underdeveloped and dominated by banks with some level of state ownership. The non-bank financial sector is rudimentary, with a limited range of financial products. The financial sector remains dominated by state-owned banks (SOBs) despite the recent restructuring of the Agricultural Promotion Bank (APB) and the Lao Development Bank (LDB). The largest commercial bank is the state-owned Banque Pour Le Commerce Extérieur Lao Public (BCEL), which accounts for about 40 percent of deposits in the banking system. Domestic credit growth decelerated over the years, with the increase in 2022 mostly explained by asset revaluations (Figure 1.17). Access to credit continues to be identified as a top constraint for enterprises, and rising financing needs from the public sector could crowd out private sector borrowing. Domestic credit to the private sector is relatively low by regional and international standards (Figure 1.18).[39] Credit to the government increased considerably in 2021 and 2022, mainly due to the issuance of domestic bonds to clear expenditure arrears and recapitalize banks. The BoL provided direct credit to the government in 2020, purchased government bonds from banks in 2021, and increased financing to banks.

Financial sector weaknesses have been aggravated by the COVID-19 pandemic, prolonged regulatory forbearance, and the recent exchange rate depreciation. Most businesses were significantly affected by COVID-19 containment measures and faced difficulties in repaying loans. More recently, the sharp exchange rate depreciation has severely impacted businesses that earn revenues in kip but must make payments in foreign currencies (e.g., to import inputs and repay debts). Financial soundness indicators appear to be relatively healthy, but they mask considerable vulnerabilities. For instance, reported nonperforming loans (NPL) are low, but

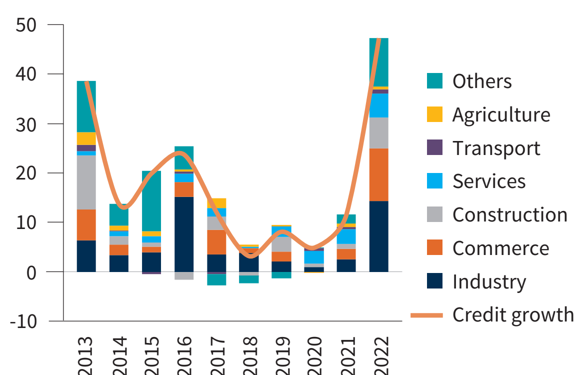
[37] The policy rate (which is a short-term lending rate) was set at 20 percent between 2002 and 2007, but it was gradually reduced to 4 percent by 2010. The rate remained broadly unchanged for a decade, despite small changes in 2015–2017.

[38] The reserve requirement declined from 5 to 3 percent for the kip and from 10 to 5 percent for foreign currencies between 2017–2021.

[39] Credit to the private sector averaged 42 percent of GDP during 2018–2021, compared to 44 percent in lower-middle-income countries and 160 percent in the EAP region.

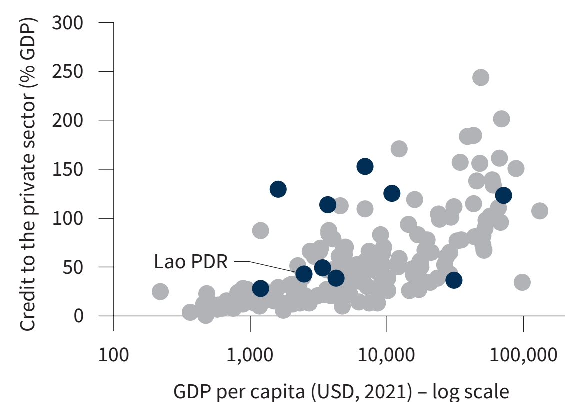
are believed to be understated due to a lax enforcement of regulatory standards, the practice of evergreening problem loans, and COVID-19 forbearance measures (i.e., frozen loan classifications).[40] Accrued interest receivables are high in several banks, indicating considerable forbearance. The average capital adequacy ratio (CAR) of the banking system conceals significant variation across banks. For example, BCEL had a capital adequacy ratio of 6.3 percent in December 2022, below the prudential minimum (8 percent). Profitability is generally low, as measured by return-on-equity and return-on-asset indicators. Weaknesses in the banking system have been compounded by macroeconomic instability, regulatory forbearance, and exchange rate pressures on bank balance sheets. These can lead to capital shortfalls in banks and significantly hamper domestic private sector credit growth, and thus undermine economic activity.

Figure 1.17: Credit growth (% and contributions)



Source: BoL and World Bank staff calculations.
Note: Credit to the economy includes SOEs.

Figure 1.18: Credit to the private sector (% GDP, 2018–21)



Source: World Bank and staff calculations.

The banking sector is highly vulnerable to risks associated with public sector liabilities, while bank recapitalization needs present an additional fiscal risk. The exposure of commercial banks to the public sector is considerable. Banks provide direct financing to the public sector through government bond purchases and loans to SOEs, and indirectly through central bank borrowing from commercial banks to finance fiscal deficits. This is likely to crowd out credit and foreign exchange to the private sector. SOBs are particularly vulnerable to public sector risks, but so are other banks through the financing of public investment projects (directly to the government or through contractors). Banks are exposed to private contractors on public projects since expenditure arrears can give rise to NPLs and even force defaults. Domestic public debt has been growing in the past few years, mostly due to the issuance of triangle and investment bonds to resolve expenditure arrears and recapitalize banks.[41] A deterioration of the fiscal position will likely exacerbate existing financial sector risks and impact credit growth. Balance sheet weaknesses in the largest commercial (state-owned) bank pose a significant threat to financial stability and compound fiscal risks (e.g., recapitalization needs).[42] A financial or banking crisis could obliterate people's savings, disrupt financial flows, create large fiscal costs (bailouts), and undermine long-term trust in the sector.

1.4 Fiscal sector

1.4.1 Fiscal deficit

Fiscal deficits were high until 2020, owing to deteriorating revenue performance and despite expenditure tightening. Total revenue (which includes grants) gradually declined from 22 to 16 percent of GDP during 2014–2019

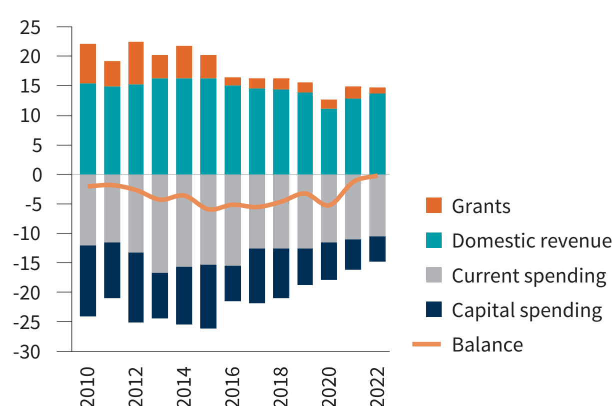
[40] At the onset of Covid-19, measures were enacted to encourage a continued flow of credit. These included lowering reserve requirements and introducing regulatory forbearance (such as credit moratoria, restructuring loans, and freezing loan classifications). As a result, banks may not be adequately provisioning for expected losses, and could face capital shortfalls as they recognize losses when forbearance measures are unwound, in addition to strong exposure to exchange rate risks.

[41] About 23 trillion kip of potential domestic arrears are being verified. In February 2023, the National Assembly authorized the issuance of bonds to clear 8 trillion kip of arrears. Two SOBs were recapitalized before being restructured in 2021–2022.

[42] Public sector borrowing contributes to currency mismatches in bank balance sheets, especially when the government has the right to repay foreign-currency loans in kip.

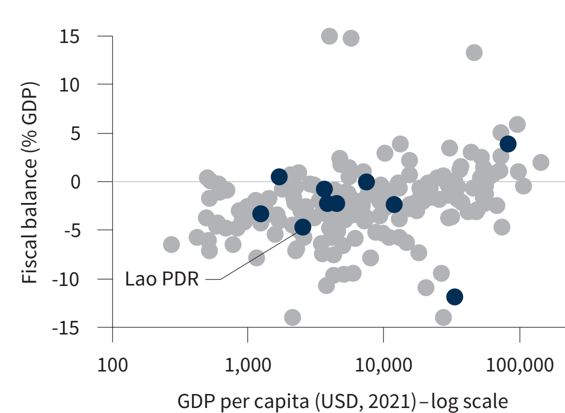
(Figure 1.19).[43] Revenue further decreased to 13 percent of GDP in 2020 due to the COVID-19 pandemic, after which it recovered to 15 percent in 2022. These trends reflect both lower grants and sluggish tax revenue.[44] As a consequence of poor revenue collection, fiscal consolidation has been achieved through tight expenditure controls and interest payment deferrals. Expenditure decreased from 26 to 15 percent of GDP during 2015–2022, owing to curbs on both recurrent and capital spending. Wage bill controls and the postponement of new public investment projects aimed to minimize the fiscal deficit. However, debt service payments have increased, despite deferrals during 2020–2022. The fiscal deficit averaged about 5 percent of GDP in 2015–2020, although it declined considerably in 2021–2022 due to strong expenditure curbs. However, there are sizable expenditure arrears that have not been included in the fiscal accounts. Pre-COVID-19 budget deficits where high compared to regional and income peers (Figure 1.20).

Figure 1.19: Fiscal balance (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.20: Fiscal balance (% GDP, 2015–19)



Source: IMF and World Bank staff calculations.

Limited fiscal space has constrained the ability to fund socioeconomic priorities and adequately respond to shocks.[45] The country has been impacted by several external shocks, including natural disasters (e.g., dam collapse in 2018), health emergencies (e.g., COVID-19 pandemic), and high international commodity prices (e.g., fuel). However, the government has not been able to provide meaningful support to households and businesses affected by these shocks.[46] Given limited fiscal resources, policy responses initially relied on bank forbearance measures and then tax cuts (e.g., reduction of fuel excise and VAT rates), which can jeopardize financial sector stability and fiscal sustainability. Tax cuts are inefficient, as they do not target the most vulnerable (in fact, they tend to benefit the better-off) and generate large foregone revenues. Moreover, spending on the social sectors (e.g., health and education) and capital expenditure have declined, which undermines economic growth prospects.[47]

Fiscal deficits have been largely financed by external borrowing and, to a lesser extent, domestic banks. The government ran large fiscal deficits until 2020, which were predominantly financed through foreign lending (Figure 1.21).[48] In fact, a significant proportion of capital spending has been financed by external project loans. Nonetheless, domestic financing has also been significant. This has mainly comprised borrowing from commercial banks, treasury bills, and asset sales. Fiscal policy can have significant repercussions on monetary aggregates and the balance of payments. Gross financing needs are very high, representing a key source of

[43] The fiscal year ran from 1 October to 30 September until 2016. From 2017 onwards, the fiscal year coincides with the calendar year. For the purposes of this chapter, the last year will be mentioned in the text (e.g., 2015-16 will be 2016).

[44] Donors gradually shifted their support from grants to loans as the Lao PDR graduated to lower-middle-income country (LMIC) status. Grants declined from 7 to 2 percent of GDP between 2012 and 2022. Generous tax incentives provided to large investors and a weak tax administration have undermined revenue performance.

[45] Fiscal space can be defined as the availability of budgetary resources to conduct effective fiscal policy. Governments can create fiscal space by raising revenues, reducing lower-priority spending, and borrowing (e.g., loans and bonds) as long as it does not compromise fiscal sustainability and macroeconomic stability.

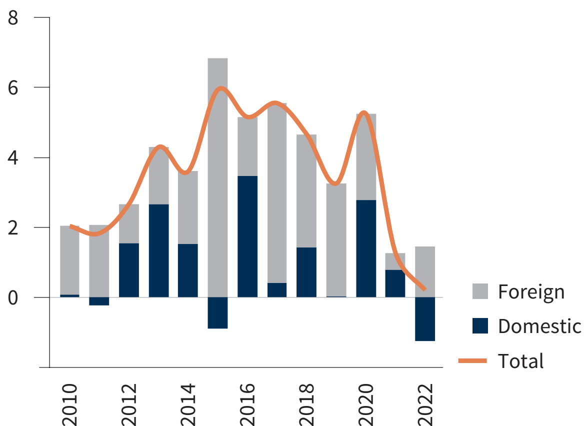
[46] Additional spending or forgone revenue accounted for less than 0.1 percent of GDP between March 2020 and September 2021, one of the lowest levels in the world. Cambodia, Vietnam, and Thailand have spent the equivalent to 1, 6, and 15 percent of GDP, respectively. See the IMF COVID-19 database.

[47] The Lao PDR is one of the poorest countries in the region and has low levels of human capital. Despite high development needs compounded by the COVID-19 pandemic and high inflation, spending on education, health, and social assistance compares poorly with regional and income peers.

[48] There are considerable data discrepancies on deficit financing as financing instruments do not add up to the fiscal deficit.

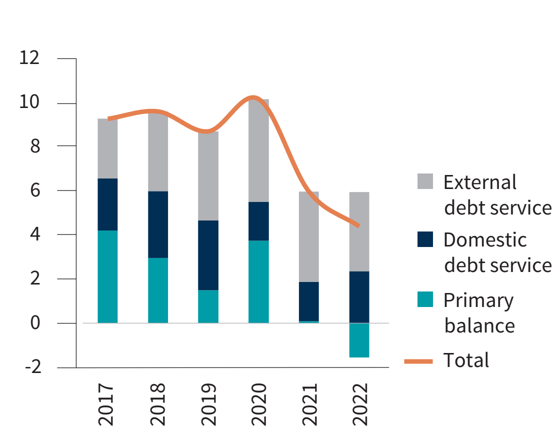
macroeconomic risk (Figure 1.22). Domestic expenditure arrears (mostly arising from off-budget investment projects) misrepresent the fiscal deficit and contribute to public debt accumulation through related bond issuances. SOE quasi-fiscal activities and PPPs are not included in the fiscal accounts, but they also threaten fiscal and debt sustainability.

Figure 1.21: Deficit financing (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.22: Financing needs (% GDP)



Source: MoF and World Bank staff calculations.

Intergovernmental fiscal relations are being developed, but fiscal discipline at the local level is a major concern. Local governments are not legally independent from the central government, as their finances are part of the national budget planning and execution process.[49] Provincial authorities fulfill some government functions at the sub-national level, such as the provision of basic public services (e.g., education and health).[50] They have the fiscal authority to levy taxes (e.g., land tax) and are de facto entitled to spend some of the revenues they collect according to their own plans and policies, while cash shortfalls are covered by the central government. Available data suggests that provinces collected 23 percent of domestic revenue and executed 31 percent of public spending during 2015–2019, accounting for about 50 percent of the fiscal deficit. Moreover, off-budget projects at the sub-national level have generated a large amount of expenditure arrears.

1.4.2 Public debt

Debt stock

Public debt has reached critical levels, driven by strong government borrowing and a sharp currency depreciation. The public debt stock increased from 57 to 96 percent of GDP between 2018–2022, according to official statistics.[51] Although external debt has recently stabilized in nominal US dollar terms, the debt burden deteriorated rapidly in 2021–2022 because of large domestic bond issuances and severe currency depreciation. In 2022, the public debt stock mainly comprised external debt (87 percent), 40 percent of which was on-lent to state-owned enterprises (mainly Électricité du Laos).[52] Domestic debt amounted to 12 percent of GDP, which is predominantly held by the banking sector and government contractors (through investment bonds), but also the central bank. Publicly guaranteed debt, an explicit contingent liability, accounted for 16 percent of GDP.[53] Hence,

[49] See the 2018 Public Expenditure and Financial Accountability (PEFA) assessment.

[50] In this report, the term 'provinces' comprises the 17 provinces and the Vientiane Prefecture.

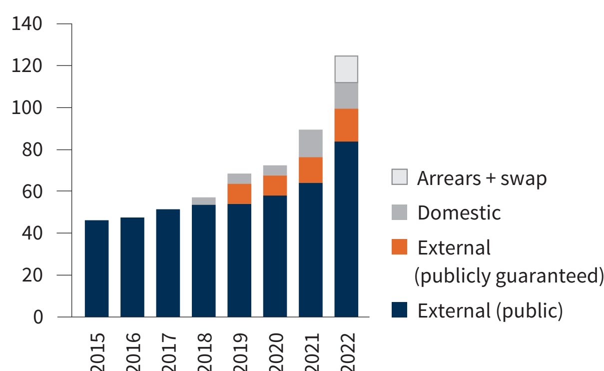
[51] Public debt covers debt owed by the central government, while public and publicly guaranteed (PPG) debt includes debt guaranteed by the central government. Domestic debt was not reported before 2018, and publicly guaranteed debt was not reported before 2019.

[52] The Lao PDR uses the currency criteria, which means that external debt includes domestic debt issued in foreign currencies.

[53] As of 2022, SOE debt guaranteed by the government was mainly held by EDL, and Lao Airlines to a lesser extent. Non-guaranteed SOE debt is an implicit contingent liability (e.g., the large borrowing by the Lao National Railway State Enterprise).

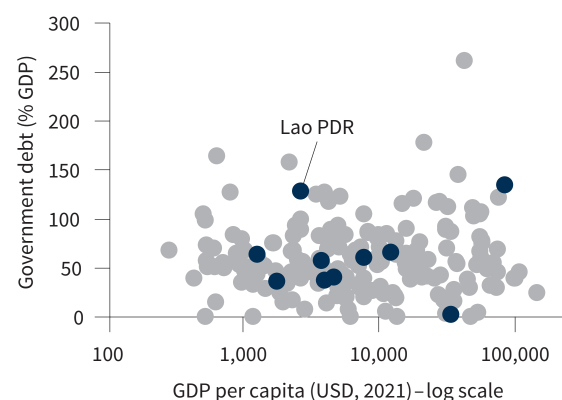
public and publicly guaranteed (PPG) debt amounted to 112 percent of GDP in 2022, of which 44 percent of GDP was related to SOEs (through on-lending and guarantees).[54] Including domestic expenditure arrears and a swap arrangement with PBoC raises PPG debt to 125 percent of GDP in 2022 (Figure 1.23). Gross public debt has become one of the highest in the world (Figure 1.24).

Figure 1.23: PPG debt (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

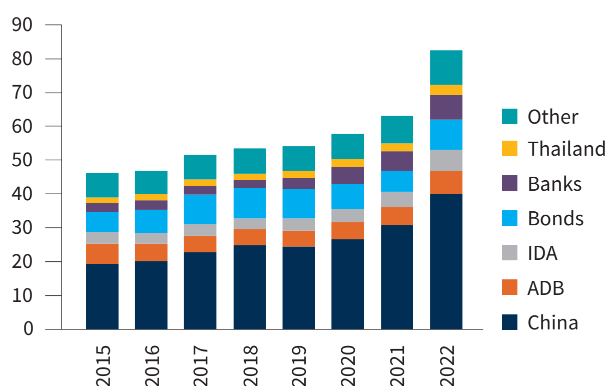
Figure 1.24: Government debt (% GDP, 2022)



Source: International Monetary Fund and World Bank.

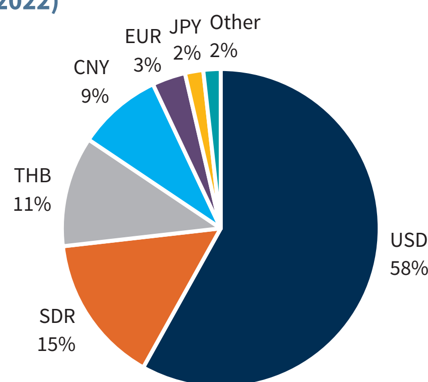
External public debt is mostly concessional, from bilateral institutions, and denominated in US dollars. External debt increased from 46 to 84 percent of GDP over the period 2015–2022 (Figure 1.25). Although most debt is contracted on concessional terms, market-based lending increased rapidly from 33 to 42 percent during 2015–2019 and stabilized at 40 percent in recent years. Most debt relates to bilateral loans (63 percent), followed by multilateral lending, foreign-denominated bonds, and commercial bank loans. Nearly 50 percent of external debt is owed to China. Debt is mainly denominated in US dollars (58 percent) and has a fixed interest rate (84 percent) (Figure 1.26).[55]

Figure 1.25: External public debt by lender (% GDP)



Source: MoF and World Bank staff calculations.

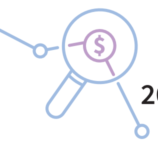
Figure 1.26: External public debt by currency (%, 2022)



Source: MoF and World Bank staff calculations.

[54] The stock of PPG debt is taken from the Ministry of Finance's 2022 public debt bulletin and nominal GDP is based on World Bank estimates. The 2023 WB-IMF Debt Sustainability Analysis estimates PPG debt at 129 percent of GDP in 2022. The latter is a projection based on 2021 values and a broader definition of debt. Domestic expenditure arrears and a swap arrangement are classified as PPG debt under the Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-Income Countries (LIC-DSF), but not under the current legal framework in the Lao PDR.

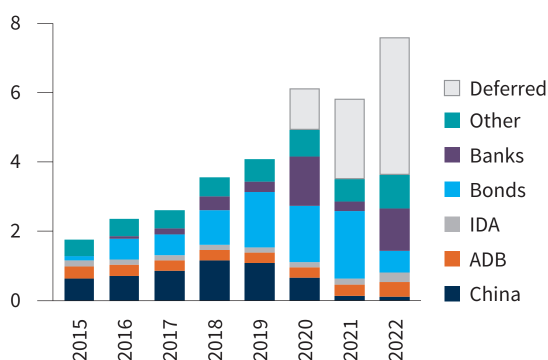
[55] Sovereign bonds were issued mainly in the Thai bond market. The government temporarily lost market access in 2020 before resuming in 2022. Multilateral loans contracted on market terms comprised less than 1 percent of external debt.



Debt service

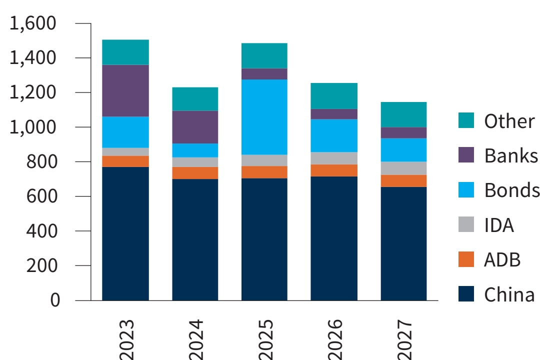
Most public debt service relates to borrowing at market terms and is mostly owed to China. Total public debt service obligations are high and growing. In 2022, principal and interest repayments amounted to 6 percent of GDP (including both external and domestic debt) despite significant deferrals. External debt service payments have been considerably below planned amounts, as deferrals to China in 2020–2022 accumulated to about $1.3 billion by the end of 2022, 8 percent of the 2022 GDP (Figure 1.27). These have provided temporary relief, but liquidity pressures have intensified with the sharp depreciation of the Lao kip.[56] Borrowing from private lenders is typically associated with higher interest rates and shorter maturities when compared to official lenders. Attempts to issue dollar-denominated bonds abroad in 2020–2021 were canceled or postponed, a sign of constrained access to international capital markets. The Lao PDR's sovereign credit rating was downgraded by Fitch, Moody's, and TRIS during 2020–2022, reflecting concerns about rising financing pressures.[57] A successful Thai baht bond issuance in March 2022 paved the way for future issuances in Thailand, although a bond issuance in 2023 was significantly undersubscribed. The authorities have stated that they aim to meet current financing needs through increased revenue, asset sales, external borrowing (including bonds), and domestic borrowing.

Figure 1.27: External public debt service (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.28: External public debt service ($ million)



Source: MoF and World Bank staff calculations.

Debt service requirements are unsustainable in the absence of a successful outcome from ongoing negotiations with major creditors. Assuming no further deferrals, external debt service obligations are estimated at over $1.3 billion per year during 2023–2027, about 9 percent of the 2022 GDP (Figure 1.28). This is higher than gross foreign reserves ($1.1 billion as of December 2022). Over half of these external public debt service obligations are due to Chinese lenders. The outcome of ongoing bilateral debt renegotiations is a critical unknown that has a strong bearing on debt sustainability and, thus, the economic outlook, through its impact on public finances, external accounts, and investor confidence.

Debt sustainability

The Lao PDR is in debt distress, and its public debt levels are unsustainable.[58] The Lao PDR is facing both liquidity and solvency challenges owing to a high debt burden, poor revenue collection, limited financing options, and low foreign currency reserves. The public debt stock and debt servicing requirements have surged in recent years, edging the country into sovereign debt distress. Most debt ratios breach the indicative debt thresholds for a country with low debt carrying capacity, except for those relating to exports (Figure 1.29). However, only a fraction of export proceeds enters the domestic banking system to boost the supply of foreign exchange, which can be misleading. In the absence of revenue reforms or debt restructuring, debt levels are expected to remain above sustainability thresholds for many years (Figure 1.30).

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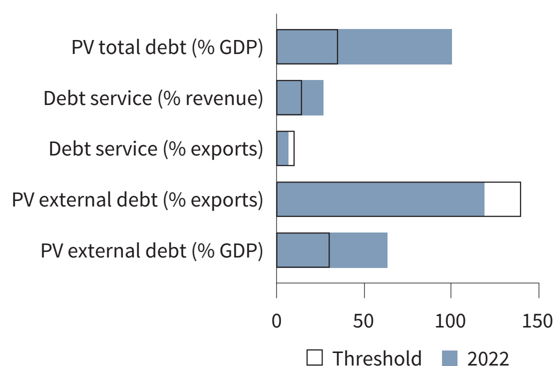
[56] The specific terms and conditions of these deferrals (e.g., repayment period) are subject to ongoing negotiations.

[57] Moody's and Fitch downgraded to Caa2 and CCC respectively in 2020. The Thai Rating and Information Services (TRIS) downgraded the Lao PDR's sovereign rating to BBB- in 2021. Several attempts to issue international bonds during this period were unsuccessful due to limited interest and transparency. There were concerns over debt sustainability, slowing growth, low foreign exchange reserves, and tight foreign exchange liquidity.

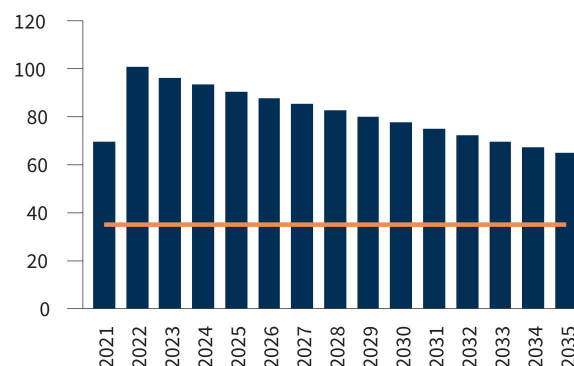
[58] In May 2023, the authorities consented to the publication of the 2023 Debt Sustainability Analysis (DSA), which is jointly conducted by the World Bank and the IMF.

Figure 1.29: Liquidity and solvency thresholds



Source: IMF and World Bank (2023 DSA).

Figure 1.30: Present value of total PPG debt (% GDP)



Source: IMF and World Bank (2023 DSA).

1.4.3 Fiscal risks

Fiscal risks can exacerbate the fiscal and debt burdens, and thus compound macroeconomic vulnerabilities. A fiscal risk is an exposure of public finances to an uncertain event that, if realized, may contribute to deviations from expected fiscal outcomes. Fiscal risks can impact public finances (e.g., deteriorate the fiscal balance) and limit the scope of fiscal policy to stabilize the economy and support economic growth. Therefore, it is crucial to identify, assess, disclose, monitor, and manage fiscal risks to secure fiscal sustainability and macroeconomic stability. This should entail a comprehensive assessment of the likelihood and potential impact of a range of risks, including macroeconomic shocks, financial crises, bailouts of public enterprises, commodity price shocks, and natural disasters. A better understanding of fiscal risks and effective risk management supports fiscal credibility and the sustainability of public finances. The World Bank and the IMF have developed diagnostic tools to identify direct and contingent liabilities and map them into a fiscal risk matrix (Table 1.1).[59]

Table 1.1: Fiscal risk matrix

Liabilities	Direct (actual)	Indirect (contingent)
Explicit (legal)	• Foreign and domestic sovereign debt (loans contracted and securities issued by central government) • Current budget expenditures (current fiscal year) • Future budget expenditures (legally binding over the long term – e.g., civil servant salaries and pensions)	• Guarantees for borrowing and obligationsmof SOEs • Guarantees for private investments (PPPs) • Guarantees for borrowing and obligations of SNGs • Guarantees for trade and exchange rate risks • State insurance schemes • Unexpected compensation in legal cases related to disparate claims • Reconstruction of public assets
Implicit (moral)	• Future recurrent cost of public investments • Future public pensions* • Social security schemes* • Future health care financing*	• Defaults of SOEs on non-guaranteed debt and other obligations • Liability clean-up in entities being privatized (e.g., public corporations) • Bank failures (support beyond state insurance) • Environmental recovery, natural disaster relief • Defaults of SNGs on non-guaranteed debt and other obligations • Failures of nonguaranteed pension funds, or other social security funds

Source: Adapted from World Bank (1998).

Notes: * If not required by law. SNG stands for sub-national government. State insurance schemes include deposit insurance, private pension funds, crop insurance, and flood insurance.

[59]These include the World Bank's Fiscal Risk Assessment (FRA).

There are significant direct and contingent liabilities, but their quantification has been undermined by a lack of transparency. There are many state-owned enterprises (SOEs) in the Lao PDR, most of which are loss-making and have large liabilities. For instance, Électricité du Laos (EDL) has made significant investments that have been predominantly funded through on-lending and guarantees from the government. Other large SOEs include Lao Airlines and BCEL, a state-owned bank. The Lao PDR has relied extensively on public-private partnerships (PPPs) to finance public infrastructure development. The government participates in PPPs largely through SOEs, such as EDL, EDL-Gen, and Lao Holding State Enterprise in the energy sector. The Lao PDR has also made major transport infrastructure investments, including the Laos–China railway and the Vientiane–Vang Vieng expressway. While the government is pursuing SOE reforms, the country's debt overhang may lead to an even stronger appetite for PPPs to boost large-scale infrastructure. The large accumulation of contingent liabilities creates additional fiscal risks that can heighten the already large fiscal and debt burdens. Chapters 4 and 5 of this report cover the two main sources of fiscal risks in the Lao PDR: SOEs and PPPs.

1.4.4 Scenarios

Scenario analysis provides valuable insights into the impact of different reform options and debt renegotiation outcomes. This section assesses the impact of different scenarios on debt sustainability. The baseline projection is the same as in the 2023 Debt Sustainability Analysis (DSA), which is complemented by two scenarios: (i) 'revenue reforms', which comprises an immediate restoration of the VAT rate to 10 percent (2024), an increase of excise taxes (boosting excise collection by 15 percent per year), and a phased elimination of CIT exemptions (doubling CIT collection by 2035 in relation to the baseline); and (ii) 'debt relief', which encompasses an immediate (2024) reduction in the PPG debt stock (equal to 20 percent of its 2023 value). Moreover, the real GDP growth rate necessary to bring the present value (PV) of PPG debt down to sustainability levels in the next 10 years is also calculated. The result (over 10 percent a year) indicates that the Lao PDR cannot 'grow out' of its debt situation. The 2023 DSA already included a contingent liability stress test, which applied a 47 percent of GDP shock.[60]

In the baseline, public debt levels remain unsustainable throughout the projection period. In the absence of reforms, debt restructuring, and further shocks, debt ratios decline because of (small) primary surpluses in the near-term and robust economic growth (Figure 1.31). Growth is expected to benefit from a recovery in tourism, improved transport and logistics infrastructure (e.g., Laos–China railway and Thanaleng Dry Port), as well as mining and electricity exports. However, debt levels would remain elevated and persistently breach sustainability thresholds. Debt service obligations would remain high and crowd out all but the most essential government spending (Figure 1.32).[61] Gross financing needs increase considerably, owing to the assumption that full external debt service resumes in 2023, which need to be financed domestically due to limited access to international markets.[62] If large contingent liabilities were to materialize, the debt burden would be overwhelming, which would likely induce a public financing crisis, leading to a very large exchange rate depreciation, extremely high inflation, and a protracted economic recession.

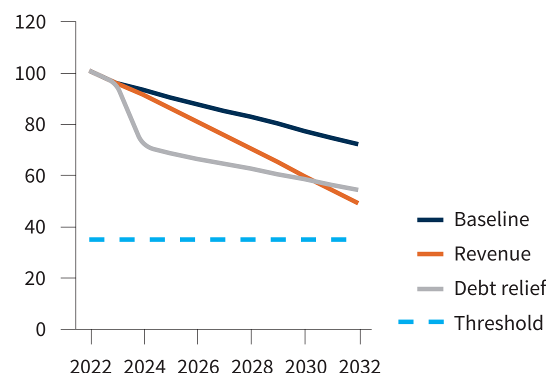
Enhancing domestic revenue mobilization would help ease the debt burden, but debt levels would remain unsustainable in the next decade. Tax policy reforms are needed to significantly (and sustainably) increase domestic revenue (see chapter on revenue mobilization). This would entail reversing recent cuts to the VAT and fuel excise rates. These measures would immediately and efficiently generate much-needed revenue. There is evidence that the VAT is a progressive tax, as it predominantly affects the non-poor (Box 1). Moreover, the government should rationalize tax incentives, although its impact would be gradual due to the

[60] The contingent liability shock is large, since it takes into consideration the very large PPP capital stock, the precarious financial situation of large SOEs (e.g., EDL), likely bank recapitalization needs, and potential additional expenditure arrears.

[61] Debt service projections are less linear than debt stock trends due to the different maturities of debt instruments. This adds an additional challenge to the government's debt management strategy.

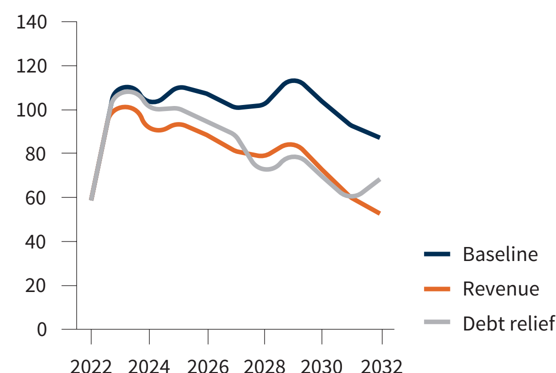
[62] Without further deferrals, no monetary financing, and no additional sources of finance (e.g., asset sales), it is assumed that financing needs are met by domestic banks, which can crowd out private credit. This could lead to rising domestic financing costs and shorter maturities, which would increase rollover and refinancing risks. This could entail a deterioration of bank asset quality and trigger liquidity shortages with a spiral of depreciation and inflation.

Figure 1.31: Present value of total PPG debt (% GDP)



Source: World Bank staff projections.

Figure 1.32: PPG debt service (% revenue)



Source: World Bank staff projections.

need to 'grandfather' (i.e., honor) existing agreements. This scenario would improve the fiscal balance and enable a faster reduction in debt burden indicators when compared to the baseline. However, debt ratios would remain above sustainability thresholds in the next decade. Tax administration measures are also important, but typically take much longer to impact revenue collection.

Debt restructuring would significantly improve fiscal and debt outcomes, but the relief would need to be significant. Given the need to service a large public debt stock, revenue reforms alone will not be sufficient to alleviate the debt burden in a decisive way. A debt restructuring that significantly lowers the public debt stock would provide a clear path toward debt sustainability. For instance, a 20 percent write-off of PPG debt would significantly reduce the public debt stock and servicing requirements, but it would still be insufficient to achieve debt sustainability within 10 years. Nonetheless, debt restructuring would considerably reduce financing needs.

Restoring debt sustainability will require significant fiscal reforms and a successful debt renegotiation. Macroeconomic outcomes depend on assumptions relating to reform implementation and debt renegotiations. In the baseline, a debt overhang (i.e., the inability to finance new growth-enhancing investments) will have a considerable impact on economic growth prospects. However, adjustment options are limited since the primary surpluses required to reduce debt below risk thresholds within a few years are not politically feasible or socially desirable. Even if critical reforms to enhance revenue mobilization are undertaken, debt sustainability would still hinge on a successful conclusion of ongoing debt renegotiations (Box 2).

Box 1: Distributional impacts of fiscal reforms

Fiscal reforms can have significant distributional impacts, which should be carefully considered. The Commitment to Equity (CEQ) methodology assesses the distributional impact of fiscal policies on household and individual welfare. It disaggregates income into stages that include or exclude fiscal interventions to analyze the impact of each intervention on poverty and inequality. This generates several income concepts used to further understand the effect of fiscal policies on welfare (see the World Bank's Fiscal Incidence Analysis entitled "Raising the Bar: Towards an Equitable and Inclusive Fiscal Policy").

Restoring the VAT rate to 10 percent would have a strong impact on revenue, while the tax burden placed on low-income households would be low. The VAT is progressive in the Lao PDR, which means that poorer households face lower effective VAT rates than richer households, due to larger shares of informal consumption. At the current rate of 7 percent, VAT payments represent 0.6 percent of the income of the poorest households (i.e., bottom decile), increasing to 4.3 percent for the richest (i.e., top decile). Restoring the VAT rate to 10 percent would increase the tax burden to 0.8 percent of income for the poorest decile, compared to 5.9 percent for the richest decile. About 80 percent of the additional VAT revenue would be paid by the richest three deciles. Therefore, restoring the VAT rate would considerably improve revenue collection while reducing inequality. The Gini index, a measure of inequality, is estimated to decline by 0.13 points.

Box 1: Distributional impacts of fiscal reforms (continued)

Raising health taxes would generate additional revenue, with larger fiscal gains achieved through reducing the health care burden in the long term. In the absence of behavioral responses to higher prices, increasing the excise tax on beer (to 9,000 kip per liter), on cigarettes (to 5,700 kip per pack), and on sugar-sweetened beverages (to 2,000 kip per liter) would enhance revenue collection, albeit to a lesser extent than restoring the VAT rate to 10 percent. Increasing the excise tax on beer would also reduce inequality, as richer households tend to spend larger shares of their income on beer. However, consumers tend to adjust their behavior by reducing their consumption in response to higher prices. While the immediate impact of health tax increases on revenue collection could be lower with behavioral responses, larger fiscal gains are expected through reducing long-term health care spending as households internalize the negative externalities of consuming these products. Moreover, inequality is expected to further reduce with behavioral responses. Poorer households are more responsive to the higher prices after excise increases, reducing their consumption by more and so bearing relatively less burden of tax increases, as well as benefitting more from better long-term health and productivity and lower out-of-pocket health expenditures.

Targeted cash transfers are an effective tool to protect vulnerable households. Targeted cash-transfer programs provide financial assistance to low-income households to support their livelihoods and protect them from shocks. The government has a proxy means test (PMT) targeting tool in place to identify potential beneficiaries, although efficiency and accuracy of the tool can still be improved. Based on the PMT tool, providing 336,000 kip (in 2018 prices, equivalent to 10 percent of the annual poverty line) to the poorest 20 percent of the population would cost the government around 480 billion kip, but help reduce inequality by over 0.8 Gini points and reduce poverty by 2.4 percentage points.

Targeted cash transfers are also an effective tool to alleviate the negative impact of high inflation on malnutrition. COVID-19 and high inflation have eroded human capital through increasing malnutrition, disrupted learning, and school dropout, with a higher incidence among low-income households. A conditional cash transfer program (CCT) to promote maternal health and children's nutrition was rolled out in 2021 in the four northern provinces (Phongsaly, Huaphan, Oudomxay, and Xieng Khuang). Evidence shows that while the nutrition situation has worsened due to the impact of COVID-19 and high inflation, the negative impact on nutrition was lower among CCT beneficiaries. Creating fiscal space for the CCT program would help mitigate the negative impacts of economic shocks on household livelihoods and human capital investment, especially among low-income households who tend to underinvest in their children's nutrition, health, and education.

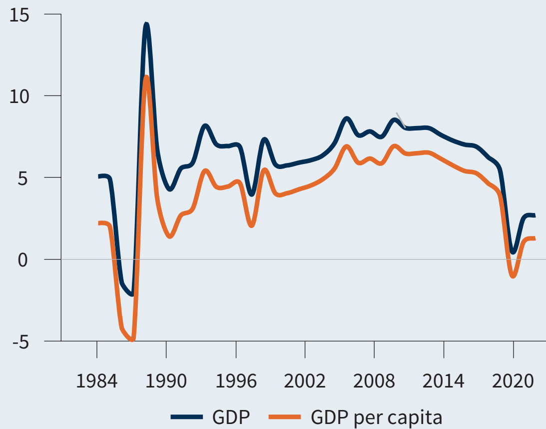
Combining the proposed tax reforms with targeted cash transfers to vulnerable households would generate significant revenue while reducing poverty and inequality. Using part of the additional revenue generated by the proposed tax reforms to provide cash transfers to vulnerable households would have considerable impacts on revenue and livelihoods. The VAT and excise tax rate increases, when combined with targeted cash transfers amounting to 336,000 kip to the poorest 20 percent of the population (as identified by the PMT tool), would help raise fiscal revenue by 16.2 percent of net fiscal revenue in the baseline, while reducing inequality by 1.0 Gini index points and poverty by 1.9 percentage points.

Box 2: Past episodes of macroeconomic instability

The Lao PDR has experienced economic difficulties throughout its history, and lessons from the past can be drawn to restore macroeconomic stability. The current levels of macroeconomic instability are not unique in the country's history. The economy has experienced high public debt levels, large external imbalances, sluggish growth, high inflation, and a weakening currency at different points in time over the past 40 years, particularly in the late 1980s and the late 1990s. The legacy of a centralized economic system, mixed reform efforts, and external shocks have underpinned periods of considerable economic volatility. The 1997 Asian Financial Crisis was a major factor affecting economic performance, albeit briefly. Recent shocks (e.g., the COVID-19 pandemic and high inflation), coupled with muted policy responses, are likely to induce deep scarring that may undermine economic prospects for many years to come.

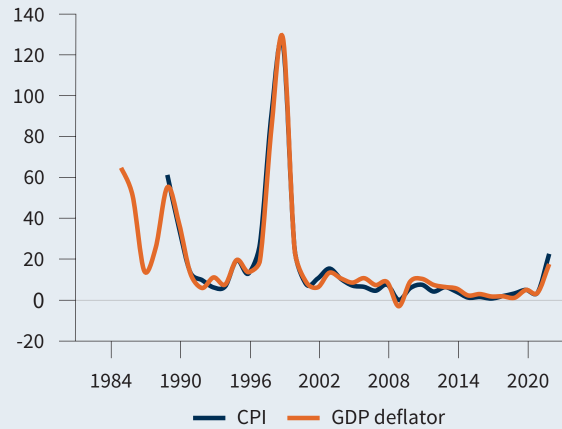
Box 2: Past episodes of macroeconomic instability (continued)

Figure 1.33: GDP growth (%)



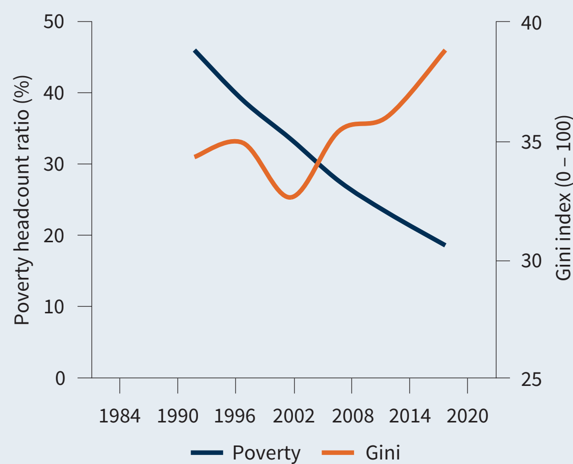
Source: World Bank and staff calculation.

Figure 1.34: Consumer price inflation (%)



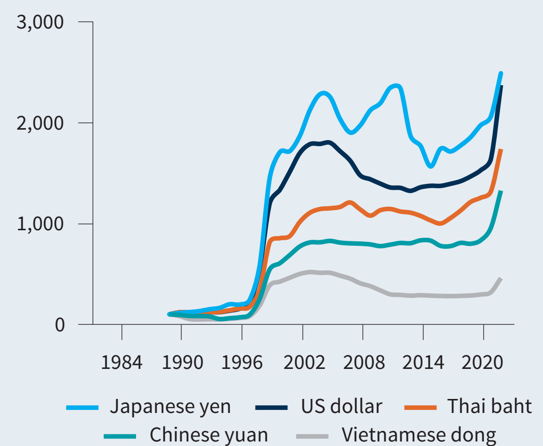
Source: World Bank and staff calculation.

Figure 1.35: Poverty and inequality



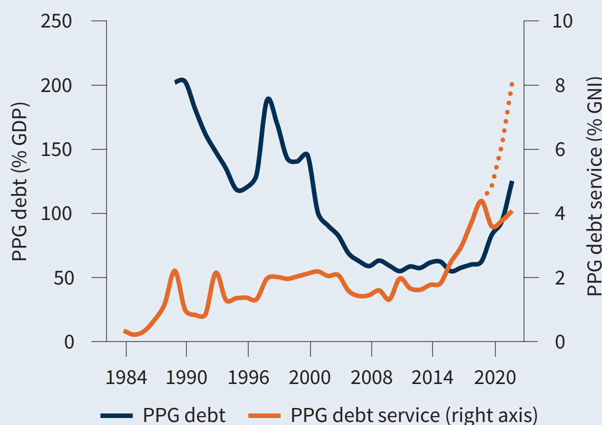
Source: World Bank and staff calculations.

Figure 1.36: Exchange rates (index, 100 = 1988)



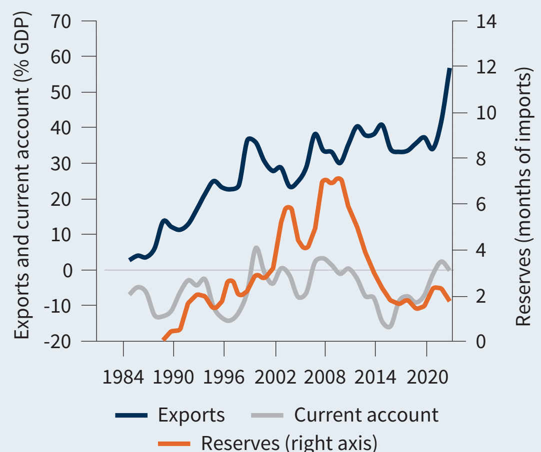
Source: International Monetary Fund and World Bank staff calculations.

Figure 1.37: Public debt stock and service



Source: International Monetary Fund and World Bank staff calculations.

Figure 1.38: External balances



Source: World Bank and staff calculations.

Box 2: Past episodes of macroeconomic instability (continued)

The first decades after independence were marked by experimentation with central planning. In the first decade after the establishment of the Lao People's Democratic Republic (PDR) in 1975, the government employed a command economy that did not meet its development objectives. By 1985, the manufacturing sector was struggling, exports fell to a fraction of imports, external debt increased rapidly, and many state-owned enterprises required budget subsidies. Early reforms to encourage trade, devalue the currency, and adjust agricultural prices failed to stem the tide.

An economic reform program was initiated in the mid-1980s, marking the beginning of a transition from a centrally-planned to a market-oriented economy. The government introduced the New Economic Mechanism in 1986, a far-reaching set of reforms aimed at granting a greater role to markets. Major reforms included liberalizing international trade and foreign direct investment, allowing private sector activity in most sectors, abolishing regulated prices for most goods (in favor of market-determined prices), and allowing greater autonomy in SOE management. Prior to 1986, central and provincial authorities determined output, prices, salaries, and other targets for state enterprises. Public expenditures were funded by SOE profits (if any) and depreciation allowances transferred to the state budget as revenue, though transfers were often financed by the banking system. Tax systems were in place but largely inoperative. The fiscal reform launched in 1988 attempted to decouple the state budget from state enterprises by simplifying the tax code and using it to collect revenue.

Inflation and public debt surged in the late 1980s, partly because of poor reform design and implementation. The decoupling resulted in a short-run decline in government revenues, while decentralization allowed local officials to increase wages. Severe droughts in 1987–1988 compounded economic challenges. Government debt increased to over 200 percent of GDP in 1988 and stayed above 100 percent for many years. Nearly half the population was living in poverty in 1992. In 1989, the World Bank and the International Monetary Fund (IMF) provided loans to bolster reforms and support medium-term macroeconomic stabilization.

Macroeconomic stability was temporarily restored in the early 1990s as reform momentum grew. As the country emerged from drought, robust economic growth was underpinned by reforms under the Third NSEDP (1991–1995). The government divested many small enterprises, although progress was more limited with medium- and large-sized SOEs. An IMF structural adjustment program aimed at achieving high growth, reducing inflation, and addressing external imbalances was coupled with government efforts to establish an effective centralized system of fiscal management. Consumer price inflation declined from about 60 percent in 1989 to less than 10 percent during 1993-1994. Financial sector reforms included the opening of private banks, while external sector reforms included allowing enterprises to be completely foreign owned and lowering trade tariffs. However, revenues remained below expectations because of slow reform implementation and 'ad hoc' tax incentives. The civil service remained oversized, while weak governance and corruption also undermined reform progress.

The 1997 Asian Financial Crisis had a significant impact on the economy. The Lao PDR joined the Association of Southeast Asian Nations (ASEAN) in 1997 to further its strategic objectives of transitioning to a market economy, reducing poverty, and improving human development. However, the 1997 Asian Financial Crisis had a severe impact on the country, particularly given its close economic relationship with Thailand, where the crisis began. The currency collapsed against the US dollar and the Japanese yen, partly due to limited foreign exchange reserves. Economic growth fell to 4 percent in 1998, while consumer price inflation escalated to 91 percent in 1998 and 125 percent in 1999. Government debt increased considerably in 1998. However, many of the negative impacts from the Asian Financial Crisis proved to be transitory. Economic growth accelerated, and inflation eased. External debt, about half of which was owed to Russia, declined. This was largely due to Russia writing off 70 percent of the balance in 2003 and allowing the government to service the remaining debt over a period of 33 years at a preferential interest rate. Nonetheless, high fiscal deficits persisted.

Box 2: Past episodes of macroeconomic instability (continued)

Several parallels can be drawn to past macroeconomic crises, but current liquidity pressures are unprecedented and require bolder solutions. As in the past, the country is currently experiencing significant uncertainty in key macroeconomic areas (e.g., public debt, inflation, and exchange rate). Limited foreign exchange reserves failed to avert a very sharp currency depreciation during the Asian Financial Crisis, while the collapse of commodity prices following the 2007–2008 Global Financial Crisis highlighted the vulnerabilities of a resource-based growth model (e.g., government revenue highly dependent on commodity prices). Despite these challenges, the government averted debt defaults, opting instead for bilateral relief from major development partners, particularly Russia in the early 2000s. Later, the country did not seek debt relief through the Heavily Indebted Poor Countries Initiative, even though it was eligible. Instead, it accepted new offers of aid from Japan. Likewise, the country has recently shunned relief under the Debt Service Suspension Initiative, instead engaging in direct discussions with key bilateral creditors. However, current debt service obligations are much higher than in the past, partly due to a larger share of non-concessional debt, which is associated with higher interest rates and shorter maturities.[63] These unprecedented liquidity pressures suggest that, more than ever before, deep economic reforms and a comprehensive debt restructuring will be needed to restore macroeconomic stability.

1.5 Conclusion and recommendations

Macroeconomic instability is undermining economic growth and threatening development prospects. Economic growth averaged 7 percent per year during 2000–19, while the poverty headcount ratio declined from 25 to 18 percent between 2012 and 2018. However, Lao PDR's capital-intensive, resource-based, debt-fueled growth model was already showing strains before 2020. Public debt levels increased rapidly, few jobs were created, and natural resources were depleted – undermining sustained, inclusive, and resilient economic growth. Pre-existing macroeconomic vulnerabilities have been compounded by recent shocks, such as the COVID-19 pandemic and a deteriorating global economic environment. An unsustainable public debt burden is constraining fiscal space, exerting pressure on the exchange rate, and jeopardizing banking sector stability. High inflation and sluggish economic growth are threatening living standards. Fiscal space has been eroded, largely due to poor revenue collection and rising debt service payments, despite recent debt service deferrals. This has constrained the government's ability to provide meaningful support to households and businesses affected by the COVID-19 pandemic and high inflation. Large external imbalances persist, even as electricity exports grow steadily. Reserve buffers are precarious, with foreign currency shortages contributing to a rapid depreciation of the exchange rate. Fragilities in the financial sector are predominately linked to the weak balance sheets of the largest commercial banks and the kip depreciation. The Lao PDR is struggling to transform its natural wealth into sustained prosperity, as it is not drawing adequate benefits from its mineral, water, and forest resources to invest in human capital.

Public debt has reached critical levels, jeopardizing macroeconomic stability, fiscal sustainability, and financial sector soundness. The Lao PDR is facing liquidity and solvency challenges owing to a very high debt burden, poor revenue collection, limited financing options, and low foreign currency reserves. These have pushed the country into sovereign debt distress. Public and publicly guaranteed (PPG) debt has surpassed 100 percent of GDP, one of the highest levels in the world. High debt service obligations have contributed to a rapid exchange rate depreciation since 2021, which has, in turn, aggravated the external debt burden. With revenue performance steadily declining over the years, an expenditure-driven fiscal consolidation (coupled with rising debt service obligations) has squeezed the fiscal space available for critical development expenditures (e.g., health and education). High public debt levels also exacerbate existing financial sector weaknesses, partly through the exposure of commercial banks to public debt. Economic growth is expected to benefit from a recovery in tourism, improved transport and logistics infrastructure (e.g., Laos–China railway and Thanaleng Dry Port), as well as mining and electricity exports. However, the macroeconomic outlook remains highly uncertain since it is contingent on continued debt service deferrals and the outcome of ongoing debt renegotiations, without which the economic situation would deteriorate further.

[63] PPG debt amounted to 145 percent of GDP in 2002, which is higher than current levels. However, debt service payments are much higher now than in 2002 . Without debt service deferrals, these would amount to about 8 percent of GNI in 2022.

Fiscal pressures are amplified by sizeable contingent liabilities, which can further jeopardize macroeconomic stability. There are large contingent liabilities arising from the operations of state-owned enterprises (SOEs) and public-private partnerships (PPPs). SOEs accounted for about 44 percent of total PPG debt in 2022, most of which were in the energy sector, with some facing considerable financial difficulties. Given the country's debt overhang, the government may rely even more heavily on PPPs to boost large-scale infrastructure investments. However, these would likely entail significant fiscal commitments, contingent liabilities, and foregone revenues. Fiscal risks can exacerbate the public debt burden if they materialize.

Restoring macroeconomic stability will require comprehensive reforms and debt restructuring. Critical macroeconomic challenges include unsustainable public debt levels, limited fiscal space, foreign exchange rationing, low reserve buffers, and growing financial sector risks. These have been exacerbated by recent shocks and underscore the need for urgent reforms. There is a need for continued tight fiscal and monetary policies to avoid a further deterioration in fiscal and external balances. However, scenario analysis suggests that even with key reforms supporting revenue mobilization, debt servicing obligations would remain unsustainable. Hence, an agreement with major creditors on a credible debt restructuring will be critical for the country's economic outlook. This needs to be complemented by structural reforms, including measures to safeguard financial sector stability and improve the business environment.[64] Improved governance and data would greatly assist all these areas.

Negotiating a credible and transparent debt restructuring plan would help restore debt sustainability and create fiscal space for growth-enhancing spending. Meeting current public debt service obligations is not achievable without a socially damaging compression of public expenditure. Hence, restructuring public debt is vital to secure macroeconomic stability and support the economic recovery. Debt restructuring can be pursued through discussions with bilateral creditors or through multilateral channels. The G-20 Common Framework aims to provide comprehensive debt relief for developing countries, while there are ongoing debt renegotiations with large bilateral creditors. Bringing these bilateral negotiations to a successful conclusion, or applying for debt treatment under the Common Framework, would ease insurmountable debt pressures, create fiscal space for growth-enhancing expenditures, and improve market confidence. A combination of debt restructuring and primary surpluses (driven by enhanced revenue mobilization) would limit financing needs and lower debt service obligations to sustainable levels. However, it is important that any agreement is credible and transparent. In the meantime, continued debt service deferrals are needed to relieve immediate liquidity pressures.

Enhancing revenue mobilization, improving spending efficiency, and curbing fiscal risks is critical to securing the sustainability of public finances. Macroeconomic instability has been largely fueled by unsustainable fiscal policies. Low tax rates and generous tax exemptions have deprived the country of vital budgetary resources and foreign exchange, while high fiscal deficits and large debt accumulation have contributed to weaken the kip and thus intensify inflation pressures. Fiscal consolidation is necessary to avert the accumulation of additional public debt, but the focus should be on improving revenue mobilization. There is also a need to balance debt management and fiscal consolidation with critical public spending for long-term economic growth. Given the limited fiscal space available, it is critical to prioritize and improve the allocation of budget resources to maximize the impact of public spending. Finally, contingent liabilities present significant risks that can further undermine fiscal and debt sustainability. Improving governance arrangements is crucial to stem the accumulation of unwarranted contingent liabilities, while risks need to be identified, assessed, mitigated, monitored, and reported. The chapters on domestic revenue, public expenditure, state-owned enterprises, and public-private partnerships provide key insights and recommendations on these topics. These fiscal reforms ought to be coordinated with other macroeconomic and structural policies, such as those pertaining to the monetary sector, exchange rate, financial sector, and the business environment.

Developing a medium-term fiscal framework and approving a revised Law on Public Debt Management are key to improving fiscal and debt management. The lack of a solid macro-fiscal framework and a sustainable fiscal strategy undermine planning and inter-government coordination. It is, therefore, crucial to establish a credible medium-term fiscal framework that provides a concrete path toward fiscal and debt sustainability. This framework should include consistent and clearly defined targets for the entire public sector (e.g., strict fiscal

[64] Business environment reforms (e.g., streamlining regulations, enforcing rules consistently and transparently, and adopting measures to enhance competition) would help attract sustainable and impactful investments, as well as promote exports. This is fundamental to address persistent structural imbalances, especially foreign exchange shortages. Investing in basic education and skills would be key to attracting foreign investment in labor-intensive sectors. However, the government should refrain from providing costly tax incentives, as these create large foregone revenues that undermine fiscal sustainability.

rules, as well as limits on SOE financing and tax incentives for PPPs) to help restore macroeconomic stability. It should also comprise reliable revenue projections and growth-enhancing budget allocation rules. Moreover, revising the 2018 public debt management law to clarify and strengthen the roles and responsibilities of the Ministry of Finance in terms of debt and fiscal risk management would be critical to avert a future (unsustainable) build-up of public debt.

Adopting supportive monetary and exchange rate policies would help reduce macroeconomic vulnerabilities. Macroeconomic instability mainly stems from previous fiscal and debt policies (e.g., large deficits and on-lending to SOEs), and a lack of coordination with monetary policies. Coupled with external imbalances, these have induced a large exchange rate depreciation that has pushed inflation to record highs. While there is limited scope for monetary and exchange rate policies to address the root causes of current macroeconomic challenges, they can still play a supporting role by complementing fiscal reforms. These include greater exchange rate flexibility and measures to improve monetary transmission. A high parallel market exchange rate premium creates distortions and corruption risks, while exchange rate restrictions often exacerbate imbalances. Reducing distortions and improving confidence requires moving toward a unified market-clearing exchange rate while avoiding exchange rate restrictions. More transparent and effective policies can help build confidence in the Lao kip (e.g., improving transaction monitoring, data reporting, and communications). There is a need for continued tight monetary policies to support exchange rate stability (e.g., no deficit monetization).

Enhancing bank monitoring and operationalizing emergency arrangements will boost crisis preparedness. Financial sector vulnerabilities can present considerable fiscal risks, as governments may have to inject capital into distressed banks to avoid systemic crises. Safeguarding financial sector stability will require enhancing the legal and regulatory framework, banking supervision, enforcement measures, financial safety nets, and crisis management. The Bank of the Lao PDR (BoL) has limited capacity to be a lender-of-last-resort, due to a high degree of financial dollarization and low foreign exchange reserves. Therefore, it is critical to have a fully operational emergency liquidity assistance facility and establish a crisis management framework to ensure interagency cooperation and coordination. In terms of remedial action, the early warning system and regulations on early intervention and problem-bank resolution need to be fully implemented. Strengthening prudential regulations and improving supervisory capacity will help prevent and manage bank vulnerabilities. There is also a need to establish a clear plan and timeline for gradually withdrawing regulatory forbearance measures, as well as strengthening the deposit protection scheme.

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