# Financial System in the Economic Transition Period: The Case of the Lao PDR

**Somvixay Chanthavong**

*Bank of the Lao PDR*

JOMEINO
ISSN:
2522-381X (Print)
2521-7054 (Online)
DOI: 10.31039/jomeino

Received 18 May 2021
Revised 30 May 2021
Accepted 09 June 2021



**Citation:** Chanthavong S. (2021). Financial System in the Economic Transition Period: The Case of the Lao PDR, *Journal of Management, Economics, and Industrial Organization, 5*(2), 24-36.
http://doi.org/10.31039/jomeino.2021.5.2.3



corresponding author:
joysomvixay@gmail.com

## Abstract

Financial system plays a key role in allocating the investment fund from household savings to the corporate sector, and increases the risk sharing among individuals and the firms. The understanding of timely financial market participation is hence crucial, particularly in the country that is on the journey of graduation from the least developed country, called Lao People's Democratic Republic. This research therefore focuses on prescribing the transition of financial system by providing the story of financial development evolution from first independent period and present direction. This pioneer article aims to create the clear understanding on how the Lao financial institutions have been formed up periodically, and what the principal strategies are presented from government in responding to the economic change of the nation. As the result, we find that the financial system in Laos seems to have impressive growth during the transition period, while the foreign branches have mostly covered and been large size in term of total assets comparing to other bank categories. This identifies a significant challenge for local banks in regard to the competition condition. Hence, we recommend considering more proper strategies on foreign own banks aiming to utilize their asset to financial intermediation as well as prevent them from having too large market power.

***Keywords*:** Financial System, Economic Transition, Commercial Bank, Monetary Policy, Bank of the Lao PDR.

# 1. Introduction

## 1.1 Background of the Study

Lao People's Democratic Republic (hereafter refers to Laos) is located in Southeast Asia, and in the middle of Indochina peninsular with five strategic neighbors: China at the north, Cambodia at the south, Vietnam at the east, Thailand, and Myanmar at the west. Laos has experienced the fast economic growth since its declaration of the new economic mechanism in 1986 forward opening its door widely to foreign investment. This breakpoint led the economic growth rate to be recorded as highest as 14% in 1989[1]. The local trade barriers were minimized to lead the benefit through private sector in transportation and various investment sectors at the first phase of new economic mechanism 1987-1994. The other way around, the financial reform was begun in 1988 by diversifying the state mono-bank into two layers of banking administration: the central bank and the commercial bank function. The State-owned Enterprise (SOE) reform also initiated, while the government was abolishing the price controls, excluding the utilities and core strategic sectors (IMF, 2006). In late 1990s, the domestic trade and SOE reform were continuously implemented, but the reformation procedures were not smoothly executed due to heavy influences from regional economic crises (Kelly Bird et al., 2010). However, the macroeconomic stability was reconstructed with healthier economic environment that was significantly contributed from financial reform and the boom of natural resources in 2000s.

As recent achievements, Laos has enjoyed the continued stability of politics, peace and stable economic growth. Prominently, the economic was reported to be 6.5% in growth rate and 2,567 USD in per capital GDP in 2018, which realized better well-being of local people, increase of employment rate, low inflation rate, and incremental public and private investment. While the government assumes to appreciate these progressive performances, the economic growth structure in fact seems to largely rely on natural resources with limited local producing, and the macroeconomic situation is still vulnerable and domestic saving is insufficient[2].

[1] Data retrieved from World Bank Group, accessed 28-October-2019.

[2] 7th Five-Year Socio-Economic Development Plan (2011-2015)-Implementation Report, Ministry of Planning and Investment, 2016.

According to the prime minister's report to the eight session of the 8th Legislation of the National Assembly[3], however, the registration procedures and business environment has not yet fully improved. Despite creating the numerous legislations, their implementation process has not yet aligned: still the inefficiency in domestic production widely remains preventing the economy from becoming competitive against imported products from neighboring countries. The fundraising channel also seems to be limited, while the credit limitation and interest obligation are pointed out to be the core obstructions in credit access.

Based on the existed studies, the banking development shows a statically significant impact on local economic growth (Cheng et al., 2010; Christopoulos et al., 2004; Levine et al., 2000; Shahbaz, 2012), while the financial system is playing a key role in allocating the investment fund from household savings to the corporate sector, and increasing the risk sharing among individuals and the firms with fostering the macroeconomic stability and poverty eradication. The understanding of timely financial market participation is therefore significance because the financial institutions are not simply veiling, disguising the allocation mechanism without affecting it, but they are crucial to overcoming market imperfections while the optimal financial system should rely on both financial market and financial intermediaries (Allen et al., 2000).

### 1.2 Research Objectives

This research focuses on prescribing the transition of financial system by providing the story of financial development evolution from first independent period and present direction. The objective of this pioneer study is to create the clear understanding on how the Lao financial institutions have been formed up during the economic transition period, and what the principle strategies are presented from government in responding to the economic change of the nation. In spite of that, this article is hence qualitative analysis by reviewing several literatures with specific attention in selected country.

## 2. Financial System in The Economic Transition Period

### 2.1 Financial System after the Independent Declaration (1975-1986)

After Lao people received independence and officially established the Lao People's Democratic Republic (Lao PDR) in 02-December-1975, banking system was restructured by

[3] The PM's report to the eight session of the 8th Legislation of the National Assembly was released on 07th November 2019 at Lao National Assembly.

integrating Lao revolutionary's bank, national bank and some commercial banks into one authorized mono-bank called "National Bank" in March 1976. This authorized bank was the started financial institution upon national independent declaration, it was later expanded its branches to provincial levels, and this created national bank to have 19 branches nationwide in 1981 (BoL, 2018). The role and function of national bank was appointed to be the centralized management for printing the national notes, providing credits to agriculture, trade and economic associated sectors, and was the domestic transaction point of the nation. Moreover, this national bank was also taking responsible for managing the foreign donors and grants from abroad and international organizations as well. This period of time, the national bank was a core authority to control the foreign exchange rate within the limitation range.

In 1981, the law on bank monopolization No. 001/81/Lao PDR, dated 21-August-1981 was adopted from people's assembly (National Assembly in present), and it was an initial law clarifying the roles and functions of central bank (BoL, 2008). Then the national bank had performed its operation in accordance with this law and supporting the direction of First Five-Year National Socio-Economic Development Plan (1981-1985) through centralized economy, cash flow, and foreign exchange management. On the other hand, the central bank was also expanding its fundraising base with various platforms to sustain local producing and economic circle. It showed in the amount of credit providing increased from 2,331 billion LAK in 1975 to 10,735 billion LAK in 1986. For fundraising side, it was largely from saving-deposit of local citizen, while the enterprises were taking deposit for business transaction and tax obligation; this led the amount of deposit to increase from 1,038 billion LAK in 1975 to 6,096 billion LAK in 1986 (Monetary Policy Department, 2014). This time, the foreign exchange rate was determined by central bank based on each usage purpose, and then the government could later turn all foreign currency rates into centralized and equalized rate in the early 1988.

As a result, the financial infrastructure had enlarged to various provinces, the organization and staffs were strengthened, accounting system was also improved, and the legislations were drafted during this period. It is worth noting that the banking sector was progressively restructured and improved over this decade.

### 2.2 Financial System from Centralized Economy to Market-Oriented Economy

From 1986, the government has implemented new economic policy with the guideline from revolutionary party's resolution by purposing the transformation mechanism from centralized economy system into market-oriented economy under the government's supervision. In 1988, following the resolution of the 4th congress of the Lao Revolutionary Party, the government issued an agreement related to bank system transformation into socialist business direction, where they reconstructed the single mono-bank into two levels of banking system management: (1) The central bank named "state bank" at this time, had macro functions in national notes management, monetary and foreign exchange monitoring, and centralized transaction management. (2) Commercial bank, which is transferred from previous branches of national bank surround provinces to be commercial bank, or branches of the commercial bank. The key roles of the reform over this period are to perform in fundraising area, credit providing, settlement services, and performed other duties based on direction from state bank.

## 3. Financial System in Laos

### 3.1 Bank of the Lao PDR (BoL)

Responding to the new economic policy implementation, the law on Bank of the Lao PDR establishment was promulgated in 1990 (amended in 2018); it was the breaking point of name change from the state bank into Bank of the Lao PDR (BoL) afterward. The BoL has played a main role in implementing monetary policy and exchange rate policy, monitoring foreign exchange with supervising commercial banks and financial institutions within macro and micro levels of the nation.

As August 2019, Bank of the Lao PDR is consisting with 13 departments, 7 equivalent departments, and 5 branches[4].

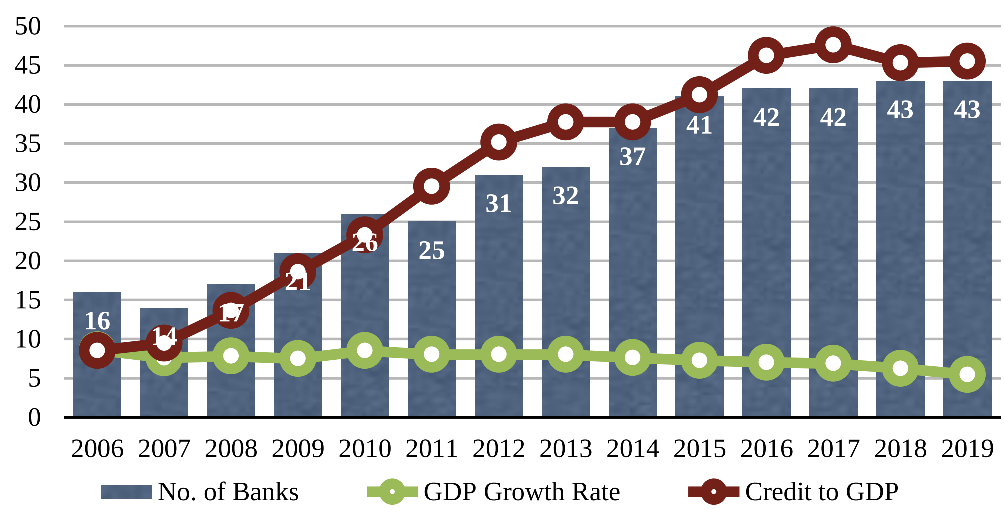
### 3.2 Commercial Bank

Following two stages of banking management, all branches of national bank were reformed and changed into commercial bank, or the branch of commercial bank, which had independent on its business operation. In 1992, the government declared decree on commercial bank and financial institution management for central bank to easily accommodate the commercial bank. This time, the role of commercial banks were appointed to be the deposit source of saving from public, provide credits in different approaches, a venue for settlement services, foreign exchange point, and involve in local and foreign investment.

[4] BoL's Organization Structure, Bank of the Lao PDR's website, accessed on 25-October-2019.

Upon financial liberalization in late 1980s, the law on foreign investment promotion was also adopted in 1988, BoL later started to approve the establishment of private bank and open its door for foreign investment. For instance, the first private bank was commenced in 1989 namely Joint Development Bank (JDB), and allowed one joint state commercial bank to open in 1999 called Lao-Viet Bank. This critical decision drove to stronger improvement of bank regulations, and it became the wisely attracted investment destination of foreign investors. As 2019, the number of commercial banks was increased to 43 with 45.5% of total credit to GDP, while the GDP growth rate was recording at 5.46% as shown in Figure 1.

**Figure 1: Numbers of Commercial Bank, GDP Growth, and Total Credit to GDP**




Source: Author calculated from annual report 2006-2019, Bank of the Lao PDR

Throughout the continuous improvement of banking sector, the central bank has putted its efforts to foster the commercial bank's role coinciding with the economic change and international standard requirement as showing in various legislation improvements, particularly the law on commercial bank, No.03/NA; this law was officially adopted and promulgated in early 2007 (amended in 2018), which was the remarkable spot to create new era of Lao commercial bank development. Thereafter, the Bank of the Lao PDR has allowed commercial bank to provide diverse financial services, particularly the deposit taking, credit providing, settlement services, self-transaction tools issuance and management, foreign exchange service, depository center for confidential documents and valuable assets, correspondent bank service, financial advisory, and other services under BoL guidance. From these critical improvements, the banking sector has dramatically grown and provided various services based on their bank category.

To be in detail, Table 1 shows the trend of commercial bank growth in Laos. We find that the foreign branch is recently the highest proportion of commercial bank in Laos, accounts for 19 banks or 44% of all commercial banks in 2019, while the subsidiary bank, private bank, state-owned commercial bank, and joint state commercial bank are followed. This is quite impressive to find a lot of foreign banks in this tiny country even though it is a small market. However, it is possible that the transaction facilitation for their respective investment could be the reason of this interpretation.

**Table 1: The Growth Trend of Commercial Bank in Laos**

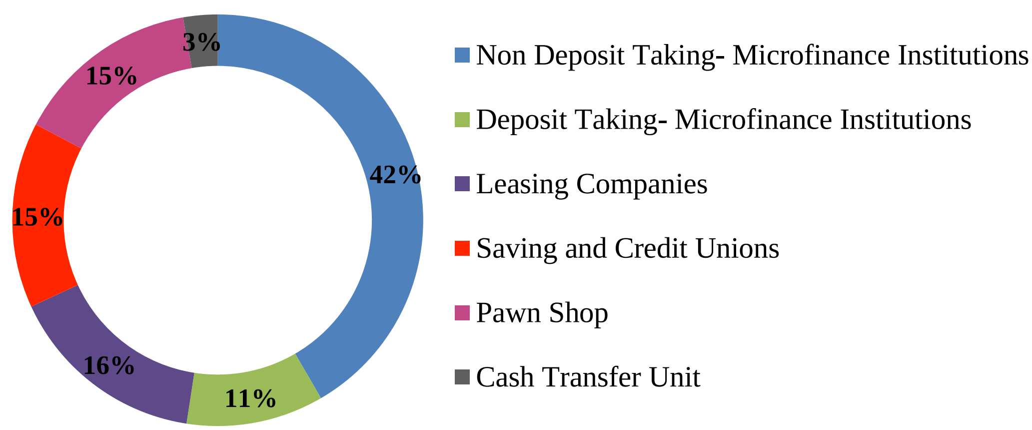
| Year | State-owned Commercial Bank | Joint State Commercial Bank | Subsidiary Bank | Foreign Branch | Private Bank | Others | Sum |
|---|---|---|---|---|---|---|---|
| 2006 | 4 | 2 | _ | 7 | 2 | 1 | 16 |
| 2007 | 4 | 2 | _ | 5 | 2 | 1 | 14 |
| 2008 | 4 | 3 | _ | 7 | 2 | 1 | 17 |
| 2009 | 4 | 2 | _ | 7 | 7 | 1 | 21 |
| 2010 | 4 | 2 | _ | 8 | 11 | 1 | 26 |
| 2011 | 4 | 2 | 3 | 8 | 6 | 2 | 25 |
| 2012 | 4 | 2 | 3 | 16 | 6 | _ | 31 |
| 2013 | 4 | 2 | 3 | 16 | 7 | _ | 32 |
| 2014 | 4 | 3 | 6 | 17 | 7 | _ | 37 |
| 2015 | 4 | 3 | 9 | 18 | 7 | _ | 41 |
| 2016 | 4 | 3 | 9 | 19 | 7 | _ | 42 |
| 2017 | 4 | 3 | 9 | 19 | 7 | _ | 42 |
| 2018 | 4 | 3 | 9 | 19 | 8 | _ | 43 |
| 2019 | 4 | 3 | 9 | 19 | 8 | _ | 43 |

Source: - Author calculated from annual report, Bank of the Lao PDR.
- The template of statistic report was adjusted in 2011-2012.

### 3.3 Financial Institution (Non-Bank)

In 1989, there were some credit unions operating in Vientiane city, but they were finally shut-downed due to lacking sufficient legislation and supervised authority. Till 2003, the government approved the rural and micro finance policy and guideline, and then the number of micro finance and village bank has been dramatically increased from local community integration, and some support from international organizations. In addition, the official prime minister's decision and order was issued to appoint BoL as the core authority for supervising and improving the microfinance institutions nationwide, and this pushed the number of financial institutions increased to 185 financial institutions in early 2019 as displaying in Figure 2.

**Figure 2: Numbers of Financial Institutions by Its Model Category 2019**




Source: Financial Institution Supervision Department, Bank of the Lao PDR

### 3.4 Capital Market Development

Pursuant to the direction of national development strategy, there is a need of large investment fund to assist the continuous growth of economy. Though the banking sector has recently played the crucial role in the development of various enterprises, it still has limitation on credit term and interest obligation, they cause the high cost of fundraising. Thus, the government decided to include the establishment plan of local stock exchange into the national socio-economic development strategy. Then, the first stock exchange was finally inaugurated in 2010 called "Lao Securities Exchange" by joining venture between Bank of the Lao PDR (BoL) 51% and Korea exchange 49%. This stock exchange is eventually under tied supervision from the national committees called Lao Securities Commission (LSC), which has its own secretariat office as the core assistant bureau.

Based on the recent findings, the Lao capital market is still in the preliminary stage of development and expected to contribute in the growth of national economy as being the significant arena for long-term fund mobilization of Lao enterprises. Notably, the market capitalization prominently increased to 11.37 trillion LAK in 2018, about two times from inauguration year, and equivalent to 13% of GDP and one-third of bank credit provided (Chanthavong, 2020). However, the number of listing companies is gently grown from 2 listing firms in 2011 to 11 firms in 2020, and this remarks the slow progress in encouraging the unlisted firms into the formal market of long-term fundraising channel (Chanthavong, 2018).

## 4. Evolution of Policy Implementation

### 4.1 Monetary Policy

To sustain the national economic development and secure the monetary stabilization, Bank of the Lao PDR (BoL) has declared and implemented direct and indirect measures related to monetary stabilization with expecting to increase the money supply and maintain the product's price.

In late 1980s, while Laos was encountering the high inflation rate, the BoL had issued the guideline of interest rate determination and encouraged commercial banks to stronger mobilize fund from public with more restriction in credit inspection. The minimum rate of deposit interest, and ceiling rate of credit interest were introduced at this time.

In 1990s, the BoL started to implement indirect strategy of money policy. They initiated the 5% bank reserve of total deposit amount within both local and foreign currency and released some government bond. The other the other hand, while the direct approach of monetary policy was still maintained until 1996, the BoL originally allowed commercial banks to determine their own interest rate in accordance with BoL direction.

During 2000s, BoL continually sustained to diversify its monetary policy approach, by setting up fundamental interest rate and bank reserve ratio and issuing Treasury bond in direction for enhancing autonomy of commercial banks in setting interest rate. As a result, these measures enable BoL to effectively control the inflation rate into single digit, as declined from 12.22% (2000-2004) to 7.16% in 2005, and the money supply (M2) averagely increased 25.62% from 2008-2015 (Monetary Policy Department, 2015).

As recently, the monetary policies, which have implemented in 2010s, are the introduction of primary interest rate of 4.5% for least as 7-day credit term; locating the 4% spread weigh between deposit and credit interest rate determination; bank reserve fund with 5% of local currency and 10% for foreign currency and stimulating the wider open and inter-bank liquidity. Moreover, the BoL also engaged the inflation rate from previous year into consideration of interest determination parallel with presenting diverse measures to make sure that monetary policy will efficiently support the national economic development.

### 4.2 Currency Exchange Policy

As diversification of foreign currency acceptance is existed in Laos with annual deficit of government's revenue, the foreign exchange policy implementation turns to be one of the crucial measures for reserving the sustainable growth of national economy. The central bank has, due to limited inflow of foreign currency, carried out the different measures related to foreign exchange policy to keep sufficient foreign reserve periodically, particularly abolishing the different rates determination of foreign currency into single fixed and centralized rate in 1988, it was later changed to determine based on market oriented mechanism in 1995, and finally the refereed rate of diary foreign exchange has been inaugurated since 2003.

In fact, the bank of the Lao PDR has recently developed numerous tools to increase strong contribution from commercial banks and exchange shops in accommodating society. For instance, BoL has introduced the forwarded contract; foreign exchange swaps and options mechanism for commercial banks to freely access the formal trading venue. On the other condition, the central bank also afford to monitor the different rate between exchange shop and commercial bank through identifying the limitation scale of rate between both exchange points in order to secure the sustainable currency movement in the nation. These dynamic implementations of foreign exchange policy lead to improve various legislations associated to the foreign exchange supervision, especially the law on foreign exchange management in 2014. The local currency is also encouraged to widely use in diary transaction, and this drives the local currency status to gradually appreciate the other currency thereafter.

### 4.3 Strategy of Financial Development 2025

Bank of the Lao PDR has arranged the national strategies on financial development till 2025 by emphasizing on four main tactics (BoL, 2016).

First, maintaining the stability of foreign exchange policy improves the management mechanism for efficient and effective implementation of monetary policy with sufficient legislations arrangement.

Second, strengthening the development of financial institutions revamps the commercial banking supervision system through updating the Basel core principles for effective Banking supervision; enhances the accessed capacity of local people in connecting the financial institutions that are non-bank; creates the capital market into stronger and readier market for regional and international integration, and other relevant tasks correlated to the financial institution capacity building.

Third, developing the modernized and secured system of settlement service: builds the national settlement system to be centralized and available in society; promotes the cashless approach into local settlement services; and improves the printing quality of national notes to be modernized and appropriate to local situation.

Fourth, expanding the financial networks in accordance with the international standard and actual situation of the nation: increases the financial infrastructure to meet the international standard via bringing ICT into various financial services with supporting capacity building among financial institutions.

## 5. Conclusion and Recommendations

This article descriptively prescribes the transition of financial system in Laos throughout the story of financial development evolution from first independent period and present direction. As the outcome, we realize that the financial system in Laos seems to have impressive growth during the transition period: centralized economy system to market-oriented economy. Exclusive observation in the banking sector, the investment into commercial banks tend to enrich in 2010s after the law on commercial bank was officially adopted and promulgated in early 2007 (amended in 2018). This showed with 43 commercial banks operating in the country, while the financial institutions marked 185 institutions in 2019.

However, it is worth nothing that the foreign branches are mostly covered within the banks (approximately 44%) and they are in large size in term of total assets comparing to other bank categories in Laos. This identifies a significant challenge for local banks in regard to the competition condition, while the foreign capital presence is extremely large. Not only many foreign owned banks enter, but there is one extremely big bank which potentially has capacity to control the market. This characteristic of foreign presence in banking sector possibly causes the delay of deposit mobilization and financial intermediation as financial system. Following all observations found from this qualitative analysis, we recommend that the policy-makers should further consider the appropriate strategies and regulations on foreign own banks aiming to utilize their asset to financial intermediation for the maximized benefits of the nation as well as prevent them from having too large market power.

## References

Allen F., a. G. (2000). *Comparing Financial System.* Cambridge, MA: MIT Press.

BoL. (2008). *40 Years of the Growth and Establishment of Bank of the Lao PDR.* Vientiane Capital, Lao PDR: Bank of the Lao PDR.

BoL. (2018). *50th Anniversary of the Bank of the Lao PDR.* Vientiane Capital, Lao PDR: Bank of the Lao PDR.

BoL. (2016). *Financial Institutions Development Strategic Plan (2016-2025) and Vision 2030.* Vientiane Capital, Lao PDR.

BoL. (2018). *Annual Report 2006-2018*. Vientiane Capital, Lao PDR: Bank of the Lao PDR.

BoL. (2019). *BoL's Organization Structure*. Internet Access, 25-October-2019.

Chanthavong, S. (2018). Stock market development in country with least development but fast economic growth: a case study of Lao PDR. *Journal of Modern Accounting and Auditing*, *14*(6), 305-314.

Chanthavong, S. (2020). Securities commission organization and stock exchange development in Vietnam and Laos. *Southeast Asian Journal of Economics*, *8*(2), 129-158.

Cheng, X., & Degryse, H. (2010). The impact of bank and non-bank financial institutions on local economic growth in China. *Journal of Financial Services Research*, *37*(2), 179-199. https://doi.org/10.1007/s10693-009-0077-4.

Christopoulos, D.K., Tsionas, E.G. (2004). Financial development and economic growth: Evidence from panel unit root and cointegration tests. *Journal of Development Economics*, 73(1), 55–74.

Department, FIS. (2019). *Number of Financial Institutions in Laos*. Vientiane Capital, Lao PDR: Bank of the Lao PDR.

Department, M. P. (2015). *Annual Report of Inflation Rate.* Vientiane Capital, Lao PDR: Bank of the Lao PDR.

Department, M. P. (2014). *History of Lao Kip. the National Currency* . Vientiane Capital, Lao PDR: Bank of the Lao PDR.

IMF (2006) *Lao PDR: Selected Issues and Statistical Appendix* (Washington, DC: IMF).

Bird, K., & Hill, H. (2010). Tiny, poor, land-locked, indebted, but growing: lessons for late reforming transition economies from Laos. *Oxford Development Studies*, *38*(2), 117-143. DOI: 10.1080/13600811003753776.

Levine, R., Loayza, N., & Beck, T. (2000). Financial intermediation and growth: Causality and causes. *Journal of monetary Economics*, *46*(1), 31-77.

MPI (2016). *7th Five-Year Socio-Economic Development Plan (2011-2015)-Implementation Report*, Vientiane Capital, Lao PDR: Ministry of Planning and Investment.

NA (2018). *Law on Commercial Bank*. No. 56/NA, 07/12/2018.

NA (2018). *Law on the Bank of the Lao PDR*. No. 47/NA, dated 19/06/2018.

NA (2019). *The PM's report to the eight session of the 8th Legislation of the National Assembly*. Released on 07th November 2019 at Vientiane Capital, Lao PDR: Lao National Assembly.

Shahbaz, M. (2012). Does trade openness affect long run growth? Cointegration, causality and forecast error variance decomposition tests for Pakistan. *Economic Modelling*, *29*(6), 2325-2339.

World Bank (2019). *Economic Growth Rate of Lao PDR*. Internet Access, 28-October-2019 from the World Bank Group.