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Financial System of the Lao PDR after Introduction of the Pianpeangmai Policy

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1. Introduction

Laos[1] is a small economy located in the Indochina Peninsula with the population of 6 million. After establishment of the new regime in 1975, Laos adopted a mono-banking system for 10 years before introduction of reforms under the *Pianpeangmai*[2] policy in 1986, where the financial system has been transformed radically from a system that a single bank (the State Bank of Laos) operated as both the central bank and a commercial bank, handled almost all financial transactions and focused largely on accounting, disbursement, and collection of financial resources to support the implementation of socio-economic development plans set out by a central planning agency, toward a two-tier system, in which central banking and commercial banking functions have been segregated.

Despite fundamental structural changes initiated during the initial reforms, resource mobilization and allocation of the banking sector had been limited. Also, the sector was structurally fragile and largely dominated by state-owned commercial banks (SOCBs). Further, lack of competition, lax banking policies implementation, and lack of qualified human resource impaired the sound development of the sector. The promulgation of new law on Commercial Bank in January 2007 encourages new entrants and promotes competitions and innovation in the sector. However, at present, the Lao financial system appears to be relatively small, weak, and under developed with most of the commercial banks play incredibly small role in financial intermediation.

In light of the financial system development in Laos since 1986, this paper examines current financial sector with particular focus on demand for financial services, institutional framework, capital mobilization and allocation, and non-bank sector development. It also provides an overview of historical development of the financial system of Laos since 1951. Importantly, this paper does not look at stability aspect of the financial system.

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1) After decades of the prolonged civil war, the Lao People's Democratic Republic (Lao P.D.R.- Laos) was established on 2 December 1975 and adopted a socialist system under the Lao People's Revolutionary Party.

2) Pianpeangmai is the name given to the economic reform policy initiated in 1986 in Laos. It literally means Transformation. In western or English literature, the New Economic Mechanism (NEM) is widely used for referring to this policy.

2. Brief Historical Development

2.1 Development during 1951-1975

Origin of the contemporary financial system in Laos was traced back to the era where Laos was colonized by France between 1893-1954. Under the French Indochina, Piastre was issued exclusively by the Bank of Indochina (Banque de l'Indochine) during 1875-1951 and circulated as the currency within the colony during 1880-1952. On 31 December 1951 this privilege was transferred to the Issuing Authority of the States of Cambodia, Laos and Vietnam (Institut d'Emission des Etats du Cambodge, du Laos et du Vietnam). Lao branch of the Issuing Authority of the States of Cambodia, Laos and Vietnam was established in 1951 to manage and issue Piastre for circulating in Laos. This marked the beginning of the financial system development in Laos.

After gaining full independence from France in 1954, the National Bank of Laos (Banque Nationale du Laos) was created in December 1954 and operated as central bank of the nation with headquarter in Vientiane and two branches, one in Luangprabang and another one in Pakse province. Also, Kip (commonly known as Viengchan Kip) was created by the Royal Lao Government in May 1955 to replace Piastre as the legal tender for payments in Laos. This marked the beginning use of the Kip as the national currency of Laos under the fiat money system.

The Civil War during 1953-1975 divided the country into two areas, in which major part of the country was controlled by the Royal Government and three northern provinces of Xiengkuang, Huaphan and Phongsaly, were under the control of the Lao Patriotic Front (Neo Lao Hak Sat). Although the country was divided, Viengchan Kip was still widely used in these areas until the creation of the Kangkai Treasury in Kangkai district, Xiengkuang province in 1961 by the coalition government, in which the Lao Patriotic Front was a part; a new currency, better known as Kangkai Kip, was created by the Kangkai Treasury to circulate in the liberalized areas that were under the control of the Lao Patriotic Front along with the Viengchan Kip. At that time, the economic situation in the liberalized area was relatively weak with high inflation and lack of infrastructure to support the economic development, which caused the Kangkai Kip to depreciate rapidly. Thus, people began to drop the Kangkai Kip in favor of the Viengchan Kip and led to the chaotic situation. In line with the resolution of the 13th Meeting Session of the Lao People's Party Central Committee in May 1965, to comprehensively develop the liberalized area into a state, the Lao Patriotic Front established the Pathet Lao Bank in its headquarter in Viengxay district of Huaphan province in October 1968 and declared the use of new Kip currency (better known as liberalized Kip or Kip Potpoi) in the liberalized area to replace the Kangkai Kip. his marked the end of the circulation of the Kangkai Kip and the beginning use of the Liberalized Kip in the area.

During this period, the banking system in Laos appears to be a two-tier system with the National Bank of Laos functioned as the central bank of the nation and five private and foreign-owned commercial banks such as the Lao Trade Development Bank (Tanakan Lao Panit Pattana), the Lao Royal Development Bank (Tanakan Pattana Heang Lasa Anachak Lao), the Lao Vieng Bank (Tanakan Lao Vieng), Indochina Bank, and Tokyo Bank. Also, these commercial banks established to serve mainly international trade, foreign assistance given to the Royal Government, and business activities in Vientiane without any branches in the provinces.

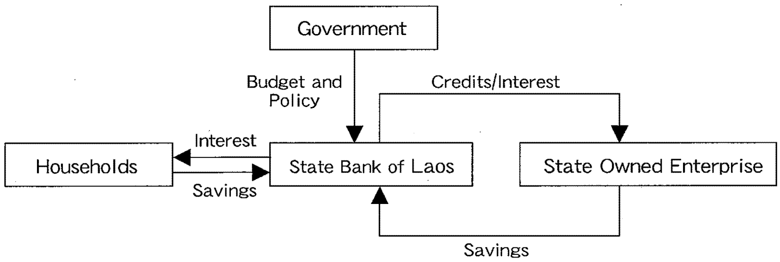
2.2 Development during 1975-1985

After establishment of the new regime, the central bank and all the commercial banks of the former regime were nationalized and merged with the Pathet Lao Bank to form the Lao National Bank with a head office in Vientiane and 19 branches: 3 in Vientiane Municipality (Tanakan Kampeang I, Tanakan Kampeang II, and Banque pour le Commerce Extérieur Lao(BCEL)) and 1 in each of 16 provinces. The bank was created with the key objective to rebuild the economy destroyed during the civil war and strengthen new regime by supporting the government development policies. In addition, the Liberalized Kip was the only currency allowed to use as a legal tender for payments in Laos on 13 June 1976; people were encouraged to exchange the Viengchan Kip for the Liberalized Kip at the rate of 20 to 1. Furthermore, due to chronic high inflation and rapid depreciation of the Liberalized Kip, on 10 December 1979, the government decided to reform the financial system and create a new currency, better known as Kip Tanakan that has been used until now, with the aim of improving purchasing power of the Kip currency. People were encouraged to exchange the liberalized Kip with the new Kip at the rate of 100 to 1. This could be seen as a way to reduce money supply in the economy, strengthen public confidence on local currency, and increase the Kip value against foreign currencies at the time. As Laos relied largely on the imports of consumer goods and machinery from the Soviet Bloc and Thailand to supply local consumption, resulted with chronic trade deficit, therefore, fixing the exchange rate from time to time was necessary for the government to keep macroeconomic stability. Further, the government adopted a multiple exchange rates system on 2 October 1985, in which the exchange rate was fixed at various rates according to different purposes such as exchange rate for international trade, grant aids etc., ranging from Kip 35 to Kip 95 per US dollar. This appears to be inefficient approach to tackle foreign exchange problem.

In 1981, the Lao National Bank was renamed to the State Bank of Laos (SBL) through promulgation of the Law on State Monopoly in the Banking Sector in August 1981. This officially marks the beginning application of mono-banking system in Laos. Under this law, SBL functioned as an entity responsible for implementing financial and monetary policies with the objective of providing necessary means for the state owned enterprises (SOEs) to meet production targets. Also, SBL was given authority to operate as both the central bank and a commercial bank. As the central bank, SBL regulated monetary policy, managed the international reserves and issued banknotes and coins. As a commercial bank, SBL mobilized savings from the public and allocated credit to SOEs through its branches.

Under the mono-banking system in Laos, funds were mobilized from the government, households and SOEs and channeled back to SOEs (exhibit 1).

Exhibit 1: Mono-Banking Framework in Laos



During this period, the imprudent use of interest rate mechanism and credit rationing by the SBL, to a certain degree, caused financial chaos and unstable economic conditions. By using the banking system to support SOEs, the system discouraged people to save and caused inefficient capital allocation and inflationary pressures. It appears that failure in management of interest rate policy contributed to an environment of dissavings and inflationary pressures. While the inflation rate increased, interest rate virtually remained unchanged. Consequently, interest rate in real term reached negative level. Deposits in the banks lost value as inflation outpaced interest earned on deposits, which discouraged people to save. As a result, households stored value of their savings in the form of real estate, gold and foreign currencies. Further, SOEs, which were required to have deposit accounts with the banks, took advantage of the loose supervision from SBL by converting cash into commodities and inventories as a way to store value of profits. In the environment of negative real interest rates, the household was unwilling to save, which drastically reduced the capital available for investments and drew back national development.

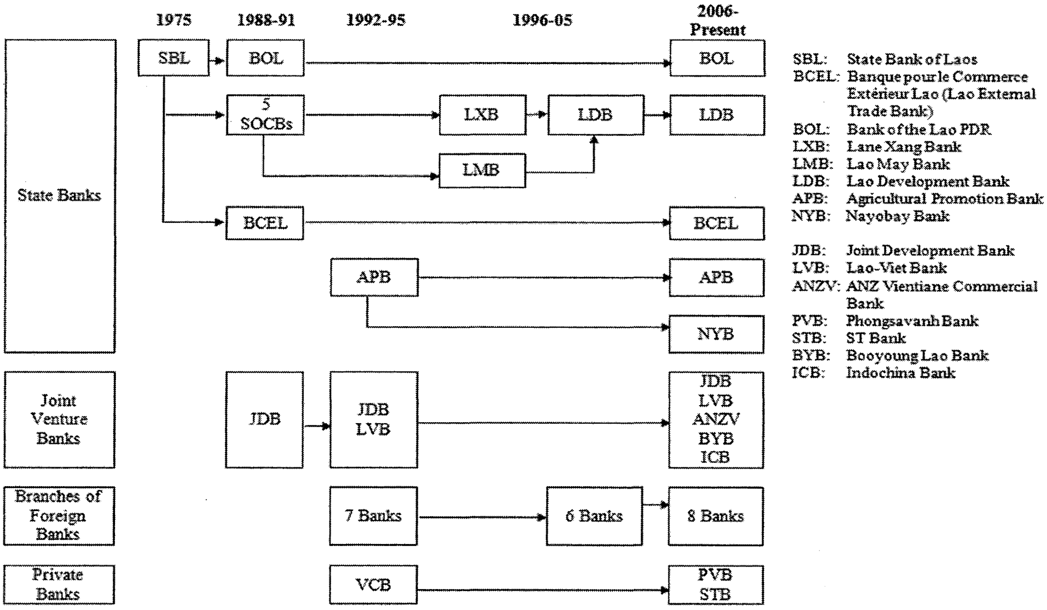
2.3 Development during 1986-2009

Since the Pianpeangmai policy was initiated in 1986, development of the Lao financial sector can be divided into four periods (exhibit 2). During the first period (1988-1991), the mono-banking system instituted in SBL since 1981 was replaced by a two-tier banking system through the Decree no.11 on the Reform of the Banking System. The Decree was enacted in March 1988 separating the commercial bank function from the central bank. Prior to the commencement of the reform, SBL managed the banking system through its branches, assigned with specific function and area of coverage. As a branch of SBL, BCEL focused on foreign exchange transactions, trade financing and management of foreign loans, and the other branches looked after all domestic commercial banking matters. As part of the reform process, the commercial banking activities of SBL were separated from the central banking function and its branches were spun off as independent commercial banks. In 1990, the Central Bank Law, no. 4, established the Bank of Lao PDR (BOL) as the central bank to replace the SBL. Three more SOCBs were created during 1990-1991. All SOCBs were under direct supervision from BOL and each was assigned a geographical area of coverage. A first joint-venture bank was also established. The legal and prudential frameworks were inadequate; bank supervision and commercial banking experience are limited, resulted with low performance and increasing non-performing loans (NPLs).

The second period (1992-1995) witnessed an increase in the number of financial institutions in Laos. The Prime Minister Decree no. 3 of 1992 on the Management of Commercial Banks and Other Financial Institutions, which defined banking business and the requirements for the establishment and operations of commercial banks, paved the way for the establishment of the private commercial banks. Six branches of Thai banks and a branch of Malaysian bank were established in Vientiane. However, these banks were not allowed to open provincial branches. In 1993, the Agriculture Promotion Bank (APB) was created by the Prime Minister Decree to act as the country's agricultural development bank. A number of foreign exchange bureaus, mostly owned by the commercial banks and some by individuals, were opened. Despite improvements brought to the legal and prudential framework, the financial health of the system did not improve due to weak enforcement resulting with high NPL. To meet capital adequacy requirements, the government proceeded with a first round of recapitalization of SOCBs.

During the third period (1996-2005), improvements were made to banks' legal and regulatory framework. Six prudential regulations for commercial banks were issued by BOL in 1996, and a new regulation on asset classification and loss provisions was promulgated in 1998. A new chart of accounts was also introduced for the commercial banks in 1996. In 1997, the Decree Law on Management of Commercial Banks and Other Financial Institutions replaced the Decree no. 3 of 1992, making the board of governors the policy making body of each SOCB and vesting in MOF the power to appoint the chairman and other members of the board. In 1999, the Law on BOL was amended; key amendment was to remove the power of BOL to appoint key executives of SOCBs. The continuing SOCBs' poor performance was revealed by financial audits on SOCBs in 1996 and 1997. In 1998, the government launched a program to consolidate, corporatize and recapitalize the SOCBs. Despite improvements in the framework, the implementation and

Exhibit 2: Banking Sector Development



enforcement remained weak throughout the second and third periods. In 1999, five of SOCBs were consolidated into two entities. Three banks headquartered in the north were merged into the Lane Xang Bank (LXB), and banks from the south became the Lao May Bank (LMB). In 2002, it was decided further to merge LXB and LMB into a single entity called the Lao Development Bank (LDB), leaving Laos with 3 SOCBs such as BCEL, LDB and APB. In 1999, a second joint venture bank between BCEL and the Bank for Investment and Development of Vietnam was established.

During the fourth period (2005-present), the new commercial bank law and its implementation decree, which encourage new entrants and expansion of the established banks and level the playing field that had traditionally favored SOCBs over privately-owned ones, were enacted in 2007. Also, the Presidential Decree on the Management of Foreign Exchange and Precious Metals was amended to be in line with the new commercial bank law in March 2008 and intended to give all market participants the same rights in foreign exchange transactions. As a result, by September 2009, four new local private and joint venture banks have been established and two foreign banks have also entered the sector. Further, the existing foreign banks and particularly local private banks have expanded aggressively to serve provincial clients. As a result of increasing competition, SOCBs have to readjust their strategies and improve their operational efficiency to compete with private competitors. According to an article in the Vientiane Times Newspaper, dated on 4 September 2009, the Management Board of the BOL approved plan to recapitalize SOCBs, enhance their management system, and encourage them to have new banking products to serve the clients. Also, APB has launched fund mobilization campaign by giving buyers of three-year deposit certificate a right to participate in lucky drawing. These developments reflect degree of competition in the sector.

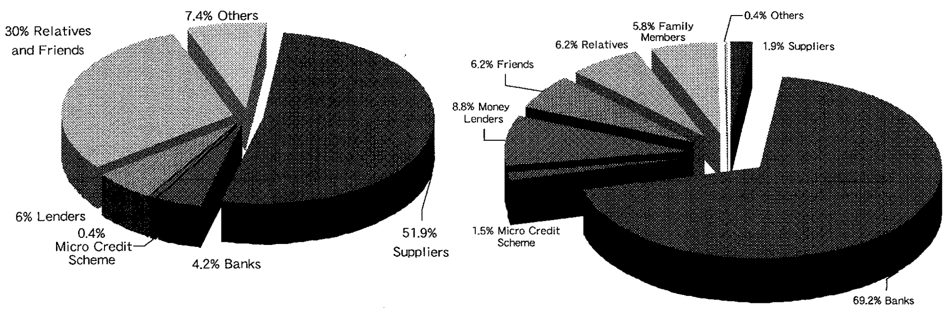
Recently, the government has split APB into 2 separate entities, APB and the Nayobai Bank (a policy bank) in January 2007 to ensure its viability. The newly restructured APB operates on a commercial basis with focus remaining on agriculture and forestry related industries. The Nayobai Bank is a non-deposit taking bank with clear mission to support government's policy. It mainly focuses on lending to the 47 poorest districts in the country with financial resources channeled from the government budget.

3 . Demands for Financial Services

The Lao government has made significant efforts in the past two decades to improve access to finance for businesses and extend financial services to households. Even though the reforms undertaken in the Lao banking sector have been far-reaching and very encouraging, there are still problems in the system that needs to be addressed. Easier access to finance supports business start-ups and growth, and creates the employment and wealth needed by the Lao economy. Also, making availability of financial services for households encourages more savings and increases funds available for business sector and financial transactions through banking system that improves efficiency of monetary management.

In the past few years, businesses faced difficulties in getting loans for their business needs. Based on the enterprise survey in 2005 by the Lao-German Human Resource Development for Market Economy (HRDME) project[3], merely 4.2% of the sample enterprises stated that they can

Exhibit 3: Source of Loans



Source: Source: Enterprice Survery 2007, HRDME, Small and Medium Enterprice Promotion and Development Office (SMEPDO), Ministry of Industry and Commerce, September 2008.

get loans from the banks (exhibit 3), which is extremely low. Almost 52% of them reported financing their businesses through suppliers' credits. Also, 43.4% stated that they get funds from informal sources such as illegal moneylenders, relatives and family, and huai[4]. This suggests that informal financial sources were widely used by businesses to finance their operations and there were problems in the banking system.

However, the situation has changed significantly as indicated in the similar survey in 2007. Almost 70% of the sample enterprises reported having loans from banks, which is much higher than the similar survey in 2005. Interestingly, 8.8% of the enterprises reported using services from informal money lenders and 18.2% borrowed from friends, relatives, and huai, reflecting high cost of financing through the banks and difficulties in accessing to finance for businesses still remain. Also, access to finance is significantly better for larger enterprises. Larger companies tend to have loans and overdraft facility to finance new investments and working capital through banks. Further, majority of SMEs and large enterprises stated that they need loans to finance their expansion in the future. The improvement in access to finance for businesses is considered to be product of the government policy that encourages new entrants, creates competition in the banking sector, and levels the playing field for all players.

Looking at the situation of access to financial services for households, it is obvious that households have faced much more difficulties in getting financial services, particularly households in the provinces. Based on findings of the recent rural finance survey by ADB[5], the banks and other types of financial institutions have failed to serve the demand for financial services of the vast majority of households in Laos. The key findings of this study are: 1) 5% of all rural households had any savings in a bank; 2) 4% had savings in a microfinance initiative; 3) 2% had borrowed from banks in the 12 months before the survey, and only 3% had borrowed from any banks; 4) 4% had borrowed from a microfinance initiative; 5) in contrast, 33% had borrowed from an informal source such as money lenders, relatives, friends, and huai.

Limited outreach of banks appears to be main constraints hampered access to financial services for households. As of June 2008, there are merely 212 banks' branches and service units including headquarters nationwide. Indeed, these are far from enough to serve both businesses and households.

3) HRDME project is a Lao-German cooperation program on human development, under the Small and Medium Enterprise Promotion and Development Office (SMEPDO), the Ministry of Industry and Commerce.

4) Rotating savings and credit associations, better known in Laos as "huai", in which members make a regular contribution to a fund, which is withdrawn for use by one member. Huai is similar to the Japanese "Tanomosi-kou".

5) Rural Finance in the Lao PDR: Demand, Supply, and Sustainability, ADB, 2006.

4. Institutional Framework

In Laos, there are two key agencies responsible for supervising the financial sector, which are the Ministry of Finance (MOF) and BOL. MOF supervises insurance sector, which currently has 4 insurance companies. On the other hand, BOL oversees the banking sector and non-bank sectors (any financial institutions other than insurance company).

4.1 Ministry of Finance

MOF appears to be a very important institution of the Lao financial system. It involves considerably in the banking sector as a dominant financial policy and decision maker, owner of SOCBs, tax and accounting practice regulator, and financial contributor to recapitalize the insolvent SOCBs. For the government, MOF is in charge of formulation and implementation of fiscal policies, preparation of the government budget to be submitted to the National Assembly, administration of the approved budget, and budget execution compliances. Also, as owner of all the SOEs in Laos, it has managed SOEs through the State Property Management Department and SOE Financial Management Department. In addition, MOF also handles foreign loans and assistance including servicing the external and domestic debt obligations of the government. Also, it played a critical role during SOCBs restructuring process and has power to appoint management of SOCBs. For example, the policy statement confirming the merger plan for SOCBs dated on 15 May 1998 was issued jointly by MOF and BOL. This policy statement was widely regarded as the official authority to proceed with SOCB restructuring program. With the merger and corporatization of these banks, MOF became the sole shareholder and the authority for appointment of members of the boards of SOCBs. The recent amendments to the Law and Decree on Commercial Bank also give MOF the authority to appoint the managing director of SOCBs. These signify the important role of MOF in the financial system of Laos.

4.2 Bank of Lao PDR

BOL appears to be effectively under the government's full control. According to the Law on BOL, dated on 14 October 1995, BOL is a monetary authority of the government of Laos, has ministry-equivalent status, and operates as central bank of the country. Also, it was entrusted by the government with responsibilities to 1) formulate and implement monetary policy, 2) supervise banking sector and other financial institutions registered with it, 3) issue and maintain stability of the national currency, 4) issue bills and bonds to implement its monetary policy, 5) perform financial transactions directly with commercial banks and other financial institutions under its control, 6) approve the establishment of the BOL branches, commercial banks, and other financial institutions under its control with consent from the government, 7) manage the national foreign reserve, 8) collect information and conduct researches on following areas: economic, financial and monetary issues, activities of commercial banks and other financial institutions, 9) represent the government in the international monetary organization, 10) report directly to the government on regular basis, and 11) provide consultations relating to economic and financial matters to the government. Further, the key members of the board of governors, which is the highest authority in BOL's governance structure, are from the executive branch such as 1) deputy prime minister as chairman of the board, 2) Minister of Finance as vice chairman, 3) governor and deputy governors of BOL as board members, and 4) knowledgeable persons from agriculture, industry, commerce, banking and financial sectors. Moreover, the governor of BOL is appointed or removed by the president with proposal from the prime minister. From the law, it is obvious that the current institutional arrangements do not promote financial sector stability due to BOL lack of autonomy toward the executive power, which appears to be different from other advanced countries, where the central banks are independent from executive branch, operates under rules designed to prevent political interference, and filled with board members who have extensive experience and knowledge on economics and finance.

In addition, it is mandatory for BOL to promote and facilitate the flow of funds to serve the government's socio-economic development plan (article 3 of BOL Law). BOL has been used as a credit window of the government to fund its development projects and SOEs complying with the national development plan. For example, in 1990s, BOL financed national irrigation scheme on the request of the government by providing loans to SOEs and private construction companies covered by the scheme. This practice deprives the BOL's autonomy in decision making to maintain stability of the financial system, especially the stability of the kip and soundness of SOCBs.

Lack of autonomy from the government appears to be a major weakness and handicapped in times of instability and high inflation as experienced during the Asian Financial Crisis, where the inflation rate stood at three-digit level. Further, monetary instruments employed by BOL were not effective to stabilize the economy during the crisis due to following major factors:

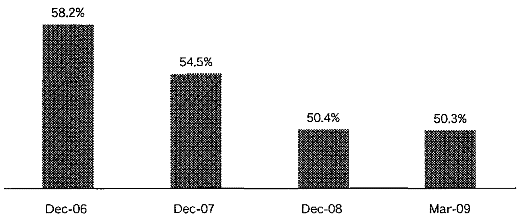
Dollarization[6] has been a protracted problem for the government of Laos. According to IMF's Lao Country Report in June 2009, as of March 2009, the dollarization rate of Laos is estimated at 50.3% down from 58.2% in December 2006 (exhibit 4). The dollarization phenomenon and a weak financial system have limited effectiveness of the monetary operation by BOL. Further, the dollarization phenomenon appears to be a reflection of a weak financial system. It impairs the

6) Dollarization here is defined as the widespread use of the US dollar/multiple currency as a medium of exchange and a store of value in the presence of the national currency. In Laos, Thai Baht and US dollar are the main currencies used for international transactions and a store of value.

ability of BOL to conduct an independent monetary policy. This is because capital inflows or outflows automatically change the money supply when a foreign currency can be used as a medium of exchange. An outflow of Thai baht or dollars contracts the money supply, whilst an inflow would expand it. An outflow of baht or dollars could be deflationary, while an inflow could be inflationary.

The impact of these capital movements on the money supply and domestic activity could be offset if BOL could conduct open market operations. For instance, the lack of monetary instruments in the form of Kip-denominated interest bearing assets prevents BOL from conducting open market operations. Even if BOL could issue Kip-denominated interest-bearing assets, the lack of confidence in Kip would limit their subscription. Other monetary instruments such as changes to the reserve requirement are likely to be blunt instruments of monetary policy because the dollarization allows capital inflows to become part of the money stock without passing-through the financial system. Thus, the ability to conduct an independent monetary policy depends on addressing the dollarization and improving the financial system.

Exhibit 4: Estimated Dollarization Rate in Laos



Source: Lao Country Report, IMF, 24 June 2009.

The lender of last resort function of BOL is also somewhat impaired by the dollarization. In the case of loss of confidence in the banking system, the monetary authorities would not be able to guarantee the whole payments system or to fully back bank deposits. The ability to print money as required is, after all, what allows a central bank to fully guarantee that all claims in domestic currency will be met. The dollarization reduces the capacity of the central bank to print money, and thus also impairs its ability to perform its function as guarantor and lender of last resort.

At present, kip has been gaining confidence from the general public progressively after years of stable economic situation and the government has launched campaign to mobilize people to use local currency for daily transactions constantly. Recently, despite Lao kip has appreciated against Thai Baht and US dollar gradually, however, people still keep part of their surplus in foreign currency due to historical reasons. It takes time to gain the confidence from people back after years of economic instability and mismanagement.

Policy making process: another cause of relatively inefficient implementation of the monetary policy in recent years appears to be the lengthy and opaque decision making process. By law, all the key monetary policies and action plans have to be approved by the Government. This is time consuming as BOL must explain the objectives, mechanism and consequences of the policies and the measures to all related parties participating in the monetary policy making processes, particularly the Prime Minister Office and MOF. As a result, by the time the final decisions are made, they tend to be outdated. Therefore, BOL autonomy is important because at times of preserving the value of the currency or keeping inflation under control may conflict with government priorities.

Policy lending[7] is a constraint to effective monetary policy. Mainly due to the relatively high fiscal deficit, the government seeks out-of-budget resources to finance its investments or SOEs and calls on SOCBs. This is another reason why BOL monetary policy cannot be very effective. When BOL uses interest rates as instrument with intention to limit credit availability to high return projects, policy lending interferes with normal market credit allocation and therefore reduces the efficiency of the policy decision. The more policy lending is the less efficient the instrument. It also makes the control of aggregate credit very difficult for BOL as policy lending decisions are not always closely coordinated. In recent global financial crisis, it appears that the government has encouraged BOL and SOCBs to lend more and finance development projects in order to prop up economy affected by the crisis. This is noticeable from an article of the Vientiane Times Newspaper, dated on 19 August 2009, BOL has provided loans of Kip 786 billion for some infrastructure development projects and also extended loans to other investment projects worth Kip 546 billion.

BOL Financial Situation: BOL's financial capacity may limit its effectiveness in implementing monetary policies. BOL's profits are required to be remitted to the state budget, after due deduction of a contribution to a business expansion fund and the general reserve account to compensate for the losses incurred from the implementation of monetary policy. The buildup of these reserves depends on the amount of contributions decided by the board of governors, in consultation with MOF. BOL may not have sufficient reserves to implement a vigorous monetary policy that the situation calls for. Also, lack of T-bills forces BOL to issue bonds to withdraw liquidity from the market, which incurs the interest costs. Furthermore, the BOL incurs losses when implementing development plan or programs. Due to fiscal constraints limiting its resources, MOF allows BOL to deduct those losses against profits without compensating BOL for those losses. This further reduces BOL's financial capacity.

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7) Policy lending is defined here as including directed lending.

Commercial Bank Supervision Function:

The Bank and Financial Institution Supervision Department (BFSD) of BOL has been entrusted with responsibility to supervise the commercial banks and financial institutions registered with BOL since 1998. It has 3 divisions such as 1) off-site supervision, 2) on-site examination, 3) regulations and information. BFSD lacks capacity in term of human resource and equipment necessary for performing its assignment efficiently. It has less than 20 auditors, who have little experience in financial institution audit and little or no banking or auditing background, responsible for supervising and auditing the increasing number of banks and financial institutions. With limited auditors, BFSD has been unable to field an on-site examination team every year in all the commercial banks currently operating in Laos. The off-site supervision division collects each commercial bank's balance sheet, trial balance, income statement and financial ratios on a daily and monthly basis. This represents a huge amount of data as the emphasis seems to be on the quantity rather than on quality of information. Valuable information that indicates risk exposures, such as data on the ten largest borrowers, the foreign currency positions, lending to shareholders and SOEs are not sufficiently obtained. Processing of raw data is largely limited to preparation of consolidated reports of all banks for reporting to the Governor. In addition, the lack of capacity to follow up the banks is also a cause of weak enforcement of Law and regulations.

Further, conflicts of interest have also been responsible for weak enforcement of regulations and decisions concerning SOCBs. Even though MOF has been in charge of appointing SOCBs' board of directors and managing director, however, most of members of the board and managing director usually come from BOL due to the fact that BOL staff tends to have more experience in and be familiar with the banking sector than staff from MOF. Hence, BOL may be reluctant to take necessary actions against former BOL staff. As a result, the decision making process may be biased and the result might not be completely reported. The present institutional setup of the BOL appears to impair the sound development of the financial sector.

5. Banking Sector Capital Mobilization

Banking sector in Laos is still in its early stage of development and very small compared to other neighboring countries. As of December 2008, total asset of the sector was equal to Kip 13,992.93 billion or US$ 1,645 million[8] and deposit to GDP ratio is merely 21.8%. Recently, although four new private and joint venture commercial banks have been established and three foreign banks have opened their branches in Vientiane. However, three SOCBs still dominate

8) Calculated using BCEL exchange rate of Kip 8506/1 US$ on 9 October 2009.

the banking sector with almost 60% of total asset and 70.4% share of deposits in December 2008. The private and joint-venture banks have played an increasingly important role and captured market share from both SOCBs and foreign banks progressively with 20.6% share of deposits in 2008, 6.8% increase, compared to 2004.

In Laos, financial resource mobilization is relatively low with 20% of gross domestic saving rate in 2008, which is much lower than neighboring countries such as Thailand and Cambodia where the saving rates are 33.2% and 30.3% respectively. The low resource mobilization reflects underdevelopment of the banking sector and is attributed to various factors. Banks' limited outreach has certainly contributed to the low saving mobilization. As of June 2008, there are merely 212 banks' branches and service units including head offices nationwide, which are far from enough to provide adequate services to public. Also, microfinance institutions (MFIs) does not functioned well and could not fill the gap left out by the commercial banks by providing financial services to low-income clients. Further, most of the existing MFIs have focused on lending to the low income people rather than balancing the saving mobilization and lending. This is not surprised as majority of microfinance initiatives are funded by international development agencies. Without ready access to saving facilities in the formal financial institutions, people living in the rural areas tend to hold cash and invest in jewelry, gold and other precious metals, houses, livestock, and other physical goods. According to the rural finance survey in 2004[9], rural households held an estimated kip 2,290.3 billion in cash savings. Almost 90% of rural households reported holding some cash savings and 5% reported having any bank deposits, suggesting a low level of outreach by the banking sector in the rural areas. Non-cash savings amounted to kip 6,292 billion and accounted for 73.3% of total savings in rural areas. Many of these informal saving mechanisms involve high risk and high transaction costs and result in savings that are not easily turned into cash.

Underdeveloped payment infrastructure and low interest rate have also contributed to the low savings mobilization. In Laos, people prefer making payments through cash rather than payment instruments such as checks, wire transfers or credit cards, which are not convenient to use. Also, demand deposit or checking account does not pay interest and time deposit appears to be risky in time of high inflation. Hence, savings account appears to be famous for those people who wish to save their money in the banks, because it allows them to set aside a portion of their money while earning an interest. However, real interest rate for savings account appears to be negative, resulted from fixing maximum interest rate on lending by BOL. Limited flexibility in the lending interest rates does not allow banks to adjust their nominal interest rates on deposits to reflect changing inflation without creating negative spreads. This situation feeds a need for

9) Brett E. Coleman and Jon Wynne-Williams, "*Rural Finance in Laos: Demand, Supply, and Sustainability*", ADB, 2006, p.8-9

holding more cash for daily transactions and does not offer much incentive for households to convert their non-cash savings into cash and deposit it in the banks. Also, this drives more people to save their money in foreign currencies. The deposit in foreign currencies is 57.8% of total deposit in 2008.

Low level of confidence in kip and local banking system is contributed to the low savings mobilization. Collapse of many credit cooperatives during early 1990s created a chaotic situation in the financial sector. Also, policy lending, excessive lending to SOE, and inefficient management caused NPL problem for the banks, particularly SOCBs. These have eroded public confidence in the banking system. Further, the inflation was relatively high, particularly during the Asian financial crisis. The inflation increased sharply from 15.8% in 1996 to 128.4% in 1999 before declining to 15.5% in 2003. With restriction on maximum lending rates set out by BOL, the commercial banks were not able to adjust the interest rates on deposits to reflect the changing environment. Consequently, the real interest rate became negative, discouraging people to deposit money in the banks.

In recent years, macroeconomic situation has been largely stabilized with relatively low inflation. The inflation decreased significantly from 10.5% in 2004 down to 7.6% in 2008 and became negative in second quarter of 2009. In addition, the financial sector reform program has been implemented to restructure ailing SOCBs such as BCEL, LDB and APB through writing off NPL, strengthening the quality of lending decision process, improving credit review process, and developing sound internal policies and procedures. Further, the SOCBs and private banks have upgraded their computer networks and introduced core banking software systems into their operations, leading to better services for the clients. Yet, the banking system and kip have been gaining confidence significantly from the public. Total deposits increased almost 99% in 2008 compared to 2004. Time deposit is a good indicator of public confidence as it could be viewed as an investment. While time deposits in foreign currencies increased about 17% in 2008 compared to previous year, down from 34% in 2007, the time deposits in kip rose 53.9% in 2008, evidenced the increasing confidence in kip and the banking sector. In spite of increasing confidence, people still prefer depositing their money in foreign currencies as a hedge against risks. In 2008, deposits in foreign currencies constituted about 57.8%, suggesting that people still do not fully trust in local currency.

Deposits appear to be main resource of the commercial banks, accounting for 72% of the total equity and liability in 2008, which is very high. With loan to deposit ratio at 34.1% and 51.2% in 2007 and 2008 respectively, it is not surprised that the commercial banks have to keep the interest rates of deposit at low level to reduce costs. Also, interest rate spreads also remain large, suggesting the need to improve operating efficiency and competiveness of the banks. Interestingly, credits from monetary authorities rose constantly since 2004 and amounted to kip

420 billion in 2008 with 140% increase compared to previous year, suggesting that the government has supported SOCBs directly as part of the ongoing restructuring process.

6. Banking Sector Loans Allocation

Credit allocation by the banking sector does not function well as expected. Total credit to the economy is merely kip 5,845 billion or equal to only 11.2% of GDP at the end of 2008.[10] This is very low compared with other economies in the region such as Thailand and Vietnam where the loan to GDP ratio stood at 105.1% and 95% respectively in 2008, and evidenced a system in its early stage of development. The low level of credits to the economy is attributed to many factors.

Lack of qualified human resource: Lack of skilled human resource in modern banking and finance, and economics appears to be major problem for the banking sector in Laos, especially SOCBs, which do not have research unit assisting management in decision making, creating new products, and finding and evaluating business opportunities. Also, it appears that credit officers do not have sufficient skills in analyzing credit risk, market risk, project risk, and foreign exchange risk. These officers appraise loan proposals based on a credit manual designed by a technical assistant project supported by an international development agency about 8 years ago. Also, supervision on borrowers' financial and business situation appears to be weak. To some extent, lack of skilled human resource and updated working procedures, and weak borrower supervision resulted with high NPL, which significantly limits lending capacity of the banks.

High interest rate: interest rate is also contributed to the low level of credit allocation. In the past, SOCBs set lending interest rates for different sectors such as 1) agriculture and forestry, 2) industry and handicrafts, 3) construction, and 4) trade, services and transportation, which appear to be based on the government development policy rather than risks. The interest rate for agricultural and forestry sector was the lowest, while interest rate for the trade, services and transportation sector was the highest. Hence, capital allocation was not efficient and fund cannot be channeled to the best borrowers. The interest rates were also high, reflecting unfavorable macro economic situation and efficiency of the banking sector during that period. This interest rate policy was terminated in February 2004. Currently, the commercial banks set their lending interest rates based on risks and maturity. Recently, as the macroeconomic situation have been stabilized and the interest rates of both short-term and long-term loans are in decreasing trend, however, it is prohibitively expensive to secure loans in local currency in Laos. Interest rates of loans in local currency are the highest compared to neighboring economies with

10) GDP is estimated at Kip 46,700 billion in 2008, Lao Statistics Appendix, IMF, June 2009.

19.2% per year in 2008, where the average interest rates in Thailand and Vietnam are 7.04% and 15.78% respectively. Further, interest rates for loans in foreign currencies (Baht and US$) are much lower than the loans in kip. Interestingly, the inflation is relatively low with 3.2% in December 2008 and 0.67% in March 2009, and kip is also pretty stable recently. To a certain degree, this indicates capacity and flexibility of the banks in response to the changing environment in Laos. In addition, gap between interest rate of loans and deposits is fairly large, suggesting need to improve efficiency of the banks. As a result, the situation drives the businesses to borrow in foreign currencies rather than kip, which appears to be in contrast with BOL's policy to encourage use of kip in all business transactions. The loans to economy in foreign currencies stood at 55% of total in December 2008, which is very high. However, it is not surprised when we look at the composition of the deposits, in which the deposits in foreign currencies constituted 57.8% of total deposits in 2008.

Accounting practice of enterprises: it appears that accounting practice of enterprises prevents the banks from granting loans to the businesses. According to the economic census in 2006 by the National Statistic Center, merely 5.5% of enterprises reported holding general and advanced accounting systems that generate proper financial reports such as balance sheet, income statement and cash flow statement required by bank credit officers to evaluate a loan application from the prospective borrowers. Also, a business plan with future cash flow projections is very important as this is basic information that banks need to evaluate sources of loan repayment. Importantly, it indicates that 94.5% of the enterprises under the survey were excluded from the bank loans since these enterprises could not meet bank's basic loan requirement.

Type of collateral required for a loan: even though the secured transaction law of 2005 permits the banks to accept tangible and intangible collateral other than land and house to secure a loan. However, the credit officers usually request the borrowers to use land and house as collaterals to secure a loan, due to the fact that law enforcement is weak and it is extremely difficult for the bank to trace movement of other type of borrower's assets such as machinery and inventory. Also, it is difficult for the bank to liquidate certain assets like industrial machinery owing to lack of second hand market. Hence, land and house appear to be secured collaterals for the banks. This indicates that loan amount to be approved by the bank is closely related to the market value of the land and house, which significantly limits capacity of businesses to finance large project. Another word, a business with viable project but limited land and house is excluded from the bank financing.

Non-performing loans (NPL): poor risk management and policy/directed lending caused high NPL in the banking sector, particularly SOCBs and joint venture banks during second half of 1990s and early 2000s. The banking system appears to be in crisis; NPL of banking sector in 1999 was estimated at 60%, which is extremely high. This limited significantly capacity of the banking sector in lending to the economy and jeopardized stability of the economy. The situation forced BOL to request assistance from international financial organizations such as ADB, World Bank, and IMF. Through assistance from the international financial organizations in restructuring process, recapitalization by the government, loan write-off and work out, SOCBs have been able to reduce NPL significantly. NPL of SOCBs decreased dramatically from 13% in 2006 down to 5% in 2007, below NPL level of the whole banking sector, which is 6.5% in 2007. Interestingly, NPL of the joint venture banks is 14%, which is relatively high.

In the past, the lending in foreign currencies, to a certain degree, caused NPL for the banks that granted loans in foreign currencies to borrowers without revenues in foreign exchange. Since the borrowers did not have any financial instruments to hedge against currency risk, they faced serious difficulty in servicing their obligations during the macroeconomic instability. As kip depreciated, borrowers needed more and more kip to repay the loans. This cost was transferred to the customers of the borrowers by increasing the selling prices of their products until it was not possible anymore and then they defaulted the loans.

Foreign asset deposited oversea in the nostro accounts stood at kip 4395 billion or 38.7% of the total asset in 2007, which is considerably high and bad for the domestic businesses in need of financial resource to expand their operations as well as economic development. It indicates that the banks invested abroad to make profits and avoid various risks involved with the lending in the country. However, it is noticeable that the growth rate of foreign asset of the banking sector has been declined gradually since 2006 and become negative in 2008. It stood at kip 4021 billion or 28.7% of total asset in 2008, down from 38.7% in 2007, reflecting increasing business opportunities in the country.

The lending volume increased sharply in 2008. The total loans outstanding as of December 2008 increased 72% compared with previous year. This is a very dramatic increase contrasting with the conservative lending activities of the past years caused by high NPL. The sharp increase in lending resulted from the government policy to reduce interest rates and encourage banks, particularly SOCBs, to lend to the businesses in order to prop up the economy impacted by the global financial crisis and lending to large investment projects. This policy has been maintained until 2009. The average interest rate in local currency declines from 19.2% in 2008 down to 13.26% in the send quarter of 2009. Also, it appears that the increase in deposits was minimal with 14.5% increase compared to 2007. As a result, the loan to deposit ratio increased to 51.2% in December 2008 from 34.1% in December 2007. These developments raised concerns about quality of the loans, which might cause NPL problem for the banking sector in the future.

Although private sector faced difficulties in getting bank loans in the past, the situation appears to have improved gradually. In 2008, the loans to private sector accounted for 88.3% of the loan outstanding, while the rest was loans to SOEs. The lending to private sector increased 71.6%

compared to previous year. The increase was resulted from the government measures to promote competition in the sector by reducing entry barrier and leveling the playing field for all the banks, to allow banks to set interest rate according to risk and market condition, and diminishing role of SOEs in the Lao economy. In addition, SOCBs have been restructured, improved their capacity in term of human resource, new products and introduction of core banking system, and recapitalized in recent years to be ready for competition with local private and foreign banks. The sign of improvement in term of access to finance by private businesses was indeed seen in the Enterprise Survey conducted by HRDME project[11] in 2007, 69% of the sample enterprises perceived that they are able to access to bank loans. This is in contrast with the finding in similar survey in 2005, where only 4.2% of the sample enterprises perceived that they can access to the bank loans for business expansion.

In Laos, the banks tend to grant more short-term loan to the borrowers reflecting the existing structure of mobilized funds. It is very difficult to get loans with maturity of more than three years that seriously restricts capacity of the businesses to invest for long term expansion. It is estimated that at least 72% of the banks' mobilized funds in 2008 are short term or in the form of current and saving accounts. The usual technique used by the banks is to continue rolling over short-term loans, which allows the banks to avoid maturity mismatch and reduce liquidity risk.

7. Insurance sector

The insurance industry in Laos was created in 1990 together with the promulgation of the Insurance Law in December 1990 and the establishment of the Assurances Générales du Laos (AGL), which is the first insurance company operating in the country. AGL is a joint venture company between the Ministry of Finance and Assurances Générales de France, which later was taken over by the Allianz Group in 1998. During 1991-2007, AGL effectively monopolized the industry with protection from MOF. In order to develop the insurance sector, the government allowed new players to enter the business in 2008 to create competition. Since 2008, there are 4 new insurance companies entered the industry.

To date, there are 5 insurance companies offering both life and non-life insurance to the public. All of them are joint venture among the government, local private entrepreneurs and foreign insurers. Whist the new players are busy with setting up their network, the insurance industry is still dominated by AGL. As the information on the insurance industry is rather limited and not available on the public sources, it is difficult to estimate the exact size of the market. However, according to Mr. Holady Volarath, deputy managing director of AGL, the annual premium

11) HRDME project is a Lao-German cooperation program on human development, under the Small and Medium Enterprise Promotion and Development Office (SMEPDO), the Ministry of Industry and Commerce.

income of AGL in 2008 is a bit more than US$ 20 million. Also, most of the premium income is from non-life insurance activities. The life-insurance activities have been increased gradually in recent years. AGL has been very profitable and invested most of its income in bank deposits of local and foreign banks due to lack of other investment choices.

The Insurance Law in 1990 has laid foundation for the insurance business development. The industry is under the supervision of the State Property Management Department of MOF. According to the law, insurance company is able to operate in both life and non-life insurance businesses. Also, it is required the company to have technical reserves deposited in the local commercial bank. At present, the government is revising the law, which is expected to be enacted next year. The revised law is expected to have new provisions relating to increase in registered capital and required technical reserves and prudential practices.

Recently, the insurance industry appears to expand rapidly commensurate with economic growth. Despite insurance market is still very much in its infancy stage of development with low insurance awareness but it has potential to grow rapidly in the near future. Life-insurance would provide surplus households with additional investment choices. Lack of financial securities for investment might impact on performance of the insurance industry. Also, similar to the banking sector, there appears to be a shortage of qualified human resource in insurance sector as there are no any educational institutions offer degree program in insurance. As a result, the companies have to provide special in-house training to the new recruited local staff, having background from business management and accounting.

8. Capital market

A capital market is a market for trading of debt or equity securities, where government and enterprises can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year. Stock market is one of the most significant sources for companies to raise money to finance business expansion through selling shares of company ownerships in the public market. Bond market is a financial market where participants buy and sell debt securities usually in the form of bonds issued by government and companies. For the government, bond is a mean for public borrowings to bridge the gap between budgetary receipts and expenditures as well as to finance long-term investment projects. Also, the prices revealed in a liquid government bond market are considered as a good source of information on market expectations of future inflation and interest rates. Capital markets play a crucial role in economic development. Well-developed capital markets will not only enhance efficient allocation of resources, but also provide investors with investment opportunities that suit their preferences of risk and return. Further, capital markets could maintain the momentum of economic growth on a sustainable basis by enlarging the sources of financial resource mobilization for businesses and government.

In Laos, there is no stock market yet and the government bond market is in the preliminary stage of development. The market is very small and thin with SOCBs as main buyers. For government, MOF has authority to issue debt securities such as treasury bonds and bills. The budget department of MOF is in charge of designing the need and volume of bonds to be issued and make a recommendation to the government. Thereafter, the treasury department issues bonds in accordance with the recommendation from the budget department. BOL managed all bonds issued by the MOF and sell them to the market. The bonds are sold at a discount in certificate form in units of Kip 10 million. Before March 1994, government debt securities were not transferable and sold in limited volume directly to individuals. Domestic commercial banks, particularly SOCBs are main buyers. From March 1994, bonds were auctioned by BOL twice a month under a tendering mechanism.

Supply of bonds: Most of the government debt securities issued by the MOF and BOL are short-term bonds with maturity of less than one year. The bonds are usually issued to absorb excessive money supply in the economy, to pay back government debts to SOEs, and to recapitalize the SOCBs. Interestingly, it appears that the government does not issue long-term bonds to finance its development projects due to lack of demand. As the main buyers, SOCBs faced difficulty in mobilizing fund from the public and are financially distressed resulted from high NPL, hence cannot hold large amount of government bonds for long time. Also, large portion of the mobilized funds of SOCBs is short-term deposits such as savings and current deposits. Therefore, SOCBs have to manage the gap carefully to avoid maturity mismatch. To attract more buyers, the government had to issue short-term bonds and increase interest rate. In 1997, yields on T-Bills were set at 20% per year, as the government sought to reduce the interest burden on the fiscal budget arising from deficit financing. As real interest rates became increasingly negative due to high inflation, participation of commercial banks in the biweekly auctions of T-Bills declined. In April 1998, the auctions were stopped because of lack of bidding from the commercial banks. From April to end of 1998, 6-month T-Bills were sold at a fixed rate of 24%. In January 1999, the rate of T-Bills issued was increased to 30% to curb the inflation.

In recent years, as the economy has been largely stabilized, the government is able to mobilize funds through issuance of long-term bonds. In 2005, the government issued 5-year bonds with annual interest rate of 7-10% to recapitalize 2 SOCBs such as BCEL and LDB. As the buyers are SOCBs, it is just a transformation of deposits into equity of the SOCBs' balance sheet. At the end of 2008, the accumulated amount of bonds issued by the government since June 2003 is Kip 704 billion[12] with 57.8% increase compared to previous year or about 2.1% of GDP in December

12) Lao Country Report, IMF, June 2009, p.23.

2008, which is still very small.

Regulatory framework: a sound legal and regulatory infrastructure is prerequisite for establishing or developing a viable capital market. Yet, there is no law on securities, which is a serious constraint hampered development of the capital market in Laos. Currently, MOF and BOL are permitted to issue bonds and bills to finance government development projects and control national macroeconomic stability through rights and responsibilities given by the laws and decrees governing activities of the MOF and BOL. For example, the BOL law gives the right to BOL to issue debt securities to control the monetary stability with approval from the MOF. However, the law does not provide details on securities issuance procedures. Also, with the existing enterprise law, public companies and state owned enterprises are allowed to issue shares and bonds to the public to mobilize funds for their expansion. Without the securities law and clear issuance procedures combined with lack of infrastructure to support the trading activities, it is almost impossible for the enterprises to issue shares and bonds for trading in the market.

Other constraints: Despite the critical role of the bond market in providing alternative financial channel to sustain economic growth momentum is well recognized and the government has put significant efforts in developing a viable bond market for long time. However, it appears that the bond market is still underdeveloped. In addition to lack of regulatory framework supporting the market activities, failure of bond market development is resulted from various constraints: 1) lack of qualified manpower with sufficient expertise seriously impedes the development of viable bond market; 2) lack of confidence and awareness on the bonds market limit the demand significantly; 3) the government budget deficits are usually financed through concessional multilateral/bilateral loans and grant aids as it is much cheaper and less complicated than borrowing from issuing bonds in the local market. Nevertheless, it would be difficult for the government to borrow large amount to finance development project, while total debt stock is very high; 4) lack of securities company has hindered the development of the bond market. Most investors hold the bonds until their maturity as the secondary market is not developed due to lack of market infrastructure and market makers; 5) there is no credit rating company in Laos. Absence of a credit rating agency implies that an issuer is not required to be rated. Investors will therefore have difficulty assessing the creditworthiness of the bond; 6) systems used to facilitate bonds transactions such as clearing, payments, and settlement platforms are crucial for development of bond markets. Yet, it still does not exist in Laos.

Securities market development: the government has put tremendous efforts developing the banking sector through recapitalizing and restructuring SOCBs, improving regulatory framework, and allowing new entrants to create competition in the sector in recent years. As a result, the banking sector has been improving significantly. Also, the economy has been largely stabilized and the banking sector has gradually gained more confidence from general public.

Obviously, companies with good performance are able to get loans from the banks much easier than before. However, with limited capacity and resources, the banking sector could not provide sufficient funds to the economy to sustain economic growth at the rate of at least 7% set out by the 6^{th} Five-Year National Socio-economic Development Plan. The domestic bonds market is underdeveloped and required urgent development. Therefore, BOL has been entrusted with responsibility to develop a comprehensive securities market in Laos, in which debt and equity securities will be traded. The new securities market will provide general public and companies with surplus money an alternative investment opportunity and alternative financing channel for government and business community.

With full support from the government, the preparation for the establishment of the Lao Securities Market has been advanced progressively. Necessary securities law, decree, regulations and working procedures have been completed and are expected to be promulgated this year. According to the plan, the Lao Securities Commission will be set up between 2009-2010 and followed by the establishment of security trading center end of 2010. At present, the 10-story securities trading center is under construction and is expected to be completed in 2010. The trading center is a joint venture between BOL and Korea Exchange, providing all the computerized securities trading platform, training for BOL staff, and other technical supports to the Lao Securities Market. Further, recently, the Lao Securities Establishment Committee (LSEC) has implemented awareness campaign through trainings, presentation of securities markets in all the Universities and colleges, and public relation to raise the public awareness on the securities market. In cooperation with the Securities Exchange of Thailand, the LSEC has offered certificate courses related to capital market for the potential brokers, dealers, SOEs and other private companies.

Despite the preparation for capital market establishment has been progressed significantly. However, there appear to be many issues to be tackled by the BOL. It is obvious that BOL lacks capacity and qualified manpower to regulate and supervise the market. Also, local educational institutions still could not supply adequate well-trained human resource to the various institutions involved in the financial sector. Ability to supply quality securities, building an efficient trading infrastructure, availability of securities companies to facilitate the trading, and well-developed accounting and auditing functions are challenges that BOL have to overcome in order to create demand for the securities.

9. Conclusion

Since adoption of the Pian Peangmai policy in 1986, the Lao banking system has been transformed from a mono-banking system into a two-tier system. Under the early stage of reform programs, a series of reforms were implemented such as segregation of the central banking function from the commercial banking activities, establishment of new SOCBs and financial institutions, alignment of exchange rate with the market rate, allowing banks to set their own interest rates, permitting establishment of private, joint venture and foreign banks with certain restrictions, promulgation of related laws and regulations to support the banking sector development, and allowing banks to lend to private enterprises. However, the banking system dominated by SOCBs suffered from policy/directed lending, excessive concentration on lending to SOEs and inadequate supervision, resulted with high NPLs in the banking system. Further, the banking sector was hampered by high transaction costs, lax policy making process of BOL, lack of human and institutional capacity, and fragile macroeconomic environment. As a result, public confidence in the banking system and local currency was very weak, led to the situation of dissaving and dollarization.

Recently, the government has liberalized the banking sector by creating a level-playing field for all the players including local private and foreign banks through the promulgation of new commercial bank law in 2007. Number of local private, joint-venture, and foreign banks has increased rapidly in the past two years, which enables the businesses to have easier access to finance with lower costs. Access to financial services by the general public has been improving. Also, prudential regulations have been revised to reflect the changing environment. The supervision function of BOL and capacity of SOCBs have been strengthened significantly with full support from the government and assistance from the international financial institutions. NPL of SOCBs has been declined dramatically through recapitalization by the government and loan workout/write off. However, financial situation of SOCBs still mains weak.

Despite of two decades of phased reforms and significant improvement in the banking sector, the Lao financial system is still characterized as rudimentary and plays a very small role in financial intermediation to support the national economic development. Still, the financial system could not provide services to meet existing demands of the business community and general public. Low capital mobilization has been caused by many factors such as limited outreach of the banks and microfinance institutions, underdeveloped payment system, limited availability of alternative financial instruments for investment, low deposit interest rates, and low confidence in the banking system and local currency. Furthermore, capital allocation of the banking sector is relatively low and the banks have faced difficulties in providing credits to the businesses, caused by various problems such as lack of skilled human resource, high interest rates due to inefficient management system, borrowers cannot meet basic loan application requirement of the banks due to accounting practice, type of collaterals required by the banks, and weak financial situation.

Together with developing the banking sector, the government has also encouraged the establishment of non-bank financial institutions such as insurance and financial lease companies to provide alternative investments and funding resources for the society. However, these companies could not be developed further, to a certain degree, due to lack of viable capital market. Recognition of the importance of capital market development, the government has put tremendous efforts in preparing for the creation of the Lao securities market since 2005. Creation of a capital market is an important component of the financial sector development stipulated in the 6th five-year National Socio-Economic Development Plan (2006-2010).

Capital market development has a strategic importance in economic development and structural reform in Laos. First, as the current economic growth is largely driven by foreign direct investment in mining, hydro power generation, large scale agricultural production, and light manufacturing industries, the economy needs to develop alternative financial channels to sustain growth momentum, complimenting the banking sector that has been under stress. Second, an efficient capital market could facilitate the needed structural reform, particularly SOE reform. Third, as foreign debt stock is very high and estimated at 95.7% of GDP in 2008, this has caused increasing difficulty for the government in getting foreign loans to finance its development plan. Domestic borrowing would be an alternative channel for the government. Also, an efficient securities market will encourage development of government bond market, which is almost inactive now, and support a sound financial system development in the future. Finally, an efficient capital market will provide alternative financing channel for the private enterprises, which have become more and more sophisticated and faced difficulty in getting loans from local banks to finance their large-scale investment projects, as the commercial banks have limited financial resources. Also, it will assist the enterprises improving their financial structure.

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