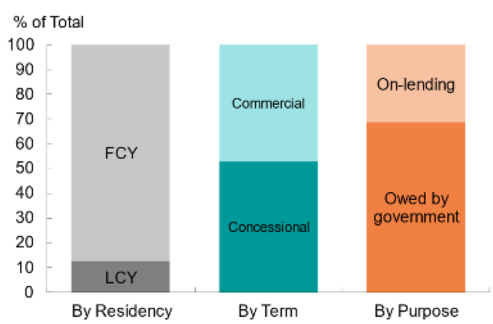
3. Debt Sustainability Analysis[105] [106]

Background

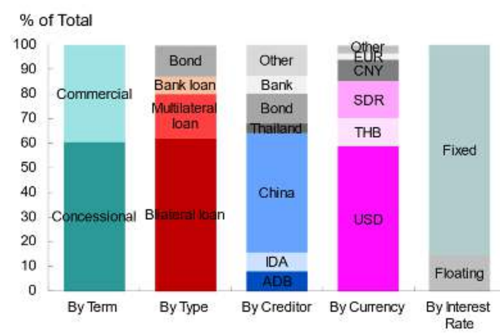
1. Lao PDR's public debt increased significantly in 2023, driven by rising domestic debt and external debt in kip terms.[107] Public debt had increased prior to the pandemic due to persistent fiscal deficits on the back of large public investments. In 2023, public debt almost doubled to an estimated 103 percent of GDP from 59 percent of GDP in 2018, driven by sharp currency depreciation, the settlement and recognition of arrears related to public infrastructure projects, and state-owned banks' recapitalization, amid an improved primary balance. Domestic debt stock in 2023 increased by 7 percent of GDP from 2022, mainly due to a public investment arrears settlement of LAK4.1 trillion and the recognition of remaining arrears amounting to LAK18 trillion.[108] With 87 percent of public debt denominated in FCY, a 30 percent depreciation of the Lao kip inflated the nominal value of external debt by 20 percent in 2023.[109] The external debt was 60 percent concessional, denominated in U.S. dollars and with fixed interest rates.[110] Bilateral loans made . up 62 percent of the external debt, with 48 percent held by Chinese creditors (Figures A3.1, A3.2).[111]

Figure A3.1. Public Debt Structure



Source: Ministry of Finance; AMRO staff estimates

Figure A3.2. Public External Debt Structure



Source: Ministry of Finance; AMRO staff estimates

2. Actual external debt repayments were lower than scheduled due to suspension of a significant portion of the repayment, while domestic debt repayments rose because of maturing bonds. The annual external debt service was originally scheduled at USD1.2 billion on average between 2020 and 2023. As fiscal revenues and borrowing in the domestic and foreign markets in FCY terms, fell short of the scheduled FCY debt service during the pandemic, the government suspended external debt repayments to major creditors, with cumulative deferred principal and interest repayments totaling USD1.422 billion and USD470 million, respectively, from 2020-2023.[112] The government also increased its FCY borrowings in the domestic market, mostly from banks, following the downgrade by the Thai-based credit rating agency TRIS Ratings in 2023. Despite the debt suspensions, actual FCY debt

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[105] Prepared by Ravisara Hataiseree, Economist, and Somphone Changdabout, Associate.
[106] The scope of public debt in this report and the debt sustainability analysis refers to government debt and excludes SOE debt.
[107]Between 2022 and 2023, external public debt increased from LAK187.3 trillion to LAK225.2 trillion, and domestic public debt from LAK25.7 trillion to LAK49.5 trillion.
[108] Public investment arrears amounted to LAK33 trillion, about LAK10 trillion of which was settled by triangulation bonds and investment bonds in 2021. In 2023, the government issued more triangulation bonds of LAK4.1 trillion and used the budget to clear another LAK1 trillion of public investment arrears. The amount remaining as of end-2023 was LAK18 trillion. The government issued yet more triangulation bonds, worth LAK3.9 trillion, in the first half of 2024.
[109] Although the nominal value of external debt in kip terms increased by 20 percent from 2022 to 2023, the external debt-to-GDP ratio declined from 87 percent to 85 percent mainly due to inflation, with the external debt in U.S. dollar terms remaining stable at USD10,517 million in 2022 and USD10,525 million in 2023.
[110] Concessional debt stock accounted for 60.4 percent of external public debt, slightly increased from 59.7 percent in 2022, in line with the government's efforts to limit commercial borrowing and rely more on concessional or non-debt financing sources to support projects and debt servicing. External public debt was largely held in U.S. dollars, accounting for 59 percent of total external debt. Around 85 percent of total debt is subject to fixed interest rates, alleviating interest rate risk.
[111] The public debt structure and external debt structure, shown in Figures 8.1 and 8.2, are based on the 2023 Debt Statistic Bulletin.
[112] Estimated deferred principal and interest payments included USD202 million in 2020, USD426 million in 2021, USD594 million in 2022, and USD670 million in 2023.

repayments nearly doubled from USD507 million in 2022 to USD950 million in 2023,[113] with amortization and redemption of commercial bank loans and bonds comprising 74 percent. Domestic debt repayments rose by 16 percent to LAK5.7 trillion in 2023 due to maturing Treasury bills and government bonds that had been issued for deficit financing and arrears clearance. The repayments were made against the backdrop of a relatively short government bond maturity profile due to the small domestic bond market, which is dominated by commercial banks in the absence of long-term institutional investors.

Baseline Debt and GFN Projections

3. Lao PDR's public debt-to-GDP ratio is projected to decline from its peak in 2023 but will remain high in the next several years. AMRO's baseline scenario assumes a more gradual pace of kip depreciation[114] and inflation over the medium term (Table A3.1). It is also assumed that the government will be able remain current on the schedule of debt repayment from 2024 onward but excluding the past suspended debt. The debt-to-GDP ratio is hence projected to decrease to 74 percent by 2028 from 103 percent in 2023, reflecting robust economic growth and continued primary surplus, and notwithstanding higher borrowing costs (Figure A3.3). The authorities plan to reduce public debt by about 5 percentage points by 2025 by strictly implementing debt management policies. This includes limiting new borrowing to prioritized projects which are expected to generate sufficient returns to repay debt, and by reducing the issuance of guarantees. However, the debt-to-GDP ratio is expected to remain higher than pre-pandemic levels in the medium term, and relative to the international benchmark of 41 percent of GDP for low-income countries.[115]

Table A3.1. Macroeconomic and Fiscal Indicators

	2018	2019	2020	2021	2022	2023	2024p	2025p	2026p	2027p	2028p
Macroeconomic indicators (%)											
Real GDP growth	6.2	5.5	3.3	3.5	4.4	4.2	4.5	4.6	5.0	5.0	5.0
GDP deflator	2.0	1.2	2.8	3.6	11.6	18.2	14.2	10.6	5.3	5.2	5.1
Headline Inflation	2.0	3.3	5.1	3.8	23.0	31.2	25.0	15.0	9.5	8.2	7.6
Effective interest rate	3.3	3.2	2.7	2.0	2.7	2.7	3.6	4.1	4.5	4.9	5.2
Exchange rate (LAK/USD, avg.)	8,403	8,689	9,054	9,744	14,316	18,707					
Fiscal indicators (% GDP)											
Revenue	16.2	15.6	12.7	14.7	14.8	17.4	17.0	17.3	17.2	17.1	16.9
Expenditure	20.9	18.8	17.9	16.0	15.0	16.6	17.7	18.3	18.3	18.4	18.4
Fiscal balance	-4.7	-3.3	-5.2	-1.3	-0.2	0.7	-0.7	-1.0	-1.1	-1.3	-1.4
Primary balance	-3.0	-1.5	-3.7	-0.1	1.6	2.9	2.5	2.5	2.4	2.3	2.2
Public debt	58.8	58.8	61.9	76.2	98.8	103.4	98.6	86.9	82.0	77.1	74.0
Gross financing needs	9.6	8.7	11.2	8.1	8.4	11.2	12.2	10.8	8.9	8.4	7.7

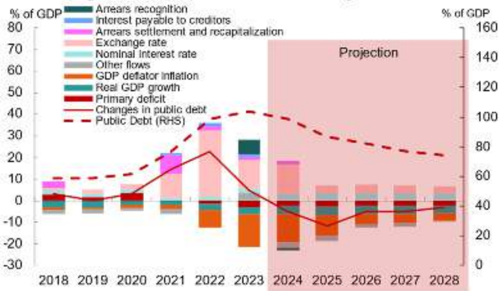
Source: LMOF; LSB; CEIC; AMRO staff estimates
Noted: The macroeconomic and fiscal indicators for 2024-2028 are based on AMRO staff estimates and projections.

4. The authorities expect GFNs to decline after 2024 due to a continued primary surplus and reduced reliance on debt financing. GFN movements are influenced by the debt repayment schedule, with the primary balance expected to remain in surplus over the medium term, supported by ongoing revenue reforms and economic growth. Using scheduled debt repayment figures published in the government's latest debt bulletin for 2024 to 2028, GFNs are projected to surge to 12.2 percent of GDP in 2024,[116] driven mainly by higher FCY financing needs. Indeed, without debt suspension, scheduled external debt service payments would average about USD1.4 billion annually between 2024 and 2028 (Figure A3.4). Challenges in securing FCY financing have been exacerbated by higher refinancing costs due to greater reliance on short-term debt rollovers and more difficulties in issuing bonds overseas, especially after the sovereign downgrade in September 2023. Against this backdrop, the government is

[113] Without external debt suspension, the scheduled repayment would have been USD1.62 billion in 2023.
[114] The inflation rate is expected to slow at a more gradual pace compared to the pace of kip depreciation due to inflation persistence and elevated inflationary expectations.
[115] The indicative threshold of 35 percent for the present value (PV) of debt-to-GDP ratio, suggested by the IMF and the World Bank, has been adjusted to 41 percent for the nominal value of debt-to-GDP ratio for more intuitive comparison with the projected nominal ratios. See AMRO's 2022 Lao PDR Annual Consultation Report, Box A1.2, for more details.
[116] The GFNs in 2024 would double from 12.2 percent of GDP to 25.4 percent of GDP if the suspended external debt of USD 1.892 billion from 2020-2023 is included in the repayment for 2024.

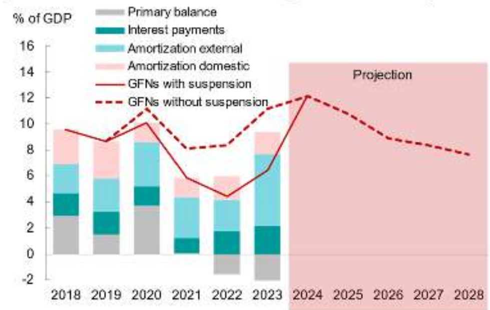
exploring non-debt financing sources such as asset privatization, and debt restructuring with major creditors to ease pressure on debt servicing and lower GFNs over the medium term. The debt service payments for domestic currency debt are projected to average LAK5.3 trillion per annum between 2024 and 2028.

Figure A3.3. Public Debt Dynamics



Source: Ministry of Finance; AMRO staff estimates
Note: Arrears settlement and recapitalization refer to bonds issued to clear public investment arrears and inject capital into SOEs, respectively. Arrears recognition refers to identified public investment arrears under government verification.

Figure A3.4. Gross Financing Needs Components



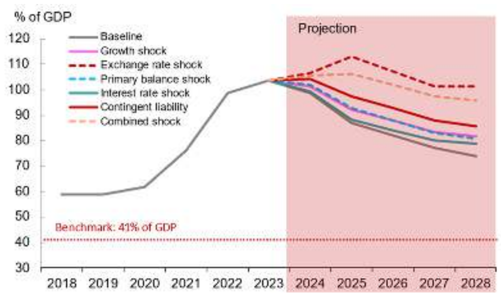
Source: Ministry of Finance; AMRO staff estimates
Note: Debt suspension to major creditors began in 2020 and is assumed to have ended in 2023. Amortization for external and domestic debt from 2024 onward follows the 2023 Debt Statistic Bulletin's schedule.

Macro-Fiscal Risks – Stress Tests

5. Stress test results suggest that Lao PDR's debt dynamics are particularly sensitive to kip depreciation and the materialization of contingent liabilities.[117] Further kip depreciation will continue to inflate the stock of public external debt in local currency terms, delaying debt reduction. If the kip were to depreciate by the same magnitude as in 2022-2023, the debt to-GDP-ratio could increase to 113 percent of GDP in 2025 (Figure A3.5). A weakening of the financial positions of SOEs would lead to contingent liabilities materializing, which would push up government debt. Despite robust fiscal consolidation plan, the primary balance could worsen due to lower-than-expected revenue. Likewise, the GFNs, which are already elevated, are sensitive to a sharp deterioration in the primary balance and to the materialization of contingent liabilities (Figure A3.6). While excluded from the stress test, the recognition of new arrears, if any, would lead to a spike in the debt stock and GFNs, further aggravating debt sustainability risks.

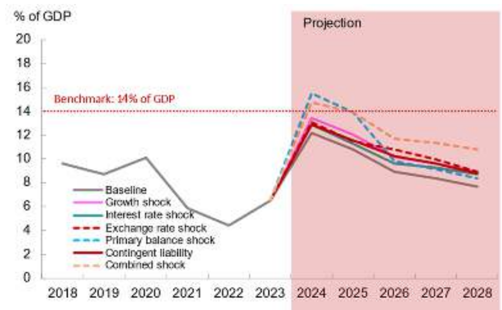
[117] The scenarios for the stress test are as follows: 1) Real GDP growth shock: one standard deviation, or a -1.6 percentage point shock in 2024 and 2025; 2) primary balance shock: one standard deviation, or a -2.6 percent of GDP shock in 2024 and 2025; 3) interest rate shock: a +3 percentage point shock from 2024; 4) exchange rate shock: a shock of 38.8 percentage points in kip depreciation in 2024 and 2025, comparable to the average magnitude of depreciation in 2022 and 2023; 5) contingent liability shock: a shock of 5 percent of GDP in 2024 and 2025, assuming 30 percent of guaranteed and non-guaranteed of SOEs debt, or 10 percent of GDP, will be realized as public debt during these two years; and 6) combined shock: combination of growth, primary balance, interest rate and exchange rate shocks, each at half the size of the individual shocks described in bullet points 1-4. The GFNs between 2018 and 2023 are actual, reflecting the debt suspension to major external creditors from 2020 to 2023. The current DSA assumes that no repayment of past suspended debt is made between 2024 and 2028.

Figure A3.5. Public Debt Stress Test



Source: Ministry of Finance; AMRO staff estimates

Figure A3.6. GFN Stress Test



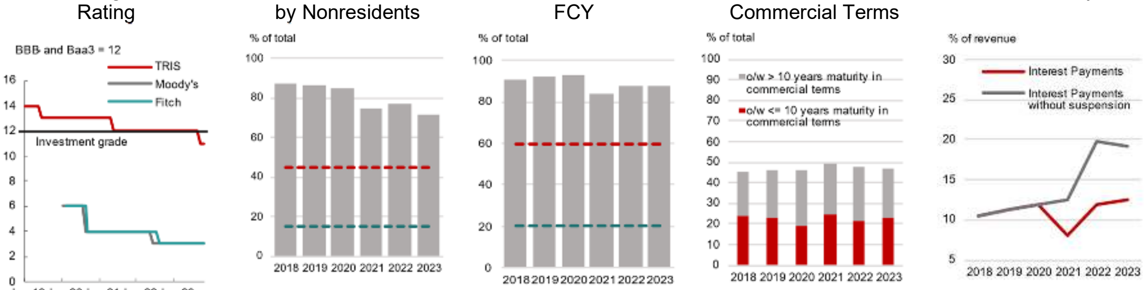
Source: Ministry of Finance; AMRO staff estimates
Note: Given the large portion of commercial borrowing, the GFN threshold for low-income countries with market access is applied at 14 percent of GDP to assess market-financing pressure, as suggested by the IMF and the World Bank.

Market Perception of Risk and Debt Profile Vulnerabilities

6. While several aspects of the government's debt profile have improved, vulnerabilities remain (Figure A3.7). Credit ratings for Lao government bonds were downgraded to below investment grade in September 2023 (Figure A3.7a), reflecting pressure from the sharp kip depreciation and high inflation on the government's capacity to service external debt amid low foreign reserves and limited financing options. The share of public debt held by nonresidents declined to 71 percent in 2023, its lowest in five years (Figure A3.7b). The share of public debt in FCY is now below pre-pandemic levels but remains elevated at 87 percent, with an increasing share of domestic debt in FCY (Figure A3.7c). Furthermore, public debt on commercial terms decreased from 50 percent of total public debt in 2021 to 47 percent in 2023, in line with the government's ongoing efforts to limit commercial borrowing and seek more concessional loans (Figure A3.7d). Despite a decline in the interest payment-to-revenue ratio from 2022 to 2023, the ratio remains elevated at close to 20 percent of government revenue, reflecting increased domestic debt requiring higher interest rates and the valuation effects of kip depreciation on interest payment in FCY (Figure A3.7e).

Figure A3.7. Debt Profile Vulnerabilities

a. Sovereign Credit Rating | b. Public Debt Held by Nonresidents | c. Public Debt in FCY | d. Public Debt on Commercial Terms | e. Interest Payments



Source: CEIC; Haver; TRIS; Ministry of Finance; AMRO staff estimates
Note: 1) --- Lower early warning (50 percent of the benchmark), --- upper early warning (75 percent of the benchmark).

Overall Assessment

7. The results of the DSA indicate that the overall risks to public debt sustainability are high. The public debt-to-GDP ratio is projected to decline going forward, but will remain highly vulnerable to a range of shocks, in particular kip depreciation and the materialization of contingent liabilities. An incurrence of new expenditure arrears could also undermine debt sustainability. While the authorities expect GFNs to fall after 2024, significant risks remain arising from high FCY financing needs and limited access to international capital markets. This implies a greater need to mobilize FCY financing from domestic sources, including tax and nontax revenues. GFNs are also sensitive to sharp deteriorations in the primary balance. On a positive note, the government has achieved a primary balance surplus in recent years and plans to maintain it over the medium term.

8. In efforts to restore public debt sustainability, the stabilization of macroeconomic conditions is crucial. Measures to address difficult macroeconomic challenges must be prioritized, in particular efforts to reduce inflationary pressures and to restore exchange rate stability. Stabilized macroeconomic conditions can contribute to an improvement in the sovereign credit rating and increased market access at lower costs, alleviating the pressure on foreign reserves. Further development of domestic financial markets can facilitate bond issuances domestically. At the same time, stronger governance and fiscal discipline is needed to prevent arrears from building up again. To close the FCY financing gap, enhanced efforts are needed to boost financing from non-debt sources and to negotiate and reach agreement on a comprehensive debt restructuring plan with major creditors. SOE reforms also have to be accelerated to contain risks arising from contingent liabilities. To ensure a sustainable reduction of public debt, the government should prioritize expenditure allocation toward projects or programs that can boost potential growth.

Table A3.2. Heatmap of Public Debt Sustainability

		2018	2019	2020	2021	2022	2023	2024p	2025p	2026p	2027p	2028p
Public Debt												
Gross Financing Needs												
Debt Profile	Public Debt Held by Non-residents											
	Public Debt in Foreign Currency											
	Sovereign Credit Rating											

Source: AMRO staff estimates
Note:
1) For Public Debt, the cell is highlighted in green if the benchmark is not exceeded under all shocks or baseline, yellow if exceeded under any specific shock but not baseline, and red if the benchmark is exceeded under baseline.
2) For Gross Financing Needs, the cell is highlighted in red due to the debt suspension with major creditors and high financing risks. Despite the GFNs-to-GDP ratios under the stress test exercise is below the 14 percent threshold in baseline scenario and exceed the threshold under certain shocks in 2024 and 2025, financing risks in Lao PDR remain substantial. The financing capacity and availability in Lao PDR are largely constrained by the sovereign credit rating downgrade by TRIS, partial repayment of on-lending debt from SOEs, a shallow domestic market, and limited access to the international bond market.
3) For Debt Profile, the cell is highlighted in green if the country value is less than the lower early warning benchmark, red if the country value exceeds the upper early warning benchmark, and yellow if the country value lies between the lower and upper early warning benchmarks. For Sovereign Credit Rating, the cell is highlighted in red if the rating falls below investment grade.

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