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Dollarization in Laos: Evidence, Causes, and Policy Implications

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Abstract

Laos is only one of a few countries in ASEAN(after Cambodia) that has experienced *de facto* a dollarized economy since the early 1990s and this situation has continued to prevail even until to date. This paper defines dollarization in the case of Laos(or sometimes is called currency substitution) as the holding by residents of a large amount of theirs assets in the form of foreign currency-denominated assets(i.e. US dollars and Thai Baht).

Firstly, the paper begins with the basic analysis through the examination of patters of dollarization experience in the Lao economy and then discusses the causes of dollarization during 1990s. The paper presents evidence on the relatively large size of dollarization as measured by foreign currency deposit to broad money in the banking system. The preliminary evidence is empirically clear that Laos can be regarded as a highly dollarized economy. This is because, for example, the use of foreign currency currently represents more than 70 percent of broad money. Residents in Laos are already used to quoting prices and carrying out transactions in foreign currency, especially large transactions are made in foreign currency, either in U.S. dollars or Thai Baht. The reserve requirements of commercial bank are met with both domestic and foreign-denominated assets; deposits and loans in the domestic banks denominated in

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foreign currencies are generally high and have risen rapidly compared with domestic currency. Dollarization in Laos appears to have directly caused by macroeconomic instability such as episodes of high inflation and rapid currency devaluation. This situation has been observed similarly in several Latin America countries or those transition economies. However, this paper also believes that indirect causes were also behind the surge of dollarization(close trade link, economic openness resulting in large foreign currency in forms of foreign investments and etc.).

Secondly, this paper believes that dollarization in Laos is rather unofficial than official ones and the national authorities neither sought nor encouraged it. It is mainly due to aforementioned factors. In this context, the question arises as to what are the possible policy options for the national authorities to undertake in the wake of very high dollarization. This paper, therefore, goes on to shed some light on policy options that may be adopted to deal with the prevalence of dollarization. It stresses the importance of economic stability to affect dollarization, especially to avoid high inflation and rapid currency devaluation. In addition, improvement of financial infrastructure (domestic payment system etc.) has also an important implication. The policy options suggested here are appropriate in the short to medium term.

Keywords: Dollarization, Causes, and Policy Implications

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