Improving the Business Environment
Through Constructive Dialogue

Lao Business Forum-13th

Position Paper on the perceived legitimization of the parallel market and enforcement of foreign exchange regulations

Presented by: Ms. Carli Renzi, Representative from the Financial Service Sector Working Group, President of Australian Chamber of Commerce in Lao PDR

- With respect to His Excellency the Prime Minister and Chairman of the meeting;
- And to all participants.

I, on behalf of AustCham and the Financial Service Sector Working Group, have the honor to present to His Excellency a position paper regarding the foreign currency shortage in Laos and perceived legitimization of the parallel market due to low enforcement of foreign exchange regulations.

This topic cuts across banks, leasing companies, insurers and all of our customers. Currency convertibility and volatility are among the largest financial risks in Laos.

Background

Laos has a single official exchange rate for conversion of US Dollars (USD) to Lao Kip (LAK), which is set at a trading band of +/-0.25 of the Bank of Laos' (BOL's) reference rate (9,533 as of 23 July 2021).

However, there are many exchange shops and bureaus who fail to comply with the BOL Agreement (No. 801 / BOL dated 05 October 2015) by setting the exchange rate of the US dollar in excess of the limits set by the BOL.

During July, the parallel market was reaching LAK 12,000 at some venues.

Financial Services Working Group Observations

Prior to the financial services working group meeting, it was observed that it was increasingly difficult for banks to source USD within the trading band of the official exchange rate, even without any profit margins (i.e. buying at the selling rate).

Customers that require foreign currency, for imports, debt repayments or dividends are having their orders unfulfilled and in desperation are forced to buy USD in the parallel market, thus perpetuating the problem and increasing the margin of difference.

Based on the experience shared by the banking sector, it is estimated that the parallel market has ~10x the depth of the official market during normal times, although from time to time there are short bouts of illiquidity.

Perceived Legitimacy

The Financial Services Working Group observations indicate that the supply of USD to the parallel market is not merely the scatterered remittances of travellers or offshore remittance from individuals. During COVID-19 times this would be minimal. Rather, USD is arriving from larger exporting companies, who are availing of the shortage in USD to demand higher pricing and increase their profits. They perceive this as legitimate business gains.

Individuals and customers who buy USD in the parallel market do so because they have no choice and indeed from an accounting perspective it is difficult to explain why LAK assets lose more value than the official rate when converted.

However sellers of USD in the parallel market do so for profit alone. This also makes it possible to book according to official rates in accounting by removing the illegal FX gains from company records at personal gain to individuals.

Consequences are unlikely because rules, including the Law on Foreign Currency Management, No: 55/NA, dated: 22 December 2014; the Agreement on Foreign Currency Business, No: 393/BOL, dated: 2 July 2020; and the Agreement on reference exchange rate between LAK and USD and foreign currencies exchange rates of commercial banks and money exchange shops, No. 801, dated 5 October 2015 are not widely enforced. Indeed the parallel market is perceived to be legitimate as one can even go to the BOL website to see observed parallel market rates https://www.bol.gov.la/exchang_rate_all. Likewise, almost all invoices from companies in Laos have a USD equivalent that is discounted relative to the official LAK equivalent. This is considered 'Business As Usual'.

Implications for Lao economy

The parallel market for foreign currency deprives the Lao PDR economy of its monetary policy sovereignty. It limits the role of the BOL to merely regulation because the central bank cannot ensure scarce foreign currency inflows to the country are prioritized, for example to purchase necessary imports or repay debt, when most of the flow is through parallel markets.

The BOL acknowledges some of these negative implications and awards exemptions to some priority industry companies or state-owned enterprises to permit domestic USD payments and/or hold capital in USD. However, these exemptions likewise reduce the supply of USD available for conversion. It means transactions are not flowing into the domestic economy, and only net amounts are converted in LAK, thus perpetuating supply-side challenges in official markets.

Implications for Lao PDR as an investment destination

The Financial Service Working Group observed that there are winners and losers to Lao PDR's parallel market, however the 'winners' are few, including the exchange bureaus and commercial banks that breach licensing requirements by trading outside of the trading band, as well as individuals and companies who receive USD and can convert to LAK through parallel market counterparties at higher rates.

Meanwhile any and all other individuals, businesses, as well as the Lao PDR Government itself, lose. By implication, the parallel market reduces the quality of foreign investment and decreases business competitiveness and ease.

The concern from a foreign investment and business competitiveness perspective is that the low quality, low integrity companies that do not abide by laws are rewarded, while high quality companies are penalized. For example, the biggest losers are those high-quality foreign investors and companies who are left with convertibility challenges when they refuse to use the parallel market to source USD and strictly abide with laws and regulation. They end up with trapped LAK capital, which is depreciating at ~5% per annum and no means to buy imports, pay foreign currency debts or repatriate local currency profits to overseas parent companies.

Developments since the Financial Services Working Group meeting

The BOL responded in a letter to the LNCCI on the Financial Services Working Group observations. This letter addressed the methods employed by the BOL for enforcement, including regular and ad-hoc inspection/monitoring both legal and illegal foreign currency exchange shops.

However, since the Financial Services Working Group meeting in October 2020, the parallel market rates have deteriorated even more.

Based on the sophistication with which the parallel market operates, it can be difficult to trace the flows, which can be masked with several offshore and onshore bank accounts, or as payments inwards and outwards for goods and services rather than foreign currency conversions. Higher rates can be masked with rounding, payments in kind or by service fees.

In their response letter, the BOL also acknowledged its objective to gradually convert illegal operators to operate legally. To this end, earlier this month, the BOL outlined a proposed model which aligns foreign exchange shops to banks through the Agreement to Change the FX shop to be the FX Agent of Commercial Banks No. 758, dated 12 July 2021.

If this notice results in fewer illegal operators, and improves transparency of foreign currency transactions through the alignment of FX agents to commercial banks, this could be a break-through. However, as with existing rules, the true test will be on enforcement.

A single account through which foreign currency inflows and outflows are traceable from agents to the banks would make audit of rates, relative to the trading band, easier for the BOL. However, the BOL will need to be vigilant for other payments-in-kind, fees or off-record payments between counterparts which gross-up the rate paid for USD beyond official rates and create an uneven playing field among banks.

Proposed Recommendations:

Some proposed recommendations have been summarized, but members of the Financial Services Working Group are eager to work with authorities on solutions, in an ongoing capacity, given their expertise in local and overseas markets as well as sight on the trade and capital flows inbound and outbound for Laos.

1. **Penalties:** Increase penalties for exchange bureaus or commercial banks in breach of their licensing who trade outside the official rate. Given how time-consuming and resource intensive audit can be, financial penalties should be highly discouraging to illegal operators.

    - Audit and identify these parallel market operators by following the supply of USD (i.e. from exporters) to LAK.

    - Greater penalties for companies who provide pricing which reflects parallel rather than official rates when invoicing in USD and LAK.

2. **FX Flexibility:** Introduce greater exchange rate flexibility and transition to a more market-based exchange rate regime (like the Thai Baht (THB) to LAK market).

    - A market-based exchange rate regime would also promote the establishment of FX forwards as a hedging product, which companies could use to manage risks; and promote a deeper interbank market and greater competition.

3. **Level the playing field so businesses can compete for FX flows:** Given the heightened difficulty to source USD, consider a period of forbearance for foreign companies in Laos to retain capital in USD or make domestic USD payments and gradually transition to LAK-only domestic payments, LAK capital and LAK-only lending (this phasing in is similar to how Cambodia applied). As an alternative, consider removing legacy special exceptions granted to some businesses which allow them to make domestic USD payments, or hold capital in USD (i.e. level the playing field so businesses can compete for FX inflows).

    - For example, when Vietnam faced foreign currency shortages 10 years ago, they required that exporters, including state-owned companies, convert their export proceeds to local currency and then convert back to foreign currencies when they are required to make import payments.

4. **Financial Incentive to Hold LAK:** Require that no interest be paid on foreign currency deposits, therein encouraging individuals and companies to hold a greater proportion of funds in local currency deposits (this method was also used by Vietnam).