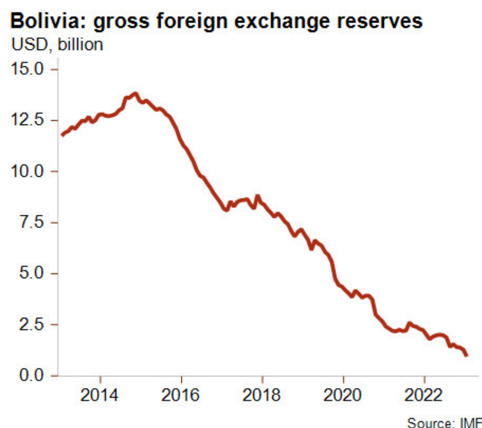
Bolivia: Downgrade from 6/7 to 7/7 for MLT political risk | Credendo

Second downgrade in almost two years, mainly due to quickly decreasing liquidity

Bolivia was downgraded twice in almost two years: first in November 2021 from category 5/7 to 6/7 and a second time in May 2023 to category 7/7. The main explanation of the latest downgrade is the quick depletion of foreign exchange reserves (see graph below) in combination with the lack of fiscal consolidation, the preference for unorthodox macro-economic policies and the absence of concrete prospects for large-scale support from official creditors. Liquidity is in dire straits with foreign exchange reserves in January 2023 amounting to only a fourth of their level of November 2021, when the country was last downgraded. Moreover, the foreign exchange reserves are likely to stand much lower today as Bolivia's central bank stopped publishing data. The very low foreign exchange reserves, in combination with the currency peg, make the country vulnerable to a confidence and currency crisis as illustrated by the mini run on the boliviano in March. The banking sector is placed under large pressure as a consequence, with a lack of USD due to the illiquid position of the central bank and the practice of lending to the central bank with currency swaps. As the government seems unwilling to loosen the peg, the risk of unorthodox policies, non-payment and non-transfer is high in the medium term.



Bolivia's economy has turned a page after an impressive commodity boom

During Morales' rule, the country surfed on a commodity boom with high minerals (Bolivia exports gold, silver, zinc and tin) and hydrocarbon prices (Bolivia mainly exports gas, but only to its neighbours). During these years, the country profited from robust economic growth and current account surpluses, and built up a huge foreign exchange reserves buffer. However, since 2015, macro-economic indicators have been steadily deteriorating due to lower gas prices and production, caused

by vast underinvestment. The government's interventionist policies, such as price and export controls and an overvalued peg, put additional pressure on the economy and the country's exports. Consequentially, real GDP growth more than halved from on average 5% between 2005 and 2016 to around 2.2% between 2016 and 2022. Furthermore, the country posted current account deficits of on average -4% of GDP since 2015. The deficits have led to an external debt build-up and dwindling foreign exchange reserves as foreign direct investment (FDI) has been only a small financing source. FDI inflows are depressed since Bolivia went on a nationalisation spree in 1999 and because of continued interventionist policies. As a result, foreign exchange reserves, excluding gold, stand at only a tenth of their peak in 2014 (see graph above) and at only a couple of weeks of imports in January 2023. The central bank also holds gold, but the government is reluctant to sell these gold reserves worth around USD 2.7 billion. External debt, on the other hand, rose to almost 40% of GDP end 2022, coming from almost 27% of GDP end 2014. Though debt ratios stand in theory at manageable levels, they stand at their highest levels since 2005, when the country benefited from debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). On the upside, debt is mainly long-term debt from multilaterals (for around two thirds of external debt) and bilateral debt (about a tenth of total external debt). Eurobonds account for almost a fifth of gross external debt. That being said, the ratio of debt service to current account revenues is projected to be at a relatively elevated level. Given the very low level of foreign exchange reserves, fulfilling the external debt payment obligations will be very challenging already this year.

Regional reliance on fossil fuels from Bolivia is declining

In the medium term, macro-economic fundamentals are forecasted to deteriorate further. Economic growth forecasts are expected to remain lacklustre, with an expected average growth of 1.9% in 2023-2025, while the current account balance is expected to remain elevated at -3 % of GDP on average in the same period. Regional reliance on fossil fuels is declining due to an accelerated green transition and preference for domestic market production. For example, in Argentina, a pipeline, which stretches from the world's second-biggest shale oil and gas fields far west of Buenos Aires, is set to start operating in June. That will reduce Argentina's need to import gas from Bolivia shortly, while Bolivian gas exports are likely to be halted in 2030 in order to continue to supply the domestic market. Hence, Bolivia is likely to turn into a net fuel importer in 2030, though some sources estimate the country was already a net fuel importer last year. Also in the coming years, FDI inflows are forecasted to be relatively stable but remain a small source of income to finance the current account deficit, amid interventionist policies. Hence, a further decrease of foreign exchange reserves and external debt issuances will be necessary to fund the current account deficits. On the upside, Bolivia's vast and undeveloped lithium deposits, the largest deposits in the world, hold great potential. In January 2023, a consortium of Chinese companies announced a deal to produce lithium by 2025.

However, the terms of the Chinese deal have not been made public and unrest could erupt if locals do not feel fairly compensated, which would delay production. Moreover, the country remains vulnerable to natural disasters, notably droughts, floods and wildfires, which could hurt the economy.

A large devaluation is necessary but difficult amid vivid memories of hyperinflation

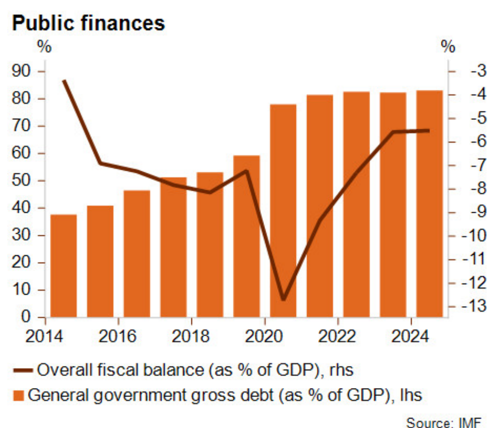
Bolivia is heading to an illiquid situation, mainly because of its determination to keep an overvalued peg. Since November 2011, Bolivia has a fixed exchange rate of 6.9 boliviano per USD, which resulted in low and stable inflation. The very low level of foreign exchange reserves is not sufficient to defend the overvalued peg. A large devaluation is necessary, but that is a political decision the government currently refuses to take. A devaluation would hurt especially poor households and the country still has a vivid memory of the hyperinflation in the 1980s. However, if the government would decide to abandon its peg and implement some macro-economic reforms, the country would see its illiquidity situation quickly improve. That being said, the combination of the current administration's fondness for ideological and interventionist policies, its staunch commitment to the current exchange rate and the lack of an independent central bank, elevate the risk of capital controls or foreign exchange shortages. In the current context of decreasing liquidity, the short-term political risk has a negative outlook.

Banking sector is vulnerable to bank runs and bank nationalisations

The low foreign exchange reserves are impacting the banking sector as well and making it vulnerable to bank runs and confidence crises. First of all, the banking sector has been experiencing large USD deposit outflows since the beginning of March, triggered by rumours of a USD shortage and devaluation of the boliviano. Secondly, while banks appear to have sufficient USD assets to face their outstanding USD liabilities on paper, their USD assets are lent to the central bank in a currency swap and made up half of the foreign exchange reserves end 2022. Given that international reserves are low and continue to fall, it is likely that the central bank's debts to banks remain outstanding. The IMF highlighted that this practice of banks lending to the central bank was increasing the bank-sovereign nexus and "creating the risk that these reserves would be unavailable in the event the financial system comes under stress." The central bank has recently reached an agreement on loans with foreign institutions, such as the French Development Agency and the Inter-American Development Bank (IADB), and other loans are currently being negotiated. While these are temporarily easing liquidity pressure on banks, it is unlikely that they will suffice for banks to service all the USD withdrawals. In the current context, with a government that prefers unorthodox policies, bank nationalisations are a possibility when banks face a bank run, as illustrated by the nationalisation of one of the country's largest banks, Banco Fassil, on 27 April, allegedly because of mismanagement.

Bolivia is likely to default on its sovereign debt in the medium term, especially on its bonds

Public finances are weak. The government spent much of the windfall from natural gas on fuel subsidies and inefficient state firms. Since 2014, public debt has more than doubled to 82% of GDP end 2022, a high level for a lower-middle-income country (see graph below). The main explanation is the falling gas production which weighs on revenues, while the government refuses to enact fiscal consolidation as this can easily trigger unrest. Looking forward, public debt is expected to continue to rise to 88% of GDP in 2025. In the past, fiscal deficits were funded mainly by multilaterals. However, this pattern is changing: about 40% of the fiscal deficit was financed by central bank credit in 2021. Private domestic sources, mostly pension funds, financed another 40%, with the remainder coming from external sources. Looking ahead, large spending cuts and decreased public investments – the motor of domestic economic growth in the past – are necessary but could lead to more political instability. Since April, the country seems to have lost market access and an important Eurobond matures in 2028. There are no concrete prospects for large-scale support from official creditors and the country is reported to have bad relations with the IMF. Hence, the sovereign's ability to repay debt is in fact primarily determined by the central bank and its willingness to monetise the fiscal deficit. Monetary financing, in the context of the fixed exchange regime, drains foreign exchange reserves and is an unsustainable solution in the medium term. Given the very poor liquidity and low willingness to consolidate public finances, a sovereign debt default is very likely, especially on its bonds, which could have a large and adverse effect on the economy.



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