TORINO ECONOMICS

A Torino Capital Group Company

BOLIVIA IN FOCUS

SEP 2018

HARD LANDING AHEAD

Francisco Rodríguez

Chief Economist

Bolivia was able to maintain sensible macroeconomic management during the commodities boom up to 2014, putting it in a favorable position when prices began to fall. But it failed to implement the necessary macroeconomic adjustments, and current data indicate that it is on the threshold of a classic balance of payments crisis.

TABLE OF CONTENTS

Hard Landing Ahead

BOLIVIA
IN FOCUS

TORINO ECONOMICS

- *Bolivia has benefitted from more than a decade of favorable commodities prices and prudent macro management.*
- *The country maintained expansionary policies as commodities prices fell, leading to the emergence of twin deficits.*
- *Morales's attempt to seek a third term in office will raise political risks.*

KEY ECONOMIC INDICATORS	
Population (million ppl):	11.1
GDP nominal (USD bn):	37.5
GDP per capita (USD):	3,395
Economic growth (%):	4.2
Poverty (%):	36.4
Inflation (%, eop):	2.7
Fiscal deficit (% of GDP):	7.8
Current account (% of GDP):	-6.3
External debt (% of GDP):	22.4
Debt service (% of exports):	6.4

MACROECONOMIC OUTLOOK

Over the last decade, Bolivia has boasted exceptionally strong macroeconomic performance, driven in part by the boom of commodities prices and – after the decline in natural gas and minerals prices in 2014 – by the government's counter-cyclical macro policies. In the 2010-2017 period, Bolivia was actually the fastest growing economy among 13 countries in South America and the second after the Dominican Republic among 19 countries in Latin America, with its economy expanding at an average annual rate of 5.0%. That said, the external shock suffered in recent years and government macroeconomic policies have contributed to increasing current account and fiscal deficits, giving rise to sustainability concerns.

GDP growth has eased somewhat in recent years, falling in 2017 to 4.2%, its slowest rate since 2010 according to the Central Bank of Bolivia's (BCB) figures. However, the data does show some acceleration towards the end of the year, with the growth rate moving from 3.6% to 4.8% y-o-y between 1H17 and 2H17 (in q-o-q sa terms, from 3.2% to 6.9% annualized). The government has pushed the case that the economy is not slowing, and maintains a growth forecast of 4.7% for 2018, which would continue to put the Bolivian economy at the top of the regional growth ranking.[1] We are slightly more bearish, expecting growth of 4.1% in 2018, but do not yet see a significant further deceleration.

> The economy has continued to expand after the decline in commodities prices due to strong expansionary policies.

Bolivia is highly dependent on natural resource exports. Since the mid-1980s, natural gas has been its most relevant registered export, accounting for more than half of official total export revenue.[2] In 2017, Bolivia's top export products were natural gas (USD 2.6bn), zinc (USD 1.4bn), gold (USD 1.0bn), silver (USD 638mn) and soy (USD 573mn). Between 2003 and 2017, hydrocarbons represented 42.8% of total exports, followed by minerals exports, which account for 30.2%. However, in the last two years, the relevance of minerals has risen, leading them to now account for 46.6% of export proceeds, as opposed to the 33.5% share of hydrocarbons.

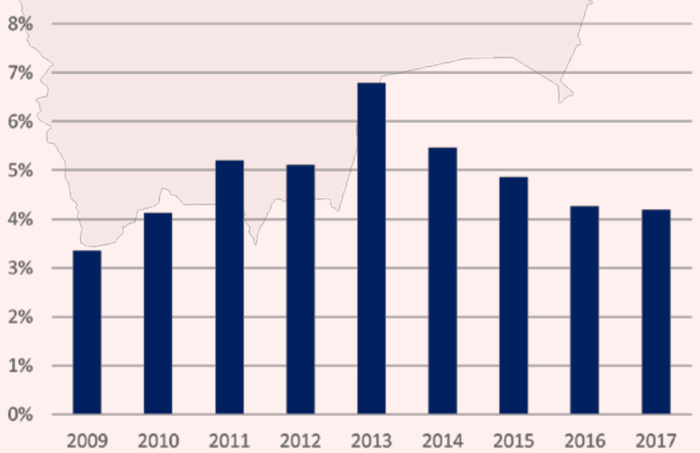
---

[1] "Gobierno boliviano celebra buen ritmo de economía y ratifica el crecimiento de 4,7%" [Bolivian government celebrates economy's upbeat rhythm and ratifies a growth of 4.7%]. *Sputnik, August 10, 2018.*

[2] In the 1980s, some analysts believed that exports of coca paste, or cocaine generated from USD600 million to USD 1 bn annually, depending on prices and output, which represents 30.2% of average exports during that decade. Larrea, Gustavo (2007) "La historia y producción de drogas en el siglo XX: hoja de coca, cocaína y fármacos" [The history and production of drugs in the twentieth century: coca leaf, cocaine and drugs] Universidad Mayor de San Andres.

In terms of GDP, oil and gas account for 6.4% of total output while metallic and nonmetallic minerals represent 5.5%.

Chart 3: GDP Growth



Source: Torino Capital, National Statistics Institute

Bolivia's reserves of natural gas are the largest in South America after Venezuela's. Most of these reserves are located in the eastern region of the country. According to the Hydrocarbons and Energy Ministry (MHE), 88.1% of total gas reserves are in Tarija state, in the South-southeast of the country, 8.2% in Santa Cruz state (east), 2.5% in Cochabamba (central) and 1.3% in Chuquisaca (southeast).[3] Tarija state is also the main gas producing region in the country.[4]

During the most recent year, economic growth was mainly driven by agriculture, finance and manufacturing, each of which respectively contributed 0.9pp, 0.6pp, and 0.5pp to the country's 4.2% growth rate. Agriculture grew at a rapid 7.6% yearly, while some services such as transportation and trade also showed fast growth (5.2% and 5.1%, respectively). Oil and mining, in contrast, contracted by 0.6%, driven by a decline of 2.4% in crude petroleum and natural gas output. Weak external demand – in particular, low demand for gas from Brazil – as well as decreasing productivity of mineral deposits, are the key drivers of this decline.

Oil and gas activities are controlled by the state-owned company *Yacimientos Petrolíferos Fiscales Bolivianos* (YPFB). YPFB is the only company authorized to carry out all production and commercialization activities.[5] The Bolivian Constitution requires the state to have a majority share of joint ventures. However, YPFB is authorized to enter into services contracts with national and foreign companies. Joint ventures with private sector companies are typically formed for extraction services for a period of 40 years and with YPBF owning a 55% share. YPFB also manages a gas sales agreement with Brazil's state-owned oil company, Petrobras, and another agreement with Argentina. Recently, because of the lack of investment in the sector (especially in exploration) and a reduction in the levels of proven reserves, the government began issuing incentives and exemptions[6] to

[3] "El 84% de las reservas probadas de gas de Bolivia está en Tarija" [84% of Bolivia's proven gas reserves are in Tarija]. *La Razón, January 9, 2012.*

[4] The southern state of Tarija, located on the border with Argentina, has seen significant economic growth in recent decades, thanks to the exploitation of its natural resources, bringing it to be the state with the second-lowest poverty rate in the region. Apart from natural resources, the state also has a highly diversified agricultural activity, with vine and vegetable crops.

[5] "Bolivia". *Latin lawyer, July 25, 2017.*

[6] Since 2014, Bolivia's Government has adopted a more open attitude to the markets, with the aim of attracting greater investments to the country. That year it approved the Investment Promotion Law, which guarantees legal security for national and foreign investment, though it also stipulates that public investment has priority over private investment and establishes that Bolivia no longer recognizes international arbitration forums. The law defines

encourage investment.[7] In November, it signed deals with several international oil companies such as Repsol, Shell and Pan American Energy, which are expected to draw in USD1.6bn of investments and boost output in the next two years.[8]

Currently, the government is attempting to attract investment in exploration in order to raise stagnating gas production. Between 2006 and 2017, only two new foreign companies started gas exploration projects in the country: YPF Argentina in the area of Abapó and Gazprom in the blocks of Acero and Ipati-Aquío.[9] Last November, Bolivia signed natural gas exploration and production agreements with three multinational companies. This year, it signed another contract with Gazprom, involving USD 1.2 bn investment in exploration and production.

The Bolivian Constitution also reserves the mining sector to the state, which grants rights of exploitation and development to state operators, private operators and joint venture entities. These acquire production property rights, but not rights to the unexploited reserves. Investment has remained stagnant after a new Mining and Metallurgy Law was approved in 2014. The law codified the stipulations set out in the 2009 Constitution and established, among other things, that there will be no more mining concessions. Contracts in the sector must be signed between private companies and the state mining company, COMIBOL. Contracts between cooperatives and private companies were forbidden, triggering conflicts among mining unions and the government.[10] The government approved changes to the law in 2016, delimiting even more the conditions under which cooperative miners can seek to enter into contracts with private mining companies.[11] There has also been a change in the tone of Morales's discourse towards private and foreign investment, especially in the mining sector,[12] triggering the interest of both old and potentially new investors.[13]

The pace of economic growth has remained solid so far in 2018, with GDP growing 4.4% y-o-y in 1Q18, driven mainly by a rebound of goods and services exports, which had contracted for the prior three years, as well as resilient household consumption (4.0% y-o-y). The fastest-growing economic activities in 1Q18 were agriculture (6.6% y-o-y), financial establishments (6.4%), and crude oil and natural gas (6.0%). In the case of this last sector, its strong recovery is only a partial rebound from its 14.1% decline in the same period of last year. On the other hand, metallic and non-metallic minerals shrank by 2.3% y-o-y.

---

incentives as fiscal or financial benefits or advantages granted by the State on a temporary basis (1 to 20 years), which may include tax reductions or exemptions and production stimulus. The ministry that oversees the sector of a particular investment may submit a request for an incentive to the Ministry of Planning, which evaluates the project, decides whether it qualifies as a preferential investment (in the case of specific incentives), and issues a recommendation to the Council of Ministers on whether the incentive should be granted.

[7] "Bolivia – Hydrocarbons". The International Trade Administration (ITA), June 22, 2017.

[8] "Bolivia says signs $1.6 billion in gas deals with Repsol, Petrobras". Reuters, November 21, 2017.

[9] "Evo invita a firmas a invertir, pero en 11 años solo dos llegaron al país" [Evo encourages companies to invest, however, only two arrived to the country in 11 years]. El Deber, November 22, 2017.

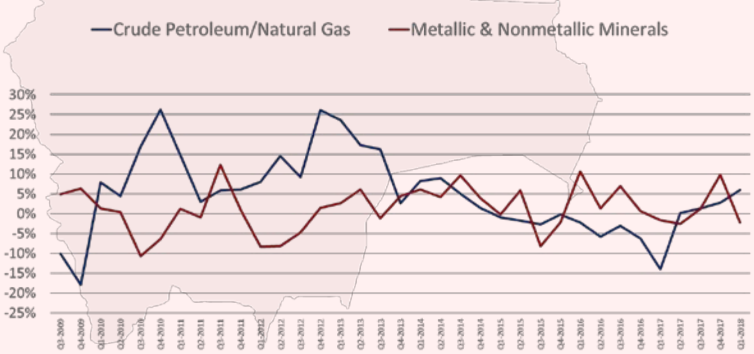
[10] "Bolivia passes mining law that bans partnerships with multinationals". Mining.com, June 5, 2014.

[11] "What's Behind Bolivia's Cooperative Mining Wars?". The North American Congress on Latin America, November 22, 2016.

[12] "In June 2016, at a UK-Bolivia trade and investment forum in London, the minister on mining and metallurgy referred to a new set of safeguards to protect foreign investors in Bolivia. Likewise, Bolivia's Attorney General, Héctor Arce, stated last year that investors should expect no further nationalizations in the future." "Bolivia's new mining laws and the future of private investment". Global Risk Insights, September 19, 2016.

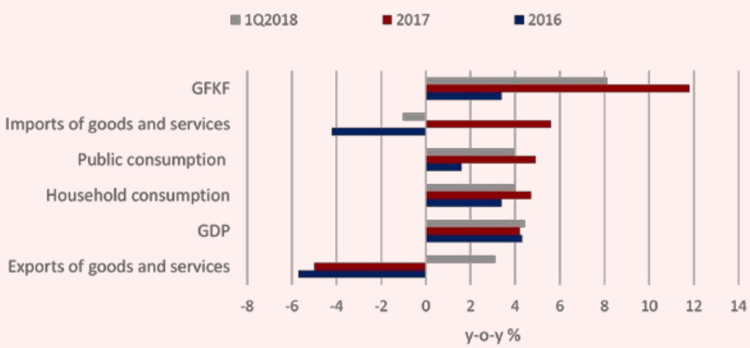
[13] "Mining in Bolivia: overview". Reuters, 2018.

Chart 4: GDP Growth by Selected Economic Activities



Source: Torino Capital, National Statistics Institute

Chart 5: GDP Growth by Aggregate Demand Category



Source: Torino Capital, National Statistics Institute

Bolivia's economic boom continues to be investment-driven, with gross fixed capital formation growing at 11.8% in 2017, followed by public and private consumption (4.9% and 4.7%, respectively). The external sector was a negative drag on growth last year, with exports dropping by 5.0% and imports growing by 5.6%. Public spending continues to be an important growth driver, with the public sector now accounting for 63% of total investment. This pattern continued into 1Q18, with investment driving growth at 8.1% y-o-y but imports now contracting in y-o-y terms.

MONETARY POLICY AND INFLATION

Bolivia's currency is the boliviano (BOB). Bolivia has had a fixed exchange rate system since 1987. The BOB is currently pegged to the USD at a rate of 6.86 BOB/USD for buying and 6.96/USD for selling. The currency's most recent adjustment was in November 2011, when authorities completed a sequence of mini-revaluations that totaled a 1.6% increase in the value of the BOB over a 13-month period. The decision to let the currency appreciate responded to the Central Bank's decision to focus on maintaining purchasing power and controlling price inflation, thus lessening the emphasis on maintaining competitiveness.[14]

The decision to revalue in 2010-11 occurred in a context of strong terms of trade. However, following the collapse of commodity prices in 2014, the country pursued expansionary fiscal policies and chose not to devalue the exchange rate. The country had ample international reserves to carry out this policy: at USD 15.1bn by the end of 2014, reserves represented 18 months of that year's imports. Reserves fell to USD 10.1bn over the next two years (15 months of 2016 imports). They have since stabilized as the country tapped international financial markets.

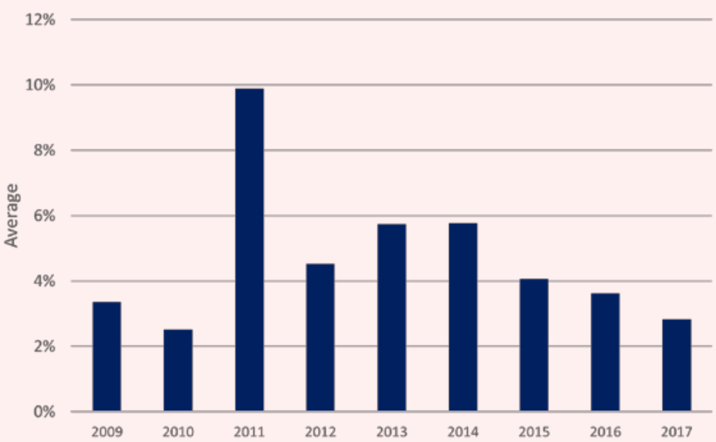
Bolivia's Central Bank follows a policy of quantitative monetary targeting, in which the primary target is the growth rate of the central bank's net domestic credit.[15] Targets are set through an annual monetary program, in which they are determined in conjunction with the overall fiscal balance target and net credit to the public sector. The program includes an inflation estimate that is indicative of the central bank's inflation target for the year, along with other key macroeconomic assumptions.

[14] Central Bank of Bolivia "Informe de Política Monetaria. Enero 2018" [Monetary Policy Report. January 2018]. February, 2018.

[15] International Monetary Fund "Inflation Dynamics and Monetary Policy in Bolivia" December 18, 2015.

The BCB uses open market operations as its main policy instrument to manage liquidity and control inflation. It has also used other instruments, including one-off savings bonds issuances accessible to the general public and management of banks' reserve requirements to control excess reserves in the banking sector. The use of these instruments has been effective in keeping inflation under control in the environment of high liquidity from hydrocarbons exports prevalent since 2006. Inflation averaged 4.7% between 2009 and 2017 with a deceleration trend evident in the last three years (**Chart 6**).[16]

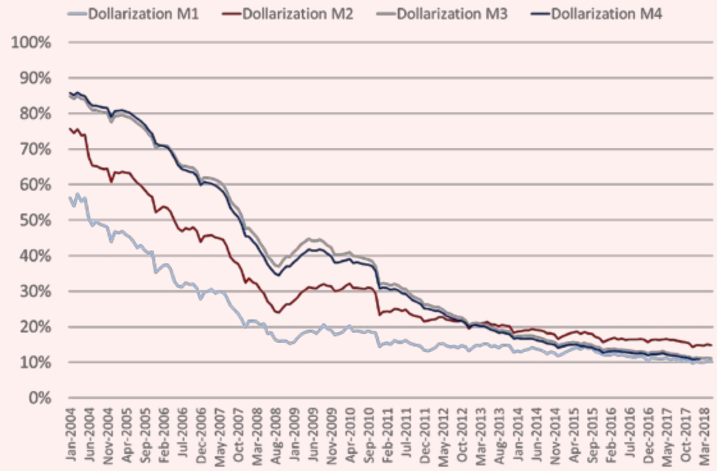
Chart 6: Inflation



Source: Torino Capital, Central Bank

As is the case in many countries that have suffered hyperinflations, Bolivia's economy is partly dollarized. However, the rate of dollarization has fallen significantly in recent years, stabilizing at around 10-15% - from 55-85% in 2004, according to BCB figures. De-dollarization has been helped by the creation of indexation mechanisms such as the "Housing Development Unit" (*Unidad de Fomento de Vivienda*, UFV). When launched in 2001, this unit of account was designed to protect the value of deposits in local currency against high inflation. As of 2003, the UFV began to be used in fixed-term, savings and current accounts. UFV deposits surged initially, peaking in 2008 as greater price stability convinced many Bolivians to move directly into local currency deposits.

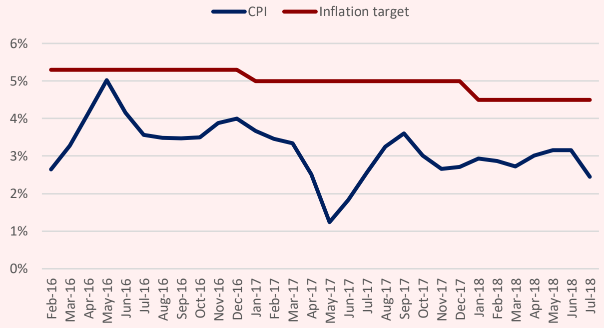
Chart 7: Dollarization Indexes (% of monetary aggregate)



Source: Torino Capital, Central Bank

The Central Bank describes its current policy stance as accommodative. In its more recent monetary policy report, it states that this is a continuation of the policy stance adopted in 2014, that aims at "ensuring adequate liquidity levels as well as holding interest rates of public securities close to zero."[17] It also claims that the fixed exchange rate system has helped anchor public expectations and contributed to keeping imported inflation under control. This argument is correct as a description of short-term dynamics but begs the question of the sustainability of continued government deficits and the ability to accommodate them with limited sources of financing. Nevertheless, inflation remains low for now, coming in at 2.5% in July.

Chart 8: Consumer Price Index



Source: Torino Capital, Central Bank

[16] Guerson, Alejandro."Inflation Dynamics and Monetary Policy in Bolivia". *International Monetary Fund. December 18, 2015.*

[17] Central Bank of Bolivia. "Informe de Política Monetaria Enero 2018" [Monetary Policy Report January 2018]. *February, 2018.*

EXTERNAL ACCOUNTS

While growth has remained robust, the adverse external shock that began in 2014 together with the boost of internal demand has contributed to an expanding current account deficit, as import volumes have risen, and export volumes have fallen. Because of lower hydrocarbon revenues, this has led to international reserves losses and higher fiscal and external deficits. Between 2015 and 2017, the current account deficit has averaged 6.0% of GDP, as opposed to a surplus of 5.7% of GDP in 2008-14. In 2017, the current account worsened to USD 2.4bn (6.3% of GDP). The economy's financing needs in 2017 were covered by a combination of net capital inflows and issuance of sovereign bonds.

So far in 2018, the recovery in commodities prices has helped reduce Bolivia's current account deficit. The current account reached a deficit of USD 435mn in 1Q18, 42% less than the same period of last year (USD 749mn). This is mainly due to a substantial increase in exports, which rose 22.0% in y-o-y terms (USD 2.03bn) while imports remained unchanged at USD 2.08bn. The result was an 88% reduction in the trade balance deficit, which fell from USD 428mn in 1Q2017 to USD 53mn in 1Q18.

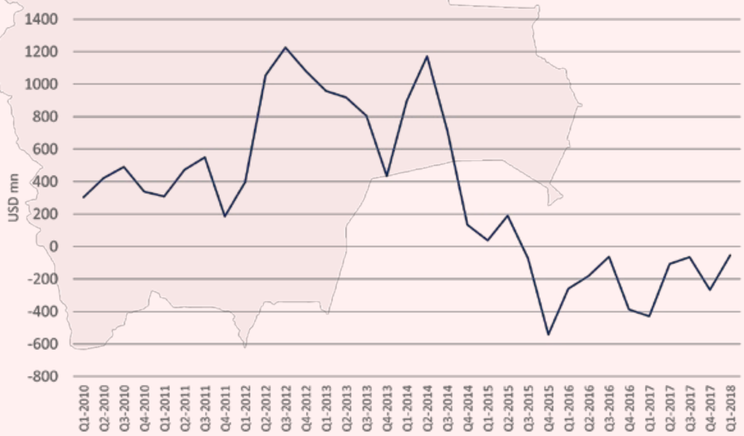
TABLE 1: External Accounts

	2016	% GDP	2017	% GDP	Var. %	1Q2017	1Q2018	Var. %
Current Account	-1,932	-5.7%	-2,375	-6.3%	22.9%	-749	-435	-42.0%
Trade balance	-889	-2.6%	-869	-2.3%	-2.2%	-429	-53	-87.6%
Exports	7,000	20.6%	7,752	20.7%	10.7%	1652	2028	22.8%
Imports	7,889	23.2%	8,621	23.0%	9.3%	2081	2081	0.0%
Service balance	-1,613	-4.8%	-1,657	-4.4%	2.7%	-368	-393	6.8%
Primary Income	-621	-1.8%	-1,122	-3.0%	80.7%	-213	-274	28.4%
Secondary Income	1,191	3.5%	1,273	3.4%	6.9%	261	285	9.5%
Remittances	1,032	3.0%	1,105	2.9%	7.1%	253	281	11.0%
Capital Account	5	0.0%	5	0.0%	4.3%	1	1	0.0%
Financing needs	-1,926	-5.7%	-2,369	-6.3%	23.0%	-748	-433	-42.1%
		0.0%		0.0%				
Financial Account	-2,257	-6.6%	-2,690	-7.2%	19.2%	-751	-811	8.0%
Direct Investment	-246	-0.7%	-645	-1.7%	161.6%	-130	-199	53.4%
Portflio Investment	932	2.7%	-1,213	-3.2%	-	-738	77	-
Other Investment	104	0.3%	-821	-2.2%	-	100	-138	-
Reserves Assets	-3,046	-9.0%	-12	0.0%	-99.6%	17	-551	-
Errors and omissions	-330	-1.0%	-321	-0.9%	-2.8%	-3	-378	14166.9%

Source: Torino Capital, Central Bank

The 1Q18 exports recovery is due to the rise in hydrocarbons and minerals exports. Natural gas exports, which account for 33.4% of total exports, rose by 36.4% y-o-y in 1Q18, while zinc and gold exports rose respectively by 31.6% and 63.6% in the same period. Demand for natural gas rose sharply in key trading partners, particularly Brazil. Non-traditional products showed an increase due to the surge in the exported volume of some items such as sugar and chemical products. Growing family remittances also strengthened the current account: remittances rose 7.1% in 2017 and in 1Q18 accelerated to a double-digit pace of 11.0% y-o-y. Bolivia's remittance receipts, at USD 1.29bn in 2017, are equivalent to 16.6% of its exports and originate in transfers from emigrants to Spain (32,8%), United States (17%), Argentina (14,4%), Brazil (11,9%) y Chile (9,7%).

Chart 9: Trade Balance



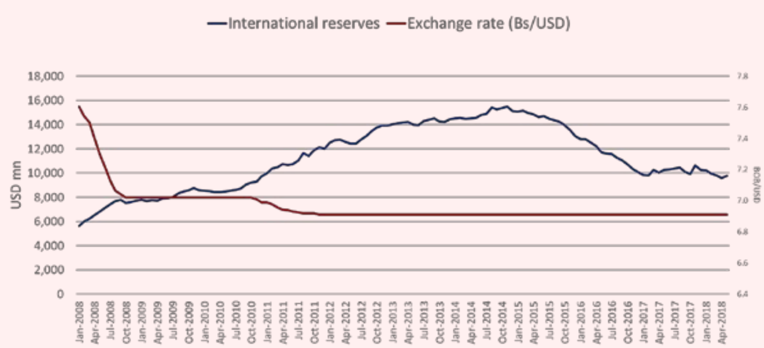
Source: Torino Capital, Central Bank

The economy received net financing for USD 811mn during 1Q18, according to the financial account of its balance of payments statistics, a similar amount to that received in 1Q17 (USD 751mn). One of the contributors was increased foreign direct investment (FDI) as well as other investment, but the main source of financing in the quarter were Central Bank reserves, which saw a decline of USD 551mn.[18]

Bolivia's exchange rate system can be described as an "incomplete crawling peg," where the exchange rate is fixed but undergoes micro-readjustments that are not pre-announced to the public.[19] The parallel rate closely tracks the official rate, suggesting the market finds the Central Bank's policy acceptable. The Central Bank has argued that given the context of high volatility of exchange rates in the region, its policy has anchored depreciation expectations, helped strengthen the financial de-dollarization process, and contributed to maintaining the low levels of inflation, providing support for the expansionary monetary policy executed since 2014.

While the BCB argues that a fixed exchange rate policy has had positive results without generating persistent misalignments of the real exchange rate with respect to its long-term level, the IMF in its Article IV recommendations concluded that central bank exchange rates are stronger than the levels suggested by macroeconomic conditions. It also pointed out that high rates of growth in real wages in recent years have implications for external competitiveness under a fixed exchange rate regime. The IMF baseline medium-term forecast points to persistent fiscal and external current account deficits and further reserve losses due to excess domestic demand and persistent structural competitiveness problems. Against this background, the Fund expects foreign currency reserves to come under pressure again, even as they stabilized in 2017 at the expense of a build-up of external debt.[20]

Chart 10: International Reserves and Exchange Rate



Source: Torino Capital, Central Bank

[18] Central Bank of Bolivia. "Avance de cifras del Reporte de Balanza de Pagos y Posición de Inversión Internacional" [Advanced figures of the Balance of Payments Report and International Investment Position]. *January 2018.*

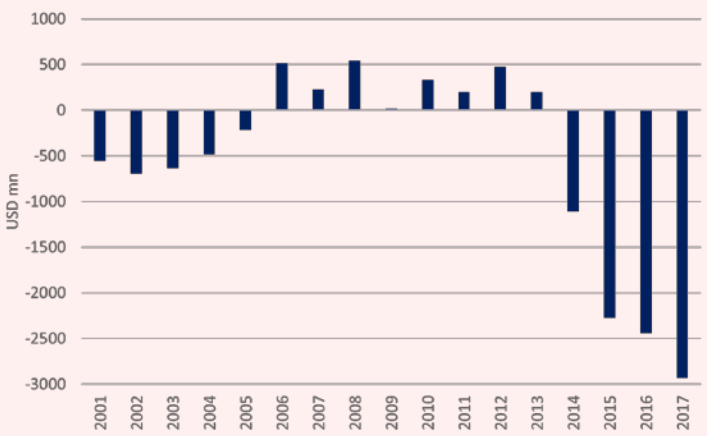
[19] "Bolivia - Foreign Exchange Controls" *The International Trade Administration (ITA), July 21, 2017.*

[20] International Monetary Fund. "2017 article IV consultation—press release; staff report; and statement by the authorities of Bolivia" *December, 2017*

FISCAL ACCOUNTS AND DEBT

The combination of higher gas and oil royalties and the nationalization of several companies in 2006 allowed Bolivia's public sector to run fiscal surpluses for eight years before commodity prices dropped in 2014. Since that year, the government has been raising public spending despite the decline of fiscal revenues. As a result, the overall fiscal result for the consolidated public sector passed from a surplus of 0.6% of GDP in 2013 to a 7.2% deficit in 2016. Last year, spending continued growing faster than revenues, and the deficit rose to 7.8% of GDP. At the level of the central government, trends have been similar: we have seen an increase from a USD 6.8bn (3.2% of GDP) deficit in 2013 to a USD 13.0bn deficit (5.0% of GDP) in 2017.

Chart 11: Overall Public Sector Balance



Source: Torino Capital, Central Bank

We expect these trends to continue into 2018, as the government appears determined to maintain buoyant domestic demand. The Financial Fiscal Program unveiled by the Ministry of Economy and Public Finance and the Central Bank on February 6 foresees growth being bolstered by expansions in construction and public works. According to the IMF, the government has stated that it is aware of the prevailing risks of the current strategy but expects that large-scale investment projects will raise productivity and provide high enough returns to safeguard growth and fiscal sustainability over the long term.

Recent deficits have been financed by the Central Bank and foreign borrowing. Public debt, however, remains moderate given that in the last decade the government has borrowed mainly in local currency and with long-term maturities.[21] Bolivia's outstanding external debt is at USD 9.58 bn as of May [22]; 76.3% is owed to bilateral and multilateral institutions, and USD 2bn is in the form of sovereign bonds. The May figure represents an increase of 1.6% compared to the 2017-end figure (USD 9.43bn).[23] During the 2017 fiscal year, 24 foreign debt loans were contracted, including an issue of sovereign bonds for USD 1bn earmarked for public investment projects, including health and infrastructure projects. Currently, Bolivia has three severing bonds outstanding with maturities in 2022, 2023 and 2028.

On May 23, Standard and Poor's downgraded Bolivia's issuer rating from BB to BB-, with a stable outlook. In a press release, the agency said that a significant trade balance deficit generates uncertainty for potential lenders. Standard and Poor's argues that the privileged position that Bolivia had acquired during the commodity boom has weakened and cites a strong politicization of the economy as a risk factor.

On the other hand, in August 2017 Moody's changed the outlook on Bolivia's bond ratings to stable from negative and affirmed the ratings at Ba3. The rating has remained unchanged since then.

[21] "The growth-interest rate differential is advantageous at this time, and public debt levels and financing needs are moderate. The authorities wisely mitigated public debt sustainability risks by lengthening the maturity of debt, increasing the share of domestic debt in local currency during the boom years, and borrowing mostly at fixed interest rates thereby reducing risks and costs associated with possible volatility in interest rates. The public sector has accumulated deposits equivalent to 18 percent of GDP (September 2017), further reducing financing risks." IMF IV Article

[22] Central Bank of Bolivia "Estado Mensual de la Deuda Externa Pública de Mediano y Largo Plazo al 31 de mayo de 2018" [Monthly Report of Medium and Long Term External Public Debt as of May 31, 2018]. 2018.

[23] Central Bank of Bolivia "Informe de la deuda externa pública al 31 de diciembre de 2017" [Public external debt report as of December 31] 2017.

TABLE 2: Basic Features of Bolivia Bonds

Bond	Issued (mn)	Outstanding (mn)	Cpn	Maturity	Issue date	Crncy	Maturity type	Current Px	% change since low	52 week high	52 week low	High Date	Low Date	260d Price Vol	Mod Dur	YTM
Bolivia	2,000	2,000														
BOLIVI 22	500	500	4.875	10/29/2022	10/29/2012	USD	Bullet	101.6	4.0%	106.8	97.7	9/14/2017	6/28/2018	3.3	3.7	4.3
BOLIVI 23	500	500	5.95	8/22/2023	8/22/2013	USD	Bullet	103.9	2.8%	113.1	101.1	9/8/2017	6/29/2018	3.3	4.3	4.8
BOLIVI 28	1000	1000	4.5	3/20/2028	3/20/2017	USD	Sinkable	92.6	6.3%	99.5	87.1	1/26/2018	6/29/2018	5.4	6.8	5.5

Source: Torino Capital, Bloomberg

The agency argued that the drivers for the change were Bolivia's stabilizing fiscal and current account deficits which suggest that the impact of lower hydrocarbon prices on the sovereign's credit profile has been contained and the expectation that Bolivia's growth, fiscal and external metrics, although weakened, are likely to remain consistent with its Ba3 rating. Fitch has kept Bolivia's sovereign ratings at BB- (outlook stable) since July 2016, when it said that Bolivia's ratings are supported by its strong external balance sheet, firm economic growth, and moderate public debt burden with low refinancing risk and debt service costs.

Public debt is still at moderate levels (34.4% of GDP at the end of 2017), which gives the authorities room to adjust policies more gradually to the permanent terms-of-trade shock. However, under current policies, fiscal and external deficits will persist and remain large in the medium term in our view, and we are concerned at the government's reluctance to cut spending or undertake significant reforms on the revenues side.[24] Furthermore, if the exchange rate is overvalued, equilibrium GDP in US dollars is lower and debt ratios should also be higher. The IMF staff recommended in its Article IV report[25] a moderate reduction in the non-hydrocarbon deficit by about 1.2% of GDP per year aimed at stabilizing public debt and slowing reserve losses while still providing space to pursue social development objectives.

POLITICAL OUTLOOK

Bolivia is ruled by Evo Morales, a former coca farmer who is one of the region's most prominent leftist leaders. Morales has been in power since 2006 and is currently serving his third term in office (the second full term under the 1999 constitution). He is running for a fourth term in elections scheduled to be held in October of 2019. Even though Morales lost a referendum on a proposal to allow him to run for a fourth term in 2016, in November 2017 the country's Constitutional Court declared term limits unconstitutional, paving the way for Morales's re-election.[26]

The ruling party, the Movement Towards Socialism (*Movimiento al Socialismo*, MAS) currently holds a two-thirds majority in both Chambers of the country's bicameral legislature. The center-right National Unity (*Unidad Nacional*, UN) party is the second most important in terms of congressional representation, with the Christian Democratic Party (*Partido Demócrata Cristiano*, PDC) occupying third place.

Morales's approval rating currently stands at 43%, according to a survey conducted by Ipsos in August. This represents a decline of

[24] On 25 May, Standard & Poor's downgraded Bolivia's credit rating from BB to BB-, citing its large current account deficit. Nevertheless, this mainly reflects the sizeable import component of equipment and capital goods that have underpinned Bolivia's public and private investment drives, which are adding to the country's potential growth.

[25] International Monetary Fund "2017 article IV consultation—press release; staff report; and statement by the authorities of Bolivia" *December, 2017*

[26] "El Tribunal Constitucional de Bolivia autoriza a Evo Morales a buscar la reelección como presidente sin límites" [The Constitutional Court of Bolivia authorizes Evo Morales to seek re-election as president without limits]. *BBC, November 29, 2017.*

six percentage points in a year, and his disapproval rating is now at 52%. 29% of respondents claim they intend to vote for Morales's re-election. According to the survey, he would defeat former president Carlos Mesa – who claims he does not intend to run – by a slim 29-27 margin, with UN leader Samuel Doria Medina (9%) and Santa Cruz governor Rubén Costas (7%) coming in behind them. Costas would benefit from strong support in Santa Cruz, where he is actually running second, behind Morales.[27] Morales is highly unpopular in La Paz, the country's capital, where his disapproval reaches 92%, but retains strong support in rural sectors and among indigenous Bolivians.

Congress recently approved a reform of the Law of Political Organizations that mandates political parties to hold primaries for the presidency in 2019. The law, which was pushed forward by the governing MAS party, is seen as part of an attempt to lend greater legitimacy to the Morales candidacy. However, the requirement that these primaries be held in January of 2019 – an earlier draft of the law delayed implementation to 2024 – could create problems for the fragmented opposition, forcing it into a candidate selection process at a time at which alliances have not yet been fully negotiated.[28]

We expect fiscal and external deficits to remain large as the government appears determined to maintain buoyant demand.

OUR VIEW

We expect Bolivia to continue to grow in the near-term as the government doubles down on expansionary macro policies ahead of the October 2019 presidential elections. Sustainability concerns, while valid, are not likely to lead to any imminent stop in growth. We expect growth of 4.1% in 2018 and 3.9% in 2019. This is in line with the view of multilateral organizations such as ECLAC and IMF, which forecast growth between 3.9% and 4% of GDP for 2018. The Bolivian official target is somewhat more optimistic, with GDP growing at 4.7% in 2018. However, a slowdown in gas demand from Argentina and Brazil could begin to restrain growth.

Inflation remains low for now. In fact, the 2017 print surprised authorities: at the beginning of last year, the official inflation forecast was 5%, and in September the CBC lowered it to 4.3%, but it actually came in at 2.7%, due to a weakening trend in food prices, falling import prices, and stable administered prices. However, in a context of rising global oil prices, we do not expect these factors to recur. For 2018, the BCB set an inflation target between 3.5% and 5.5%. 12-month inflation now stands at 3.25, and we expect it to rise back again to 3.1% by the end of this year.

Public debt is still at moderate levels, which gives the authorities room to adjust policies more gradually to the permanent terms-of-trade shock. The government is aware of the prevailing risks of the current strategy, but it claims to expect that the large-scale investment projects will raise productivity and provide returns high enough to safeguard growth and fiscal sustainability over the long term.

However, in the absence of a material policy adjustment, we expect fiscal and external deficits to remain large in the medium term, as the government appears determined to maintain buoyant domestic demand (which will keep import demand high). Against this background, foreign currency reserves are likely to come under pressure again, and under the quasi-fixed exchange rate, macro imbalances are likely to lead to a steady decline in reserves, worsening Bolivia's vulnerabilities and forcing authorities at some point in the future to abandon the exchange rate peg implemented since 2011.

Bolivia will sooner or later face a significant macroeconomic adjustment. With a current account and fiscal deficits of 6.3% and 7.8% of GDP, respectively, the country needs to realign its relative prices in order to reduce macroeconomic imbalances. This will require fiscal reforms including very likely a retrenchment in spending. This is, of course, unlikely to take place before the October 2019 elections. In fact, we are if anything likely to see

[27] "La aprobación de Evo baja 6% en un año y Mesa está a dos puntos en intención de votos" [Evo's approval drops by 6% in one year and Mesa is two points in intention to vote] El Deber, August 22, 2018.

[28] "Aprueban primarias en Bolivia en medio del intento reeleccionista de Morales" [Primaries in Bolivia are approved amid Morales' reelection attempt] France 24, August 29, 2018.

more aggressive expansionary policies during the next 12 months as Morales's pre-election drive gets underway.

Barring a dramatic improvement in external conditions and under the continuation of current expansionary policies, we view a hard landing as close to inevitable for the country. The economy may yet continue to tap international markets to keep the music going, but the increase in public debt stock will be clearly unsustainable and the attempt to maintain an over valued exchange rate will likely generate further losses in reserves. Without a structural economic adjustment, the country should sooner or later experience a classic balance of payments crisis.

Morales could lose his re-election bid, a result which would likely be well-received by markets. However, the new administration would probably have to push forward politically costly macroeconomic adjustments in a country that has been living beyond its means for at least the past four years. Bolivia could then turn into a mini-Argentina – a country with a market-friendly government that has international support but is beset by confidence crises and political instability. On the other hand, a re-elected Morales could decide to carry out the necessary adjustments or further delay them, leading to an even more potentially traumatic hard landing.

BOX 1: Economic Data and News Sources

Official economic data sources:

- Central Bank of Bolivia – https://www.bcb.gob.bo/
- Institute of Foreign Trade – http://ibce.org.bo/ibcecifras/index.php?id=663
- Unit of Fiscal Analysis and Studies – http://www.udape.gob.bo/
- Ministry of Finance and Economy – http://www.economiayfinanzas.gob.bo/index.php
- Hydrocarbon Ministry – https://www3.hidrocarburos.gob.bo/
- YPBF (Bolivia's national oil company) - https://www.ypfb.gob.bo/es/
- National Statistics Institute - https://www.ine.gob.bo/index.php

News and other information:

- El Deber [The Duty] newspaper (Spanish) – https://www.eldeber.com.bo/
- La Razón [The Reason] newspaper (Spanish) – https://listindiario.com/
- Bolivian Information Agency (Spanish) – https://www.eldinero.com.do/
- Bolivia en tus Manos [Bolivia in your hands] (Spanish) – https://www.boliviaentusmanos.com/

TORINO ECONOMICS

TABLE 3: Annual Economic Time Series and Forecasts, 2012-2019

Variable	2012	2013	2014	2015	2016	2017	2018	2019 (F)
General indicators								
Nominal GDP (US$ bn)	27.1	30.7	33.0	33.0	33.9	37.5	40.0	41.0
GDP per capita (US$)	2,645.0	2,948.0	3,124.6	3,078.5	3,078.5	3,394.5	3,566.2	3,604.4
Unemployment rate (%)	2.0	2.4	2.0	3.1	3.1	3.1	3.0	3.0
Population (millions)	10.2	10.4	10.6	10.7	10.9	11.1	11.2	11.4
Output and aggregate demand components								
Real GDP growth (% yoy)	5.1%	6.8%	5.5%	4.9%	4.3%	4.2%	4.1%	3.9%
Domestic demand growth (% yoy)	4.2%	7.4%	6.5%	5.6%	3.2%	6.2%	3.7%	3.3%
Real investment growth (% yoy)	2.5%	11.7%	9.9%	5.0%	3.4%	11.8%	-0.2%	3.3%
Real consumption growth (% yoy)	4.6%	6.4%	5.6%	5.8%	3.1%	4.8%	5.4%	3.3%
Real private consumption growth (% yoy)	4.6%	5.9%	5.4%	5.2%	3.4%	4.7%	5.8%	3.3%
Real government consumption growth (% yoy)	4.9%	9.3%	6.7%	9.2%	1.6%	4.9%	3.0%	3.3%
Real export growth (% yoy)	13.3%	4.1%	10.9%	-5.9%	-5.7%	-5.0%	8.3%	5.9%
Real import growth (% yoy)	4.3%	8.2%	15.1%	-5.4%	-4.2%	5.6%	1.0%	3.5%
Prices, wages and exchange rates								
CPI inflation (% yoy, eop)	4.5%	6.5%	5.2%	3.0%	4.0%	2.7%	3.1%	3.5%
CPI inflation (% yoy, avg)	4.5%	5.7%	5.8%	4.1%	3.6%	2.8%	3.8%	2.8%
Minimum wages (% yoy)	22.6%	20.0%	20.0%	15.0%	9.0%	10.8%	3.0%	3.5%
Monetary and credit indicators								
Monetary base growth (% yoy)	19.4%	14.1%	14.7%	6.7%	1.6%	5.8%	7.0%	7.9%
Broad money growth (% yoy)	29.5%	21.0%	18.9%	18.1%	3.7%	11.8%	12.4%	13.3%
External accounts								
Current account balance (% of GDP)	8.3	3.4	1.7	-5.9	-5.7	-6.3	-3.9	-5.3
Current account balance (US$ bn)	2.3	1.0	0.6	-1.9	-1.9	-2.4	-1.5	-2.2
Trade balance (US$ bn)	3.8	3.1	2.9	-0.4	-0.9	-0.9	0.1	-0.5
Exports, f.o.b. (US$ bn)	11.7	12.1	12.8	8.7	7.0	7.8	9.3	9.4
Imports, f.o.b. (US$ bn)	8.0	9.0	9.9	9.1	7.9	8.6	9.2	9.9
Service balance (US$ bn)	-0.3	-0.6	-1.8	-1.6	-1.6	-1.7	-1.7	-1.8
Income balance (US$ bn)	-1.6	-1.9	-1.7	-1.1	-0.6	-1.1	-1.3	-1.5
International reserves (US$ bn)	13.9	14.4	15.1	13.1	10.1	10.3	9.7	9.3
Fiscal accounts								
Central gov. expenditures (% of GDP)	67.8%	72.8%	76.0%	76.0%	58.9%	53.5%	51.0%	48.5%
Central gov. revenues (% of GDP)	71.5%	75.6%	71.3%	67.6%	53.2%	45.7%	43.5%	41.4%
Central gov. primary budget balance (% of GDP)	5.6%	4.1%	-3.3%	-6.8%	-4.7%	-6.8%	-6.5%	-6.0%
Central gov. budget balance (% of GDP)	3.7%	2.8%	-4.7%	-8.4%	-5.7%	-7.8%	-7.1%	-7.5%
Debt Indicators								
Gross external debt (% of GDP)	22.5%	25.1%	25.4%	28.1%	30.4%	31.7%	31.6%	36.3%
Public (% of GDP)	15.6%	17.4%	17.5%	19.2%	20.7%	22.4%	23.3%	27.5%
Private (% of GDP)	6.9%	7.7%	7.9%	8.8%	9.7%	9.2%	8.2%	8.7%
Gross government debt (% of GDP)	31.3%	30.5%	30.1%	31.6%	33.3%	34.4%	36.3%	40.6%
Domestic (% of GDP)	15.7%	13.2%	12.6%	12.4%	12.6%	12.0%	13.0%	13.1%
External (% of GDP)	15.6%	17.4%	17.5%	19.2%	20.7%	22.4%	23.3%	27.5%

TORINO ECONOMICS

A Torino Capital Group Company

800 3rd Avenue, 37th Floor, New York, NY 10022

+1 212 6612400

www.torinocap.com