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Currency devaluation can help boost growth and employment in Bolivia

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Key messages

- Devaluing the exchange rate while reducing government expenditures could help boost growth and employment in Bolivia.
- Short-term inflation is an inevitable result of devaluation but inflation rates increase the least when devaluation is accompanied by a fiscal adjustment.

Is Bolivia heading towards another balance of payments crisis?

Bolivia seems to be heading towards an imminent currency (balance of payments) crisis caused by its fixed nominal exchange rate.

Over the last 20 years, Bolivia has gone from a period of financial crisis (1998-2003) to economic prosperity (2004-2014). But since 2014, the country's economic growth has slowed, gross public debt has increased to about 53% of GDP (15 percentage points), and fiscal savings and international reserves have decreased.

The combination of twin deficits (increasing fiscal deficit and current account deficit), increased external debt, low inflation, and falling international reserves are reminiscent of the economic characteristics of the late 1970s that led to a balance of payments crisis and the inevitable devaluation of the nominal exchange rate at the time.



In November 2011, Bolivia adopted a de facto fixed exchange rate to help stabilize inflation. But now, as gas—the country's main export commodity—is running out, Bolivia's economy is vulnerable again. If this happens, Bolivia has no other commodity to replace gas exports and will likely face a currency collapse unless the government devalues the boliviano (BOB).

A team of local PEP researchers sought to find out whether Bolivia should revise its fixed exchange rate policy, and what policies could help avoid a new currency crisis.

The analysis

The research team used a computable general equilibrium (CGE) model that was calibrated to a new Social Accounting Matrix (F-SAM) for the year 2014—built by the team—to simulate five scenarios and investigate the effects of devaluing the nominal exchange rate:

1 – Business as Usual (BAU) scenario

- The nominal exchange rate remains fixed.
- Provides a comparison for all other scenarios.

2 – Devaluation of the nominal exchange rate scenario

- 15% devaluation (to bring the exchange rate to around 8 BOB to 1 USD)

3 - Policy response scenario

- 15% devaluation and 15% reduction in government expenditures

4 - External shock scenario

- 15% devaluation and 15% increase in the export price of gas (Bolivia's main export commodity)
- The result the government was hoping for so that no adjustment in public spending would be necessary.

5 – Gradual devaluation scenario

- 3% devaluation on the nominal exchange rate in 2020, increasing by 3% each year until reaching a 15% devaluation in 2024, held at this rate thereafter

Key findings

Compared to the Business as Usual scenario:

- **The devaluation scenario had only a transitory effect**

- There was a U-shaped effect on all national accounts variables, i.e., there was a positive effect in 2020, which weakened in 2021 and then recovered in subsequent years.
- The real exchange rate depreciated in 2020 and, to a lesser extent, in 2021.
 - Contrary to policymakers' fears that devaluation would cause inflation and real exchange rate appreciation.
 - This meant that exports increased in 2020 and decreased by in 2021.

- **The policy-response scenario saw growth without inflation**

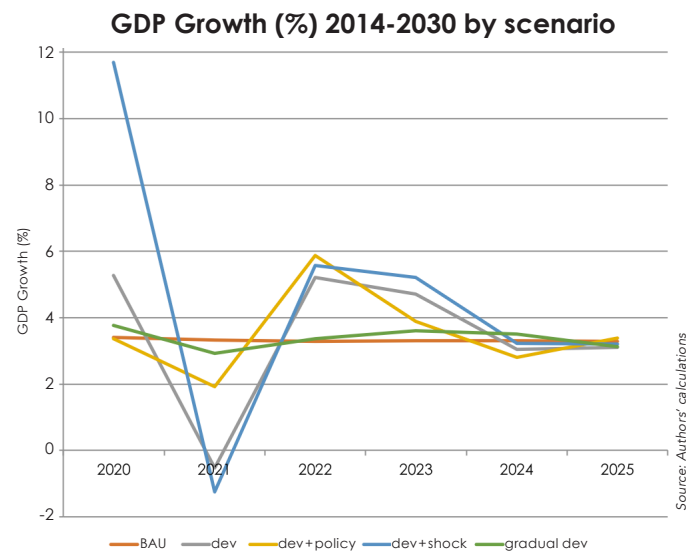
- GDP grew by 3.5%, on average, between 2020 and 2025.
 - Without the volatility of the devaluation scenario.
- There was continuous real depreciation and a continuous increase in exports.
 - These effects corresponded to a large recovery of the current account deficit.
- The average inflation rate between 2020 and 2025 was 1.4%.
- However, unemployment increased significantly in 2020 when the high concentration of employment in the public sector was abruptly reduced.

- **The external-shock scenario produced volatile growth**

- The economy grew by 12% in 2020, but then decreased by 1.3% in 2021.
- The inflation rate soared to 11.7% in 2020.
- Government savings increased, and more so than in the policy response scenario.
 - Due to a larger increase in government savings, which was thanks to export taxes increasing government income.

- **The gradual-devaluation scenario slowly incentivized exports and discouraged imports**

- Exports increased by 2.47% when devaluation was at its peak in 2024.
- Household consumption, private investment, and government consumption gradually increased.



Conclusions and policy implications

The fixed exchange rate policy should be revised before the depletion of the international reserves forces a devaluation of the nominal exchange rate.

The simulation results indicate that the best scenarios for growth come from the policy-response and the external-shock. Given that the external-shock scenario is uncertain and unstable, **the policy-response scenario (devaluation accompanied by a fiscal adjustment) should be applied.**

The policy-response scenario also provides the lowest inflation rate. While gradual devaluation would allow the government to distribute the effects of inflation across the years, it remains higher than under the policy-response scenario.

To reduce the harmful effects on growth of fiscal adjustment (in the policy-response scenario), the literature indicates this should be achieved through cutting expenditures, rather than through tax increases.

To preserve employment, devaluation would need to be implemented when there is a boom in export commodity prices. Unfortunately, it is uncertain when and if this will happen. Therefore, the government should implement devaluation with an aim to preserve economic growth or inflation stability, rather than employment.



This brief summarizes outcomes from **MPIA-20260** supported under the **PAGE II initiative (2016-2020)** and conducted by researchers at INESAD, Bolivia. To find out more about the research methods and findings, read the full paper, published as part of the **PEP working paper series.**



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