

**The Exchange Rate Regime, Trade Policy,  
and Investment Policy of Bolivia:  
Implications for Direction Investment**

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## **Executive Summary**

I do not recommend Bolivia as an attractive country for direct investment based on an analysis of the exchange rate regime, trade policy and investment policy. This recommendation is based on a broad overview of the deterioration of the political situation and rule of law in Bolivia, economic narrow-mindedness and shortsightedness by the executive branch, and the uncertainty caused by the two aforementioned effects of President Evo Morales' time in office.

President Morales bills himself as Bolivia's first indigenous president and in doing so has polarized the north, where Bolivia's indigenous communities are concentrated, and the south, where agriculture and industry have made communities more prosperous. President Morales' efforts to de-marginalize indigenous groups in Bolivia have included inefficient social spending programs and the increased legalization of coca production, which puts him at odds with both Bolivians who oppose his clear favoritism and with the international community which opposes coca because it can be processed into cocaine among other things, and of which Bolivia is the third largest producer in the world. He has also polarized the international community by aligning himself with Venezuela's President Hugo Chavez, who has targeted the U.S. and the capitalist West as his enemies.

President Morales' increasingly tight control over the economy and the political instability that accompanies his term in office has deterred foreign investors and prevented Bolivia from becoming a major energy supplier in South America. According to the American Chamber of Commerce in Bolivia, "In the 5-year period 2003-2007 net FDI averaged just under US\$ 200 million per year, according to the Central Bank of Bolivia, compared with an average net inflow of around US\$ 600 million per year in the previous 5-year period 1998-2002." By

increasing taxes on hydrocarbons Morales has managed to increase short-term revenues but hurt long term prospects for foreign investment in Bolivia's most profitable sector.

In addition, changes to the Constitution passed in January of 2009 also deter foreign investors from Bolivia. Land reform, legislative process reform, and new rules on foreign investment and profits by foreign firms all have the dire effect of driving away any economic opportunity for foreign investors. Political violence, including the recent "assassination attempt" on President Morales has also had the negative effect of driving away investment as well as tourists. In conclusion, I cannot recommend Bolivia as a good investment opportunity despite its wealth of natural resources. The political situation is too unstable and greatly affects any form of commerce in the country. It would be best to steer clear of Bolivia until President Morales leaves office.

### **The Exchange Rate**

Bolivia employs a crawling peg exchange rate regime to regulate its currency, the Boliviano. It periodically adjusts the nominal exchange rate in conjunction with changes in the real exchange rates of its major trading partners, which include (but is not limited to) the United States, Brazil, Argentina, Peru, Colombia, and Venezuela.<sup>i</sup> The Central Bank of Bolivia has committed to keeping the nominal value of the Boliviano stable and has generally not intervened in the past five years, although it allowed slight appreciation in 2007-2008 in response to inflationary pressures from rising food and export commodity prices (see Appendix 2).

Inflation greatly affected the real exchange rate of Bolivia in 2008, peaking at 17.3 percent in June of 2008 but ending the year at approximately 12 percent.<sup>ii</sup> With the recent fall in commodity prices at the end of 2008 inflationary pressures will ease in 2009, but Pres. Morales

is expected to continue his path of expansionary fiscal policy, bringing expected annual inflation up to 8 percent.<sup>iii</sup> This will also cut into the current account surplus (see table below), although it will probably not affect the Central Bank's ability to feed the Bolivian appetite for dollars.

Year	2004	2005	2006	2007	2008e	2009p
Current Account as percent of GDP <sup>iv</sup>	3.9	6.6	11.3	8.7	12.8	.6

The previously rising prices of export commodities greatly benefited Bolivia in a number of ways, despite contributing to inflationary pressures. An export boom led by the hydrocarbon and mining sectors led to positive current account balances, significant real GDP growth, and increased fiscal revenue (and a fiscal surplus), especially after changes to the laws governing taxation of hydrocarbon revenues were enacted in 2005-2006.<sup>v</sup> Exports increased three-fold from 2004-2008, but this trend will probably reverse itself in 2009 due to decreased global demand for Bolivia's natural resources because of the global economic downturn reducing production of goods that require Bolivia's natural resources, political instability in the country, and the possible short-term overvaluation of the Boliviano.

The appreciation of the Boliviano is also due to the relative depreciation of the currencies of Bolivia's trading partners as a result of the global economic downturn. As a result, this year we can expect the Boliviano to become overvalued unless the Banco Central intervenes, as has been recommended by the IMF. In response, the Banco Central will allow the Boliviano to devalue gradually over 2009 and 2010 to maintain Bolivia's export competitiveness.<sup>vi</sup> The effects of the global financial crisis and resulting economic downturn have been much more felt by Bolivia's trading partners because their financial sectors and economies are much more

exposed than Bolivia's; Bolivia is mainly affected by declines in remittances and commodity prices, reducing the current account surplus drawn in 2007-2008.<sup>vii</sup>

### **Trade Policy**

Bolivia's main export markets for agricultural goods are Venezuela, Colombia, Peru, Europe, and the United States; for nonagricultural goods its main export markets are Brazil, the United States, Argentina, Japan, and Korea.<sup>viii</sup> Its greatest exports are mining and fuels, agriculture, and manufacturing.<sup>ix</sup> Bolivia belongs to a number of preferential trade agreements with these countries and others, including MERCOSUR and ALBA, which is the Bolivarian Alternative for the Americas, an invention of Hugo Chavez that includes Venezuela, Bolivia, and Cuba but has not opened new markets so much as symbolized political solidarity and cooperation between the three countries.<sup>x</sup> Bolivia has utilized 86 percent of available preferences from the U.S. and Europe but this only accounts for 3.2 percent of total exports.<sup>xi</sup> It has belonged to GATT since 1990 and the WTO since 1995, and has never been a complainant or respondent in any trade disputes.<sup>xii</sup> Bolivia also has individual trade agreements with Cuba, Chile, and Mexico.<sup>xiii</sup>

Bolivia also belonged to the ATPDEA, or Andean Trade-Promotion and Drug-Eradication Act, sponsored by the U.S. and granting preferential trade terms to Latin American countries compliant in the U.S. war on drugs, until October 2008 when it was suspended due to "non-compliance," evidenced by a substantial increase in coca production sanctioned by President Evo Morales. It is estimated that this suspension could cost upwards of 50,000 jobs in Bolivia and \$400 million in exports to the United States. The Bolivian government is trying to offset this loss by paying the extra duties faced by affected firms and by encouraging its

“friendly” trading partners, such as Venezuela, to import more Bolivian goods in the short term.<sup>xiv</sup> Bolivia has the opportunity to rejoin the ATPDEA in June, 2009, if it shows progress in cutting coca production, but this is unlikely as Morales has the full support of Venezuelan President Hugo Chavez to continue increased coca production.<sup>xv</sup>

Bolivia’s average for MFN-applied tariffs is 8.3 percent, for 2005-2007, down from 9.7 percent from 1995-1999.<sup>xvi</sup> However, this figure may have changed because in early 2008, Bolivia began raising some tariffs to 20 percent (its maximum tariff, from 10 percent) and suspended tariffs on food staples imports (while prohibiting exports of food staples) to increase domestic supply.<sup>xvii</sup> Previously, none of Bolivia’s agricultural imports were duty-free, while all of its agricultural exports to Venezuela, Colombia, Peru and the U.S. were duty free.<sup>xviii</sup> Collectively, manufactures, machinery, and transport equipment face the lowest tariffs. Bolivia’s tariff dispersion was .3 when the maximum and average tariffs were 10 percent and 8.3 percent, respectively.<sup>xix</sup>

The Doing Business Report, published by the World Bank, ranked Bolivia at 150 out of 181 countries in 2009; only Haiti and Venezuela are ranked below it in the LAC region. The number of procedures required to start a business in Bolivia stands at 15, compared to the regional average of 9.7 and the OECD average of 5.8. The cost of starting a business, as a percent of GNI per capita, is 112.4, compared to 39.1 percent regionally and 4.9 percent in the OECD countries. Alarming, the Legal Rights Index, which measures accessibility to credit and the Extent of Disclosure Index, which measures transparency in transactions, both measure a 1 out of a possible 10, compared to 5.6 and 4.1 respectively in the region, and 6.8 and 5.9 respectively in OECD countries.<sup>xx</sup>

Bolivia's trade restrictiveness is comparable to other countries in the Latin American and Caribbean region and to other countries in the Lower Middle-Income Countries group, categorized by the World Bank. It "imposes few specific import standards," according to the U.S. Trade Representative.<sup>xxi</sup> Favorably, Bolivian exports face lower tariffs in export markets compared to LAC or LMIC members; however, its exporters' access to international markets is less favorable than that of the other countries in these groups, likely due to its geographic location (one of two landlocked countries in South America) and its lack of supply chain infrastructure.<sup>xxii</sup>

### **Investment Policy**

Bolivia's Investment Law, enacted in 1990, gives foreign firms relative ease in investing in Bolivia, at least on paper. It guarantees national treatment, no special registration requirements, no restrictions on repatriation of profits, and the right to international arbitration.<sup>xxiii</sup> However, firms must deal with arbitrarily enforced and ill-interpreted regulations and slow legal processes that prevent economic efficiency. In addition, the new constitution reflects hostility toward foreign investment and Article 320 specifically states that "Bolivian investment will be prioritized over foreign investment," according to analysis by Bolivia scholar James M. Roberts of the Heritage Foundation. The new constitution contradicts the Investment Law of 1990 by placing limits repatriation of profits.<sup>xxiv</sup> It also retracts the right to international arbitration, forcing foreign firms to maneuver through Bolivia's slow, susceptible legal system.

### **Status of Privatization and Deregulation**

The process of privatization and deregulation in Bolivia has reversed since President Morales took office in 2005 and is not likely to continue in a positive direction until this

president leaves office. Both the hydrocarbons and the telecommunications sectors have been completely nationalized since 2005, and President Morales has threatened the same with the mining and forestry sectors, two of the few sectors in which foreign firms find it valuable to invest.<sup>xxv</sup>

The Supreme Decree to nationalize the hydrocarbons sector was issued in May 2006. It followed the May 2005 Hydrocarbons Law 3058 requiring firms mining hydrocarbons to negotiate new contracts with the state, only sell hydrocarbons through the state (and supply the domestic market first, in which prices were kept artificially low), and accept an additional 32 percent tax on revenues. With the Supreme Decree, firms had to negotiate new contracts again and accept a 50 percent tax on revenues in addition to a ranging (0-32 percent) tax paid to the state-owned Yacimientos Petroliferos Fiscales Bolivianos (YPFB). At that time the government also offered YPFB a majority share in five of the firms currently operating during that time, two of which had U.S. investors.<sup>xxvi</sup>

Lithium is another natural resource that Bolivia is tightly controlling. Bolivia may have about half of the world's lithium reserves, most of which is located in the more indigenously-populated North. Bolivia's new constitution could give indigenous peoples the right to natural resources in their territories, further complicating any negotiations foreign firms might make with the Bolivian government over mining these reserves. Lithium is becoming increasingly important as a main ingredient in car and electronics batteries.<sup>xxvii</sup> This lithium would provide a slight diversification of Bolivia's exports and a move away from Dutch disease; however, such tight control will hamper efficient and profitable export.



In addition, a recent popular referendum in January, 2009, allowed President Morales to engage in a significant land reform program. While land ownership will remain private, the constitutional changes now allow for only 12,400 acres per single farm tracts. In March, President Morales confiscated 94,000 acres of land from 5 ranches in Bolivia's lowlands, including land belonging to an American rancher. Morales defended the action, stating that these farms employed near-slave labor. "Private property will always be respected but we want people not interested in equality to change their thinking and focus more on country than currency," he said.<sup>xxviii</sup> This will greatly impact the economies of scale of Bolivia's agricultural sector and while firms in other sectors of the economy may find it possible to operate on less than 12,400 acres, this is only one example of government intervention which has and may continue to increase under President Morales.

### **Fiscal and Monetary Policy**

Bolivia's main source of fiscal revenue is from taxes and royalties in the hydrocarbons sector. In 2006, the law regarding hydrocarbon revenues was amended to enact up to 82 percent tax on hydrocarbons revenues. Bolivia's fiscal policy is relatively constrained due to the Dutch disease, as tax revenue from the hydrocarbons sector is mainly determined by world natural gas and oil prices. However, as noted later in this section, the Dutch disease may no longer be a constraint since the new constitution in Bolivia allows executive control over the Central Bank, effectively giving Evo Morales a blank check for public spending. Public spending is expected to increase anyway this year because it is an election year in Bolivia and thus the fiscal balance will turn negative for the first time since 2005.

Year	2004	2005	2006	2007	2008	2009
Fiscal Balance as %GDP <sup>xxxix</sup>	-5.5	-2.2	4.5	1.7	3.2	-3.5

Bolivia also employs a low income tax of just a maximum of 13 percent and a moderate corporate tax of 25 percent.<sup>xxx</sup> Firms also pay a monthly transactions tax of 3 percent on total sales (including VAT). Social security contributions on behalf of employees are also paid monthly and totals 13.7 percent of their gross salaries. The value-added tax (VAT) is 13 percent.<sup>xxxi</sup> In 2008, tax revenue totaled 27 percent of GDP.<sup>xxxii</sup>

In 2008, hydrocarbons tax revenues made up 50 percent of total tax revenues in Bolivia.<sup>xxxiii</sup> However, the total figure for hydrocarbons tax revenues is going to decline significantly in 2009 because of decreased industrial activity in the countries to which Bolivia exports its natural gas. In January 2009, hydrocarbons export earnings declined 32.5 percent year on year to \$177 million.<sup>xxxiv</sup> Previously strong hydrocarbons and agricultural commodity prices allowed Bolivia to amass \$7 billion in reserves before and during President Morales' first years in power, which has helped buoy the economy and allow for increased public spending, until now.<sup>xxxv</sup> While Bolivia enjoyed on average 34 percent revenue growth per year 2006-2008, tax revenues will sharply decline in 2009 and 2010 and domestic public debt is expected to increase in the same timeframe.<sup>xxxvi</sup>

Despite declining revenues and reserves, the Bolivian government has announced big public spending plans in 2009 and 2010 in anticipation of December's presidential elections. The Ministry of Finance announced in mid-March that the bottom 55 percent of the poorest pensioners will receive a 17 percent increase in their pensions, backdated to the beginning of 2008, which suggests that President Morales is trying to maintain his popularity.<sup>xxxvii</sup> Other

public spending projects will include infrastructure, health and education, and a loan to the state-owned YPFB for investment. The cost of these projects is projected to total \$1.85 billion, or 11 percent of GDP.<sup>xxxviii</sup>

Monetary policy in Bolivia is relatively ineffective given the low level of credit use in Bolivia. The credit to GDP ratio in 2008 was estimated to be only 30 percent. While the central bank will attempt to constrain any increases in commercial lending rates to encourage lending and growth in the private sector, as well as attempt to curtail inflation, many of President Morales' plans and policies directly contradict these efforts.<sup>xxxix</sup> The efforts and open market operations of the central bank will also likely cause an increase in public debt.<sup>xl</sup>

In addition, the central bank will lose its independence from the government this year, given the passage of the new constitution, which states in Article 326, "The State, through its executive branch, will determine the monetary and exchange rate policies of Bolivia, in coordination with the Central Bank." This ruling may allow Morales to further flout fiscal responsibility and finance his social spending programs by printing new money, which has dangerous consequences for inflation.<sup>xli</sup>

## **Capital Markets and Attitude and Rules Concerning Foreign Investment and Overall**

### **Savings and Investment**

Bolivia has 12 banks (none of which are government-owned), three of which are foreign-owned, and 45 non-bank financial institutions. Residents and non-residents may have bank accounts in Bolivia and there are "no restrictions or controls on payments, transactions, transfers . . . or repatriation of profits," made in the local currency, according to the Heritage Foundation's 2009 Index of Economic Freedom report for Bolivia. Since domestic collateral is

required to secure domestic loans and since commercial credit is only available short-term and at high interest rates, foreign firms should attempt to secure credit abroad before investing in Bolivia.

Despite bank privatization and growth in the financial services sector, Bolivia's regulatory authorities remain inadequate for both Bolivia's needs and compared to international standards. A modern Securities and Exchange Commission does not yet exist due to political and social unrest that has disrupted the economy. Both accounting standards and financial sector regulations do not meet international standards.<sup>xlii</sup> However, both OPIC and MIGA provide financing assistance, loan guarantees, political risk insurance, and a variety of investment security products to firms operating in Bolivia.<sup>xliii</sup> Bolivia also has had a small stock exchange located in La Paz, in existence for 20 years.<sup>xliv</sup> Firms are allowed to issue debt in local capital markets. Fixed return securities are a popular form of investment.<sup>xlv</sup>

Despite the low overall credit penetration in Bolivia, it has one of the region's most developed microfinance markets. According to the U.S. State Department Investment Climate Report for Bolivia, "Most Bolivian borrowers are small and medium sized enterprises, and have received a large share of credits over the past four years." Parallel to the private microfinance institutions, the government also operates the Productive Development Bank, created in 2007 to support small and medium sized enterprises.<sup>xlvi</sup>

Bolivia has bilateral investment treaties (BIT's) with 16 countries, but it remains to be seen whether these treaties will stand in the future because the new constitution gives President Morales the right to renegotiate all of the treaties.<sup>1</sup> Some of the smaller countries with which

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<sup>1</sup> Argentina, Belgium, Luxembourg, China, France, Germany, Italy, Mexico, the Netherlands, Peru, Romania, Spain, Switzerland, the United Kingdom, and the United States.

Bolivia has BITs may choose not to renew their treaties (see footnote for list of countries). The U.S.-Bolivia treaty was enacted in 2001 and entitles U.S. firms to MFN-or-better status and protections on their investments in Bolivia. The transition in which these BITs find themselves stuck after the new constitution was approved mean that firms from these countries may face additional trouble in receiving fair consideration and due process if issues arise with their investments.<sup>xlvi</sup>

### **Rule of Law, Transparency of Rules and Regulations, Intellectual Property Protection**

Especially since the new constitution came into being, rule of law has declined considerably under President Morales and transparency and protection have never been Bolivia's strong suits owing to high corruption and little effort toward reform. Rules and regulations are enforced arbitrarily and bribery is rampant. A report from Bolivia's own government asserts that the national police, customs, and courts are Bolivia's most corrupt sectors.<sup>xlvi</sup>

Bolivia has a Copyright Law dating from 1992 to protect intellectual property; however this law is not well-enforced. Bolivia is on the U.S. Trade Representative's 301 Special Watch List for this shortcoming. There is a large black market of counterfeit goods operating all across Bolivia. The International Intellectual Property Alliance estimates that music piracy reaches 90 percent and software piracy reaches 83 percent in Bolivia. However, Bolivia has never been a defendant in an IPR-related case at the WTO, perhaps because the market is so small and the country is so isolated.<sup>xlvi</sup>

### **Other Conditions Affecting Investment in Bolivia**

Bolivia is South America's least developed and poorest country. The percent of people living in poverty, while declining in the last five years, is still approximately 60 percent in a

population of almost 10 million (see Appendix 1).<sup>i</sup> Poverty is concentrated in Bolivia's indigenous population, which is estimated to be 55 percent of the total population.<sup>ii</sup> The biggest indigenous groups are the Quechua, Aymara, Chiquitano, and Guarani. Spanish, the official language, is spoken by 87 percent of the people.<sup>iii</sup> These indigenous people were long subjugated under Spanish rule and while indigenous political movements began to develop in the 1930s, they remained marginalized and cut off from social and economic opportunity until Evo Morales took office.

Many education, health, and social problems exist in Bolivia. Illiteracy, especially in rural areas, is high despite efforts directed toward indigenous communities to improve literacy rates. In these rural areas, agriculture, forestry, and fishing account for 44 percent of employment, but most agricultural workers are subsistence farmers. Mining instead dominates the economy, although not as a source of employment.<sup>liii</sup>

Bolivia's economic activity also relies heavily on remittances from abroad; nearly half the remittances come from Spain and Europe, and the rest is divided between the United States, Argentina, Brazil, and Chile. Remittances, at almost \$1.1 billion in 2008, make up between 5 and 9 percent of GDP, but this share is expected to greatly decline in 2009 due to economic conditions in host countries.<sup>liv</sup> The Central Bank is working to decrease the relevance of the dollar in the banking system and since mid-2005 there has been a tax on foreign currency deposits and withdrawals which captures a portion of remittances coming from the United States.<sup>lv</sup>

Bolivia has a long history of political instability and social movements and is prone to civil unrest in the form of protests, some violent. Notably, the United States' Bechtel

Corporation faced this issue in 2000 when Aguas del Tunari, in which Bechtel subsidiary International Water Ltd. was a major shareholder, won a 40 year contract to privatize Cochabamba's water system as a loan stipulation from the World Bank. Protestors took to the streets and after months of increasingly violent protests the government retracted its contract to Aguas del Tunari and placed control of the water system in the hands of the grassroots opposition group that organized from the protests. Cochabamba's water was not privatized and the rate, which would have increased drastically under Aguas del Tunari, stayed the same.<sup>lvi</sup>

Bolivia's most recent bout of violence came in the form of an interrupted plot to assassinate President Morales. Police commandos stormed a hotel room in Santa Cruz and shot three foreign nationals: an Irish man, a Hungarian-Bolivian man, and a Hungarian man who were believed by Bolivian intelligence to be plotting the assassination of Evo Morales. Two other men, a Croatian and a Romanian, were detained.<sup>lvii</sup> While it remains to be determined whether an assassination plot actually did exist, the killing of foreign nationals in Bolivia is surely a warning sign to foreign firms or individuals wishing to conduct business there.

### Conclusion

In conclusion, the political, social, and economic situation is only likely to get worse as President Morales continues his tenure in the Bolivian government. As history demonstrates, it is much more difficult to reverse bad policies than to create them in the first place. President Morales has made his policies with relative ease but without relative benefits to the whole of society and the economy. As this is the reality in Bolivia, I reiterate that I cannot recommend investing in Bolivia.

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- <sup>vi</sup> "Bolivia," Economist Intelligence Unit, April 2009.
- <sup>vii</sup> *Ibid.*
- <sup>viii</sup> "World Tariff Profiles 2008: Bolivia," World Trade Organization, 2008.
- <sup>ix</sup> "Bolivia Trade Brief," The World Bank, 2008.
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- <sup>xv</sup> Steven Kaufman, "Bolivian Suspension from Trade Pact Only U.S. Option," America.gov, 9 Dec 2008.
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- <sup>xxiii</sup> "2009 Investment Climate Statement: Bolivia," U.S. State Department, February 2009.
- <sup>xxiv</sup> "Bolivia Economy: Back to Slow Growth," Economist Intelligence Unit, 26 March 2009.
- <sup>xxv</sup> "Bolivia," U.S. Trade Representative, 2007.
- <sup>xxvi</sup> *Ibid.*
- <sup>xxvii</sup> Simon Romero, "In Bolivia, Untapped Bounty Meets Nationalism," New York Times, 2 February 2009.
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- <sup>xxxii</sup> "2009 Index of Economic Freedom: Bolivia," The Heritage Foundation, 2009.
- <sup>xxxiii</sup> "Bolivia," Economist Intelligence Unit, April 2009. P5.
- <sup>xxxiv</sup> *Ibid.*, P3.
- <sup>xxxv</sup> Peter DeShazo, "Bolivia's Constitutional Vote: Implications for the Future," Center for Strategic and International Studies, 22 January 2009. P2.
- <sup>xxxvi</sup> "Bolivia," Economist Intelligence Unit, April 2009. P5.
- <sup>xxxvii</sup> *Ibid.*, P15.
- <sup>xxxviii</sup> "Bolivia Economy: Back to Slow Growth," Economist Intelligence Unit, 26 March 2009.
- <sup>xxxix</sup> "Bolivia," Economist Intelligence Unit, April 2009. P5.
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- <sup>xlvi</sup> *Ibid.*



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<sup>xlvi</sup> Ibid.

<sup>xlvi</sup> Ibid.

<sup>xlix</sup> "Bolivia," U.S. Trade Representative, 2007.

<sup>i</sup> Bolivia Historical Data Graphs, IndexMundi.

<sup>li</sup> "Background Note: Bolivia," U.S. Department of State, December 2008.

<sup>lii</sup> *Country Profile: Bolivia*, Library of Congress- Federal Research Division, January 2006. P 11.

<sup>liii</sup> Ibid, P 12.

<sup>liv</sup> "Remittances to Bolivia Outpace Investment by 2-1," Latin American Herald Tribune, 2008.

<sup>lv</sup> "Economic Outlook," American Chamber of Commerce in Bolivia, 2009.

<sup>lvi</sup> "Timeline: Cochabamba Water Revolt," PBS.org, June 2002.

<sup>lvii</sup> Rory Carroll, "Bolivian president Morales links US embassy to alleged assassination attempt," The Guardian, 20 April 2009.