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Bolivia: Bleak Economic Prospects for a Threatened Democracy

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An Intelligence Assessment

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ALA 84-10101
October 1984

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Bolivia:
Bleak Economic Prospects for a Threatened Democracy [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
with a contribution from [redacted] both of 25X1
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Analysis. It was coordinated with the Directorate of
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Bleak Economic Prospects for a Threatened Democracy

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Key Judgments

Information available as of 12 September 1984 was used in this report.

Bolivian President Siles is struggling with an economy that is deteriorating domestically and losing support internationally. Inflation has climbed to over 500 percent, nearly a third of the work force is idle or underemployed, strikes have hampered production, and the government has halted payments on its foreign debt. The pace and magnitude of the decline, the reluctance of international creditors to risk further support, and Siles's preoccupation with his political survival leave little prospect that he will reverse the slide. Under these circumstances, Bolivian radical leftist groups, backed by Cuba and the Soviet Union, are preparing to capitalize on the disorder, whether or not the President's opponents in the armed forces replace him under the excuse of ending economic chaos.

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In our judgment, leftist influence in general is likely to grow during Siles's remaining two years in office. In part because he needs the political support of leftist and Communist political parties during this period of economic difficulty and in part because of his ideological affinity with the left, Siles is likely to retain the Communist Party in the Cabinet. His radical advisers, some with close connections to the Communist Bloc and Cuban-trained paramilitary units, will remain dominant. Cuba and the USSR probably will attempt to increase their involvement by offering technical and security advisers and sales of military equipment on concessionary terms and by strengthening links with labor and other important sectors. Already, some 100 Soviet Embassy and technical personnel and 19 Cuban mission representatives are based in Bolivia—together, they are double the size of the US diplomatic presence.

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The greatest potential long-term threat to US interests in Bolivia is the growing capability of the various radical leftist and Communist groups to exploit economic deterioration and social and political instability. There is a danger that Cuba and the Soviet Union will be able to expand their links to such groups if Siles perceives he has been abandoned by Western allies. Even if this trend toward the growth of leftist influence is halted, however, US interests will suffer. In the near term, US investors will face more stringent restrictions on their operations, while US bankers may not see La Paz's suspension of debt repayments lifted for some months. Additionally, financial constraints, nationalism, and Siles's political weakness will continue to hinder narcotics cooperation with the United States.

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In addressing the economic problems, Siles has avoided broader reforms out of fear that the resulting social strains—especially labor protests—would provide military coup plotters the opportunity they have been seeking to oust him. His piecemeal approach has enabled him to weather labor opposition, garner some modest assistance from Western countries, and escape one serious coup attempt, but it has produced no lasting economic or political gains. 25X1

Nevertheless, we believe Siles will continue his short-term, patchwork strategy because it best serves his overriding objective of political survival. In our view, however, his failure to undertake broad reforms will lead to further economic contraction, accompanied by an average annual inflation rate in excess of 500 percent for 1984 and probably for the next year or two as well. The likelihood of inconclusive negotiations with the IMF will preclude both the refinancing of Bolivia's $4 billion debt and a resumption of Western aid and credit flows. 25X1

While economic deterioration itself is unlikely to bring down the government, Siles must be deft in juggling his adjustment policies. With the economy unstable and fiscal discipline yet to be restored, any miscalculation in his approach could quickly cause prices to spiral upward at an accelerating rate; we believe the resulting social unrest would lead the military to force Siles from office. In our view, radical left elements would also take action, including terrorist violence, to exploit the instability and to protect their positions following a military takeover. 25X1

In our opinion, Bolivia's only hope for rekindling economic growth is to implement fully a stabilization program under IMF guidance. Although a healthier economy might lessen any government's vulnerability to military coups over the long term, the short-term political dangers of the kinds of adjustment policies needed—including devaluation, cuts in government spending and employment, and relaxation of price controls—are so great that we doubt Siles will pursue them. Nevertheless, we judge there is only a slight chance that he will break completely with the IMF in an effort to rally domestic support through nationalistic fervor; any resulting economic surge would collapse well before his term is up. 25X1

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Bolivia: Bleak Economic Prospects for a Threatened Democracy [redacted] 25X1

The Political-Economic Stakes

The civilian government of President Hernan Siles Zuazo, in office since the military withdrew to the barracks in October 1982, is fragile. Because of his weak political base and domestic opponents on the right and on the left, Siles is vulnerable to popular demands for rapid economic expansion, but he also must take steps to redress financial imbalances and satisfy international creditors. Siles is finding the balance difficult to maintain without the backing of force enjoyed by his military predecessors. The government has so far survived splits within the ruling coalition, labor strikes, military coup plotting, and power struggles with opposition parties in Congress—but at the expense of forgoing the reforms necessary to deal with the ailing economy. [redacted]

We do not believe, however, that the link between Bolivia's economic problems and its renowned and continuing political instability is necessarily a direct one. Personalist politics, weak institutions, and the traditionally interventionist military establishment mean the political system is likely to remain inherently unstable regardless of the state of the economy. In addition, most Bolivians are somewhat inured to hardship. Thus, rather than directly fostering political upheaval through social unrest, economic distress conditions the atmosphere in which political struggles—that would most likely occur in any event—take place. When these struggles revolve around the choice of economic policies and their frequent modification, as has occurred in Bolivia over the past year, the effects are highly disruptive. [redacted]

[redacted]

This setting—deteriorating economic conditions and an unstable political atmosphere—would hardly be unusual for Bolivia, except for a new factor, the presence of a sizable number of radical leftists in and out of government bent on profiting from the threat of disorder. Over the two years of the Siles administration, several groups of extreme leftists have emerged, built links with Cuba and the USSR, established paramilitary cadres, and maneuvered to influence government policies. The most important groups are:

- The *palaciegos,* a clique of executive branch officials and advisers led by Felix Rospigliosi, chief adviser to the President, who are the principal organizers of paramilitary groups of ruling party militants.
- The *sergios,* moderately leftist senior military officers who have been placed in key command positions and are reportedly loyal to the President. 25X1
- The Communist Party of Bolivia (PCB), which serves in the ruling coalition, occupies the important Ministries of Labor and Mining, exerts significant influence in organized labor, and is closely guided by Moscow.
- The Movement of the Revolutionary Left (MIR), which—as the party of Vice President Paz Zamora—is also in the ruling coalition, but which seeks power in its own right, has organized some of its own leftist paramilitary groups, and competes with most of the other leftist sectors.
- The Bolivian Workers' Confederation (COB), which is dominated by independent leftist labor boss Juan Lechin (who has longstanding presidential ambitions), but is strongly influenced by the Communist Party. 25X1 25X1

There is little or no cooperation among these groups and frequently, competition among and within them. Nevertheless, their goals are roughly similar: to develop the capability to defend themselves from the conservative armed forces and like-minded civilian groups, to gain and keep control of the government in order to promote a state-run economy and other leftist domestic policies, and to expand ties to the Third World and the Communist Bloc. The plans, opportunities, and potential of these leftist forces over the next few years will be significantly affected by the course of the economy and the kinds of economic policies the government adopts. [redacted]

The Political Setting

Siles took office determined to revive the stalled impetus of the 1952 revolution and has looked to radical leftist activists to assist him in that task. His key advisers in this effort include not only Rospigliosi, but also Congresswoman Tamara Sanchez, Minister of Information Mario Rueda (who lived for a time in East Germany), and Subsecretary of the Interior Gustavo Sanchez [redacted] However, Siles's weak political base has limited his ability to carry through with the broad economic reforms necessary to correct the economy's structural defects. The leftist Democratic and Popular Unity coalition—composed of the PCB, the MIR, and Siles's own National Revolutionary Movement of the Left (MNRI)—has been strained from the beginning by policy disputes, personality differences, and debates over inclusion of the Communists. This dissension produced—and continues to do so—recurring Cabinet crises and has hampered Siles's efforts to formulate a coherent economic program. The President has recomposed his Cabinet five times in an unsuccessful effort to broaden his political base in order to implement unpopular economic measures. [redacted]

Despite his reliance on leftist counsel, Siles is a pragmatist, who recognizes that his political survival depends upon continued Western political support and economic assistance and maintaining a modus vivendi with the conservative military. Therefore, throughout his two years in office he has been open to advice on stabilization policy from Western-educated technocrats who serve in the Cabinet and as close economic advisers. He also has been at least partly receptive to US counsel on a variety of issues, especially the need for economic adjustments. Even his leftist advisers have seen the necessity of reaching an acceptable agreement with the IMF, according to the US Embassy. [redacted]

Siles keeps the Communists in his Cabinet, in our view, to induce the Communist Party to moderate the miners' union and the Bolivian Workers' Central, the principal labor confederation, where the party holds influential executive board positions. Hardline Communists have argued that participation in the government contradicts their Marxist-Leninist principles; and another round of austerity measures would probably intensify dissension within the party. Nonetheless, 25X1
we believe the Communist leaders will stay in the governing coalition because of the opportunities it provides to increase their strength and influence [redacted] 25X1
[redacted] 25X1

In our view, Bolivian labor will continue to exercise its muscle to extract economic concessions and mobilize against the government's economic policies. According to the US Embassy, the President does not want his economic policies to provide Lechin, Bolivia's most 25X1
powerful labor leader and Siles's longtime foe, with leverage against his administration. This consideration, [redacted] was behind the 25X1
suspension of debt payments to foreign banks in May and Siles's failure to decontrol prices and restrain wage hikes. Leaders of the Bolivian Workers' Central now contend that public announcements by the government that its foreign debt will be renegotiated violate the recent labor accord and will be challenged by the unions. We believe Siles will continue to try to placate organized labor to avoid providing a pretext for military intervention. [redacted] 25X1

The Military. We expect that, in charting his economic course, Siles will remain sensitive to the ways his economic policy choices contribute to military 25X1
coup plotting. [redacted] 25X1
[redacted] unremitting military dissatisfaction 25X1
with Siles's leadership. This sparked an unsuccessful coup attempt by a maverick army colonel and a police unit in late June, and the military will probably continue to threaten Siles. [redacted] 25X1

We believe several factors have accounted for the armed forces' reluctance to move more strongly as a group against Siles. The military is still somewhat discredited and dispirited by its poor performance in

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Siles Bending Under Pressure

During his first six months in office, Siles attemped to restore fiscal discipline by reducing subsidies for gasoline, utilities, and many food staples. He established a unified exchange rate to bolster the trade accounts and required that foreign exchange from exports be remitted to the state. To conserve thin reserves, he banned nonessential imports and introduced controls on the outflow of foreign exchange. To assuage labor for the increased prices resulting from reduced subsidies, Siles authorized upward wage adjustments every six months to keep pace with inflation.

This combination of measures temporarily muted labor criticism. As the US Embassy reported, Bolivian workers allowed the new civilian government some breathing space through May 1983 to revive the economy, but thereafter used their muscle to extract economic concessions. Under the stewardship of Juan Lechin, the Bolivian Workers' Central (COB) began mobilizing opposition to government economic policies. In June 1983, the COB led a takeover of the state mining corporation, demanding worker "comanagement" to prevent planned layoffs aimed at increasing efficiency. Subsequently, other public workers in the state petroleum company and the Central Bank demanded—and received—the right of comanagement.

In August, Lechin insisted that the administration adopt populist measures such as greater state control of the economy, price freezes, and a rationing system. President Siles's counteroffers of increases in the minimum wage and a cost-of-living wage escalator were rejected, and, in September, the unions launched strikes and demonstrations to force annulment of austerity policies. Labor continued thereafter to stage strikes to challenge Siles at every turn, including his attempts to reconcile with the IMF and his hike in staple prices last November. 25X1

Under pressure from labor—and political opponents—Siles avoided thoroughgoing economic reforms, failed to prepare a budget, and did not institute the administrative mechanisms—such as regular devaluations—required to sustain his economic adjustments. After workers won the right of comanagement, he was reluctant to use decree powers to improve efficiency in the state-owned enterprises. The constant political turmoil also prevented him from devising a credible program to revitalize the flagging agricultural sector, according to US Embassy reporting. Despite initial adjustments, gasoline and food prices were not increased at a rate to offset inflation, resulting in continued subsidies and contraband exports to neighboring countries. Press and US Embassy reports indicate that in April 1984 Siles increased public spending and allocated new credits for farmers, industrialists, and exporters, thus perpetuating rapid monetary expansion. 25X1

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running the government before 1982. In addition, Siles has assigned potential military rivals to innocuous positions and placed loyalists—some of whom are moderate leftists—in key command positions. Finally, the military has taken vigorous US support for civilian rule to heart, according to US defense attache sources.

We believe the danger of a coup attempt will increase over the next several months. Many officers expect a hardening in Washington's attitude toward the Siles administration after the US Presidential elections in November, according to a US Embassy observer, and changes in military assignments at the end of the year probably will engender new resentments among senior officers. Should the military decide to intervene, we believe it would precipitate widespread labor unrest, leftist violence, and probably a diplomatic backlash from countries that have supported the democratic process in Bolivia. On balance, we judge that this prospect will probably continue to deter a well-organized military coup for some months to come, but may not be sufficient to prevent an ambitious or disaffected officer from putting together an attempt. 25X1

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Communist Opportunities. Early in his administration, [redacted] Siles believed he could find badly needed economic assistance in new places, especially in the Communist Bloc and the oil-rich Arab world. For this reason, as well as his own leftist sympathies and the influence of his radical advisers, Siles has allowed the Soviet Union and Cuba to make political and economic inroads in Bolivia. The USSR has broadened its involvement in the mining industry—participating in financing and constructing two-tin processing (volatization) plants and a lead-silver smelter. The Soviet presence has grown and includes 61 embassy officials and 40 technicians who serve at the trade mission, various mining facilities, and the two Soviet-manned satellite tracking stations. Siles is instinctively less comfortable with the Soviets than with the Cubans, according to the US Embassy, and he has, for example, denied Aeroflot landing rights, while allowing a ticket office to be opened. Nevertheless, if the economy continues to deteriorate, longstanding Soviet offers of attractive financing for military and industrial equipment would be appealing. [redacted]

The President established diplomatic relations with Cuba in January 1983 [redacted] at only the Charge level, primarily to avoid antagonizing the United States and jeopardizing Western aid. The 19 members of the Cuban mission unobtrusively promote Havana's interests with Bolivian leftists. At the same time, the Castro regime has provided covert paramilitary training in Cuba for 300 to 500 members of Siles's party, [redacted] This training apparently was suspended in 1983, [redacted]. In our view, the coup attempt in June probably persuaded Siles of the need to renew paramilitary training. [redacted]

Bolivia's Economic Nosedive

Siles has publicly acknowledged that improvements in Bolivia's dismal economic performance are now necessary to bolster democracy and regain foreign financial support. On several occasions he has attempted to make some economic adjustments, but labor reaction and political dissension have caused him to backslide. [redacted] 25X1

Origins of Disintegration: 1983. Siles's failure to adopt thoroughgoing economic reforms, combined with natural disasters, led to the worst economic crisis in Bolivian history, starting last year. The economy had been running uncontrolled for most of the past decade, sustained by a surge of public borrowing and spending during the 1970s at a time of high prices for its tin, oil, and gas exports. The government tried to maintain the pace of expansion in the face of low export prices and revenues during the past several years, instead of adjusting by holding down government deficits, reducing subsidies, controlling wages, and improving public-sector efficiency. [redacted] 25X1

Poor weather brought these economic problems to a head last year. A freak change in the ocean current (known as El Nino) caused severe drought on the Altiplano (the high plain) and flooding in the lowlands in 1983. The US Embassy reports that agricultural output dropped at least 60 percent below normal, forcing many related industries to close. Moreover, the floods heavily damaged roads, bridges, and other facilities. Increased food imports put an additional drain on Bolivia's thin foreign exchange reserves, while food shortages helped spur inflation: food prices increased fivefold throughout the Altiplano, according to the US Embassy. La Paz received some international assistance, but not enough to match the economic damage that, according to estimates by the US Agency for International Development, exceeded $600 million. [redacted] 25X1

The effects of the natural disasters and of Siles's inability to exert strong management were stark:

- GDP fell at least 12 percent, and 30 percent of the work force became idle or underemployed.
- Per capita income dropped at least 15 percent, compared to 1982 levels.
- Inflation skyrocketed to almost 300 percent, up from about 100 percent in 1982.
- The current account deficit nearly doubled to $183 million because of low mineral production and export earnings and increases in food imports. [redacted] 25X1

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Bolivia's Root Problems

Bolivia is an economic backwater. The majority of the population is composed of poor Indians outside of the economic mainstream. Annual per capita income (about $875) ranks among the lowest in Latin America. Life expectancy in 1981 was 51 years, a full 10 years below the South American average, and infant mortality that year claimed an estimated 129 out of every 1,000 live births before age 1. According to World Bank statistics, only a third of the population has access to potable water.

Political instability also has traditionally hampered Bolivia's economic development efforts. The armed forces have been the active agents in most of the 193 changes of government in 159 years since independence. Political parties are undisciplined and quarrelsome, civilian institutions are weak, and labor strife regularly disrupts economic activity.

As a result of these problems, La Paz has been unable to frame and implement economic reforms. In recent years, fiscal discipline has collapsed, causing the government deficit as a share of GDP to increase from about 5 percent in 1977 to almost 29 percent in 1982. This reflects the failure to trim the losses of a large and inefficient public sector that controls over 70 percent of Bolivia's economy, the political unwillingness to eliminate subsidies, and the need to grant large wage increases to placate influential labor groups.

These sizable budget deficits have been financed through monetary expansion: money supply grew over 120 percent in 1982, compared to about 38 percent in 1980, fueling spiraling inflation. Moreover, the government's unwillingness to submit to an IMF stabilization program has accentuated structural and financial imbalances and precluded progress in refinancing the foreign debt. 25X1

The lucrative narcotics trade has increased corruption at all levels of Bolivian society and among government officials. We believe that little of the narcotics money has found its way into domestic economic savings or investment; 25X1 *most of the profits are banked outside the country.* 25X1 25X1

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Formidable internal obstacles also have hindered broad-based development. Economic infrastructure is primitive; transportation and communications links reach only a fraction of the country. With limited opportunities at home and frequent political changes, numerous Bolivian technical and professional workers emigrate abroad. Worker productivity is generally low as a result of inadequate schooling, health care, and diet. Despite a relatively rich resource base, Bolivia has been unable to attract the foreign capital necessary to develop fully its extractive industries or to start other lines of production. 25X1 25X1

The Bolivian economy depends on mining, which provides some 60 percent of exports and 20 percent of government revenues. Subsistence farming supports half of the population and accounts for about 20 percent of GDP. The cocaine trade has stymied efforts to diversify agriculture and siphons talent away from the modern sector. The small internal market, antiquated production facilities, lack of managerial skills, and continuing political turbulence handicap the development of modern industry, commerce, and finance. 25X1 25X1

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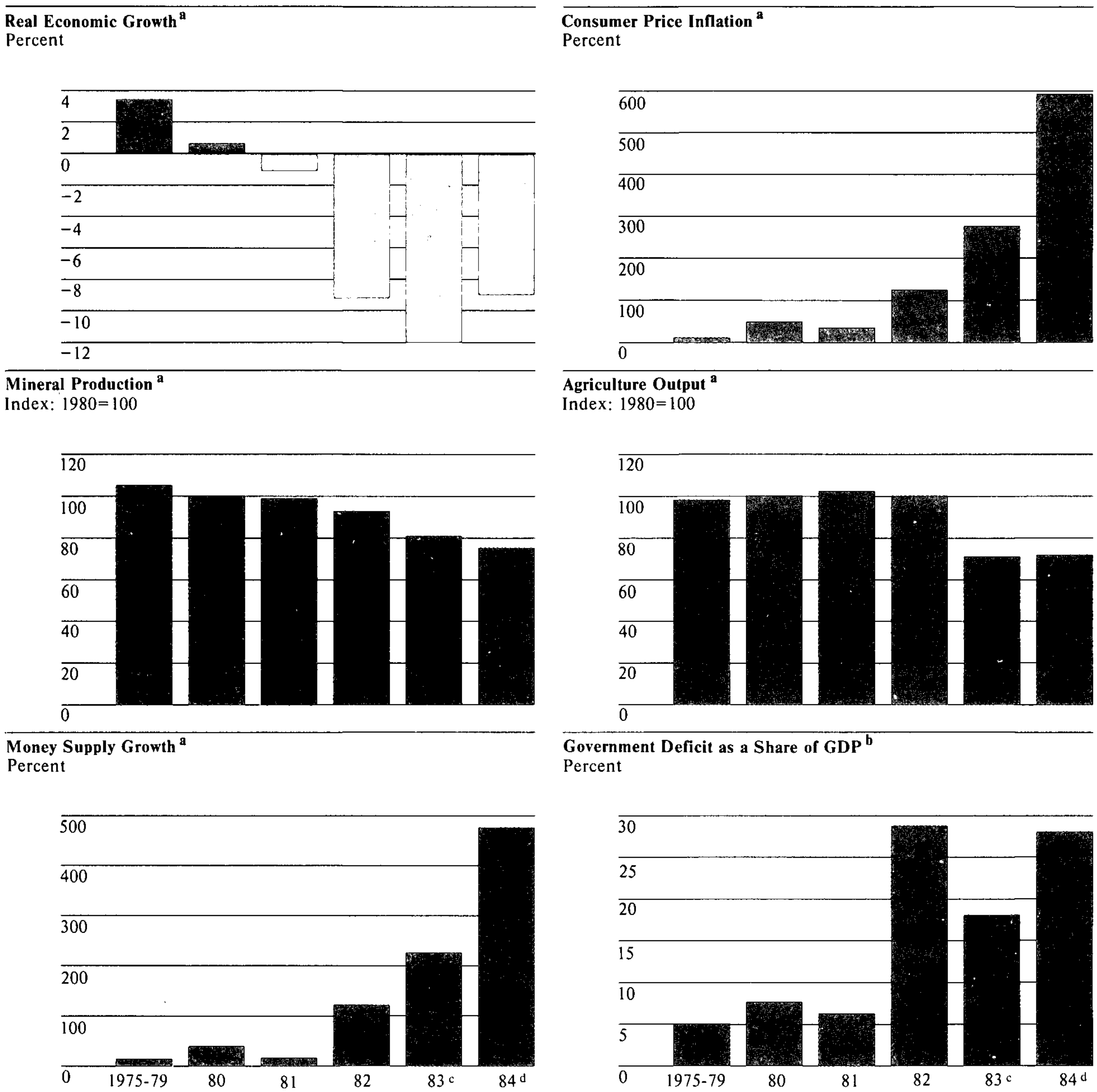
Figure 1
Bolivia: Selected Economic Indicators, 1975-84



[a] Annual average 1975-79.
[b] Weighted average 1975-79.
[c] Estimated.
[d] Projected. Assumes La Paz backs away from austerity program.

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Bolivia: Balance of Payments, 1975-84

Million US $

	1975-79 Average	1980	1981	1982 [a]	1983 [a]	1984 [b]
Total debt	**1,534**	**2,515**	**2,836**	**3,112**	**4,800**	**5,000**
Current account balance	**−227**	**−118**	**−287**	**−93**	**−183**	**−279**
Trade balance	−14	262	229	399	275	114
Exports, f.o.b.	606	942	909	828	778	822
Of which:						
Tin	297	378	343	278	240	286
Natural gas	70	221	337	382	350	378
Imports, f.o.b.	620	680	680	429	503	666
Net services and transfers	−213	−428	−541	−420	−345	−340
Interest payments, net	−74	−249	−334	−380	−309	−250
Arrearages	**3**	**0**	**50**	**250**	**430**	**300**
Capital account balance	**238**	**19**	**319**	**209**	**185**	**135**
Direct investment	15	41	60	37	45	40
Long-term loans	391	441	434	305	390	375
Short-term capital	−12	−20	148	−36	31	30
Foreign exchange reserves (at end of year)	**170**	**106**	**100**	**156**	**137**	**135**

[a] Estimated.
[b] Projected. Assumes La Paz continues piecemeal approach.

[redacted] 25X1

These deteriorating economic conditions aroused considerable unrest. Miners struck to protest food shortages; public-sector workers denounced the government's refusal to grant bonuses and improve social security benefits; and peasants blocked roads in La Paz Province to demand lower prices and additional seed and machinery. Citizens' groups in the capital also organized mass demonstrations in protest against food shortages and reduced urban transport services. [redacted]

Siles's Response. To halt the economic plunge, Siles in November 1983 decreed a series of piecemeal measures to try to stabilize the economy, improve the payments account, and qualify for IMF assistance. [redacted] the President first announced a 72-percent increase in minimum wages to soften labor reaction. Then, when he implemented a 60-percent devaluation, a reduction in food and gasoline subsidies, and a 50-percent hike in transport fares and electric power tariffs, Siles simultaneously announced income tax reductions and new credits for businesses. [redacted] 25X1

Siles implemented additional austerity measures last April, bolstered by the decision of the Movement of the Revolutionary Left Party to rejoin the government coalition it had abandoned a year earlier. He devalued the peso 75 percent and implemented large hikes in the prices for basic foods, gasoline, and transportation. The Monetary Board more than doubled domestic interest rates in an attempt to resuscitate financial markets and to control capital flight. To compensate for the rise in living costs, however, Siles decreed quarterly indexation of wages and new bonuses. [redacted]

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To dampen labor militancy, Siles agreed to a request by the chief Bolivian labor confederation to suspend debt payments to foreign commercial banks in May. [redacted] bankers agreed to a 90-day payments standstill in July, but are now treating Bolivian loans as nonperforming and accelerating the writeoff of these credits because they expect no resumption of payments this year. [redacted]

Economic deterioration continued apace, however. Bolivia continued to experience erratic and unpredictable fluctuations in prices that made any rational economic planning impossible. According to reports from the IMF and the Bolivian Statistical Institute, following the economic adjustments last spring, consumer prices jumped 63 percent in April and 47 percent in May. Although the US Embassy reports that agricultural production is recovering from the drought, the erosion of purchasing power that occurred early this year has depressed the industrial and construction sectors, kept about a third of the labor force either idle or underemployed, and impeded banks' ability to fund new investments. Frequent strikes are creating spot shortages by disrupting production in a number of sectors, including transportation. One such strike, however—a prolonged walkout at the Central Bank that curbed the issue of bank notes—was a key factor in the deceleration of inflation to only 4 percent in June. [redacted]

Meanwhile, Bolivia's payments position is worsening. The suspension of debt servicing, payments from Argentina for past gas deliveries, and a $50 million trade surplus in the first quarter took some pressure off foreign exchange reserves, but only temporarily. Increased imports of food, raw materials, and spare parts in the second quarter and the failure so far to establish a payments schedule for 1984 gas shipments to Argentina suggest that the current account will continue to deteriorate: we project a payments deficit of some $280 million by yearend and foreign exchange reserves sufficient to support a little more than two months of imports. [redacted]

Siles recognizes that additional measures are needed, and, according to the US Embassy, he is promising another devaluation and a round of price hikes. According to the US Embassy, the IMF representative in La Paz reported that further actions will be

Figure 2
Bolivia: Monthly Consumer Price Fluctuations, 1982-84[a]

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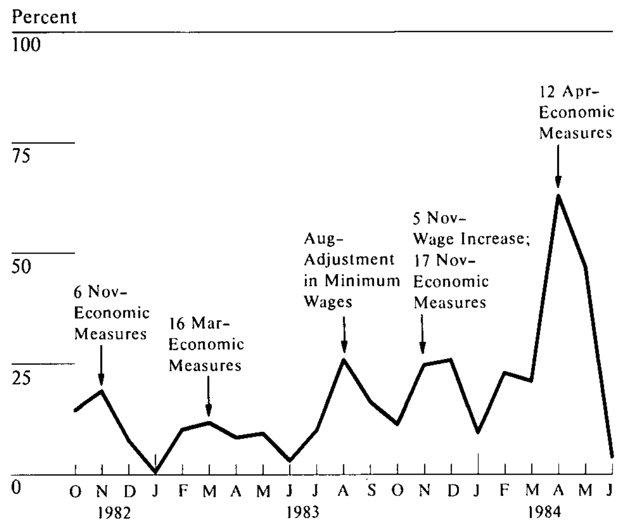

[a] Source: Bolivian National Institute of Statistics.

[redacted]

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necessary before Bolivia can qualify for a $300 million Extended Fund Facility. These include deeper cuts in the budget deficit through reduced spending and increased tax collections, tighter monetary policy, and positive real interest rates and currency devaluations in line with inflation. Moreover, La Paz will need to clear arrears and resume debt repayments. Negotiations are continuing with the IMF, but the US Embassy reported that La Paz still had no budget in early August and that the public deficit could reach 28 percent of GDP in 1984, compared with IMF guidelines of 4 to 5 percent. [redacted]

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Bleak Near-Term Economic Prospects

Even though Siles has promised to continue the economic adjustment process, we are skeptical that he—or any successor in the event he is ousted—will have the maneuvering room over the next year to implement sweeping economic reforms. More popular dissatisfaction—manifest in strikes, work stoppages,

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and consumer demonstrations—over government economic policies is likely in coming months. Unemployment will remain high, and inflation is likely to spurt again. Despite the past devaluations, many private manufacturing firms will probably have to stop production because of lack of foreign exchange to buy spare parts. Price controls that discourage domestic production and fuel contraband exports to neighboring countries are likely to continue, resulting in frequent shortages of consumer goods. We foresee three possible economic policy scenarios over the next several months, described below in descending order of probability.

Continued Piecemeal Approach. We believe there is a strong chance that La Paz will continue austerity on a piecemeal basis, resulting in continued economic stagflation—no growth, high unemployment, and soaring inflation—and foreign financial difficulties. Based on our evaluation of labor's strength and limited tolerance for further austerity, we think Siles will put a premium on political survival and backslide on economic adjustments in an effort to muddle through the next two years. In this case, we believe the government will resist scrapping the $150 million in annual consumer subsidies to avert popular protests, and influential state corporations probably will resist fiscal discipline. Although La Paz will probably implement some spending restraints, political disarray will impede scaling down the public deficit to 4 to 5 percent of GDP (compared with the 1983 level of 18 percent) necessary to meet the targets established by the IMF.

We estimate that under this piecemeal approach annual inflation would be on the order of 500 percent because of shortages, the large public-sector deficit financed by rapid monetary expansion, and peso devaluations. Although devaluations would cut demand for imports, we believe La Paz would not make progress in reducing the current account deficit because of depressed world prices and demand for mineral exports and relatively high international interest rates. Piecemeal policies would enhance the likelihood of inconclusive negotiations with the IMF, precluding refinancing the debt over a longer term and inhibiting aid and credit flows. These financial pressures would probably lead Siles to prolong the suspension of debt payments well into 1985.

Forecasting Inflation in Bolivia

Erratic, large fluctuations in Bolivia's monthly inflation rate during 1984—price increases ranged from a high of 63 percent in April to a low of 4 percent in June—make forecasting especially hazardous. Because historical relationships are statistically unreliable during periods of rapid price changes, most observers of the Bolivian economy are extrapolating current data to obtain an annual trend. Business Latin America, *for example, projects Bolivian inflation at 1,700 percent in 1984, an estimate obtained by extrapolating the price increases in April and May for the year as a whole. An IMF report used the 63-percent rise in May to project an annual inflation rate of 2,500 percent. We believe these estimates are too narrowly based and exaggerate the impact of the April 1984 corrective economic adjustments—policies that usually lead to rapid increases in prices for several months.* 25X1

Our forecast is based on extrapolating the observed rate of inflation during the first six months of 1984 to an annual level. According to the National Institute of Statistics, Bolivia recorded a 167-percent increase in prices through June or an annual inflation rate of about 600 percent. We believe this estimate—the basis of our forecast in the piecemeal approach scenario—is consistent with Siles's past record and future plans for implementing patchwork economic adjustments. 25X1

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Based on the cessation of monetary expansion in May, we judge Bolivia is not now experiencing a "hyperinflationary" spiral. Academic research indicates that hyperinflation is a temporary process of rapidly accelerating price increases—generally in excess of 50 percent monthly—driven by massive currency issues. Between August 1922 and November 1923 in Germany, for example, prices rose an average 322 percent per month fueled by a currency issue of 192 quintillion marks. In Bolivia, a six-week strike at the Central Bank curbed rapid monetary expansion in May, but we believe the country remains vulnerable to a hyperinflationary process if the government is unable to restore fiscal and monetary discipline. 25X1

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Under this scenario, prospects for the rejuvenation of the private sector over the next year or two would remain dismal. Even with improved weather, the lack of adequate seed varieties and machinery and the diversion of land to higher paying coca leaf cultivation probably would impede a significant increase in food production. Inability to purchase spare parts, combined with expensive credit, would cripple private manufacturing.

Although economic performance over the next several years would be poor, we believe Siles would stand the best chance of prolonging his tenure in office under this approach. Most Bolivians are somewhat inured to economic hardship, and Siles has ready scapegoats in world bankers and higher interest rates. In the face of pressures from labor and business, he would continue to offer economic concessions to blunt the impact of austerity. Such tactics have temporarily mitigated serious unrest in the past, pacified labor, and restrained the military, and we see no indication that their effectiveness is waning.

The strategy is a delicate one, however. Miscalculation in implementing economic adjustments or external economic factors outside the government's control—for example, with debt talks stalled, bankers are already threatening to seize Bolivian assets if La Paz does not resume payments by the end of the 90-day grace period on 13 October—could spark popular unrest and improve the atmosphere for a military takeover.

Reconciling With the IMF. We judge there is a small chance that Siles will follow through and implement a determined and consistent austerity program under IMF guidance. Such a program would precipitate popular opposition to the fragile coalition government, lead quickly to a major confrontation with labor, and prime military opponents to move against him when his public backing reached low ebb. Such an IMF-guided program would also arouse nationalistic sentiment by aggravating domestic hardships in favor of Bolivia's foreign creditors. We believe Siles recognizes these risks and would opt for the course of thorough economic reform only if he believed that large-scale foreign financial support and economic assistance would become available to bolster his political standing.

To reconcile with the IMF, La Paz would have to take concrete steps aimed at restraining wage increases, strengthening controls over state corporations, and significantly reducing the budget deficit. We concur with the US Embassy that, to restore production incentives and eliminate contraband to neighboring countries, La Paz would also have to allow higher domestic prices for essential commodities and continue devaluations to restore the competitiveness of Bolivian exports and to hold down imports. If this were accomplished and La Paz resumed interest payments, we expect that foreign bankers would be willing to provide debt relief, while development assistance would be renewed to enable the government to blunt some of the impact on living standards. Under this approach, economic stagflation would continue for the better part of the next year or so, but the foundation would be laid for future progress.

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Nationalistic Backlash. We judge there is only a slight probability that massive domestic political discontent would cause Siles to adopt nationalistic economic policies to regain popular support. In this scenario, Siles—under intense pressure from labor and political opponents and probably military coup plotting—would reject any agreement with the Fund. Such pressures would lead him to impose price controls and increase spending in an effort to satisfy popular demands for growth.

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In this case, we judge that economic instability would become more pronounced. Price controls aimed at keeping an artificial lid on inflation would cause larger quantities of goods to find their way into the black market, where they would command more lucrative prices. Because production at controlled prices would become even more unprofitable, manufacturing activity would decline if producers could not use the black market as an outlet, exacerbating product shortages. We would expect to see an increase in business failures and a steady rise in unemployment. As the gap between controlled and black-market prices widened, we believe urban dwellers would lose confidence in Bolivian money, and galloping inflation—price rises consistently in excess of 50 percent per month—would take hold, destroying the modern economy.

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The Faint Hope

With a narrowly based economy, Bolivia's best hope is to exploit its minerals to finance social and economic development and to persuade international lending agencies and bankers to ease loan requirements in recognition of the government's political vulnerability. Although tin has been the country's economic mainspring since the 19th century, we judge that Bolivia's future will depend on untapped resources of oil and gas. The tin industry has lost ground because of substitute materials, increasing production costs, scarce financial and technical resources, and competition from Asian producers. [redacted]

According to World Bank studies, Bolivia's untapped reserves of natural gas and oil are far in excess of domestic needs and would enable La Paz to develop new export earnings and create new jobs in nonenergy sectors of the economy. Based on World Bank and US Embassy reports, we judge that gas sales to Brazil are Bolivia's only realistic option for new foreign exchange earnings. These sales —which could begin as early as 1986-87 and double La Paz's export earnings to more than $1 billion—will be necessary to replace natural gas exports to Argentina, which will probably end in 1991. The proposed Santa Cruz–Sao Paulo pipeline project, however, is an emotionally charged issue in Bolivia, according to the US Embassy in La Paz, because it involves exporting the country's depletable resources. Brazilian interest in Bolivian gas also has been placed in doubt by the discovery of the large Jurua gasfields in the Amazon region of Brazil, by declining Brazilian energy consumption, and by the large capital costs of the pipeline—at a time of fiscal austerity. Nevertheless, we believe the uncertainty about the size of the Jurua gas reserves, the expense of a Jurua–Sao Paulo pipeline, the nine-year construction period for the pipeline, and Brasilia's longstanding interest in having a stable Bolivia on its border will keep the possibility of a Brazil-Bolivia gas pipeline agreement open. [redacted] 25X1 25X1

Because of Bolivia's undeveloped financial markets, the bulk of the investment funds to exploit mineral resources will have to come from foreign lenders. La Paz is counting on a major fundraising drive for over $2 billion in new credits to finance development projects over the next four years. Because lender requirements for such funds are likely to be stiff, La Paz will seek some concessionary financing from official sources, requiring a reconciliation with the IMF, but on politically palatable terms. [redacted] 25X1

The break with the IMF, in our view, would worsen the international financial confrontation. Foreign governments would be likely to cease official aid and loans, while foreign private bankers would probably judge it prudent to seize Bolivian assets in the face of nationalization of banks and repudiation of the debt. Although the nationalistic route would be popular initially, the resulting financial consequences—such as the cessation of trade credits and seizure of assets—would ultimately spur even greater social unrest and probably would lead to a military takeover in less than a year. [redacted]

Longer Term Prospects

Without sustained economic reform, we believe Bolivia faces a bleak future. Political unwillingness to carry through with stabilization will probably result in continuing payments constraints, deep-set financial distortions, a deteriorating economic infrastructure, and declining domestic investment. We judge that continued failure to reduce the public deficit and restrain monetary expansion would ultimately drive the inflationary spiral into the four-digit range, paralyzing the modern economy. Because Bolivia would yet have to create the indexation mechanisms to blunt the impact on living standards, such inflation would cripple domestic production and generate persistent civil strife. With access to foreign credit cuts, La Paz would also have little choice but to resort to more protectionist trade and investment policies to shore up its external accounts. Such policies would end Bolivia's ability to attract foreign capital and technical expertise. [redacted] 25X1 25X1

Under conditions of unremitting economic deterioration—and with a weak political system—we judge that there is little chance for long-term political stability in Bolivia. Siles or any successor president would face the same economic problems. Initially, we judge that a successor military government would attempt to win US acceptance in order to demonstrate its legitimacy and gain foreign financial assistance. Thus, we would expect a new military regime to try to appear responsive to US urgings for economic adjustment measures. Nonetheless, such a government would probably continue to deal with the economic situation much as Siles has, on a short-term, ad hoc basis.

Successive governments—most likely military dominated, even if headed by civilians—would have no spare funds, and thus no flexibility, in rectifying social imbalances. With social ills continuing to fester, Bolivia's key political sectors would focus primarily on competing for their own share of a shrinking economic pie. Consequently, we believe that the collapse of civilian rule would make Bolivia increasingly vulnerable to the growing power of drug traffickers, terrorist activity by paramilitary forces on the left and right, and rising Soviet and Cuban maneuvering for a Communist foothold in South America.

Implications for US Interests

Threat From the Left. The greatest potential long-term threat to US interests in Bolivia is the growing capability of domestic radical left groups, especially the palace clique of advisers, to exploit unstable economic conditions. Although we believe these groups and their Cuban-trained paramilitary forces are far from being able to challenge the armed forces directly, they have the capability now to stage disruptive terrorist operations. Communist Party participation in the government is a longer term threat as Communist cabinet officials use their positions to build on already substantial influence among organized labor. Cuba and the USSR probably will try to increase their influence in Bolivia by offering technical and security advisers and sales of military equipment on concessionary terms. They also are likely to try to exploit links with labor and other groups in a period of economic deterioration, and Havana may offer additional secret paramilitary training for ruling party militants.

Commercial Stakes. US commercial interests in Bolivia, although small, are being hurt by the severe economic slide, and, if our bleak predictions for the future hold, we would expect a further decline in commercial opportunities. US exports to Bolivia shrank by one-half to $99 million in 1982, failed to recover in 1983, and are likely to remain depressed this year. La Paz also unilaterally suspended debt servicing payments to US and other foreign banks, and we are concerned about its ability to resume such payments quickly. These debt servicing difficulties led Bolivia, most recently at the Cartagena debt conference in June, to call for radical action by Latin American debtors, including tougher steps against 25X1 creditors. Bolivia may begin to seek out alternatives, such as non-Western sources of financial support, since economic assistance from Washington and other Western donors is increasingly contingent on economic reforms and eradication of the cocaine trade. 25X1

Cooperation on Narcotics. In our estimation, the Siles administration has not seriously attempted to curb burgeoning coca production and trafficking. Despite his repeated promises to US Embassy officials that the government will undertake more effective control, we estimate that illicit coca paste exports have been unaffected and amount to some $1.5 billion annually, 25X1 and that roughly 40 percent of the 35 to 45 tons of cocaine consumed in the United States annually comes from Bolivian coca. There are several reasons for Siles's failure to curb coca production:

- He has been reluctant to antagonize narcotics traffickers, who are powerful enough to help unseat him.
- He has been unable to extend effective and sustained law enforcement in the coca-growing regions because of limited police resources, rampant corruption, and trafficker-organized campesino resistance.
- Natural disasters and the deteriorating economy have driven more farmers into coca growing, especially in the absence of crop diversification programs.
- Strong nationalistic sentiment, fueled by traffickers, has inhibited cooperation with the United States on narcotics-related matters.

We expect that Siles will, at best, continue the present level of passive cooperation on narcotics enforcement, as the government's financial problems undermine efforts to coordinate and enforce tougher policies. 25X1
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