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Bolivia's Oil Crisis

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ABSTRACT

Bolivia has recently nationalized its oil reserves in hopes of modernizing the country. This will increase oil revenues received by the state to over $1 billion. This extra revenue will be used to fund economic growth and socio-economic programs. Government spending will now be dependent on these revenues. Oil is an extremely volatile commodity and will likely see drastic changes in price. This research finds that nationalization will have an adverse effect on Bolivia's economy. The nationalization of the oil industry will leave the economy undiversified and will stifle foreign investment.

INTRODUCTION

Bolivia is the poorest country in South America with a Gross National Income per capita of only $1010.00 and a 63% poverty rate. In addition, Bolivia has seen its GDP per capita decline over the past five years (Bolivia Data Profile). The country is reported to be full of corruption and is plagued by poverty and civil unrest. Evo Morales was elected President in 2005 on a platform that promised to turn Bolivia around, and on May 1, 2006, Bolivia nationalized its oil and natural gas reserves. This transition from privatization followed Venezuela, which nationalized oil a year earlier. Evo Morales promised to bring the oil back to the people redistributing the oil wealth to the population of 9 million. Bolivia and Venezuela's nationalization of their oil reserves are a part of the Socialist movement occurring in Latin America led by the Venezuelan President, Hugo Chavez.

The state-operated oil company in Bolivia, Yacimientos Petroliferos Fiscales Bolivianos (YPFB), owns all energy reserves and is responsible for drilling and exploration. Private oil companies will still be allowed to operate but will now be forced to pay 82% royalties, as opposed to the previous 18% under privatization. As expected, this was met with significant opposition from oil companies. This new policy increased the revenue of the Bolivian government tremendously. The annual revenue received from these oil companies will total approximately $1 billion, which is one-ninth of Bolivia's GDP (Chavez 1). Morales plans to use this newly created income for social programs to help develop and modernize the country.

The state is now in charge of production, distribution, and exploration, which require a tremendous amount of capital. They will need to increase spending because it is likely that private firms will no longer invest due to the political climate. Bolivia will need to seek out financial help by taking on large amounts of debt to finance their drilling operations. In comparison, Venezuela has actually seen a decrease in oil production since the nationalization of its energy resources. This alone "has cut world output by more than 1%" (Luhnow and Millard A1). Nationalization is expected to reduce Bolivia's production of oil. Oil dependent countries perform economically and socially worse than other non-oil producing countries (Schubert 3). Schubert also claims that "if a country is seeking rapid development, to escape the grips of poverty, oil is certainly not a blessing" (5). In fact, oil reserves are negatively correlated with economic growth.

In summary, extensive reliance on oil leaves developing countries' economies undiversified. These countries are prone to the "Dutch Disease" in which other sectors of the economy decline due to the extraction of oil. Excessive investment in oil will crowd out investment in other sectors of the economy such as agriculture. Nationalization will also limit the amount of foreign investment. This negative effect is sometimes known as the "Curse of Oil" in which countries would have been better off without oil reserves. Bolivia is on a path to remaining the poorest country in South America.

In the next section I will discuss the brief history of Bolivia and its economic struggles. Then, I will argue that the nationalization policy will: 1) leave the economy poorly diversified and 2) stifle foreign investment.

RECENT HISTORY (1994-2006)

Oil was nationalized from 1916 to 1920, then again from 1937 to 1996 and now has returned in 2006 (Bolivia: A Country Study). Bolivia is an extremely ethnically? divided country with over two thirds of the population being indigenous. These people tend to be poor, and this extreme division has existed since the arrival of the Spanish conquistadors in 1532 (Grootaert and Narayan, 5). This could explain why the poverty rate is very similar to the population percentage of indigenous people. Bolivia has seen tremendous political heterogeneity in the past due to this division. The political climate is extremely unstable marked by frequent power struggles. Bolivia has seen approximately "190 changes of government since independence in 1825- more then one change of government per year" (Bolivia: Selected Issues Report 12). Bolivia still remains one of the most divided countries with the highest Gini inequality index in the region (United Nations Development Programme).

In 1993, Gonzalo Sanchez de Lozada came to power. His primary focus was economic and social reform. In 1994, he established a capitalization program of oil, telecommunication, utilities, and transportation. This new policy increased foreign investment significantly reaching close to $27 billion in 1999 (Bojanic and Krakowski 1). This was a tremendous increase considering that the investment was minimal in the 1980s. The population still suffered from poverty and rarely saw benefits from oil operations. This was primarily due to the inefficiency of the tax system and its allocation methods (2). These two factors will play an important role in developing the country.

In the 2002 presidential election, de Lozada was re-elected after, winning by a slim margin against Evo

Morales. Many violent uprisings occurred due to unsatisfactory economic conditions and policies. The country was swept by anti-imperialistic views that saw foreign companies as exploiting their natural resources. The population had enough of this economic suppression and revolted. Despite the uprisings, the International Monetary Fund and the World Bank convinced Bolivia to privatize their public water system in exchange for a $600 million debt reduction. The population was outraged, and it was put back under state control.

2002 marked one of Bolivia's worst financial years with a fiscal deficit amounting to 8.8% of its GDP (Catena and Navajas, 2). With the support from the U.S., the government declared the cultivation of coca to be illegal. As a result, there was an increase in unemployment and a negative stigma of U.S. involvement was created. Another uprising occurred in 2003 opposing the exportation of oil to the United States. Protestors created road blocks and demonstrations prevented gas from being exported. The people demanded "that the gas should be industrialized at the national level, to provide local employment and greater income for the Bolivian people" (Brownlee and Lodge 9). At the time, the Bolivian government was only receiving 18% of oil revenues, while foreign companies received the remainder. The government spent more on servicing debt than on social programs, such as education and healthcare (7). As a result, Bolivia's social welfare system is in desperate need of repair.

After a bloody riot on October 8th in 2003 de Lozada was forced to resign. The Vice-President, Carlos Mesa assumed power and planned to reform the energy industry. Mesa was under tremendous pressure from the International Monetary Fund to reduce the debt and increase privatization. This proved to be difficult, and Mesa resigned that same year. Bolivia was heavily dependent on IMF's debt relief and was unable to come to a middle ground. Massive strikes, demonstrations, and marches supporting the nationalization of oil occurred over the following months demanding the nationalization of oil. Elections took place on December 18, 2005 and Evo Morales was elected as the first indigenous president. He won by an astonishing 54% over his competitor.

The economy did not see any improvement since the privatization of oil in 1996. The tax rate was raised to 50% under Mesa, but that would soon change. Astonishingly, 95% of the voters approved of the nationalization of hydrocarbons. On May l, 2006 Morales nationalized Bolivia's oil and natural gas reserves. This new policy would now require all oil companies to renegotiate their contracts that would shift the royalties in Bolivia's favor. This new policy has been met with severe opposition from foreign oil companies that have invested over $3.5 billion in Bolivia since 1996. The IMF has even threatened the government that it would cut off loans and debt relief. Morales has defied most of the international community and refused to seek financial help from foreign investors (Dillon 2). Bolivia is strongly reliant upon Venezuela and Cuba for support of its social and economic programs. Venezuela has provided financial help, while Cuba has sent doctors to help with its poverty stricken conditions. Morales' supporter, Oscar Olivera, claims that "the resources exist to modify the structure of the national production by broadening its industrial base, improving the transaction system, and diversifying the economy" (1). This could not be farther from the truth. This new policy of using oil to develop the country will fail for two reasons: 1) it will reduce foreign investment and 2) it will leave the economy poorly diversified.

Argument One: Nationalization will leave the economy poorly diversified

Bolivia′s economic base has shifted dramatically since the 1950s. Bolivia has seen a boom in oil exports with oil comprising 47% of all exports. In 1998, it was only 8%. The exportation of oil has drained investments from other profitable sectors of the economy. Since 1998, mineral exports have decreased by 21% and non oil exports have decreased by 25% (Bolivia: Selected Issues Report 56). This has left the economy undiversified.

Diversification is essential for the growth of developing countries but with this policy the economy will remain undiversified. Developing countries are more volatile due to their limited access to funds, political instability, and high dependence on cyclical revenue streams (Baldini 4). Bolivia′s economy has been relatively undiversified over its history, primarily depending on one export for revenue. Oil is an extremely volatile commodity, with it likely to see a monthly price change of 8% (Barnett and Ossowski 13). As a result, the growth of the Bolivian economy is highly dependent on these price fluctuations. Similarly, Venezuela′s GDP is highly dependent on oil prices and has a correlation ratio of .80 as seen in Figure 1 (Baldini 4). Venezuela′s oil revenues make up approximately 25% of its GDP. Accordingly, ‟a change in the oil price US $1 [per] barrel on an annual basis is associated with a variation of close to 1 percentage point of Venezuela′s public sector revenue″ (Barnett and Ossowski 13). Similarly, Bolivia′s oil exports account for 20% of its revenue and will face similar price volatility. Therefore, it would be erroneous for Bolivia to use nationalized oil revenue as a source of income.

Few countries have escaped the ‟Curse of Oil″. The majority of the countries that do escape tend to be well developed and diversified. This would prevent the economy from being susceptible to price fluctuations. Better developed countries, such as Norway, tend to base their government spending on their non-oil GDP (Barnett and Ossowski 18). By doing this they remove a great deal of uncertainty and sustain growth. As a result, Norway has the highest ‟Human Development Index″ in the world. Bolivia ranks 115th on the HDI index. Barnett and Ossowski (2006)claim that ‟the dependence of revenue on oil proceeds, which are volatile, unpredictable, and exhaustible, significantly complicates fiscal management in the short and long runs″. When oil prices are high countries will be more apt to increase their public spending. Consequently, when prices drop they will no longer be able to sustain current or future programs. Thus, they will have to issue debt to make up for the windfalls. Since Bolivia′s economy is undiversified it will not be able to accommodate these shortcomings in oil revenue.

Revenues from oil when prices are high tend to raise the exchange rate, increase the price of labor, and reduce incentives to invest in non-oil sectors (Schubert 6). Venezuela has seen tremendous increases in its exchange rate with it increasing from 762.21 in January 2002 to 2144.60 in March 2007 (Spot Exchange rate - Venezuela). These factors destroy the competitiveness of the economy by ‟squeezing out vital sectors like agriculture and manufacturing, leaving oil as the only functioning revenue source″ (Schubert 6). Catena and Navajas predict that the real interest rate in Bolivia will steadily increase over the next 4 years, climbing to

7.2% in 2011 (27). This increase will ultimately crowd "out private sector credit" (Barnett and Ossowski 18). Consequently, the government will have to suspend social programs and government spending.

According to the "Bolivia: Selected Issues Report", Bolivia has a correlation of -0.75 between volatility and economic growth (13). The majority of this volatility can be explained by trade fluctuations in exports. Unforeseen government spending and an inflationary environment are also contributing factors (14). Bolivia is much more vulnerable to trade shocks because of its lack of diversification. The reduction of these shocks would "help reduce output volatility and enhance growth through a more predictable macroeconomic environment" (Bolivia: Selected Issues Report 20). Bolivia will find this difficult with the majority of exports being oil, and it will have no other industry to even out the volatility of trade shocks.

During the early 1990s Bolivia's government was centralized which prevented local governments from having tax control. The laws were made at the federal (central) level. During this time, 73% of public spending was allocated to transportation, hydrocarbons, energy, and various other public investments (Faquet 6). In 1994, the government was decentralized resulting in the creation of new municipalities and the privatization of all industries. As a result, government spending shifted dramatically with municipalities investing "most heavily in education, urban development, and water and sanitation, together accounting for roughly 79 percent" (Faquet 6). The local governments invested more heavily in projects that would directly help the society. "The criteria of allocation of resources to different areas shifted from one of political consideration to allocation based on population" (Grootaert and Narayan 7). This improved social programs, especially in education.

Local governments within Bolivia will suffer with a nationalized oil economy. The new revenues received under the 82% tax rate will be disbursed to municipalities based on location, rather than being allocated based on poverty levels. Oil is concentrated near two main municipalities. This system is inefficient, and it makes municipalities' dependent on others rich in resources (Bolivia: Selected Issues Report 43). This has created an enormous amount of revenue transfers between the local governments. Bolivia lacks the infrastructure and administration to implement this effectively. There is little oversight and allocations do not necessarily represent current municipal needs. This has made auditing public finances and allocation procedures difficult and will raise more concerns in the future.

Since nationalization, municipalities have lost their individual oil taxing power, which is now decided at the centralized level. This centralization of power will hinder economic growth and revokes the right of municipalities to raise taxes based on their specific developments. This discrepancy can be seen in the "Bolivia: Selected Issues Report", with the oil rich municipalities receiving more per capita than poorer regions (46). After learning this, it is evident that allocations are not based on poverty levels as they should be. Inequalities will continue to persist and municipalities will be left under-funded. This policy also removes accountability from local institutions. "Governments that lack accountability are breeding grounds for corruption and foster a nasty cycle of weakened institutions, patronage and poor governance, which in turn fosters even more corruption" (Schubert 9). This will leave the country geographically undiversified and create further inequalities.The long term effect on the economy could be horrendous. In order to sustain economic growth, Bolivia needs to develop other sectors of the economy and by doing this it will create a broad tax base. This new tax base will provide a more stable revenue stream, since it would be diversified over multiple industries.

Nationalizing the oil industry will leave the labor force undiversified. The labor force is highly skewed based on exports. Oil accounts for half of all exports but only employs about 0.2% of total employment (Bolivia: Selected Issues Report 27). Agriculture accounts for 60% of employment, while manufacturing is only 15%. Unlike the oil sector, the ‟manufacturing sector appears to be linked to productivity growth and technical advance″ (Larsen 1). Employment in the oil industry can leave workers unsuited for other industries. It is also difficult for employees in other sectors to transfer into the oil industry (Gylfason 5-6). Bolivia has seen very little growth in all sectors except for oil. Education can help reduce the negative relationship between oil and growth. As seen earlier, the municipal expenditures on education were at their highest under a decentralized model. Referring to Figure 2, in 1990, when oil was nationalized, a very small portion of funds was allocated to education. More emphasis was placed on the energy sector since it was their main source of income. This shows that allocation will become inefficient under the new nationalization policy. Education will suffer and so will Bolivia′s economic and social growth.

Argument Two: Reduction of Foreign Direct Investment

Foreign Direct Investment (FDI) will be greatly reduced under this new policy of nationalization. A major factor contributing to Bolivia′s reduced FDI is the rise of volatility from nationalization. ‟Increased volatility reduces the risk-adjusted-return on capital, and thus the overall growth″ (Bolivia: Selected Issues Report 12). According to the World Bank, developing countries depend more on FDI than any other financing methods. Therefore, FDI is essential for Bolivia′s growth and emergence from poverty.

Prior to the May 1, 2006, decree, FDI was on the rise. Figure 3 shows a steady increase in FDI from 1995. The hydrocarbon sector saw a huge influx of investment that exceeded $4 billion between 1997 and 2005 (Bolivia: Selected Issues Report 29). Krakowski claims that FDI in electricity, gas, and water sectors accumulated to $27 billion in 1999 (1). This increase was largely due to the capitalization policy in 1994. This was considered the ‟golden period″ with above average growth (4). The economy was able to respond better to economic shocks due to the influx of foreign investment. The nationalization policy has created an unattractive investment environment where investors fear that the government will further nationalize its economy

Oil companies′ investment strategies in the region have shifted. Petrobras, the largest oil company in Bolivia, stands in strong opposition to the new policy. They have stated that ‟it will suspend investments in Bolivia and begin to look elsewhere for natural gas″ (Forero 1). As a result, Petrobras saw a sharp decline in its stock price shortly after. Similarly, when Venezuela nationalized its oil industry, the country′s stock exchange plunged 19% (Gaffen 1). Foreign firms are now hesitant to make new investments with the fear of their assets being nationalized. Bolivia′s actions have been met with large opposition from foreign governments as well. The U.

S. denounced the new policy and has claimed that Bolivia must maintain open markets for economic growth. Morales, along with Chavez, have long opposed the U.S.'s intervention in South America. This new policy is likely to alienate Bolivia from the international market

Bolivia still remains a very difficult place to do business, especially with the radical policy change. The World Bank ranks Bolivia 131 out of 175 countries, based on the ease of doing business. Bolivia dropped in ranking from 126 in 2005 largely due to the new nationalization policy (Doing Business). The dependence on oil will potentially cause appreciation of the currency and can be related to the previously mentioned "Dutch Disease." The "Bolivia: Selected Issues Report" claims that Bolivia has failed to become competitive, ranking 101 out of 117 on its growth competitiveness index (64). The "United Nations Conference on Trade and Development (UNCTAD) Brief", claims that

> "changes in policy stance towards more control by the State and bigger government revenues in extractive industries (e.g. in Bolivia) may have a chilling effect on investors. Moreover, high commodity prices and resulting improvements in the current-account balance have led some local currencies to appreciate, making FDI in export-oriented manufacturing less attractive" (1).

This will potentially reduce investment in Bolivia's manufacturing sector which is essential for economic growth.

The Bolivian government relies heavily on foreign aid to sustain its economy. Bolivia receives a tremendous amount of aid from international institutions, such as the IMF, World Bank, and the U.S. government. However, these institutions have re-evaluated their economic assistance programs since the adoption of nationalization. Figure 4 shows World Bank commitments significantly dropping since the adoption of the new policy. This will reduce funds in healthcare, education, and infrastructure improvement programs and will impede Bolivia's economic growth and support (Bolivia Country Brief). The new policy has limited the government's access to capital. They will now have to make up for these shortfalls with oil revenue.

CONCLUSION

Bolivia's reliance on oil will potentially leave the economy undiversified and stifle investment. This will have a profound effect on the nation's debt levels. The country has been fortunate to receive debt reduction from the IMF and the World Bank, but the country's current nationalization policy may counteract these reductions. The country's debt levels will be largely dependent on the price volatility of oil. Figure 5 shows the economic surplus with the adoption of the new nationalization policy. Bolivia will see a short term economic surplus until 2007. This is largely due to the short term effects of the oil tax restructuring and debt reduction. Bolivia is projected to have a spending deficit every year after 2007 at an increasing rate and will find it difficult to combat these spending deficits due to the decrease in FDI (Catena and Navajas 9). Figure 6 shows the "Average Debt to GDP Ratio." It is important to notice that the debt levels increase tremendously with the volatility in oil prices. Catena and Navajas predict that Bolivia's debt under the new economic policy will reach 34% of its GDP by 2015 (21). Taking this into consideration, the nationalization of Bolivia's oil will have potentially damaging effects on the economy.

Bolivia must seek other forms of development besides oil exports in order to modernize and become competitive. Bolivia has isolated themselves from the international community, further complicating the situation. Bolivia's nationalization plan is ill-suited for its long term development and it will leave the economy undiversified and reduce FDI. These two factors are essential for the country's growth and prosperity. Bolivia must take a broader look and re-evaluate their long term goals. This new policy will not work and will leave Bolivia in the worst possible economic condition.

Bolivia still remains the poorest country in South America. The country is overwhelmed with corruption and political unrest. This has forced the current administration to seek immediate relief through its radical nationalization of oil. Morales has misleadingly promised to lift the country out of poverty by redistributing oil revenues to the people. Unfortunately, Bolivia has failed to learn from the mistakes of other oil dependent countries. In fact, countries that are dependent on oil have historically performed worse than countries without oil reserves. Bolivia's closest neighbor, Venezuela, has nationalized their oil with the same intentions to develop and modernize the country; they have yet to see sustainable growth. With Bolivia becoming increasingly dependent on oil, they will meet the fate of the other countries suffering from the "Dutch Disease."

FIGURES

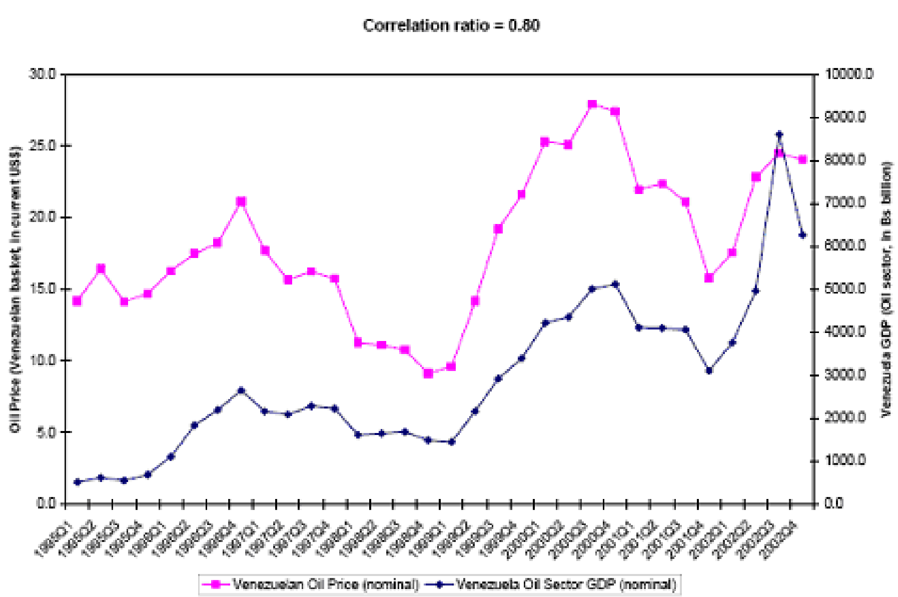

Figure 1. Venezuela Oil Price and Oil Sector GDP Fluctuations, 1991-2002

Source: Baldini, Alfredo. "Fiscal Policy and Business Cycles in an Oil-Producing Economy: The Case of Venezuela." ***Social Science Research Network.*** **December 2005. International Monetary Fund. 2 February 2006. Figure 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=888106>**

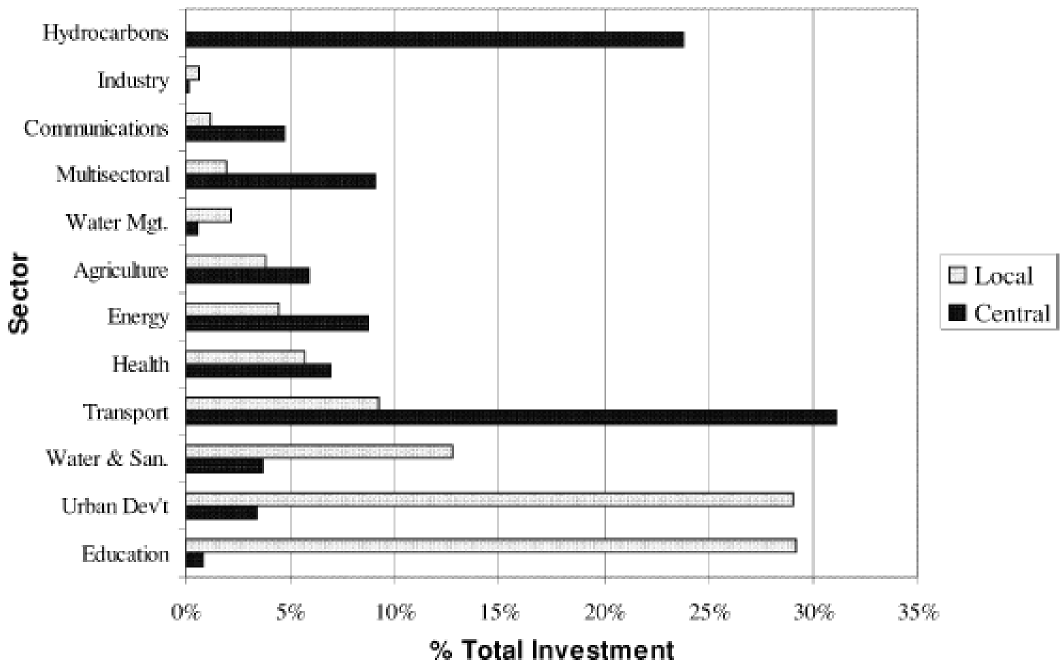

Figure 2. Decentralized v. Centralized Government Investment

Source: Faquet, Jean-Paul. "Does Decentralization Increase Responsiveness to Local Needs? Evidence from Bolivia." ***Social Science Research Network.*** **November 2000. World Bank. 3 February 2006. Figure 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=260579>.**

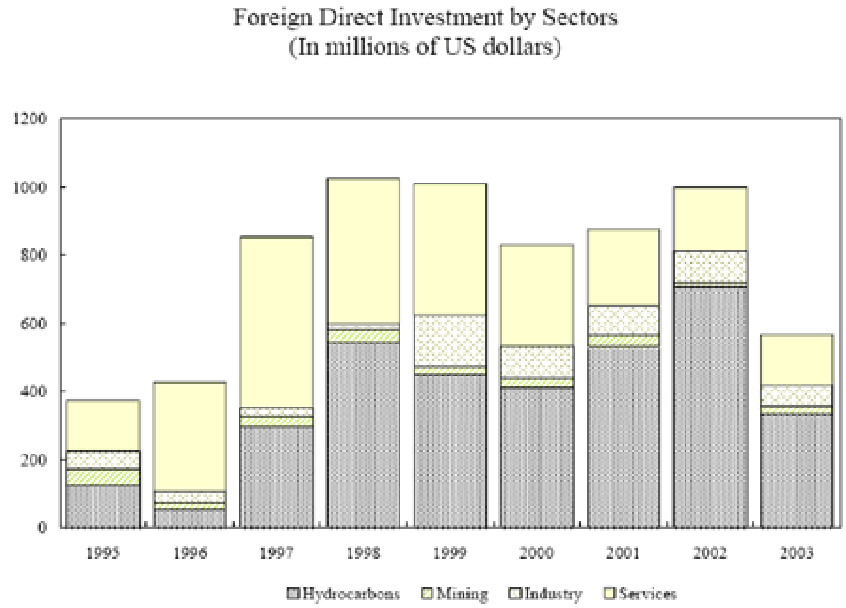

Figure 3. Foreign Direct Investments in Bolivia by Sectors

Source: *Bolivia: Selected Issues Report.* July 2006. International Monetary Fund, Washington. 2 January 2007 <http://www.imf.org/external/pubs/ft/scr/2006/cr06273.pdf>

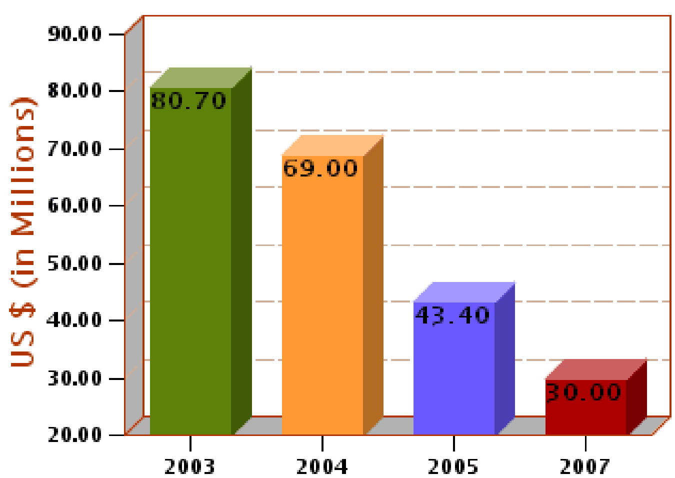

Figure 4. Lending Commitment from the World Bank to Bolivia in US Dollars Source: *Bolivia Country Brief.* September 2006. World Bank. 9 March 2007 <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/LACEXT/BOLIVIAEXTN/0,,menuPK:2204220~pagePK:51331374~piPK:2037600~theSitePK:322279,00.html>

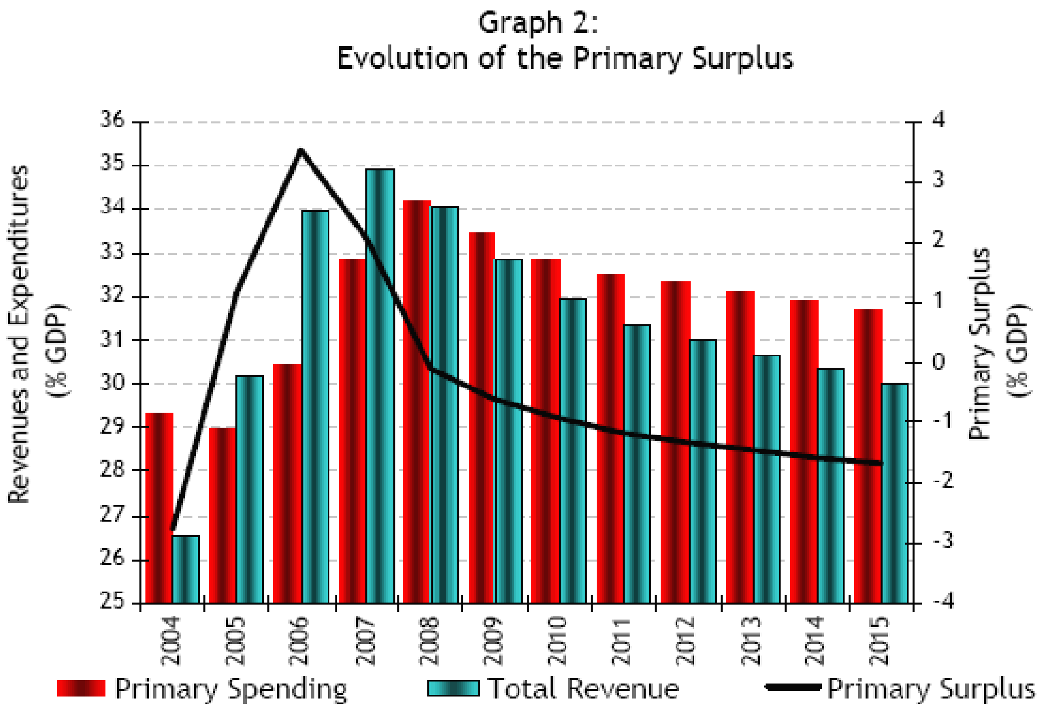

Figure 5. Economic Surplus with the Adoption of the New Nationalization Policy

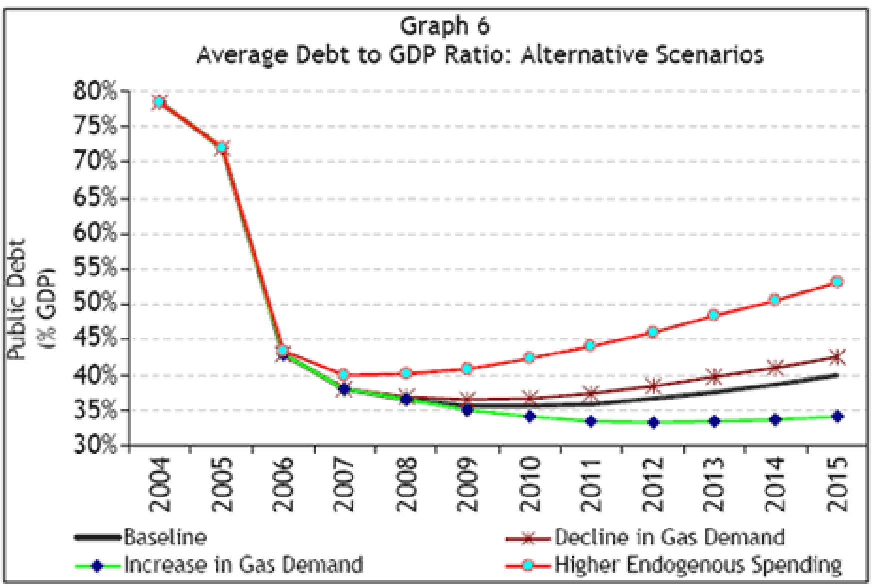

Figure 6. Average Debt to GDP Ratio

Source: Catena, Marcelo and Fernando Navajas. "Oil & Debt Windfalls and Fiscal Dynamics in Bolivia." ***Social Science Research Network.*** **22 June 2006. Fundacion de Investigaciones Economicas. Latinoamericanas. 2 February 2006. Graphs 2 and 6 <http://papers.ssrn.com/sol3/apers.cfm?abstract_id=904218>.**

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