BOLIVIA : THE NEW ECONOMIC POLICY OF 1985 AND AFTER

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SURAIYA NAHER

LATIN AMERICAN STUDIES
CENTRE FOR AMERICAN AND WEST EUROPEAN STUDIES
SCHOOL OF INTERNATIONAL STUDIES
JAWAHARLAL NEHRU UNIVERSITY
NEW DELHI-110 067

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जवाहरलाल नेहरू विश्वविद्यालय
JAWAHARLAL NEHRU UNIVERSITY
NEW DELHI - 110067

CENTRE FOR AMERICAN AND WEST
EUROPEAN STUDIES
SCHOOL OF INTERNATIONAL STUDIES

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CERTIFICATE

Certified that the Dissertation titled Bolivia: The New Economic Policy of 1985 and After, submitted by Ms Suraiya Naher in partial fulfilment for the award of the degree of MASTER OF PHILOSOPHY is original and has not been previously submitted for any other degree of this or any other University.

R. P. Kaushik — Narayanan

(PROF. R.P. KAUSHIK)
CHAIRPERSON

(PROF. R. NARAYANAN)
SUPERVISOR

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P R E F A C E

A prominent characteristic of the political economy of Latin America during the 1980s was the escalating economic crisis of many of the countries manifested in their burdensome debt, declining growth rates, rising unemployment and ruinous inflation. Inflation has been a recurring theme in most of the Latin American countries and much attention has been focussed on understanding and resolving the causes of inflation.

Opinion is divided regarding the causes of inflation and the methods for dealing with it. There are two basic schools of thought - structuralism and monetarism. Stabilization policies based on structuralism are called heterodox policies and those based on monetarism are known as orthodox policies. The latter diagnosis is favoured by international lending institutions like the International Monetary Fund (IMF) and the adoption of orthodox programmes is often a precondition to securing loans from the IMF.

The outbreak of the Latin American debt crisis with its attendant problems of inflation in late 1982 saw these countries turning to the IMF for both finance and macroeconomic advice. The IMF-sponsored orthodox programmes failed to check the steadily increasing inflation and by mid-1985 countries like Argentina, Peru and Brazil adopted heterodox stabilization programmes.

Bolivia, staggering from an inflation rate of over 4000 per cent in just the first seven months of 1985, went against this trend and instead adopted a series of orthodox measures. Within weeks the monthly inflation fell to two digits. The apparent success of Bolivia was greeted with enthusiasm and held up as an example by the IMF and main-stream economists.

What were the causes of the Bolivian hyperinflation and how did the shift towards orthodoxy end it? Since its independence in 1825, Bolivia has suffered through an extreme cycle of economic boom and bust pivoting around a primary product export economy. Led by a downturn in commodity prices and a collapse of the tin economy, Bolivia in the early 1980s sustained years of negative growth rates and plummeting living standards. As net resource transfers from the rest of the world turned negative, the government increasingly resorted to the printing press to finance spending. This resulted in eroding fiscal revenues and inflation soon skyrocketed.

In August 1985, the new centre-right government of Victor Paz Estensorro took power and within three weeks spelled out its New Economic Policy (NEP) in the Supreme Decree 21060 of 29 August 1985. Embodying a series of liberalizing measures, the NEP sought to open the economy to international competition and capital and trade flows, to free internal prices and interest rates, to eliminate credit controls in the domestic capital market, and to reduce the scope of public sector activities.

The NEP addressed the political and technical determinants of inflation with five essential policies: (i) stabilization of exchange rate; (ii) liberalisation of trade and capital accounts; (iii) the reduction of government deficit and monetary emission; (iv) the resolution of the distributional and political conflicts in favour of capital; and (v) the achievement of new external resources, mostly because the orthodoxy of the programme allowed a rapprochement with official creditors.

The stabilization programme ended hyperinflation but left a series of problems in its wake: an overvalued exchange rate, a significant trade deficit, high real interest rates, dependence on short term capital, curtailed private investment, stagnant growth, and a regressive distribution of income.

What are the options open to the government to resolve these problems? Economists have emphasized the need for policy makers to shift policy once stabilization has been achieved. Deviations from the NEP's orthodoxy are, however, constrained by the need for foreign exchange: any distributionally progressive programme could be derailed by either capital flight or the loss of support from conservative international financial institutions such as the IMF. For Bolivia, barely recovered from the hyperinflationary damage of the early 1980s, the present is fragile and the future uncertain.

There exists a plethora of literature on the processes of Latin American politics and economics. The bulk of this material, however, is mainly concerned with the larger and economically more important countries of Brazil, Argentina, etc.

A fair amount of periodical literature has been published dealing with the Bolivian stabilization programme and its consequences. Political scientists, economists and others have offered their interpretations of the NEP and its consequences -- economical, political and social.

Some studies focus on the political aspect of the crisis examining the political context within which the Bolivian government of Victor Paz Estensorro launched, implemented and sustained the stabilization. The commonly held view is that the success of the economic programme was mainly due to the political skill and leadership of President Paz.

Economists who were involved in the planning of the NEP have focussed mainly on explaining the various economic indicators especially the exchange rate which were used to eliminate hyperinflation.

Criticism of the NEP has come from many quarters which mainly focus on the tremendous human and social costs of the NEP.

Other studies analyse the effect of coca production and trade on the NEP and also on the Bolivian economy. There are many who hold the view that drug money was the key to the success of the stabilization programme.

The relations between Bolivia and the United States which is dominated by Bolivia's dependence on drug money and the pressure from the United States to suppress drug production and trafficking as a prerequisite for securing financial assistance, has been the focus of some studies.

The objective of this study would be to arrive at a descriptive analysis of the "Bolivian experience" within the broad conceptual parameters outlined before".

Although the economic success of Bolivia is a much touted example of IMF sponsored orthodox policies there are many who view the stabilization as less of an economic miracle and more a result of the return of finance capital i.e. international loans, debt reduction, and drug money to Bolivia. Of all these durg money is least mentioned and has the most serious implications. Coca is an essential ingredient of Bolivia's success story. The coca economy generates as much foreign exchange as all other Bolivian exports combined, and provides a critical cushion for many of those left unemployed as a result of the austerity programme. The coca trade employs about 20 per cent of the work force and generates about $ 600 million every year. Cocaine profits have thus been especially critical to the stabilization programme. This aspect will be examined in greater detail.

Other than being dependent on coca, Bolivia is at the same time dependent on the goodwill of the United States for the loans needed for the stabilization programme. This has given the United States tremendous leverage in Bolivia and this is most evident in the increasingly militarized strategy of the U.S. to suppress drug trafficking. There is a general consensus that the U.S. policy to strengthen the Bolivian military, as part of the anti-drug drive, can only weaken Bolivia's nascent democratic institutions.

The attempt of this monograph will be to critically study and analyse these issues of economic crisis, stabilization policy, dependence on coca, relations with the United States etc. all with particular reference to Bolivia.

The research study will be based essentially on secondary source materials such as books and periodicals. For comparison of the economic situation before and after the implementation of the stabilization programme, statistical measures of economic factors will be used. Wherever necessary numerical data and statistical analyses will be used to supplement the thesis. For the chronology of events relevant newspapers and periodicals will be referred to.

(Suraiya Naher)

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(Suraiya Naher)

CHAPTER 1

INTRODUCTION

The economic and political history of Bolivia by and large conforms to the pattern of the nineteenth and early twentieth century development in most of the Latin American countries rooted as they were in narrow economic bases and dependent on trade and external financing. Much has been written on this condition of economic underdevelopment and a variety of cause and effect explanations exist. The contrasting explanations of underdevelopment focus on different levels of analysis. In the post-war period considerable importance was attributed to the role of capital, entrepreneurship, and the size of local markets. This was followed by a shift in emphases to public and private sector strategies in which state promoted growth combined with private sector business groups was deemed to be the key to economic and industrial development. However, it was during the 1960s and 1970s that the dependency paradigm was set forth by scholars who viewed development from a global perspective.

There exist a number of differing explanations for the economic underdevelopment of these Latin American countries. According to dependency and world system paradigms, the shortage of capital in these countries results from a global process of capital accumulation. The dynamics of the capitalist world economy serve to concentrate most surplus in the developed countries. Dependency scholars like Andre Gunder Frank, Raul Prebisch and Samir Amin argue that imperialist countries have for centuries depleted the resources of the less developed world and impeded their balanced growth. Through a process of unequal exchange, the underdeveloped countries became raw material exporters and consumers of goods manufactured in the more developed countries.

The dependency perspective has been carried forward by social scientists like Fernando Henrique Cardoso and Enzo Faletto who argue that in foreign owned enclave economies like Bolivia, an industrial bourgeoisie does not develop of its own accord. In such societies the basis of capital accumulation is external, and production is oriented towards export. Cardoso and Faletto note that before industrialization can occur the middle classes must take over and reorganise the state. They also recognize that structural changes do not occur automatically and they stress that revolutions are generally necessary before nationally and industrially oriented middle-class groups displace export-oriented oligarchies.[1]

In 1952 Bolivia experienced such a social and political revolution. Despite the revolutionary leadership and an ample supply of natural resources the country remained underdeveloped even by regional standards. In this chapter we shall briefly outline the history of colonial rule in

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1 Susan Eckstein and Frances Hagopian, "The Limits of Industrialization in the Less Developed World: Bolivia", Economic Development and Cultural Change (Chicago), vol. 32, no. 1, October 1983, p. 65.

Bolivia till independence in 1825, which will be followed by a study of the post-independence era till the Revolution of 1952; and the final section will be concerned with the post-revolutionary period till the decade of 1970.

The Colonial Era[2]

Historically, Bolivia's problems begin with the inherent difficulties of growth in a very large and sparsely populated country dependent on a land-locked mining economy centred in forbidding terrain more than 14,000 feet above sea level. Bolivia's area exceeds those of the United Kingdom, West Germany, and France combined, yet her population is barely 6 million. The country is divided geographically between the Andean highlands where the mining industry is located, and the lowlands to the east, where the petroleum products industries and commercial agriculture are situated. From early colonial times, Bolivia's political and economic centre of gravity has been in the highlands known as the altiplano. However the progressive decline of mining in recent decades has led to a shift of economic and political activity to the east.

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2 This section is mainly written from the historical analysis of William Z. Foster, Outline Political History of the Americas (New York: International Publishers, 1951); Herbert S. Klein, Parties and Political Change in Bolivia 1880-1952 (Cambridge, UK: Cambridge University Press, 1969); United States Department of State, Background Notes: Bolivia (Bureau of Public Affairs) September 1991; and Encyclopaedia Britanica, Macropaedia, vol. XII.

Bolivia's dependence on mining dates from the colonial period. The search for precious metals was a paramount factor in the colonization and settlement of Latin America and mining was one of the dominant economic activities in colonial Latin America. The southern Andean valleys and central plateau of Bolivia, with their dense Indian population, became a core population area within the Spanish empire after the conquest. The greatest concentration of energy and manpower in the mines took place in what was then known as Upper Peru during the sixteenth and early seventeenth centuries. Precious metals gave Spanish America its early fame and throughout the colonial era they constituted the bulk of exports in terms of value and occasionally in terms of tonnage. Mining formed the hard core of economic activity upon which other industry depended.

To the economic resource represented by Indian labour there was added the mineral wealth from the silver deposits of Potosi in 1545. These were the largest silver mines then known in the Western world. From the sixteenth to well into the eighteenth centuries, this southern Andean area, known as the Charcas, or Upper Peru, was one of the wealthiest and most densely populated centres of Spain's American empire. By the middle of the seventeenth century, the central mining city of Potosi was the largest city in the Americas. Its mines were supplied with forced drafts of Indian labourers, known as _mita_[3], all over the Andes. The economic prosperity and wealth of Potosi has been documented by Herbert S. Klein who says:

> From its founding in the mid-sixteenth century until the middle of the seventeenth century, Potosi had produced enormous quantities of silver and the city reached a population of over 150,000 persons. Although the region declined in the eighteenth century, it was still the greatest single source of revenue in the viceroyalty of Peru, and was a key area of contention between the Buenos Aires and Lima viceroyalties. (4)

Silver remained the leading product during the colonial era and for a period of 150 years Bolivia was the source of incomparable wealth for the Spanish Empire. However, despite its legendary colonial wealth and prominence, Bolivia remained paradoxically an economically retarded area.

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3 The forced labour _mita_ system existed in Bolivia and Peru for working the mines. It was also applied in agriculture, cloth manufacture, and other fields of work. The _mita_ was established in 1572 and lasted for two hundred years. It was essentially an exploitative and distorted form of a system which the Incas had formerly used to organise the labour force to work the mines. In the adapted version during colonial times one-seventh of all Indian males were assigned to work three months per year in the Potosi silver mines for little or no recompense. But many of these worked continuously. It is said that when Indians were drafted for the _mita_, they disposed of their wordly goods and they were virtually given a funeral since working conditions were so ardous that many did not survive their forced employment. For further details see William Z. Foster, _Outline Political History of the Americas_ (New York; International Publishers, 1951), p. 73.

4 Herbert S. Klein, _Parties and Political Change in Bolivia - 1880-1952_ (Cambridge, UK; Cambridge University Press, 1969), p. 2.

In 1809, revolts first at Chuquisaca (now Sucre) and then at La Paz gave rise to the wars of Independence in South America. However, it was only in the last days in 1825, after 16 years of civil war that Bolivia gained independence.

<u>Post-Independence Period</u>

Since independence Bolivia has been characterized by a multitude of irregular changes of government and an extreme cycle of economic boom and bust pivoting around a primary product (mining) export economy. The Republic which emerged in August 1825 was essentially the same as its predecessor. The oligarchy which had ruled before was the one which ruled now, only it was no longer responsible for its actions to a distant crown. But the new republic was not as viable as it had previously been. It was economically retarded despite the legendary, colonial wealth and prominence of the region. The late eighteenth century mining decline had given way to severe depression as a result of the Independence Wars and between 1803 and 1825 silver production at Potosi declined by 80 percent.

Besides the decadence of the mining industry, the new republic also inherited a poorly integrated national territory with a disproportionate population distribution. The bulk of the population was located on the <u>altiplano</u> highlands and in the tropical valleys of the east. Over two-thirds of the national population was concentrated in these two regions, according to the 1846 census.[5] The majority of the population was located in the mountain highlands and valleys far from the sea and the neighbouring republics. The nations farming, mining and all important urban centres also existed in this populated core.

Communication was poor and the core population was several days journey by mule transport from the nearest seaports. Therefore, it was impossible to export anything except the most valuable national products i.e. the precious minerals. Bolivia was rich in these mineral resources, but the years of war and civil strife had drained the nation of capital, without which these resources could not be exploited.

Though 90 percent of the population in this early period was listed as rural, Bolivia was not even agriculturally self-sufficient. The national agricultural production was insufficient in both quality and quantity for exportation. There were fertile lands in many parts of the country but most of the population lived on the impoverished lands of the altiplano, and the rest were cut off from the national market by poor internal communications. With the single exception of quinine, no agricultural products were exported and few products even left their local regions.[6] In fact, Bolivia imported not only cereals, meats, and pack animals

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5 Ibid., p. 3.

6 Ibid., p. 5.

from abroad, but even imported from Peru such locally produced foodstuffs as potatoes and '<u>chuno</u>'.[7] Given this agricultural underdevelopment, and the depression of the mining sector, Bolivia became, for the first time in its post-conquest history, a net importer of goods and ran an unfavourable balance of trade until well into the middle of the century. This when the areas of Chile and Rio de la Plata were forging ahead on the basis of meat and cereal production, Bolivia became a net importer of basic foods, even those exclusively consumed by its Indian population.

The Bolivian republic with little trade to tax and few resources to export beyond its precious metals production was forced to rely on direct taxation of its Indian peasant masses who made up over two-thirds of the estimated population in 1825. Whereas the prime sources of government income under the crown had been mining, production, and sales tax, the republican government obtained the bulk of its funds from a head tax on Indian landowners, and received only a minor income from production, trade, or mining and smelting. Until well into the last quarter of the nineteenth century, this regressive Indian taxation was the largest source of national government revenue.

Alongwith this depressed public and private economy, the new republic also emerged with one of the most backward

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7 A dried root food indigenous to the Andean highlands.

social systems in the Western hemisphere. Its population at independence was sharply divided along racial lines between an Indian population estimated at 73 percent and a non-Indian minority. In the words of Herbert Klein:

> Bolivia was probably the most predominantly Indian of the new American republics, and its stratification along racial lines was unquestionably one of the most rigid. The Bolivian Indians were almost totally unaware of the nation's existence and formed a separate society with their own languages and culture. Their relations with the non-Indian society were confined to the economic sphere, and even here they were almost exclusively rural, and largely subsistence farmers, leaving the urban centres overwhelmingly to the Whites and the mixed Indian-White population known as the cholos. These two societies were hierarchically arranged; and the non-Indian minority, the only part of the nation truly aware of national existence, totally exploited the Indian majority, both through the discriminatory tax system, and even more importantly in its growing control over the land. (8)

In early nineteenth century Bolivia, the land was divided between an expanding *latifundia* system controlled by the white elite and a village communal pattern of land ownership, *comunidad*[9], used by the Indians.

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8 Klein, n. 4, p. 7.

9 *Comunidad* is a self-governing and land-owning Indian peasant community. There are three types of *comunidad*: *originarios*, or original settlers of the community; *agregados*, or post-settlement arrivals who possess land; and *forasteros sin tierra*, or late arrivals who do not possess land. The latter usually sell their labour to the community. For further details see Klein, n. 4, p. 413.

Though the 5000 white *hacendado* families were only 2.3 percent of the total rural population, they were an aggressive and expanding minority which throughout the nineteenth century utilized the laws of the state to destroy Indian communal property ownership and to exploit the lands for their own ends.

The *hacendados* rapidly absorbed the richest lands in each area and were able to extract free labour from the previous landowning Indians in return for the use of land on the newly created estates. In what was the most exploitative Indian peasant - *hacienda* system in the nineteenth century, the land owners extracted both free farm labour and free personal service (*ponqueaje*)[10] from their colonos in return for the use of land for their own crops. The exploitative and inequitable nature of the hacienda system is obvious from a comparison of the figures of the number of proprietors and the size of holdings which reveal the gross inequality in land distribution. A look at Table 1 will show that the 615 hacendados who composed a mere 0.7 percent of the total number of property owners possessed 49.6 per cent of the land. Further, 91.9 percent of the total owned property was held by 6.3 percent of the total

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10 *Ponqueaje* was a type of menial personal service to the patron *haciendado*, either at his estate or at his town residence. Since the entire system was without legal sanction the *pongo* was entirely at the mercy of the patron who decided the type of service and the number of days. For details see, ibid., p.162.

Table 1

Agricultural Ownership of Cultivated Land, 1950

Size of property (in hectares)	Number of Proprietors	Total owned (in hs.)	Total exploited	Exploited as % of owned
Less than 5 hectares	51,198	73,877	40,028	54.2
From 5 to 50 hectares	19,503	278,459	86 ,378	31.0
From 50 to 200 hectares	5,014	478,291	76,090	15.9
From 200 to 1,000 hectares	4,033	1, 805,405	134,790	7.4
From 1,000 to 5,000 hectares	4,000	8,724,776	167,006	1.9
From 5,000 to 10,000 hectares	797	5,146,334	55,365	1.0
Over 10,000	615	16,233,054	85,850	0.5
Totals	85,160*	32,741,096	645,506	

Source; Oficina Nacional de Estadfstica y Censos, Seccion Agropecuario, Censo national agropecuario de 1950 La Paz, 1950, mimeo.

* Total number of proprietors was 86,377, with 1,217 unknown.

number of landowners. On the other hand 93.7 percent of property owners controlled a bare 8.1 percent of the total land area. There was gross inefficiency in the size of area under cultivation. As can be seen, the greater the size of the property, the smaller the area of land under cultivation, until the extreme is reached of 0.5 percent utility on properties of 10,000 hectares or over.

Since the *latifundistas* had access to free labour which came with the control of the land, they had no need to invest capital in their holdings and as a result they were scarce products for a high-cost food market. Supplied with free labour, and a guaranteed market, they used only rudimentary technology and poor quality seed. The result was stagnation in Bolivian agriculture which was increasingly unable to meet the needs of Bolivia's expanding population. Thus in the period 1925-9 food imports represented 10 percent of the total imports into the country, whereas by 1950-2 they had risen to 18.5 percent of total imports.[11]

Though the majority of the nation's Indians during this time were free *comunidad* Indians their level of existence was little better than the landless estate Indians. This was due to the primitive level of technology and the lack of capital together with the progressive subdivision of the meagre soil resources where the communities were located. There were no rural schools, no rights to citizenship - since literacy was the primary qualification - and an exploitative system of local *corregidor* government retained all the abuses of the royal era. The office of the *corregidor*, usually held by a *cholo*, was one of the most abused in nineteenth century American government. The *corregidor* was in charge of collection of the discrimi-

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11 Ibid., p. 396.

natory head labour for public works and even for private exploitation. The _corregidores_ at times even controlled the price of such basic commodities as salt and coca.

The 1870s saw a resurgence of the _altiplano_ mining industry and the rise of a new mining elite within the traditional oligarchy. Within a decade, however, the world silver market began to collapse in the 1880s and early 1890s. This fortunately coincided with a shift in tin mining as world demand for tin increased. This change in the economic base was so profound that the new century came to be known as the _siglo de estano_ (century of tin) as tin became the dominant product of the nation.

Tin had been an important byproduct in the production of silver from the earliest times. This, however, took on a new importance and value with the change in industrial technology in Europe and North America at the end of the century. Tin became a basic metal in both consumer and heavy industry, and was suddenly one of the most sought after metals. As traditional European sources were either on the point of exhaution or incapable of expansion, demand exceeded supply and the price of tin rose astronomically. Taking advantage of its rich deposits and the rail network which had been elaborated for the silver industry, Bolivia was soon able to meet this growing demand. From the annual production in the 1000 ton range at the beginning of the 1890s, tin production was up to 3,500 tons in 1879, 9000 tons in 1900, and by 1905 the figure was over 15,000 tons per annum.[12] Very rapidly Bolivia became one of the leading producers in the world.

The shift in tin mining brought about a basic change within the capitalist class in Bolivia. Whereas the silver mining elite had been exclusively Bolivian, the new tin miners included foreigners of all nationalities as well as some new Bolivian entrepreneurs. Tin mining itself absorbed far more capital and produced far more wealth than had the old silver mining industry, and the new companies that emerged became complex international ventures directed by professional managers.

Thus by the twentieth century Bolivia became the world's leading producer of tin but in a manner that neither propelled internal development nor drew the country out of its isolation.

It is important to take into account the relationship between Bolivia and Britain in this connection since it was Britain to which the bulk of Bolivian tin concentrates were exported. Britain on the eve of World War II controlled 70 percent of the world's production of tin concentrates and the bulk of this was treated in British smelters. Britain's pre-eminence was symbolized by the role of the London Metal Exchange (LME) as the place where world prices were set.

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12 Ibid., pp. 31-32.

The key to the British position in the world tin market lay in her control over the smelting technology of Bolivian tin concentrates. Britain denied foreign smelters access to this technology as a result of which the Bolivian concentrates could only be processed in the UK.[13] On the eve of the war, Bolivia was entirely dependent on European smelters, with around 75 percent of her output going to the UK, 18 percent to Holland, and 7 percent to Germany.[14] Britain was thus in a favourable position and crucial to that was her control over Bolivian ores. This exploitative control was maintained at great cost to the Bolivian economy. In the words of John Hillman "relationship" between Bolivia and Britain

> was always narrowly commercial. Bolivia only existed as a source of concentrates to be smelted into metal. While a world market existed, price was largely immaterial, since whatever she (Britain) paid Bolivia in Sterling she would more than recoup through exports. When it was suspended, she was anxious to pay as little as possible. Such cold calculations were never affected by any concern with the human suffering of the miners and their families, nor with the political processes designed to overcome the distortions of a mono-product economy. (15)

Thus Bolivia remained a backward economy structured through combined and uneven development in which a relatively

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13 John Hillman, "Bolivia and British Tin Policy, 1939-1945", Journal of Latin American Studies (Cambridge), vol. 22, no. 1, May 1990, p. 291.

14 Ibid., p. 292.

15 Ibid., p. 315.

advanced, export-oriented capitalist sector - tin mining -- co-existed with an archaic, stagnant and predominantly provincial organisation of agriculture. The imbalance caused by the fact that the control of the vital tin industry lay in the hands of a tiny oligarchy -- the Rosca (literally, small kernel). The Rosca wielded such enormous influence over the state's fiscal affairs and exercised a corresponding political power that it was given the title of Superstado minero (mining superstate). The power of the tin companies was indisputable; three family firms controlled eighty per cent of an industry that controlled eighty percent of national export and provided the state with its only secure tax base and input of foreign exchange.[16]

Many of Bolivia's problems can be seen as the tragic consequences of the continuing decline of the mining sector. The first major crisis came with the depletion of silver deposits and the fall of world silver prices at the end of the nineteenth century. The crisis was resolved when world demand for tin boomed with the development of the modern canning process and heavy industry. In many respects tin was built on the infrastructure of silver to carry into the twentieth century Bolivia's dependence on mining. The peak of modern Bolivian economic development was reached in the first two decades of the twentieth century, when tin

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16 James Dunkerley, Rebellion in the Veins: Political Struggle in Bolivia, 1952-82 (London: Verso, 1984).

was intensively developed. World tin prices were high and export earnings provided the basis for a major extension of the country's infrastructure, including roads and the railway system.

As tin lodes approached exhaution in the 1920s, Bolivia began to lose export competitiveness, and when tin prices collapsed at the start of the Great Depression, Bolivia in January 1931, became the first country during the crisis to default on its foreign debt.

The collapse of the tin economy, and Bolivia's costly and unpopular involvement in the Chaco War[17] with Paraguay

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17 Chaco War. The Gran Chaco is a large territory of about 150,000 sq. miles lying between Bolivia on the north and Paraguay on the south. It is an extremely fertile region noted for its agriculture and timber resources and more importantly for its oil deposits. This territorial dispute had been boiling ever since the independence wars with both countries unable to reach any agreement to amicably divide the territory. In the years 1879, 1887, and 1894, successive treaties had been drawn up between Bolivia and Paraguay but these agreements were all stillborn with both countries claiming the entire region as their own. The quarrel became more acute after the question of oil came into it. Britain and the United States also had a hand in the dispute and many scholars are of the view that the Chaco war was actually between the Royal Dutch Shell and Standard Oil. In 1926 Standard Oil was granted extensive concessions in the Chaco area and undertook considerable development work, drilling and refining. However, there was no way to transport the oil out of Bolivia except through Paraguay to a Brazilian port. Under Argentine and British pressure, Paraguay refused to allow it to go through except on conditions that Bolivia was unable to accept. Standard Oil could not pump its oil over the Andes and the Chaco War was deliberately precipitated. In December 1928, fighting broke out between Bolivian and Paraguayan armies. During the next three years there

in mid-1930s eroded the hegemony of the export-oriented tin and land based oligarchy. This was further hastened with the political mobilization of workers and the dissatisfaction of the middle classes with the leadership of the oligarchy.

The Revolution of 1952 and Since

The oligarchy was finally swept aside by La Revolucion Nacional of 1952. The 1952 revolution led to the installation of an economic model described as state capitalism. Politically, Movimiento Nacionalista Revolucionario (MNR)[18]

Footnote 17 cont'd ...

was intermittent fighting mixed with peace negotiations. The League of Nations, the United States, United Kingdom, and several South American countries all took a hand to bring about a settlement. By the middle of 1932, however, Bolivia and Paraguay were in open war with each other. The Bolivian army was at a disadvantage since most of its soldiers came from high altitude plateaus and were unadapted to the low jungle areas of the Gran Chaco. The war came to an end in July 1933 with Bolivia having to cede most of the territory of the Gran Chaco to Paraguay. For further details see Foster, n. 3, pp. 200-203.

18 The MNR was formed during the social disorganisation which followed the Chaco War in 1941. To its founders such as Victor Paz Estenssoro and Hernan Siles Zuago, the MNR was intended to be more like a movement, a broadly based structure that linked miners, peasants, and middle class intellectuals under a banner that was revolutionary and nationalistic and thus against the members of the established oligarchy. For details see Brian Loveman and Thomas M. Davies, Jr., eds., The Politics of Antipolitics: The Military in Latin America (Lincoln: University of Nebraska Press, 1978). Also see Klein, n. 4.

which led the revolution tried to follow the example of Mexico and create a formal democratic regime based on a de facto single party control.

An important characteristic of the Bolivian revolution was anti-imperialistic in its thrust. Nationalization of the mines and agrarian reform was designed to eliminate the foreign owners and to abolish the feudal structure of land ownership and labour under the hacienda system. In the words of Charles Anderson:

> ... the Bolivian Revolution of April 1952 was not a direct product of the postwar spirit of reformist agitation and discontent, noted as a critical variable in the experiences of other nations. Rather, the Revolution was a culmination of a pattern of conflict, labor organisation, and stillborn reformist governments, that had originated early in the 1930s. (19)

He further goes on to say:

> The revolutionary component of the Bolivian experience is generally confined to two distinctive public policy innovations, the redistribution of lands formerly owned in large units to small-holders, and the nationalization of the mining properties of three large concerns. (20)

During the time of the 1952 upheaval, the dominant class in Bolivia centred around three tin families - Simon

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19 Charles W. Anderson, Politics and Economic Change in Latin America: The Governing of Restless Nations (Princeton: Van Nostrand, 1967), p. 298.

20 Ibid.

Patino, Mauricio Hochschild, and Carlos Aramayo - and a landed oligarchy. Although two of the tin magnates were Bolivian by birth and the other an immigrant, the export sector approximated the enclave situation described by Cardoso and Faletto. Structurally integrated into the economies of advanced capitalist countries, the mining sector had weak links with the rest of the Bolivian economy. The tin enterprises were incorporated abroad, most stockholders were foreign, and profits tended to remain outside the country. Moreover, the corporations were treated as foreign owned under Bolivian exchange regulations.[21] Mining generated most of the country's wealth and foreign exchange earnings and mineral products accounted for 96 percent of exports in prerevolutionary Bolivia.[22] Yet the mining sector was more closely tied to the economies of advanced capitalist countries than to the rest of the domestic economy. Only a small proportion of the proceeds accrued to national development and there was hardly any capital accumulation domestically. Very little of the income was directed to any Bolivian development enterprise outside the mining sector.

In spite of being outward-oriented, the mining economy provided the state with most of its revenue and

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21 Eckstein and Hagopian, n. 1, p. 66.

22 Ibid.

financing. This naturally provided the mine owners with enormous influence in the running of the government policies and state activities and it was in their own interest to support the raw material exporting economy. The mining concerns were deeply immersed in Bolivian polities, and their elimination by nationalization of the mines was one of the primary goals of the MNR.

The state appropriation of the main mines led to the revolutionary regime gaining control of the country's principal revenue source. In recognition of organized labour's role in the revolution, the nationalized tin industry was initially established with a joint labour-government management, and a new set of advanced labour decrees were passed, giving extraordinary job security to Bolivian labour.[23] The MNR also tried to transform the trade-oriented economy by having the public sector assume new entrepreneurial functions and by encouraging private sector agriculture and industrial import-substitution. The Revolutionary leaders looked to the public sector as an engine of growth that would be both more broadly based and more equitable. The installed economic system assigned to the public sector the bulk of capital formation, both for infrastructure and for industrial production in state enterprises. The leading state enterprises were COMIBOL, the national tin company, and YPFP, the state petroleum

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23 Klein, n. 4, p. 403.

company.

The second important change to be affected by the 1952 Revolution was agrarian reform. The principal goal of the Bolivian Agrarian Reform Decree of August 1953 was the destruction of the inefficient, monolithic, latifundias and the feudal structure of agricultural labour that prevailed on these estates. In the words of Herbert Klein:

> ... this decree completely destroyed the ponqueaje and colonato system of free labour which was at the very heart of the latifundia system. Though the legalization of land titles for the peasants was relatively slow, the latifundia class was literally wiped out and there were none left, at least in the heavily Indian populated areas, to exact labour tribute. (24)

The distribution of lands among the Indians was rather slow initially but it accelerated towards the end of 1950s. By the early 1960s approximately 178,400 land titles had been issued.[25] (Table 2).

In addition to these fundamental economic changes, there were also major political changes. The army was temporarily abolished and civilians, workers and peasants were all given arms and organized into militia units. Immediately after 1952, the old officer corps was purged, most military personnel were demobilized, and only MNR

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24 Ibid., pp. 403-4.

25 Anderson, n. 19, p. 301.

Table 2

Year	Titles Issued	Hectares (000)
1954	3,400	52
1955	4,463	47
1956	11,400	276
1957	9,193	202
1958	18,380	321
1959	38,877	853
1960	45,511	1,168
1961	2,589	70
1962	133,833	2,989

Data from Republica de Bolivia, Direccion Nacional de Informaciones, Bolivia; 10 anos de revolucion (La Paz; Emp. Industrial Grafica E. Burillo, 1962), p. 57.

members were allowed in the service. The military share in the national budget dropped from 23 percent in 1952 to less than 7 percent five years later.[26] The pre-revolutionary literacy qualification was abolished and the voting population increased from 200,000 in the last

26 Michael A. Morris and Victor Miltan, eds., Controlling Latin American Conflicts; Ten Approaches(Boulder Co.; Westview Press, 1983), p. 206.

election of 1951, to 958,000 in the first election after the electoral law was passed, or from 7 percent to 29 percent of the population.[27]

Post-Revolutionary Era

The two basic innovations that undermined the economy of the export-oriented oligarchy after the 1952 Revolution were nationalization of the mining sector and agrarian reform. Although the MNR leadership perceived these two policy reforms as a step towards economic and political development, the outcome of both these policies was different from what was envisaged before the revolution.

The elimination of the powerful private mining interests did not lead to economic prosperity for the country. Of the many reasons for this, one was unrelated to the act of nationalization. The quality of Bolivian ores had been declining and in most of the existing mines the richest lodes had been depleted by 1952. The tin industry was a high cost, low quality industry and during the time of the Revolution, Bolivia was a high cost producer in the world market. The high capital investment required for excavation combined with high transportation costs made the tin industry an inefficient one. Moreover, the Revolution gave rise to increased and often excessive demands by the labour force in the mines. Substantial

27 Klein, n. 4, p. 404.

wage increases, employment of redundant employees, and excessive peripheral benefits were forced on COMIBOL, the national mining company. Labour productivity dropped, absenteeism increased, and work stoppages over minor issues frequently occured. With the withdrawal of the foreign owners, an acute shortage of working capital developed, and skilled technicians and managers left the country.[28] By 1961, the productivity of the tin mines had dropped by 40 percent. In 1961, when the price of tin was US dollars 1.20 per pound, the cost of production in Bolivia was US dollars 1.27.[29] This necessitated the government to grant substantial subsidies which in turn fed the existing inflationary trend.

Agrarian reform in the aftermath of the Revolution had a mixed outcome. Although land distribution led to the dismantling of the latifundistas and granted property rights to the Indian cultivators but this did not lead to any increase in agricultural productivity. Rather there was a sharp decline in agricultural output immediately after the reform and only in 1958-59 the agricultural production returned to the 1950 level.[30] This resulted in increased government expenditure on importing foodstuff. One of the reasons for this was that land distribution after MNR

28 Anderson, n. 9, pp. 299-300.

29 Ibid., p. 300.

30 Ibid., p. 301.

took power formalized small-scale farming in the densely populated peasant regions. Bolivian agriculture was at subsistence level before and after the Revolution. Much of the land which was redistributed among the Indian peasants were too small to be efficiently exploited. In the words of Susan Eckstein:

> The reform incorporated peasants more directly into the market than under the old regime, but the size of the parcels contricts the beneficiaries ability to maximise their labour productivity and, in turn, their earning power. With little income they can consume few commercial products. Since they constitute the largest fraction of the labour force, and since land rights have given peasants reason to remain in the countryside, the revolutionary agrarian reform may have had the effect, though not the intent, of discouraging industrial investment. (31)

Thus Bolivia's problem changed from that of latifundia to minifundismo.

The 1952 Revolution led to the MNR leadership reducing and reorganizing the armed forces. Military personnel were demobilized and by 1953 workers and peasants were organized into militia which alongwith the armies of the regional strongmen, kept the military from monopolizing the means of force. Yet in contrast to this, a newly-constituted military gained preeminence within less than

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31 Susan Eckstein, "Revolutions and the Restructuring of National Economies; The Latin American Experience", Comparative Politics (New York), vol. 17, July 1985, p. 480.

a decade after the Revolution in Bolivia. By 1964 the military had become so influential that the Air Force Chief of Staff, Rene Barrientos, could insist on running as vice president on the MNR slate, and shortly thereafter he was able to stage a successful coup that ousted the MNR from power.[32]

The military build-up occurred in large part because the central government turned against organised labour, with which it had allied in 1952. The government instead turned to the armed forces to repress worker demands and enforce anti-labour policies, after having granted labour a variety of economic and political concessions[33] in its first years in power.

While the middle class faction of the MNR and labour shared a common interest in overthrowing the oligarchy, their interests in other respects conflicted. The disjunction between their interests became especially

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32 Morris and Milton, n. 26, p. 207.

33 During the early years of the MNR regime, labour was granted a number of economic and political concessions. Labour was awarded corporate status in the government and the party. Within the MNR labour came to control a number of posts on the executive council, the majority of MNR congressional seats, and the Party's vice-presidential candidacy. Within the government, labour gained formal power through a system known as <u>co-gobierno</u> (co-government) allowing it to name heads of several ministerial posts. Labour participated in both the government and Party through a newly formed labour confederation, the Bolivian Workers Confederation (COB), dominated by the miners and mine leader Juan Lechin Oquendo. For further details see ibid.

apparent after the introduction of an IMF-US backed financial stabilization programme in 1956, and it was at this point that the military was rebuilt to help undermine labour's power.

The stabilization programme reduced real wages and ended labour subsidies. Although labour formally remained part of the ruling coalition until the 1964 coup, beginning in the late 1950s only unions that supported the stabilization programme were permitted to hold party and government office. "Thus post-revolutionary governments with time increasingly turned against labour groups with which they had initially associated and allied more exclusively with capital".[34]

Finally, a discussion of the Bolivian revolution would be incomplete without mentioning the role of foreign capital. Despite MNR nationalism, Bolivian post-revolutionary development has been heavily financed from abroad. With the mine nationalizations the government acquired direct access to the mineral surplus but the drop in tin prices caused tin revenues to decrease. Since the revenue base was limited and demands of government resources were great, the MNR had to seek international financing. Most of the initial funds came from the United States. In the words of Susan Eckstein:

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34 Ibid., p. 210.

> Although the U.S. government does not typically finance revolutions, once it recognised the non communist bent of the leadership it extended more per capita aid to the MNR (1952-1964) than to any other Latin American country at that time. With the aid the U.S. coopted the national leadership, helped stabilize the economy, and strengthened the power of the military and segments of the bourgeoisie. (35)

Also, the US government recognised very soon after the upheaval that in assisting the fiscally poor state it could coopt the revolution and keep the country within the Western bloc at a time of intense Cold War struggle. With the support of the IMF, the U.S. government helped develop a domestic bourgeoisie, but one rooted in an enclave economy with a small economic base. In addition, the US government helped rebuild and modernize the military, which although highly factionalized, has periodically repressed defiant workers and peasants.[36]

Although bilateral aid from the US had a positive effect on the economy, it was at the expense of local political autonomy and labour-peasant strength in the government. The funding led U.S. agencies to participate directly in Bolivian state bureaucracies and in government decision-making.

The MNR also received major financing from other multilateral agencies as well. While the IMF helped to

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35 Eckstein, n. 31, p. 485.

36 Morris and Miltan, n. 26, p. 211.

create conditions that made the country attractive to other foreign creditors, it has imposed more restrictions on its loans than any other funding source. Its policies have adversely affected local industrialists, labour, and peasants. By 1970s private banks began to lend to Bolivia. The internationally financed growth strategy backfired, however. In the 1970s the official debt came to nearly equal the value of the national product and the country became bankrupt and in technical default.

To sum up, the leaders of the 1952 Revolution had envisioned a democratic regime based on single party control. The regime would govern by incorporating all the key sectors of society into the party and thereby into the regime. This strategy proved unsuccessful and the whole concept of more equitable growth through a large state sector collapsed in a mass of inconsistencies over the thirty years between the Revolution and the onset of hyperinflation. As explained by James Malloy[37] state capitalist development and populist distribution soon proved to be incompatible since capital accumulation generated costs that demanded a shift to anti-populist policies in which the costs fell on urban labour and rural peasant workers. In the post revolutionary period, leftist leaders could never amass

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37 James Malloy, "Democracy, Economic Crisis and the Problem of Governance: The Case of Bolivia", <u>Studies in Comparative International Development</u> (New Brunswick, NJ), vol. 26, no. 2, Summer 1991, pp. 40-41.

the political strength to satisfy their redistributional aims. For example, their objectives of raising public sector salaries and of increasing public sector investment and employment were frustrated by lack of capacity to tax. For these reasons, leftist or populist leaders have repeatedly turned to inflationary finance or foreign borrowing to carry out their distributional and developmental goals. Bolivia's first bout of high inflation came in the wake of the Revolution, and the second after the left-wing government of Siles Zuago came to power in 1982.[38]

The right wing leaders on the other hand, worked to use the state to satisfy a different agenda. Governments on the right sought to bolster segments of the private sector through generous government subsidies. They have rejected higher taxes and have instead sought to finance the government through a reduction of public sector wages and through foreign borrowing, as compared to left-wing governments who have generally paid for higher public salaries through printing money or through foreign borrowing. The common theme in both types of government has been foreign borrowing.

The MNR soon developed divisions and the middle class leadership lost its ability to control key sectors

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38 Jeffrey Sachs and Juan Antonio Morales, Bolivia: 1952-1986 (San Francisco, California: International Center for Economic Growth, 1988), p. 18.

of the party. Government followed government and by mid 1960s the single party, ostensibly democratic regime had shifted into a military backed authoritarian regime. This was ratified in November 1964 when the military overthrew the MNR and took direct control of the government and state power.

CHAPTER 2

THE ECONOMIC CRISIS OF THE EIGHTIES LEADING TO THE IMPLEMENTATION OF THE NEP

An attempt is made in this chapter to review in some detail the political and economic crises that confronted Bolivia in the 1970s and early 1980s. A combination of political and economic developments experienced by Bolivia during these years ultimately brought the country to an economic dislocation which culminated with a runaway hyperinflation in 1984-85.

Divided into three sections, the first section of this chapter will briefly sketch the seven-year long uninterrupted administration of General Hugo Banzer beginning in 1971. The second section will describe the fast-moving political events between 1978 and 1982. The final section will highlight the economic problems faced by the administration of Zuazo Siles that led to the implementation of the New Economic Policy in late 1985.

The Banzer Administration (1971-78)

In the recent political history of Bolivia, at least in one respect the administration of General Hugo Banzer is significant. For, he stayed in power for seven straight years from 1971 to 1978 which is a record in modern Bolivian history. During the first three years of his rule, General Banzer had the support of both the leftist and rightist political parties. Most of these political parties in Bolivia are extremely small personalistic groups euphemistically known as <u>taxi partidos</u>, because they were so small that they could even hold the party convention in a taxi cab. After three years of co-opting these parties within his administration, Banzer jettisioned these parties in 1974 when he recognised that "they were rump factions who represented little more than cliques whose primary purpose was to lay claim to public sector jobs".[1] Soon after he imposed an anti-populist model of economic growth and began ruling with the support of private sector business, the military, and some technocrats. In part because of this model and in part because of favourable international factors such as high prices for commodities, Bolivia experienced a burst of economic growth during this period. The gross domestic product (GDP) during the Banzer years averaged 5.4 percent per year and prices rose only moderately especially during 1975-78, when Bolivia's inflation rate was close to the world inflation rate.[2] Because of the booming economy, Banzer enjoyed the support of the urban middle classes, and even some favoured labour groups such as the railway workers, but faced continued strong opposition from most of organised labour and from the left-wing parties.

Another important dimension of support and opposition to Banzer was regional. The eastern part of the

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1 Jeffrey Sachs and Juan Antonio Morales, Bolivia: 1952-1986 (San Francisco, California: International Center for Economic Growth, 1988), p. 20.

2 Ibid., p. 6.

country, and especially Banzer's home province of Santa Cruz, provided strong support and in return benefited greatly from Banzer's policies. A number of groups in this region were given grants of property rights over public lands, plus generous subsidized credits.

In 1975, the Banzer regime announced a five-year development plan which encapsulated the growing philosophy of economic growth through foreign borrowing. The plan aimed at export promotion led by state investment. The public sector was targeted with 71 percent of total investment over the period, focussed heavily on hydrocarbons, mainly in the Santa Cruz region. Financing of the plan was to rely on the profits from petroleum exports, which never materialized, and on foreign borrowing, which did. Most of the plan, however, was never implemented.

The economic growth during this period soon proved to be superficial and did not reflect a structural basis for sustained long-term economic development. In spite of the apparent economic success, Banzer was unable to create a new institutionalized regime to generate power and to underwrite the government. In the words of James Malloy Banzer's

> government degenerated into a personalistic patrimonial regime, and Banzer had to devote larger and larger amounts of property to manipulate the complex factional networks of

> personalistic clients that allowed him to cling to formal symbols of power. (3)

Banzer's capacity to govern declined over the period and by 1978 Bolivia had no effective national institutions. By this time even the military had degenerated into numerous factions dominated by ambitious officers.

In 1977 and 1978, General Banzer faced growing pressure from the Carter administration for a return to democracy. An election was called, but was annulled after charges of massive fraud. In 1978, he was summarily ousted when he tried to engineer a formal transition to democracy with himself as the elected president.

<u>Economic Problems of the Banzer Era</u>

It was during the Banzer era, in the 1970s, that Bolivia's external debt rose dramatically. The Bolivian debt crisis was among the worst in the region. Although the size of the debt was much less than the larger Latin American countries as Argentina, Brazil and Mexico, its debt (export and debt service) export ratios deteriorated dramatically in the 1970s, including relative to other Latin American countries. Its debt/export ranking rose from tenth to third, and its debt service/export ranking

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3 James Malloy, "Democracy, Economic Crisis and the Problem of Governance: The Case of Bolivia", <u>Studies in Comparative International Development</u> (New Brunswick, New Jersey), vol. 26, no. 2, Summer 1991, p. 41.

rose from tenth to fifth between 1974 and 1980 (see Table 1).

Bolivian borrowing capacity increased in the 1970s because of an expansion in international liquidity and favourable international prices for Bolivian exports. In particular Bolivia benefited from high prices for its exports of petroleum. Moreover, the Banzer government promoted an internationally financed growth strategy. This strategy unfortunately backfired, when known reserves of exportable crude were quickly exhausted and new reserves were not found. Meanwhile, international commercial lending rates increased and world inflation drove up the cost of imports. As a consequence, the government's fiscal strength deteriorated rapidly and revenues had to be diverted from productive investments and from purchases of inputs needed for industrialization to debt repayments. Although this was a common occurence in many developing countries in the 1970s, it was more exaggerated in the case of Bolivia, where in 1979 the debt nearly equaled the value of the national product (97.4%).[4]

As further argued by Susan Eckstein and Frances Hagopian, Bolivia's high dependency on foreign capital has, in a way, resulted in impeding economic growth and industrialization. Foreign capital often carry conditions

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4 Susan Eckstein and Frances Hagopian, "The Limits of Industrialization in the Less Developed World; Bolivia", Economic Development and Cultural Change (Chicago), vol. 32, no. 1, October 1983, pp. 73-4.

which limit domestic growth options, since creditors may make loans contingent on conditions that adversely affect production in certain sectors of the economy. Also, loan repayment obligations may compel a country to emphasize production for export at the expense of production for domestic consumption,and interest payments on debts may reduce the economic surplus locally available for capital formation.[5] The nature of foreign funding also has a direct bearing on economic growth. Between 1970 and mid-1979 the foreign loans contracted by the government rose from US dollars 670 million to nearly US dollars 3.4 billion.[6] But the 1970s increase mainly involved costly short-term credits. By the end of 1977 Bolivia owed 28 percent of its foreign debt to private banks and 14 percent to private suppliers, and these two sources of foreign funding combined accounted for two-third of foreign disbursements.[7] This private financing and World Bank financing is more costly than the low-interest bilateral aid that Bolivia enjoyed in its first revolutionary decade. Reflecting the increased cost of foreign capital, and the portion of the public debt contracted between 1971 and 1977 at an interest rate of less than 3 percent dropped

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5 Susan Eckstein, "Revolutions and the Restructuring of National Economies: The Latin American Experience", Comparative Politics (New York), vol. 17, no. 4, July 1985, p. 485.

6 Eckstein and Hagopian, n. 4, p. 73.

7 Ibid.

Table I

Cumulative Outstanding Hard Currency Foreign Public Debt: Amount and Amount in Relation to the F.O.B. Value of Foreign Exchange Generating Exports and to the Value of the National Product in Current Prices

Year	Amount (millions $ US)	LA ranking in size of debt	Debt as % of exports	LA ranking in debt as % of exports	Debt as % of national product	LA ranking in debt as % of nat'l prod.	Debt service as % of value of exports of goods and services	LA ranking in debt service/ exports ratio
1974	906	8	157	10	58	1	11.1	10
1975	1225	8	265	6	60	1	14.6	7
1976	1605	8	279	4	54	2	16.2	7
1977	2010	9	309	4	82	2	21.5	5
1978	2353	10	376	3	87	2	49.8	3
1979	2745	10	360	3	93	1	30.3	4
1980	2944	9	313	3	92	2	26.2	6
1981	3009	9	329	4	87	2	-	-

Source: U.S. Joint Economic Committee (USJEC).

from 55 percent to 34 percent, while the portion contracted at over 6 percent, rose from 16 percent to 54 percent.[8]

Bolivia's rapid accumulation of external debt in the 1970s (Table 1) reflected a number of forces at work. Part of the foreign borrowing financed a plausible attempt to generate a more diversified export base through various investment projects. Some of these projects, such as natural gas exports to Argentina, proved successful; others such as investment in crude petroleum production, ended as failures. The foreign borrowing also reflected an attempt to finesse the internal distributional conflict on borrowed money and borrowed time. The government made no attempt to raise taxes and indeed failed to implement any tax reform. The debt crisis also derived from the sudden rise in interest rates and deterioration in commodity prices with world recession. While these conditions were common with the other countries in the region, Bolivia's domestic political and economic dynamics accounted for the particular severity of the country's debt burden.

Although the strategy of financing economic growth through foreign capital brought disaster to Bolivia, some of the foreign borrowing also had the purpose and effect of enriching a narrow set of private interests via the public sector's access to foreign loans. High level functionaries have purportedly stolen millions of dollars

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8 Ibid.

and invested funds unwisely because of kickbacks that they could accordingly get. In a society with a weak private economy, government office came to be viewed as a sinecure. Also the weak central government lacked control over the fiscal policy of public enterprises some of which contracted loans from foreign banks on their own which provided opportunities for graft. Government instability also inclined functionaries to take advantage of opportunities when they arose as their term in office was unpredictable. Top-level public enterprise posts were political appointments that shifted with government changeovers. Bolivia's foreign debt had been further compounded by its global economic marginality. Because local production is inefficient and poor in quality, the country has had difficulty marketing goods internationally. The overvalued exchange rate also, maintained through foreign borrowing became a channel for capital flight for wealthier individuals.

The economic record of Banzer years seems rather impressive when seen in isolation. Bolivian Gross Domestic Product (GDP) growth averaged 5.4 percent per year, which was far above the average 2.4 percent during the whole period of 1952-85.[9] Investment as a share of GDP reached historical highs, though the gap between government expenditures and government revenues widened.[10] In an era of

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9 Sachs and Morales, n. 1, p. 20.

10 Ibid.

easy foreign finance, however, the gap was readily filled by foreign loans. The Banzer boom, however, proved to be precarious, built as it was on a temporary commodity boom, easy access to foreign finance, and a narrow political base.

Political Instability During 1978-82

The Banzer era gave way to a four year period -- 1978-82 -- of intense political instability with several interim presidents, coups, and three aborted national elections, producing nine different heads of state between Hugo Banzer and Hernan Siles Zuazo.

The disintegration of the Banzer regime led to a period of presidential turmoil during which Bolivia had no less than five heads of state within the span of a single year -- 1979. The first in this presidential line-up was Banzer's own candidate General Juan Pereda Asbun who ultimately seized power through a military coup when his electoral victory was challenged. However, he managed to stay in power for only a brief period of three months before being overthrown in November 1978, by General David Padilla. As president, Padilla called for new elections in July 1979. The results were indecisive, and Congress compromised by naming Walter Guenara Arce, who had been elected to the Senate, as interim president.[11] Guenara

11 Robert J. Alexander, "Bolivia's Democratic Experiment", Current History (Philadelphia), vol. 84, no. 499, February 1985, p. 74.

Brief Political Chronology, 1952-85

1952	The Bolivian Revolution is carried out by the Nationalist Revolutionary Movement (MNR), under the leadership of Dr. Victor Paz Estenssoro.
1952-56	Paz Estenssoro holds presidency; inflation rises to 178.8 percent in 1956.
1956-60	Siles Suazo (MNR) holds presidency; economic stabilization takes place with U.S. and IMF supervision and finance.
1960-64	Paz Estenssoro holds his second presidency.
1964	Paz Estenssoro holds his third presidency; he is deposed in military coup led by Barrientos Ortuno.
1964-66	Ovando Candia and Barrientos Ortuno serve as co-presidents.
1966-69	Civilian presidency is held by Barrientos; he dies in a plane crash in April 1969.
1969	Vice President Siles Salinas becomes president and is deposed in a coup by Ovando Candia.
1970	Ovando Candia is deposed by General Miranda, Miranda is deposed by General Juan Jose Torres.
1971	Torres rules a left-wing radical government. He is deposed in a coup jointly sponsored by military, the Falange Socialista Boliviana (FSB), and MNR.
1971-73	General Hugo Banzer Suarez rules with MNR support.
1974-78	Banzer holds presidency under military rule, MNR withdraws from government in 1974.

1979 Pereda becomes president in an election marked by accusations of fraud. Pereda is deposed by Padila, who calls for an election. Election results in stalemate (no majority); Senate President Walter Guevara Arze serves as interim president. Guevara is deposed by Colonel Natusch Busch; Busch resigns in 15 days. Lidia Gueiler, President of Chamber of Deputies, becomes interim president.

1980 Election ends in stalemate. Gueiler is deposed in a coup by Major General Luis Garcia Meza.

1981 Garcia Meza is forced to resign in favor of General Bemal. General Bemal resigns in favor of General Torrelio.

1982 General Torrelio is deposed in a coup by General Vildosc Calderon. Congress reconvenes and names Siles Suazo as president.

1985 Siles Suazo announces early elections. Paz Estenssoro becomes president. New economic policy is declared on August 29, 1985.

Arce was deposed by Colonel Natusch Busch who resigned within 15 days. After a period of confusion, the Congress in November 1979 named Lidia Gueiler, President of the Chamber of Deputies as interim president. She presided over still further elections in May 1980, which were also indecisive. Before Congress could carry out its decision to elect Hernan Siles Zuazo, who had received a plurality of notes, another military coup brought General Luis Garcia Meza to the presidency. It was under the rule of Garcia Meza that Bolivia reached its political nadir in 1980 and 1981.

The installation of President Garcia Meza began the most disastrous and disgraceful period of twentieth century Bolivian history. Leaders of the military regime protected and participated in the international cocaine trade, encouraging the spread of the growth of coca, the raw material for cocaine. The regime also borrowed very heavily abroad which exacerbated the economic crisis. Since the Garcia Meza regime was deeply implicated in the burgeoning cocaine industry, therefore it never received international support, except for the backing from similarly corrupt and violent military regime in Argentina. During the Meza regime, capital flight reached new heights, with errors and omissions in the balance of payments in 1980 and 1981 totalling 590 million US dollars. The commercial banks stopped all lending and negotiated an emergency rescheduling agreement, which was soon defaulted upon. The rest of the international community also ceased new lending, except for important loans from the Argentine regime.

In August 1981, Garcia Meza was overthrown and during the next 13 months there were three other military presidents. General Bernal came to power after Garcia Meza was forced to resign. In turn, General Bernal had to resign in favour of General Celso Torrelio Villa who was deposed in a coup by General Vildoso Calderon. The Congress was finally called back into session to elect a constitutional president. Hernan Siles Zuazo was the one named to form a constitutional government.

Of all these governments chronicled above, few had the will and none had the power to address the hard choices in economic policy. As has been stated by James Malloy, the implementation of austerity programmes

> ... in Latin America is not so much a matter of political will as it is of governmental capacity. In Bolivia, the fact is not that governments did not want to administer the medicine, they quite simply could not do it because there was no governmental capacity to mobilize support for such an exercise in statecraft. (12)

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12 Malloy, n. 3, p. 42.

Malloy further goes on to say that:

> such (austerity) programmes demand a substantial amount of political will to impose the costs that they carry, particularly because these costs fall on the very groups that expect from democracy, the alleviation of the costs they had been forced to pay under authoritarian military governments. (13)

None of the heads of state during the chaotic period of 1978-82 had the political backing to address the acute economic problems facing the country. The one president who made a significant effort -- Lidia Gueiler -- was deposed in short order by General Garcia Meza. Moreover, by this time, Banzer's strategy of foreign borrowing had run its course, with insufficient export earnings and government revenues to show for it. None of the various governments following Banzer during 1978-82 was in any position to raise taxes or enforce economic austerity. Consequently, they resorted to printing money when the flow of foreign capital changed from net inflow to net outflow. Added to the problem of obtaining fresh credits, commodity prices started to slide in 1981, and existing rates on the existing international loans soared. By October 1982, when the government of Hernan Siles Zuazo came to power, the economy was in sharp downward slide. Real GDP had declined by an estimated 0.9 percent in 1981 and by 8.7 percent in 1982, and the price levels had risen

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13 Ibid.

by 308 percent in the twelve months preceding Siles accession to power.[14]

The Siles Administration

The Siles government inherited an annual inflation rate of approximately 300 percent, an inability to borrow, on the international markets, and an economy declining sharply in real terms. At the same time, the new government was called upon to satisfy pent-up social and economic demands. The demands on the government were heightened by the fact that the government represented a coalition of forces on the political left that pressed for increases in social spending, public sector employment, and public sector pay, but that lacked the political base to raise tax revenues to fund such spending.

The main problem for the Siles government was the severe economic crisis which demanded vigorous governmental action. Over the next three years (1982-85), the Siles government formally launched five separate economic programmes or packages, paquetes economicos, aimed at stabilizing the economy. None of these paquetes were implemented as designed, and all failed miserably in the end.

All the paquetes of the Siles period followed a similar scenario. Because of international and local

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14 Sachs and Morales, n. 1, p. 22.

pressures, especially from the IMF and the CEPB[15], the government would announce a fairly severe set of austerity measures. The COB would immediately attack these measures and coerce the government to soften, if not eviscerate the package. This would bring cries of outrage from the CEPB and elicit further international pressure. Ultimately, the battered package would fail and the situation deteriorate.

To better understand the crisis it is important to take into account the political implications of Siles accession to power in 1982. The new administration represented the first elected government in 18 years. Therefore, pent-up social and economic aspirations were sure to boil over early in the term. Siles, representing the left wing of the MNR, governed in a coalition with various leftist parties, including the Communist Party of Bolivia. In the early phase of the administration, organized labour gave support to the new government, but only in return for significant wage increases. Ultimately, when the financially strapped government was unable and unwilling to grant wage increases to keep ahead of the accelerating inflation, organised labour turned bitterly against Siles' coalition. General strikes by organised

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15 CEPB and COB were the two main interest associations. CEPB was the main association of private entrepreneurs and COB was the central labour confederation.

labour (COB) in 1984 and 1985 killed the final two stabilization attempts of the Siles administration. The government's problems in controlling the state were also manifest during an open struggle with the employees of the Central Bank, who used their union to thwart all attempts by the government to control the bank.[16] This was a crucial battle, because control of the bank was the key to asserting fiscal control over the entire public sector and failure to control the bank doomed all efforts to assert authority over the public sector.[17]

The hyperinflation under Siles was not so much the result of an explosion of new spending, which did occur early in Siles' term, as of the inability to restrain spending in the face of falling loans, falling tax revenues, and higher debt service payments abroad. The coalition members were never able to agree on policies to restrain spending, while the government's right-wing opponents in the Bolivian Congress rejected all proposals to broaden or even stabilize the tax base. Jeffrey Sachs carries forward this line of argument to say that

> at a fundamental level the government failed to realize that the deepening crisis was an indictment of the system of state capitalism itself, and especially of the financial limitations of that system. (18)

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16 Malloy, n. 3, p. 49.

17 Ibid.

18 Sachs and Morales, n. 1, p. 23.

The hyperinflation and debt crisis developed as Bolivia's net resource transfers from the rest of the world turned negative in 1982. Seignorage[19] financing i.e. printing money substituted for the decline in foreign resource flows. A look at Table 2 will show that for 1980 and 1981 net new borrowing by the public sector exceeded the interest payments on the public debt. In 1982, however, new borrowing plummeted, so that the transfer of resources to Bolivia (the new loans minus interest payments) turned sharply negative. The jump in seignorage which fueled the hyperinflation and the decline in net resource transfers were approximately of the same magnitude. As the government devoted an increasing share of resources to foreign debt servicing, it resorted to printing money to finance the rest of its domestic spending. Seignorage jumped in mid-1982, several months before Siles' term began and reached a high plateau of about 12 percent of GDP annually[20], until stabilization was achieved in late 1985.

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19 According to monetarism, inflation cannot persist without sustained money growth. The government's source of revenue from printing money is called seignorage. When the government finances a deficit by creating money, the money is absorbed by the public. As prices rise, the purchasing power of a given stock of nominal balances falls. For further details see Eliana A. Cardoso, "Hyperinflation in Latin America", Challenge (New York), vol. 32, January-February 1989, pp. 11-12.

20 Sachs and Morales, n. 1, p. 24.

Table II

Bolivia's Debt Servicing of Medium- and Long-Term Public Sector Debt (millions of dollars)

	1980	1981	1982	1983	1984
Net Interest Payments	163.9	171.0	180.9	172.8	201.3
Official Creditors	42.8	50.3	66.2	64.7	166.2
Private Creditors	121.1	120.7	114.7	108.1	35.1
Net New Lending	341.9	263.2	88.6	-18.0	60.5
Official Creditors	191.0	163.9	103.0	13.5	63.3
Private Creditors	150.9	99.3	-14.4	-31.5	-2.9
Net Resource Transfer	178.0	92.1	-92.2	-190.8	-140.8
Official Creditors	148.2	113.6	36.8	-58.3	-102.9
Private Creditors	29.8	-21.4	-129.1	-139.5	-37.9
Net Resource Transfers Total % of GDP	6.2	3.1	3.4	6.9	-5.1

Source: World Debt Tables, World Bank, 1985-86 Edition.

The relative constancy of government seignorage does not reflect a stable level of government spending, taxes, and monetary emission. Rather, the constancy of the seignorage collection hides a process of fiscal collapse in which tax revenue collections all but disappeared, while government spending particularly on public investment was cut back sharply in a vain attempt to catch up with the moving target of falling tax collections. The monetary expansion meanwhile, prompted repeated and accelerating depreciations of the exchange rate, which then fed into inflation. As inflation accelerated, the demand for real money balances fell, so that a constant rate of seignorage collection as a percentage of GDP was associated with accelerating inflation and a falling level of real money balances.

Government revenues in Bolivia in the early 1980s relied heavily on three main forms of taxes: internal taxes (mainly sales, property and income taxes); and taxes on trade (mainly tariff collections); and taxes on minerals and hydrocarbons (mainly paid by COMIBOL and YPFB). Each of these plummeted as a percentage of GDP. Overall, revenues of the central administration fell from more than 9 percent of GDP in 1980 to just 1.3 percent in the first nine months of 1985.[21]

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21 Ibid., p. 25.

Inflation itself is a major factor in undermining government revenue collections. In Bolivia, several factors were at work. With income taxes, simple lags in collection reduced the real value of collections to almost nothing by 1985. Similarly, property taxes and several excise taxes were stated in specific, rather than advalorem terms. Thus, as the price level rose, the real value of the tax collections fell. Tariff revenues declined for several reasons. The downturn in economic activity reduced imports, and therefore tax collections. Equally important, there was a persistent and large gap between the official exchange rate and the black market rate. This had the effect of encouraging smuggling, on which tariffs are typically not collected. Even when goods were imported legally, however, the tariff in pesos was collected on the basis of the official exchange rate, and therefore the real value of tariff collections was substantially reduced. The taxes on mining and hydrocarbons were similarly squeezed. The overvalued exchange rate reduced the profitability of the state enterprises in these sectors, and they therefore paid taxes to the central government on a sporadic basis only. Indeed, the central bank made large transfers to the state enterprises to keep them functioning in the face of the squeeze on their operating revenues.

Data limitations do not allow for any detailed account of central government spending patterns. However, some major points are clear. It was public investment spending rather than wages and salaries that was sharply cut as the Siles government attempted to cope with the growing fiscal crisis. Union opposition successfully forestalled any serious attempts to reduce public sector real wages or public employment until the end of hyperinflation. Rather, in the first year of the Siles government, public sector employment jumped markedly. Until the spring of 1984, the government squeezed internal spending and relied on monetary emission to make room for interest servicing on the foreign debt. In 1984, the government finally quit debt service payments on government debt to the commercial banks. By this time, ironically, the rising inflation had so ravaged the tax system even with the suspension of interest payments, the deficit on a cash basis remained enormous, so that the resort to seignorage finance was hardly slowed.

In a short-sighted attempt to restrain inflation, the government resorted continually to ineffectual price controls, overvalued and multiple exchange rates, and other forms of intervention. These policies had no effect on the general price level, but they frequently threatened the solvency of private and public firms. In response, the government would typically find some indirect way to compensate the firms for the intervention measures. In this way, a direct price control measure would end up triggering an indirect fiscal subsidy, thus adding to the government's need for inflation finance.

Before concluding this chapter, there is one important point to be made. While the hyperinflation was a disaster for the economy and for Bolivian society as a whole, many well-connected, rent-seeking individuals made considerable fortunes during its course. Anybody with access to official foreign exchange from the central bank could become wealthy almost instantly during thisperiod, by purchasing cheap dollars at the central bank and selling them at several hundred percent profit in the black market. Similarly, commercial bankers, who took deposits at zero interest and lent money at high nominal interest rates, shared in the governments' seignorage gains. Moreover, the government extended many low-interest loans during the period, often to politically powerful landowners. These loans in effect became grants as a result of the inflation. Price controls on public sector goods, generated opportunities for lucrative smuggling operations. All of these opportunities for gain helped create a powerful constituency of those who wanted to see the hyperinflation continue.

CHAPTER 3

THE WORKING OF THE NEP

This chapter will be an attempt to study the phenomenon of hyperinflation and the dynamics of stabilization programmes in general and will examine the Bolivian stabilization of 1985 in detail. Divided into two sections, the first will deal with the two main schools of thought which exist regarding the causes of inflation and the measures needed to bring about disinflation. It will also deal with the peculiar economic and social consequences which result when inflation escalates into hyperinflation. The second section will take up the Bolivian stabilization programme of August 1985 and examine in detail the various policy measures which were adopted by the Bolivian government to bring an end to inflation.

Inflation: Problem and Prescriptions

Although a number of definitions have been put forward by various scholars the one commonly held defines inflation as a sustained rise in the general level of prices. During an inflationary period the average level of all prices continues to rise, though the relative prices may change for a variety of reasons. Similarly deflation is defined as a sustained fall in the general level of prices and disinflation is the reduction or elimination of inflation.

High inflation poses a grave threat to fledgeling democracies in Latin America. It erodes the purchasing power of wages, creates an intense feeling of insecurity, and undermines popular support for constitutional governments. Although the costs of stabilization are high, inflation is a bigger threat to democracy than stabilization policies. Inflation also threatens sustained growth. Uncertainty creates short horizons for production decisions and a tendency to concentrate assets on inflation hedging. The resulting economic structure emphasizes finance at the expense of production. Inflation also leads to capital flight which is a common phenomenon in most Latin American countries.

The problem of inflation is common to most of the Latin American countries and different points of view have been presented by the various governments of Latin America, international organisations such as International Monetary Fund, and the United Nations Economic Commission for Latin America and the United States. There is no lack of explanation for the inflation and growth experiences of the different Latin American countries. Of these the two most prominent explanations have been based on the monetary and structural theories of the relation between inflation and growth.

According to monetarism, inflation is the result of overspending, and inflation in Latin America is caused by large budget deficits financed by money creation. To stop inflation, budget deficits must be cut.

The opposing view, structuralism, maintains that budget deficits simply do not matter. The causes of inflation are in supply shortages, bottlenecks, and inconsistent claims of different groups in society trying to get a larger share of the pie. For structuralists, incomes policy is the answer to stop inflation.

Monetarism explains inflation as the result of too much money chasing too few goods. The reason for too much money is the finance of budget deficits by money creation. Once inflation is built into peoples' expectations, increases in money supply only result in the level of prices. According to Eliana Cardoso;

> The basic truth in monetarism is that inflation could not persist without sustained money growth. The government's source of revenue from printing money is called seignorage. When the government finances a deficit by creating money, the money is absorbed by the public. As prices rise, the purchasing power of a given stock of nominal balances falls. Therefore, inflation acts like a tax.(1)

As money growth increases above the real growth of income, inflation rises. Seignorage revenue also increases but at a decreasing rate. This happens because, as inflation rises, people reduce their real holdings of the money base, as it becomes more and more costly to hold. Thus, seignorage will increase less than proportionately with the increase in

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1 Eliana A. Cardoso, "Hyperinflation in Latin America", Challenge (New York), vol. 32, January-February 1989, p. 13.

money growth and inflation. Eventually, inflation will become so high that no increase in money growth can produce an increase in real seignorage.

The inflationary experiences of most of the Latin American countries can be interpreted in the light of their external debts. The wave of inflation in the 1980s in Latin America began with the debt crisis, when governments of these countries were deprived of foreign capital inflows to finance their deficits. To produce the trade surplus and the needed exchange resources to service the debt, the exchange rates were greatly depreciated. The devaluations had inflationary consequences through their impact on imported intermediate and final goods. They also had an impact on the domestic cost of servicing the external debt. Because the devaluations increased the debt service measured in domestic currency, the budget deficit also increased, increasing the required money creation and inflation. The result was that Latin American inflation doubled in the early 1980s.

One of the consequences of inflation is the increasing dollarization of the economy. As inflation rises and confidence in domestic money declines, people tend to favour foreign currency. The use of U.S. dollars by Latin Americans in place of domestic currency is referred to as the dollarization of Latin America.

Continuing inflation also diminishes the volume of resources available for domestic investment. Community savings get reduced and a significant part of this saving is channeled to foreign rather than domestic investment. Capital flow from abroad is discouraged and a substantial part of this reduced resources is diverted to uses which are directed by profit motive than by social good. There is also a diversion of savings away from capital markets, where investment decisions are subject to longer-term economic criteria, and toward luxury housing and other kind of investment which are socially less useful but may be highly profitable because of the inflation.[2] In order to reduce the foreign deficit, the government may resort to controls which usually protect uneconomic production. Political pressures lead to further restrictions which create further distortions. Economic activity thus becomes steadily more distorted.

The monetary school stresses the control of inflation as one of the major objects of economic policy in the developing economies. The monetarists recognize that rapid economic development is likely to provoke inflationary pressures. Thus inflation control should be a priority of the governments of developing countries. Price stability,

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2 Richard Ruggles, "Summary of the Conference on Inflation and Economic Growth in Latin America", in Werner Baer and Issac Kerstenetzky, eds., Inflation and Growth in Latin America (New Haven: Yale University Press, 1970), p. 3.

hence, is a necessary prerequisite for sustained economic growth.

In contrast, the structural position is that in developing economies with rapid urbanization, structural maladjustments themselves may be responsible for imbalances which cause unavoidable price increases. The structuralists argues that growth of real income and economic potential in a country increases demand in some sectors of the economy which develop at different speeds, causing bottlenecks. In the presence of downward price rigidities in some sectors, those bottlenecks cause inflation spurts that money squeezes cannot correct.

Structuralists preach investment in areas where bottlenecks are supposed to appear. These are usually sectors in which social revenues exceed private revenues. Investment in these sectors is necessary even if those investments can only be financed by money creation.

Some structuralists blame inflation in countries with low productivity in the agricultural sector on changes in relative prices. During the process of industrialization there is a shift of resources from the agricultural to the industrial sector. With a stagnant food-producing sector, growth in the industrial sector will increase the demand for food faster than its supply. Because the inadequate purchasing power of exports prevents sufficient food imports, excess demand for food induces increasing prices. Yet the food price increases are not matched by price declines in the industrial sector. This is the case because industrial prices are marked up over wages, and the behaviour of wages depends on food prices. Hence overall inflation is induced.

The increase in food prices sets off further price increases elsewhere in the economy via its impact on the cost of living. With the initial rise in the cost of living there will be immediate pressure to raise wages. Governments usually respond to such pressure by raising the minimum wage rate. Unless there is a fall in employment, an increase in wage rate will result in larger wage bills and thus in an increase in purchasing power, which in turn will cause an additional increase in food prices, and thus an upward price spiral is generated.

In some countries other sectors may create structural difficulties. One such sector is exports and imports. Export earnings may not keep up with the growth of the rest of the economy, because of either a failure of the export industries to grow or a continual decline in world prices of the export commodities. This is further elaborated by Ruggles:

> ... increase in real income in the economy will cause an increase in demand for imported goods, which in the face of the failure of export earnings to rise at a similar rate will result in balance of payments difficulties and a rise in the prices of goods in the import sector.(3)

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3 Ibid., p. 5.

The difference between the monetary and structural position thus essentially comes down to a difference in their view of the nature of price increases in the economy. The monetarists consider that price stability is a prerequisite for rapid economic growth and that governments should give it high priority and take the necessary measures, despite the difficulty of such measures, to insure it. The structuralists consider that, in an economy with major bottlenecks and weak export markets, the attempt to achieve price stability through monetary and fiscal means will result in unemployment, underutilization of industrial capacity and slow growth.

Theoretical Constructs of Macroeconomic Stabilization

The debate between orthodox and heterodox stabilization programmes parallels the arguments between structuralists and monetarists. Orthodoxy, like monetarism views socioeconomic structures as flexible and inflation as the result of overly expansive monetary and fiscal policies. In this view tight fiscal policy and free markets should produce optimal outcomes in both the long and short runs. Heterodoxy, on the other hand, views economic, social and political structures as rigid and inflexible. In this view, prices are set by predetermined rules, and the battle over income shares combines with these fixed-price rules to produce cost-push inflation. Thus, heterodox policy solutions give short shrift to the free market and rely, instead, on government intervention and direct management of the distributional conflict through income policies.

<u>Orthodox Policy</u>

The principal elements of orthodox stabilization policies have been part and parcel of IMF programmes over the years. They include (i) currency devaluation to shift positively the external balance; (ii) reduction of the public sector's fiscal deficit by modifying existing taxes, instituting new ones, adjusting public sector prices, and reducing consumer and producer subsidies; (iii) tighter monetary policy, particularly a reduction in the monetization of the fiscal deficit; (iv) reduction of real wages through market mechanisms; (v) opening of the economy by reducing tariffs and eliminating quotas and export taxes; and (vi) rapid decontrol of internal prices. Besides these integral elements, orthodox strategy will also include (i) financial reform to let credit markets determine interest rates; (ii) trade reform, especially the maintenance of near equilibrium exchange rates, the development of institutions to promote exports, and the reduction and simplification of import duties; (iii) opening up the economy to greater foreign investment; (iv) privatization of some government services and state enterprises; and (v) streamlining of government activities, like improved budget techniques and reduced public employment levels.

From the 1950s to the 1980s, numerous orthodox programmes have been applied in Latin America -- Chile (1956-58, 1973-78), Argentina (1959-62, 1976-78), Bolivia (1956), Peru (1959, 1975-78), Uruguay (1959-62, 1974-78), Mexico (1983), and Brazil (1982-83).

Heterodox Policy

Heterodox stabilization programmes rely on the structuralist argument that budget deficits do not matter, that speeding up domestic growth while controlling prices is what is needed to stop inflation. They reason that inflation results less from demand pressures than cost pressures, which are passed into the economy by price-setting firms and then fed into an inflationary spiral through wage indexation.

The elements of heterodox policy focus on breaking inertial inflation through the use of incomes policy which imply a temporary freeze on wages and prices, altering inflationary expectations by adopting new currencies, and reducing whatever demand pressures existed by practicing fiscal restraint.

Hyperinflation

Hyperinflation in generally described as a situation of extreme inflation. According to P. Cagan hyperinflation can be defined as a price increase of more than 50 percent per month. The main feature of hyperinflation is that money loses almost all of its value. Prices rise to fantastic levels, and the velocity of circulation becomes enormous. Money loses value so rapidly that people are unwilling to hold it for more than a few moments. The change in the velocity of circulation has been explained by Stonier and Hague with the help of the quantity theory of money.[4] The quantity theory of money states that if 'M' is the amount of money; 'V' is the velocity of circulation (the number of times that each unit of money is spent during a given period); P is the price level; and 'T' is the volume of trade then MV = PT.[5] In words, the quantity of money multiplied by the number of times that each unit of money is used during any period of time, equals the price level of output multiplied by the quantity of output bought during the same period.

Thus in a normal situation when the amount of money doubles the prices will correspondingly double and V will remain more or less constant. However, a larger increase in M, which occurs in a situation of hyperinflation, will raise the value of V. This in turn will raise prices more than in proportion to the initial rise in M. In the words of Stonier and Hague –

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4 Alfred W. Stonier and Douglas C. Hague, A Textbook of Economic Theory (New York; Longman, 1988), edn. 5, pp. 554–83.

5 Ibid., p. 555.

> If the supply of money is increased to a hundred times its original amount, prices are unlikely to become only a hundred times as high. They may well rise to a thousand or even a hundred thousand times the old level. The velocity of circulation will become very large. (6)

The velocity of circulation is the obverse of liquidity preference or the demand for money. If the demand for money is high, then money circulates slowly, V is low, and vice versa. When prices rise beyond a certain point, people speculate on the likelihood of a continuing price rise. Hence, if commodity prices rise sharply and at an increasing rate, people realize that money will lose its value and this will lead to a decrease in the demand for money.

Hyperinflations are thus characterized by a substantial rise in the velocity of circulation and a rapid increase in the money stock. A consequence of the increase in money stock is that printing presses work at full capacity and are still unable to keep up with the demand for currency. Therefore, at the height of hyperinflation there is an apparent scarcity of money. One other consequence of the increase in currency is that banknotes are denominated in increasingly larger units.

The role of expectation in fueling hyperinflation has been explained by Brian Griffiths who says -

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6 Ibid., p. 575.

> Hyperinflations usually start with a rapid increase in the money supply, which produces a rapid increase in prices. But the increase in prices raises the expectation of future price rises, and therefore money holders wish to reduce their real balances. Even though they cannot reduce their balances in absolute terms, the aggregate effect of all money holders purchasing more goods and assets is to drive up prices even further. (7)

The economic and social consequences of hyperinflation are the same as that of inflation differing only in magnitude. Trends which are barely discernible during a creeping inflation become glaringly obvious during a hyperinflation. The same underlying forces are at work in all inflations, the only difference is their magnitude and the speed with which they operate.

An important consequence of a hyperinflation results from attempts to economize on the holding of money. Because money does not bear interest, inflation is a tax on its holding. At a time of hyperinflation the rate of this tax reaches enormous proportions, so creating an incentive for persons to economize even further on the holding of money.[8]

A common feature of all hyperinflations is the frenzied speculation which takes place in goods, securities

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7 Brian Griffiths, Inflation: The Price of Prosperity (London: Weidenfeld and Nicolson, 1976), pp. 146-7.

8 Ibid., p. 151.

and foreign exchange. At the first sign of runaway inflation, people make a deliberate attempt to spend as much cash as they can and to buy goods instead. Instead of holding bank notes and deposits, they will buy real estate and art treasures. As the internal value of the currency plummets consumers hoard goods and firms accumulate stocks and capital equipment, foreign currencies replace the domestic currency as a temporary store of value, and industrial share prices, especially of those firms which have extensive foreign interests, rocket.[9]

The Bolivian Stabilization

Bolivia, between early 1982 and late 1985, experienced the highest inflation in the history of Latin America. Although high inflation had been present since the early months of 1982, hyperinflation started approximately in April 1984 and ended in September 1985. According to Jeffrey Sachs, the Bolivian hyperinflation was the seventh largest in the twentieth century.[10]

The economic situation degenerated in the second quarter of 1984 in a clear case of hyperinflation. Hyperinflation was the most visible element in a picture

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9 Stonier and Hague, n. 4, p. 153.

10 Jeffrey Sachs, "The Bolivian Hyperinflation and Stabilization", National Bureau of Economic Research (Massachusetts), Working Paper No. 2073, November 1986.

of general economic decline. Between 1980 and 1985 the Gross National Product (GNP) fell by 20 percent[11], per capita income declined by 30 percent[12], and legal exports shrank by 25 percent between 1984 and 1986.[13] Investment rates also diminished steadily to reach an all time low of 5.7 percent in 1985.[14] The average monthly rate of inflation between March 1984 and August 1985 was 46 percent and in February 1985 the inflation rate beat all Latin American records when it reached 182 percent.[15] In 1985 inflation skyrocketed in Bolivia, when the government turned to printing money to cover the growing deficit. The biggest shock to the economy occured in October 1985 when the world prices for tin, Bolivia principal legal export, collapsed. Further in early 1986, the price of natural gas, another major Bolivian export, plummeted.

Against this backdrop the Siles government called elections a year earlier than originally planned and the new centre-right government of Victor Paz Estenssoro came

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11 Peter R. Andreas and Kenneth E. Sharpe, "Cocaine Politics in the Andes", Current History (Philadelphia), vol. 91, no. 562, February 1992, p. 75.

12 Ibid.

13 Ibid.

14 Juan-Antonio Morales, "Inflation Stabilization in Bolivia" in Michael Bruno and others, Inflation Stabilization : The Experience of Israel, Argentina, Brazil, Bolivia and Mexico (London; MIT Press, 1988), p. 314.

15 Ibid. (See Table I).

to power in August 1985. Within three weeks, the new government spelt out its New Economic Policy (NEP) in Supreme Decree 21060 of 29 August 1985. This severe austerity programme based on the International Monetary Fund (IMF) guidelines contained an ambitious agenda, that went beyond macroeconomic stabilization to include fiscal reform, trade liberalization, price decontrol, and the decentralization or privatization of public enterprises. The NEP addressed the political and technical determinants of inflation with five essential policies: (i) stabilization of the exchange rate; (ii) liberalization of trade and capital accounts; (iii) the reduction of government deficit and monetary emission; (iv) the resolution of the distributional and political conflicts in favour of capital, and (v) the achievement of new external resources, mostly because the orthodoxy of the programme allowed a rapprochement with official creditors. The NEP, in short, attempted to encompass both short-run stabilization measures and longer run structural changes designed to modify the hitoric statist model and shift to a vision of market-oriented economic growth.

The first goal of the NEP was exchange rate stability. Unification of the foreign exchange market generated a de facto devaluation of the Bolivian peso which dropped from the official rate of 75,000 pesos to the dollar to the parallel rate of 1,000,000 overnight.[16] The government then adopted a managed float and attempted to meet most demand in order to prevent a reoccurence of the sharp divergence between official and parallel rates. This was achieved by permitting free access to foreign exchange by means of a system of daily bids at prices above a base rate fixed by the Central Bank.[17] It is important to note that Bolivian policy makers on the advice of analysts like Jeffrey Sachs embraced the view that the exchange rate was the key instrument for controlling inflation and the government subsequently resisted any rapid depreciation to correct growing trade problems.

The second component of the NEP was the libralization of trade and capital accounts, including the elimination of import prohibitions and the adoption of a uniform tariff. Import competition, coupled with exchange rate stability, essentially played the role of price control, that is, domestic producers were constrained from raising prices beyond the exchange rate times the dollar price. Moreover, the uniformity of

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16 Manuel Pastor, Jr., "Bolivia: Hyperinflation, Stabilization, and Beyond", The Journal of Development Studies (England), vol. 27, January 1991, p. 224.

17 Arthur J. Mann and Manuel Pastor, "Orthodox and Heterodox Stabilization Policies in Bolivia and Peru: 1985-1988", Journal of Interamerican Studies and World Affairs (Coral Gobles, Florida), vol. 31, no. 4, Winter 1989, p. 171.

tariff,[18] served as a signal of orthodoxy that was important in attracting support from international creditors.

The third major thrust of the NEP involved curtailing government deficits and monetary emission. The government immediately froze public sector salaries, spending and investment. As a result, real wages of public employees fell leading to a general reduction of worker income. New revenues were raised by increasing the price of gasoline and derivatives to international levels and subsequently indexing it to movements in the exchange rate. This increased the de facto gasoline tax from 0.4 percent of GDP in 1984 to 5.6 percent in 1985 and 7.1 percent in 1986.[19]

These short term measures were soon accompanied by a longer term strategy to control expenditures and enhance tax revenue. Expenditures were brought under control by reducing public sector employment, particularly in the government mining corporation COMIBOL where the bulk of the workers were dismissed. COMIBOL's labour force fell

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18 Tariffs were initially set at a uniform 10% plus 10% of previous tariff. In August 1986, all tariff rates were set at a uniform 20%. In early 1988, the tariff rate for capital goods was reduced to 10% and the rate for all other imports (non-capital) was fixed at 17%.

19 Pastor, n. 16, p. 225.

by over 75 percent between 1985 and 1987.[20] Public sector wages were initially frozen, and wage indexation in the private sector was abolished. Henceforth, wage rates were to be set at the level of the firm via bargaining between the employer and the union/employee, and regulations were loosened to permit easier dismissal. This set of labour policies sparked protests, and uncontrolled monetary growth as fed by the public sector deficit. To close the fiscal deficit, nominal government spending was frozen, and public enterprises were required to deposit their revenues in custody accounts with the Central Bank. The use of these funds was made dependent on the approval of the Minister of Finance. On the revenue side, the de facto gasoline tax and the value-added tax succeeded in raising the tax ratio to some 17% of GDP by 1988.[21]

It is relevant to note here that the anti-worker and anti-popular tone of the new government was not simply a consequence but an integral aspect of the stabilization programme. Reducing labour's power was important both in its own right and as a signal. Like the more technical measures on exchange rates and monetary emission, the anti-labour thrust evidenced the seriousness of the new government and thus enhanced its credibility to both domestic capital and orthodox international institutions.

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20 Ibid.

21 Mann and Pastor, n. 17, p. 172.

A final aspect of the stabilization programme involved measures to restore net external flows of credit, a requirement for exchange rate stability given the continuing fall in export revenues and the liberalization-induced import boom. The repatriation of capital flight was encouraged by both the government's legalisation of dollar deposits and its failure to remonetize when the end of the hyperinflation raised the demand for local currency. The resulting liquidity crisis drove real interest rates to an average of ten percent monthly[22] between October 1986 and March 1987. This encouraged the repatriation of flight capital but also choked productive investment. The government also allowed dollar deposits to be made without proof of origin, a thinly disguised ploy to put coca dollars into the financial system.

The Bolivian stabilization effort thus included all the principal elements of an orthodox stabilization package i.e. currency devaluation and unification, restrictive fiscal and monetary policy, a public sector wage freeze, decontrol of markets and prices, external opening of the economy, financial and trade reform, and budget rationalization. There were, however, two significant deviations from orthodoxy; (i) the unwillingness to free the exchange rate and (ii) continued non-payment of the external

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22 Active or lending rate.

commercial debt.

A fifth of Bolivia's external debt was owed to private financial institutions with the remaining owed to multilateral and bilateral creditors. By the end of 1988, outstanding external debt amounted to around 100% of GDP and 700% of recorded exports, while debt service payments made in 1988 took up over one-half of official export revenues.[23] As part of the stabilization programme, the government reestablished cordial relations with official international creditors, particularly the IMF, World Bank and the Club of Paris. In 1986, Bolivia signed its first stand-by agreement with the Fund since 1980. Another agreement on longer-term structural adjustment assistance and rescheduling with the Club of Paris was reached by the end of 1986. In 1987, Bolivian authorities were allowed to indirectly enter into the secondary market for LDC debt (using money deposited by friendly nations in an IMF escrow account) and repurchase their own loans. Analysts viewed Bolivia's favourable treatment by international financial institutions as a reflection of both Bolivia's inflation success and its decision to stick to orthodox measures. As opined by Manuel Pastor - "with Argentina, Brazil and Peru turning to heterodox stabili-

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23 Ibid., p. 173.

zation policies, Bolivia had become the 'good boy' of an increasingly 'bad' group of Latin American debtors".[24]

24 Pastor, n. 16, p. 227.

CHAPTER 4

THE POST-STABILIZATION ECONOMY

This chapter will be an attempt to assess the results and consequences of the 1985 New Economic Policy (NEP) in Bolivia and also to analyse the particular socio-economic problems that emerged in its wake. It will also try to analyse the important and often overlooked role of narco-trafficking and drug money in bringing about and sustaining the stabilization. Divided into two broad sections, the first will deal with the immediate achievements of the NEP detailing the specific economic instruments that were used to bring about stabilization in Bolivia and the consequences of taking those measures. The second will highlight the cocaine economy in Bolivia and analyse the role of drug profits in the stabilization programme.

<u>Results of the NEP</u>

The most important achievement of the Bolivian stabilization programme has been the dramatic fall in inflation. Except for September 1985 and the period from December 1985 to February 1986 the monthly inflation rate has been lower than 4.3 percent.[1]

A look at the macroeconomic data in the given table will show that stabilization was achieved but not without cost. The stabilization kickoff began in the foreign exchange market and the Bolivian government used the

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1 Juan Antonio Morales, "Inflation Stabilization in Bolivia", in Michael Bruno et. al., <u>Inflation Stabilization</u> (Massachusetts; MIT Press, 1988), p. 323.

exchange rate as an instrument for inflation control. Jeffrey Sachs, one of the architects of the programme puts the following explanation for the sudden end to the hyper-inflation -

> By August 1985, the U.S. dollar and not the Bolivian peso was satisfying two of the three classic roles of money: the unit of account and the store of value (though it was not the medium of exchange for most transactions). Prices were not either explicitly or implicitly in dollars, with transactions continuing to take place in peso notes, at prices determined by the dollar prices converted at the spot exchange rate. Therefore, by stabilizing the exchange rate, domestic inflation could be made to revert immediately to the U.S. dollar inflation rate! (2)

Whatever the explanation the NEP was successful in its primary goal as the rate of inflation plummeted down to 273.3 percent in 1986, 14.6 percent in 1987, and 16.5 percent in 1988 (see Table). Towards the end of 1988, however, the annual rate of price increases had risen to over 20 percent. The government continued to use the exchange rate as an instrument for inflation control running the risk of serious overvaluation. While during 1987 and the beginning of 1988, the rate of currency devaluation was substantially higher than the rate of domestic price inflation, the opposite occurred during the latter half of 1988. Even now, there is a general consensus among

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2 Jeffrey Sachs, "The Bolivian Hyperinflation and Stabilization", The American Economic Review (Nashville, TN), May 1987, vol. 77, no. 2, p. 281.

analysts that the Bolivian peso is overvalued by at least 20 percent. The overvaluation problem was highlighted to Bolivian policy makers by the import surge of 1986 and 1987. 1988 brought some import restraint but not enough for Bolivia to recapture the surplus position it had enjoyed throughout most of the decade. While the trade liberalization was clearly important the trade deterioration, the 1986-87 import boom was also due to the appreciating peso and the trade improvement of 1988 was partly driven by depreciation.

The NEP had produced a more rational exchange rate policy and the large gap between official and parallel rates during the hyperinflation was nearly eliminated in 1987. However, the following overvaluation of the peso worked against the longer term need to shift resources towards the export sector and gave momentum to the shift away from the production of goods towards the commercialization of imported articles.

By 1988, several problems besides overvaluation had also become evident, particularly in the monetary realm. The end of the hyperinflation brought about a large increase in the demand for suddenly useful foreign currency. However, the policy makers fearful of re-igniting inflation allowed only a slow remonetization and need to retain mobile dollar deposits produced extraordinarily high real interest rates. Persistently high interest rates hold back economic activity in the private sector. The poor internal and external demand have only added to this feature. There are also the problems associated with the high domestic transportation and energy costs, which in turn result from the high domestic prices of oil and the high interest rates. In 1987, the real savings rate was around 20.1 percent while the lending rate was 45.1 percent.[3] By the end of 1988, the savings rate had fallen to 10 percent and the lending rate to 20 percent,[4] an improvement that reflected some remonetization but still constituted a significant to domestic investment.

Overall, the financial system was also quite fragile. Bolivian bankers had profited from the hyperinflation by serving as channels for capital flight acquiring fixed assets, and paying negative real interest rates on deposits. Many banks expanded employment, opened new branches and purchased new capital goods during the hyperinflationary period of the Siles Zuazo.[5] With the success of disinflation, fixed assets became less desirable and real interest rates skyrocketed. Both phenomenon threatened the asset side of bank balance sheets. Moreover, high rates and the legalization of dollar deposits had produced a domestic

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3 Manuel Pastor, Jr., "Bolivia: Hyperinflation, Stabilization, and Beyond", The Journal of Development Studies (England), vol. 27, January 1991, p. 229.

4 Ibid.

5 Ibid., p. 230.

banking system in which roughly two-thirds of total deposits in the banking system were in dollars and nearly all these deposits were short-term. Thus, the success at repatriating capital had also contributed to fragility. Any bad news could result in a rapid exit of this capital, shattering the financial system and the exchange rate policy in its wake.[6]

By 1988, government finance was also a source of concern. The NEPs' impressive performance at reducing the central governments deficit had been largely accomplished by generating tax revenues in the domestic market for oil products and payment of arrears on tax liabilities. In the last quarter of 1985 taxes from the oil sector constituted 74 percent of all central government revenues and 8 percent of quarterly GDP.[7] The quick fiscal recovery was possible because of the jump upward in public prices from the low initial levels. The combination of high prices for oil derivatives, high taxes, and tight control of current expenditures in YPFB, the state petroleum company, and the freeze in its investments retired money from the public and made room for other sources of expansion of the monetary base. As stabilization continued, the government was able to regain credibility and access to international finance.

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6 Bolivia's financial fragility was made quite clear when general uncertainty and fears of a sharp devaluation produced the withdrawal of one-fourth of local bank deposits prior to the 1989 elections.

7 Michael Bruno et. al., n. 1, p. 325

Bolivia secured new loans from official lending institutions for more than U.S dollars 1.2 billion. The net international reserves of the Bolivian Central Bank increase from a low of U.S. dollars 30 million at the end of August 1985 to US dollars 350 million by December 1986.[8] A significant fraction of these reserves was due to the repatriation of capital induced by the high rates of interest. Interest rates are high not only in pesos but also in dollars and dollar-indexed accounts.

Before concluding this section on the results of the NEP, it is important to note the enormous social and economic cost that the programme has entailed. Besides the costs in foregone output and employment which have been substantial, stabilization has also imposed austerity on several segments of the population, miners, teachers, pensioners, etc.

Estimates of the decrease in GDP in 1986 range from 2.9 percent to 3.5 percent. The investment rate in 1986 reached one of its lowests values in Bolivian history. Public sector employment decreased 10 percent within a year[9] and reached 20 percent by the end of 1986.[10]

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8 Ibid., p. 329.

9 Melvin Burke, "Bolivia: The Politics of Cocaine", Current History (Philadelphia), vol. 90, no. 553, February 1991, p. 66.

10 Bruno, et. al., n. 1, p. 326.

Underemployment also increase from 56 percent to 60 percent.[11] All these measures including devaluation of the peso were part of the IMF conditions. In return for complying with these Bolivia increased international financial assistance from the IMF, the World Bank, the Inter-American development bank and the Paris Club. International finance, specially the initial agreement with the IMF was of "fundamental importance to the stabiization programme".[12] More important Bolivia negotiated an unprecedented repurchase of US dollar 450 million of its foreign debt with the money received from international institutions. However there are analysts who look askance at this arrangement and are of the view that,

> Paz Estensorro's center-right government was handsomely rewarded for returning Bolivia's economy to an open, laissez-faire and subordinate position in the global capitalist community. (13)

The stabilization programme also led to the privatization of the mining company COMIBOL, and the firing of 23,000 of the company's 30,000 miners. Many of these unemployed are employed in the coca growing region. Employment in the petroleum industry YPFB was also reduced

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11 Ibid.

12 Jeffrey Sachs and Juan Antonio Morales, Bolivia: 1952-86 (San Francisco, California; Institute for Contemporary Studies, 1988), p. 37.

13 Burke, n. 9, p. 66.

from 9000 workers in 1985 to 5000 in 1987. Unemployment of workers was almost entirely in the blue collar jobs and increased to an estimated 20 percent. Real wages decreased and rural teachers quit their jobs in record numbers. Even IMF analysts like Sachs and Juan Antonio Morales, two of the key architects of the orthodox programme admit that the programme has not succeeded in bringing about economic prosperity or social justice for the country. On the contrary inequality has increased and the economy has shrunk.

In conclusion the NEP eliminated hyperinflation and established price stability but the underlying problems in the Bolivian economy and society that contributed to the hyperinflation remain unresolved and in some cases have worsened.

The Cocaine Factor in Bolivia

"Bolivia is the quintessential coca nation, a veritable cocalandia".[14]

The coca bush for centuries has been known as the sacred plant of the Andean people and its leaf is indispensable to Indian social intercourse. Coca leaves are

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14 Richard B. Craig, "Illicit Drug Traffic; Implications for South American Source Countries", Journal of Interamerican Studies and World Affairs (Coral Gables, Florida), vol. 25, no. 3, 1988, p. 2.

consumed to numb fatigue, increase productivity, undertake rituals and tighten social bands. Under Bolivian law it is legal to grow coca but illegal to manufacture coca derivatives. In addition to serving as an opiate and a social adhesive, coca since 1970s has acquired value as an ingredient in the production of one of the worlds most important drug - cocaine. Bolivia played a minor role in international narcotics until the 1970s. Coca for chewing was cultivated primarily in the Yungas, and only minor amounts grown elsewhere were converted to paste for smuggling into Chile and Argentina. With the rise in external demand, the first major processing centers were organised in the mid 1970s through collusion with military authorities. Soon increasing amounts of coca paste were being shipped to Colombia for final processing.

The surge of Bolivia's cocaine since the 1970's is due to a number of reasons; growth in the international demand for cocaine during the 1970s pulled farmers and traffickers into coca cultivation and cocaine production; since the 1930s, the government has promoted agricultural development in the tropical lowlands mainly the Chapare region; government policies have discriminated against highland farmers and produced unfavourable terms of trade for traditional agriculture, inducing farmers to pursue coca cultivation to raise incomes; lowland entrepreneurs switched to cocaine trafficking in the mid-1970s after the sugar and cotton markets collapsed; and finally, the 50 percent decline in real wages during 1982-6 and the enormous loss of jobs resulting from the stabilization of 1985 pushed people even further into drug production.[15]

The extent to which coca production and trade now dominate the Bolivian economy is astounding. In the words of Melvin Burke:

> Coca accounts for an estimated 30 to 40 percent of Bolivia's agricultural production, half of its GDP and 66 percent of its export earnings. Between 40,000 and 70,000 peasants produce coca and about 500,000 Bolivians (1 in 5 of the working population) depend on coca for a livelihood either directly or through support industries. (16)

The superior profitability of coca is the most important reason for the growth of the drug industries. Since the mid-1960s, coca cultivation has generated more profits per unit of area than any other agricultural activity.[17] The superior profitability of coca also appears at other levels. Cocaine enjoys lower domestic costs of production per dollar of export revenue than other

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15 Mario de Franco and Ricardo Godoy, "The Economic Consequences of Cocaine Production in Bolivia: Historical, Local, and Macroeconomic Perspectives", <u>Journal of Latin American Studies</u> (Cambridge, UK), vol. 24, Part 2, May 1992, p. 385.

16 Burke, n. 9, p. 67.

17 Franco and Godoy, n. 15, p. 385.

exports.[18] The drug industry could also depend on highland labour because coca cultivation and highland agriculture require labourers at different times of the year.

As cocaine production expanded, it absorbed an increasing number of unemployed and underemployed urban people. According to Mario de Franco and Richard Godoy:

> As the economy crumpled during the early 1980s official unemployment more than tripled from 6 to 20 percent but so did the number of people working in the cocaine production. Structural adjustment and stabilization after 1985 produced no visible rise in unemployment, no civil unrest, no decomposition of the Body politic, but instead gave rise to more informal work, more petty trade and to a progressive sharing of a relatively stagnant pie among an increasing number of have-nots. (19)

Besides increased employment, the cocaine industry has a number of positive impacts on the Bolivian economy. It increases income for the poor, foreign exchange for the nation and demand for industrial inputs - kerosene, acetone, sulphuric acid, toilet paper and the like - needed to produce the final good. The profitability of the cocaine industry has also indirectly bolstered democracy by increasing incomes and standards of living.[20] As F.L. Tullis notes:

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18 Ibid.

19 Ibid., pp. 394-5.

20 Ibid., p. 376.

> ... the coca industry does almost all that the current view in rural and agricultural development in less developed countries calls for: it is labour intensive, decentralized, growth-pole oriented, cottage industry promoting, and foreign exchange earning. If the coca industry were completely licit and high returns to the growers held, it could be the final answer to rural development in economically stagnating areas. (21)

In a similar vein Peter R. Andreas and Kenneth E. Sharpe say:

> From an economic perspective, cocaine is simply the most recent in a long line of primary commodity exports from the region, as economically vital as silver, rubber, cotton and tin once were. The current boom provides employment for hundreds of thousands of peasants, and is the single most important source of foreign exchange for the region's debt-burdened economies. (22)

Yet countervailing the rewards of cocaine production, Bolivia is also a victim of the Dutch disease,[23] the symptoms of which are a strengthening of the currency, expansion of imports, an increase in monocropping and a

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21 Ibid., p. 377.

22 Peter R. Andreas and Kenneth E. Sharpe, "Cocaine Politics in the Andes", Current History, vol. 91, no. 562, February 1992, p. 74.

23 The Dutch disease is said to spread when the exports of one commodity, such as oil or coca, overshadow other exports. The boom siphons of resources from other activities which decline and cause an exchange rate appreciation. As the key export expands, other exports decline and imports increase as a result of the stronger currency. Dependency on a single export makes the country vulnerable to market downturns. For details, see Franco and Godoy, n. 15, pp. 377-98.

decline in food self-sufficiency. Besides this, there is also the problem of increasing drug addiction and corruption of the body politic. The huge profits made from trafficking are used by the drug lords to buy airplanes, weapons, army officers and politicians in Bolivia and abroad.

Before concluding it is important to note the extent of the role of drug money in bringing about price stability. In the words of Melvin Burke;

> This stabilization, however, is not an economic miracle. The return of finance capital (international loans, debt reduction, and drug money) to Bolivia after 1985, the freeing of prices and regressive taxes brought price stability to Bolivia. The drug deposits and repatriation explain why Bolivia's currency and price levels have stabilized since 1985 and there is little doubt that much of the investment capital used by Bolivia's new entrepreneurs is drug money. (24)

Similarly Richard B. Craig notes;

> The macroeconomic impacts of Bolivian narcotics are at best crude estimates. Crude or not, US or Bolivian, these calculations leave one indelible impression: without <u>coca-dolares</u>, the economy, already a basket, would be virtually bankrupt. Only coca-cocaine exports kept the economy afloat. (25)

Peter R. Andreas and Kenneth E. Sharpe sum up the role of drug money in the NEP;

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24 Burke, n. 9, p. 66.

25 Craig, n. 14, p. 5.

> Rarely mentioned, however, is the not-so-secret ingredient of Bolivia's economic "success" story: coca. The coca economy generates as much foreign exchange as all other Bolivian exports combined, and provides a critical cushion for many of those left unemployed as a result of the government's austerity programme. (26)

They further go on to say:

> The 600 million dollars generated every year from coca sales have been especially critical for the economic stabilization programme. Paz Estenssoro implemented several measures that facilitated the absorption of drug profits into the banking system, such as tax amnesty on repatriated capital, relaxed disclosure requirements for the Central Bank, and prohibitions against official investigations into the origin of wealth brought into Bolivia. Thus cocaine profits slashed in Carribean bank accounts could safely come home. (27)

Many analysts feel that coca production is likely to remain Bolivia's main comparative advantage in the world economy for years to come. It is well known that cocaine is the only Latin American commodity whose price in the late 1970s and 1980s showed any real increase. In terms of real growth rates returns from coca cultivation grew by 11 percent per year during 1960-85.[28] Thus, if the coca boom became a bust, for reasons of lagging external

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26 Andreas and Sharpe, n. 22, p. 76.

27 Ibid.

28 Franco and Godoy, n. 15, p. 385.

demand or internal law enforcement, Bolivia could be thrown into a serious crisis and the gains made by the NEP could come to naught.

CHAPTER 5

CONCLUSION

The major focus of the present monograph has been to examine the various economic and political factors which led to the decline and the ultimate collapse of the Bolivian economy during the early 1980s, most evident from the hyperinflation that soared beyond control. Desperate measures were called for and, it was in response to that that the newly elected government of Paz Estenssoro within three weeks of coming to power enforced the New Economic Policy (NEP) in August 1985. In the foregoing chapters, an attempt was made to delineate at some length the processes of the IMF-sponsored stabilization programme and to analyse the logic of orthodoxy emphasizing on the main economic indicators that were used to bring down inflation figures. An effort was also made to examine the consequences, both positive and negative that were the result of the NEP. An important and often ignored focus was the role of macro-trafficking on the stabilization programme. The present concluding chapter purports to sum up the processes of the NEP and to see them in the light of what is relevant for the future.

As has been detailed in the preceding chapters the 1952 Revolution saw the subsequent nationalization of the mining sector and agrarian reforms in Bolivia. Until 1985, Bolivia pursued a policy of state capitalism which was justified as a response to the private sector's perceived inability to generate the investment required for economic growth. The resulting scenario was import substitution behind high tariff walls, subsidized and managed credit, public sector expansion, currency overvaluation, monopolistic rents, price controls and subsidies, and a constant distributive battle.

Propelled by the exploitation of petroleum and natural gas resources as well as external credits, the Bolivian economy grew at an average rate of 4.5 percent between 1965 and 1980. By the end of the 1970s, however, Bolivia's debt servicing capacity came into question and new international lending ceased soon thereafter.

During this time the Bolivian economy was characterized by three key economic sectors: (i) a domestically oriented sector, consisting of manufacturing, agriculture and public administration; (ii) an export oriented sector in which two dominant activities, mining and petroleum, provided 90 percent of export revenues during 1980-85; and (iii) a service sector including construction and services, which were largely derivative of output and income in the first two sectors.

For analysing the causes of hyperinflation, the most salient features of the Bolivian economy were its nearly monocultural export structure and the public sector's heavy reliance on external finance. The former meant that falling mineral prices has had a serious impact on both GDP and inflation.

Alongwith falling commodity prices for minerals the early 1980s also brought rising external interest rates, and weak, changing governments. As net resource transfers from the rest of the world turned negative after 1981, the government increasingly resorted to printing money to finance spending. The resulting inflation eroded fiscal revenues and led to an increased deficit.

Despite the six different stabilization programmes launched by the government of Siles Zuazo, between 1982-85, inflation skyrocketed. True hyperinflation as defined by price increases of 50 percent or more per month was reached by May 1984 and lasted through September 1985.

While the hyperinflation was rooted in Bolivia's export structure and public reliance on external finance, the take-off to a true hyperinflation also reflected the political and policy paralysis of the administration of Siles Zuazo. Zuazo's coming to power coincided with the military retreat from political power and the return to the barracks was preceded by a complete disorganisation of the economy. In 1980-81, government authorities had permitted capital flight of nearly 600 million US dollars.[1] Helped along by a drop in tin prices, 1982 saw a nearly ten percent

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1 Manuel Pastor, Jr., "Bolivia: Hyperinflation, Stabilization, and Beyond", Journal of Development Studies (London), vol. 27, January 1991, p. 214.

decline in export revenues and a five percent drop in GDP.[2] With capital flows also collapsing, net international reserves declined to 266 million US dollars by mid-1982.[3]

Siles Zuazo sought to deal with the crisis while simultaneously avoiding measures that would hurt his own constituency in the working and popular classes.

Foreign exchange problems, government deficits, and inflation were further aggravated by the government's early efforts to partially meet its debt obligations, a strategy which did not promote new lending and thus drained the country of resources even as it worsened the fiscal situation. In retrospect, it seems curious that a seemingly leftist government would honour international obligations at the cost of its own economy. In 1982-84, however, no Latin American government had yet attempted to openly restrict debt service and the penalties for non-service were perceived to be extremely high.

The Siles government gave way to the new centre-right government of Paz Estenssoro. Within three weeks, the new government spelled out the NEP in a Supreme Decree on 29 August 1985. Embodying a series of liberalizing measures, the NEP sought to open the economy to international

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2 Ibid.

3 Ibid.

competition and capital and trade flows, to free internal prices and interest rates, to eliminate credit controls in the domestic capital market, and to reduce the scope of public sector activities. The NEP attempted to encompass both short-run stabilization measures and longer-run structural changes designed to modify the historic statist model and shift to a vision of market-oriented economic growth.

Central to the stabilization plan was exchange rate stability and fiscal reform and control. During the hyper-inflationary period the exchange rate had become the principal variable pushing up the price level, so that exchange rate stability became the key policy instrument in the attack on inflation. The other basic cause of the inflationary process had been uncontrolled monetary growth as fed by the public sector deficit. To close the fiscal deficit, nominal spending was frozen, and public enterprises were required to deposit their revenues in custody accounts with the Central Bank. The use of these funds was made dependent on the approval of the Minister of Finance.

The Bolivian stabilization package deviated from traditional orthodoxy in two significant ways: the unwillingness to free the exchange rate; and continued non-payment of the external commercial debt.

Thus, to revive the ailing economy, the government of Paz Estenssoro launched the severe IMF sponsored stabilization programme. But while this economic remedy has been applauded by the international financial community, the success of the programme has depended on the thriving drug economy.

From an economic perspective, cocaine is simply the most recent in a long line of primary commodity exports from Bolivia, as economically vital as silver and tin once were. The current boom provides employment for hundreds of thousands of peasants and is the single most important source of foreign exchange for the debt-burdened economy.

Caught between reliance on the drug trade to sustain the economy and the need to retain United States support, Bolivia is going along with the U.S. militarized counter-narcotics strategy yet is ultimately unwilling and unable to attack the drug economy seriously. Meanwhile, both the drug trade and the drug war are weakening civilian institutions and deepening existing problems of violence, human rights abuses, and military corruption.

Paz Estenssoro's successor, Jaime Paz Zamora, has remained committed to the stabilization plan since assuming office in late 1989. In 1990 inflation was brought down to 18 percent, the lowest rate in the region.[4] Modest annual

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4 Peter R. Andreas and Kenneth E. Sharpe, "Cocaine Politics in the Andes", Current History (Philadelphia), vol. 91, no. 562, February 1992, pp. 75-76.

growth of 2.5 percent in GDP which began after the launching of the NEP, has been maintained.[5] Between 1987 and 1990 Bolivia reduced its foreign debt 12 percent by negotiating buybacks with commercial banks and the United States government and a series of partial write-offs with the Paris Club.[6] Exports have also risen, although Bolivia still spends almost 25 percent of its total export earnings to service its debt.

The NEP, thus, succeeded in reducing inflation and eliminated much of the panic that surrounded the hyperinflation in 1984 and 1985. Price stability has now been re-established in Bolivia. However, many of the underlying problems in the Bolivian economy and society that contributed to the hyperinflation remain unresolved, and in some cases have worsened. The challenge now for the government of Bolivia is to convert the current stabilization phase into the first phase of renewed economic development.

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5 Ibid.

6 Ibid.

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