DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

FOR AGENDA

SM/11/85
Correction 1

May 17, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Bolivia—Staff Report for the 2011 Article IV Consultation**

The attached corrections to SM/11/85 (4/29/11) have been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 4, para. 2, column 2, line 4: for "due to longstanding social and regional disputes"
read "due to social and regional disputes"

Mischaracterization of the Views of the Authorities

Page 9, para. 18, column 1, line 8:

for "The authorities also believe that central bank sterilization policies will effectively absorb liquidity over the coming months and that interest rates will naturally find their equilibrium levels. They acknowledged that inflationary expectations had been temporarily de-anchored in December, but highlighted that food prices would soon decline as a result of favorable weather conditions and ongoing government policies to increase supply."

read "They explained that inflationary expectations had been temporarily de-anchored in December and early 2011 as a result of politically-motivated speculation in goods markets, the impact of which will quickly reverse. Moreover, they highlighted that food prices would soon decline as a result of favorable weather conditions and ongoing government policies to increase supply, and that central bank sterilization policy will effectively absorb liquidity over the coming months, with interest rates naturally finding their equilibrium levels."

Page 12, para. 21, last bullet, column 2, line 10: “,while allowing the exchange rate to adjust to changes in the external environment” removed

Questions may be referred to Mr. Lopetegui (ext. 39688), Mr. Rosales (ext. 38688), and Ms. Sulla (ext. 38766) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (3)

Other Distribution:
Department Heads

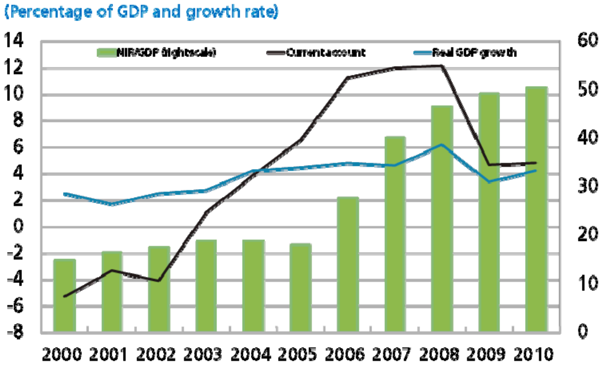
FIGURES

BOXES

BACKGROUND

1. Bolivia has posted a solid macroeconomic performance in recent years, on the back of strong terms of trade and prudent economic policies. Increased export volumes and prices led to a doubling of export receipts between 2005 and 2010, while real GDP growth rose from 3.1 percent in the first half of the past decade to 4.6 percent in the second half. The strength of the external and fiscal positions in recent years has allowed Bolivia to build a strong reserves cushion which has reduced macroeconomic vulnerability, while the net international investment position switched to a credit balance in 2008 and rose to the equivalent of 17½ percent of GDP in 2010.

Bolivia: Growth, Current Account and NIR
(Percentage of GDP and growth rate)



Source: Central Bank of Bolivia.

2. At the same time, deep political and social changes have been taking place. The election of president Morales in 2006 initiated a period of strengthening of social policies and a broader role of the state in economic affairs. The new constitution (2009) is leading to profound changes in the country's legal framework, and requires amending key economic laws, including those ruling the central bank, the financial sector, the exploitation of natural resources, and inter-governmental fiscal relations. Despite broad support for government policies, tensions persist due to social and regional disputes, which constrain the room for policy maneuver.

3. Progress has been made on improving social inclusion and income distribution. Cash transfer programs have been successful in reducing extreme poverty (from about 30 percent in 2008 to 26 percent in 2009). However, poverty, infant mortality, school desertion, and other long-standing inequalities persist, including with large disparities in access to basic services across territorial, ethnic, and gender lines. The percentage of the population living in extreme poverty is still above the average in Latin America (12.6 percent), with high levels of infant mortality and child malnutrition.

4. The authorities' development plan envisages the expansion and industrialization of natural resource production. The plan is ambitious, particularly in the areas of hydrocarbons, mining, electricity, and infrastructure (amounting up to 100 percent of current GDP over the next few years). While strategic control of these sectors would remain in the hands of the state, the authorities favor entering into partnerships with the private sector for the implementation of the plan, with a view to improving access to modern forms of management, technology, and financing. However, the implementation of investment projects has suffered delays, while private

inflation. Despite higher hydrocarbon revenue, the overall surplus of the public sector is expected to fall from 2 percent of GDP in 2010 to 0.7 percent in 2011. To a large extent, this would reflect an increase in capital expenditure.[2] With the output gap virtually closed, the estimated fiscal impulse for 2011—about 1½ percent of GDP—may run counter to the inflation objective of the government (Box 2).

17. Staff suggested a tighter policy mix in 2011 to contain inflationary pressures. In particular, staff noted that the central bank would need to tighten monetary conditions further—including through stepped-up open market operations and higher reserve requirements for domestic currency deposits. The envisaged fiscal impulse will also increase the burden on the central bank to withdraw liquidity and increase interest rates. Staff also suggested a faster appreciation of the boliviano, which is estimated to be moderately undervalued (Box 3).

18. The authorities reaffirmed that containing inflation is a priority for them, and they considered that the recent resurgence was temporary, warranting a gradual approach. In their view, the main driver of inflation has been external, and the gradual appreciation of the exchange rate will help moderate the effects of this factor. They explained that inflationary expectations had been temporarily de-anchored in December and early 2011 as a result of politically-motivated speculation in goods markets, the impact of which will quickly reverse. Moreover, they highlighted that food prices would soon decline as a result of favorable weather conditions and ongoing government policies to increase supply, and that central bank sterilization policy will effectively absorb liquidity over the coming months, with interest rates naturally finding their equilibrium levels.

19. With gas prices at high levels and current policies, staff projects moderate fiscal surpluses in the coming years. Export prices for gas are expected to reach historic highs in 2011—about twice as high as in 2005—and remain elevated in the next few years, implying hydrocarbon revenues of about 12 percent of GDP for the public sector as a whole, or above one-third of total revenue. Spending has been projected to gradually rise to 35 percent of GDP, in line with the levels achieved in 2008-09—a projection which does not incorporate major investment projects planned by the government, as the precise phasing of these investments still needs to be decided. On this basis, the overall fiscal balance would remain in surplus (1–1½ percent of GDP), consistent with a non-hydrocarbon deficit of 9½ percent of GDP and a gradual decline in public debt to 30 percent of GDP by 2016.

20. Given the strength of financial cushions, the favorable outlook, and the prevalence of poverty and development needs, staff indicated that investment levels could rise above baseline projections without jeopardizing debt sustainability. An increase in

[2] Staff's fiscal projection assumes that 75 percent of the investment budget will be implemented, somewhat above the outcome in recent years.

total spending of 2 percent of GDP above baseline projections during 2012–16 would result in a stable net debt ratio by 2016, still maintaining Bolivia's strong fiscal position. Staff noted that higher investment could benefit Bolivia in terms of economic growth if care was taken to ensure that it is accompanied by efforts to boost its effectiveness. In turn, this would require enhancing implementation capacity across all levels of government. The authorities agreed with the need to maintain current spending under control, and noted that boosting public investment was also necessary for GDP diversification.

B. Strengthening the Policy Framework

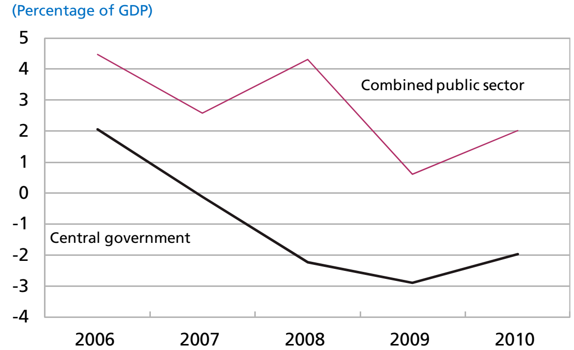
21. While the authorities should be commended for their macroeconomic management in recent years, there is room to enhance the policy framework to improve the economy's resilience to shocks and strengthen the sustainability of fiscal policy. Bolivia has built large macroeconomic buffers thanks to a fiscal policy that has largely avoided spending the hydrocarbon-revenue windfall resulting from high gas prices. While fiscal savings have been key to limiting real appreciation pressures from the export boom, volatile commodity prices and large current account surpluses have posed challenges to monetary and exchange rate policy. Inflation has been volatile, peaking in boom years (2007–08), declining to near zero in 2009, and rising again in 2010 and early 2011. In the context of limited exchange rate flexibility, the central bank has faced challenges in sterilizing international reserve accumulation, which has led to high levels of money growth and some inflationary pressures. Against this background, a number of key issues need to be considered in improving the policy framweork, most of which are in the authorities' agenda:

- **Medium-term fiscal framework.** Taking into account Bolivia's fiscal dependency on hydrocarbon resources, and given the plans for large public investment projects, the authorities are working on a multi-year framework to guide fiscal policy and budget planning. This framework would be sent to congress to complement annual budget discussion and align the government strategic priorities with projected resources. On the revenue side, the authorities plan to base their budget projections on prudent estimates of oil and gas prices, so as to generate savings in periods of high prices. These savings would be accumulated in a fiscal fund, for stabilization and development purposes. Staff strongly supported the authorities' efforts in this area, which should help avoid procyclical public spending and maintain strong liquidity buffers. Staff also suggested that the authorities' plans to create a fiscal fund would benefit from an expansion of its revenue base—at present, it only takes into account two-thirds of total hydrocarbon royalties—and from clearer rules for the use of the resources.

- **Limiting central bank financing of public sector and state-owned enterprises.** While the authorities have shown restraint in the use of central bank financing to date, the 2011 Budget authorizes the central bank to provide large credits to SOEs (up to 30 percent of net international reserves), in addition to US$2 billion already committed in previous years (equivalent to 20 percent of current reserves). Staff noted that such a large potential fiscal claim on the central bank risks jeopardizing confidence in the policymaking framework, compromising independent monetary policy and raising external vulnerabilities. In this context, staff suggested that the authorities strengthen the public debt strategy to identify alternative financing sources. Moreover, staff stressed that, to avoid introducing credit risk in the central bank balance sheet, more transparency would be required in the credit assessment of public corporations. The authorities indicated that, instead of being on-lent to public enterprises, part of the foreign reserves could be used to set up the envisaged fiscal fund. While the details would need to be worked out, the authorities stressed that the central bank would keep a strong reserve cushion, to ensure macroeconomic stability.

- **Reform of intergovernmental fiscal relations**. Due to the imbalances between revenue assignments and spending responsibilities—as most of the natural resource revenue is earmarked to sub-national levels of governments, with low spending responsibilities and execution capacity—the fiscal position of the central government [3] has deteriorated in recent years, while sub-national governments and public corporations (mainly YPFB, the oil holding company) remain in surplus. Addressing these imbalances is important to preserve the financial strength of the central government and its ability to implement counter-cyclical fiscal policy in adverse scenarios. The revision of revenue assignments and spending esponsibilities, in the context of the road map established by the decentralization law, will take time, due to the complexity of technical and political decisions. In the meantime, the authorities have been discussing ways to tap the surpluses of subnational governments on a voluntary basis, through the issuance of central government paper to municipalities and departments. Staff commended the authorities for the provisions in the decentralization law that aim at a

Bolivia: Fiscal Balances
(Percentage of GDP)



Source: IMF's staff estimates with official data.

[3] Including decentralized agencies and social security.

sustainable management of local public finances, and reaffirmed the need to avoid an increase in consolidated public spending as a result of decentralization.

- **Public enterprise reform.** Staff noted that the expansion of the number and activities of state-owned enterprises (SOEs) could lead to significant fiscal risks, if not complemented with greater transparency and accountability. In particular, staff recommended that SOEs minimize their quasi-fiscal operations, address existing constraints to investment execution, and be subject to independent audits. In addition, the Ministry of Economy and Public Finance should continue to develop technical expertise about the operations of the large firms, in particular YPFB, and expand the coverage of public sector accounts to include all SOEs. The authorities broadly agreed with these recommendations and indicated that they continue to work on a framework law for public corporations, which would provide the tools for effective management and governance.

- **Exchange rate/monetary policy regime.** Staff encouraged the authorities to move to a more flexible exchange rate regime over the medium term, to enhance the capacity to respond to external shocks, and to develop an independent monetary policy framework focused on keeping inflation at low levels. The authorities concurred that monetary policy should focus primarily on price stability. They noted, however, that that further declines in dollarization and a deepening of domestic financial markets would, in their view, be preconditions to adopting a more flexible exchange rate regime.

C. Maintaining Financial Sector Soundness

22. **The FSAP-Update found an important improvement in the financial sector compared to 2003 (initial FSAP).** The favorable macroeconomic environment and strong growth performance of recent years have allowed banks to rebuild their capital buffers with respect to the period of distress in the early part of the decade. Capital ratios are strong and financial institutions appear broadly resilient to a range of shocks. Importantly, a significant reduction in the level of dollarization has lowered foreign-currency exposures in the financial and non-financial sectors. The banking sector was found to be fairly competitive and efficient, and profitable, despite recent declines in interest rates.

23. **Against this background, a number of issues would need to be addressed to protect macro-financial stability:**

- **Negative real interest rates are a source of macroeconomic risk.** If maintained,