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HEADLINES

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Key Judgement

Although a descent into all-out civil war in Bolivia is unlikely in the next year, the recent escalation of violent unrest by proponents of greater autonomy for five of the country's nine states has exacerbated the already deep divisions in the country. Ahead of a probable January 2009 referendum on a new constitution, Santa Cruz, Beni, Pando, Tarija and Chuquisaca states are likely to experience regular bouts of disruptive and violent unrest, especially targeting state entities such as telecoms firm Entel and regional tax offices. The deployment of the Army to protect gas installations is likely to reduce, although not halt, disruptions to gas exports to Argentina (which were temporarily halted) and Brazil (which were temporarily halved). The causes of these disruptions have included acts of sabotage. The vast majority of Bolivia's gas and oil is produced in the pro-autonomy states. Brazil and Argentina are both heavily dependent on imports of Bolivian gas. The national government is unlikely to recognise efforts by pro-autonomy state governments to form new regional entities and regulations. These states, in turn, will likely

ignore the new Constitution championed by the governing Movement to Socialism party, whose leader, President Evo Morales, could potentially govern until 2021. This is likely to create an environment of legal and contractual uncertainty for investors.

Recent Risk Relevant Events

15 Sep 08 The governor of Tarija began crisis talks over unrest with the government, which ordered the arrest of Pando's governor.

11 Sep 08 Near Porvenir, Pando, 26 government supporters were killed in what President Morales termed an 'ambush' by opposition activists.

11 Sep 08 Reports said that American Airlines had twice stopped flights to Santa Cruz's Viru Viru International Airport due to protests.

11 Sep 08 About 2,000 protestors forced the closure of the Yacuiba gas facility, halting gas exports to Argentina.

11 Sep 08 The US expelled the Bolivian ambassador to Washington, a day after President Morales asked the US envoy to leave Bolivia.

10 Sep 08 State telecoms firm Entel said damage by protesters at its Santa Cruz office had resulted in reduced GSM phone services.

10 Sep 08 The head of state hydrocarbons firm YPF said that gas exports to Brazil had been reduced following a 'terrorist attack' on the GASYRG gas pipeline.

05 Sep 08 Opposition protesters took over the airport in Cobija, Pando, seizing a military aircraft and slashing its tyres.

15 Aug 08 Pro-autonomy activists took over the federal police headquarters in Santa Cruz province and declared a new regional police force.

10 Aug 08 President Morales was endorsed by 67% of voters in a recall referendum; two opposition governors lost their positions.

Summary of recent developments

Anti-government protesters have blocked key roads and taken over airports and state entities in Santa Cruz, Beni, Pando, Tarija and Chuquisaca states, leading to fuel shortages. Property damage has led to disrupted telephone services. Actions against the country's gas assets has included the sabotage of a pipeline, which caused gas exports to Argentina to be temporarily halted and those to Brazil to be reduced by half.

Since mid-August, the National Democratic Council (Conalde), the body ostensibly coordinating actions in the five pro-autonomy states, has encouraged protests and civil disobedience, which Morales has subsequently called a 'civil coup'. This has included the occupation of airports, the offices of state customs, internal revenue, telecoms, agrarian reform, education, TV and immigration agencies and the closure of border crossings to Argentina, Brazil and Paraguay. The Bolivian national roads service reported 35 road blockades and occupations of highway toll booths on 14 September; these have resulted in fuel shortages in the 'half moon' states. Violent confrontations with the police have been reported in Tarija and Pando and with the police and military in Trinidad, Beni, where civilians threatened to attack the 6th Army Division barracks. There have also been several incidents of violent confrontations between pro-and anti-government supporters in Pando, including an alleged 'massacre' of 26 pro-government supporters on 11 September. Bolivia is South America's leading natural gas exporter. It produces 40 million cubic metres / day (MCMD), of which 31.7 MCMD are exported to Brazil, 1.3 MCMD to Argentina and 7 MCMD retained for domestic consumption. Brazil imports around half its gas needs from Bolivia, with its industrial heartland around São Paulo particularly reliant on Bolivian gas imports. In Argentina, price controls have deterred investment in the power sector, meaning the country relies heavily on Bolivian gas for its power, and has halted gas re-exports to Chile on a number of occasions. Gas production is concentrated in the Gran Chaco region that straddles the pro-autonomy states of

Tarija, Chuquisaca and Santa Cruz. On 12 September, various protest actions at key energy installations led to a temporary halt in gas exports to Argentina and a 50% reduction to Brazil. Most incidents involved protesters forcing their way in to facilities and closing pipeline valves, such as occurred at the Vuelta Granda facility, partly owned by British Petroleum. However, on 10 September, a section of the Yacuiba-Río Grande (GASYRG) gas pipeline, operated by Brazilian firm Petrobras, was sabotaged in Tarija. The head of state hydrocarbons firm YPFB said protesters had deliberately ignited a gas leak they themselves had caused and that losses would be around \$100 million.

Background

The integrity of the Bolivian state is threatened by a destabilising conflict along racial lines and demands by five of the country's nine provinces for greater autonomy. The situation has deteriorated since a 10 August referendum emboldened both sides to harden their positions.

Bolivia is experiencing a worsening stand-off between the central government in the highlands (supported by the indigenous population) and five southern and eastern lowland states demanding autonomy (supported by descendents of European settlers, led by the predominantly urban-based commercial and landowning elites). The conflict threatens the integrity of the Bolivian state. The call for regional autonomy resulted in a series of referenda being staged between May and June 2008 in Santa Cruz, Beni, Pando and Tarija states (collectively known as the 'half moon' region) to approve statutes for them to handle their internal affairs. The highland state of Chuquisaca joined their fold after the government refused their demands to relocate the seat of government (i.e. the executive branch and Congress) from La Paz (the administrative capital) to the city of Sucre in Chuquisaca. Sucre is officially Bolivia's constitutional capital, where the Supreme Court and judiciary are based. The opposition Podemos party had attempted to oust President Evo Morales through a 10 August 2008 referendum, which also asked voters to either

recall or confirm eight regional governors. Although a majority of people in the five southern and eastern states voted against Morales, 67% of the total population supported his presidency - up from the 54% he obtained during the 2005 presidential elections. Morales interpreted this result, and the recall of opposition governors in La Paz and Cochabamba (both of whom had supported increased autonomy), as a mandate to forge ahead with his leftist agenda enshrined in a new Constitution. A draft of this was pushed through Congress by Morales' Movement to Socialism (MAS) party in late 2007, despite a boycott by the opposition, who do not recognise congressional approval of the text. Congress will now debate Morales' plan to hold a referendum on 25 January 2009 to approve the new Constitution. For their part, the pro-autonomy regions interpreted their rejection of Morales in the 10 August referendum as a mandate to implement their regional statutes for self-government and protest against the proposed new Constitution and the central government's share of hydrocarbons taxes. Indeed, the vast majority of Bolivia's gas and oil is extracted from eastern states, which strongly reject the central government's October 2007 decision to cut their share of the Direct Hydrocarbons Tax (IDH) by 15-25% in order to fund a monthly pension payment for the over 60s.

Detailed Analysis

There will likely be a lull in unrest in the coming weeks, but sporadic flare-ups are likely ahead of a probable 25 January 2009 referendum on a new constitution. Agribusinesses are likely to be disrupted by fuel shortages and state entities further targeted in the five pro-autonomy states; violent unrest is likely around government buildings in La Paz.

On 14 September, the governor of Tarija flew to La Paz for crisis talks with President Morales and the head of the influential Santa Cruz Civic Committee called for a lifting of road blocks as a sign of goodwill. Some pro-autonomy leaders are conscious that the prospects of them establishing respected regional entities in the future are being damaged by the current antagonising of Brazil

and Argentina over gas exports and their inability to prevent incidents such as the alleged massacre of 26 people in Pando by a pro-autonomy mob. As such, they will likely encourage their supporters to maintain pressure on the government while toning down the violence. Nevertheless, the proposed 25 January 2009 referendum on the new Constitution is likely to act as a focal point for anti-government unrest. Morales' MAS party has a majority in the lower house of Congress, but the opposition Podemos party has a one-seat majority in the Senate. As he has done in the past, Morales is likely to mobilise supporters to lay siege to Congress while it debates the validity of the referendum, leading to significant unrest and sporadic violence in La Paz. The co-opting of Senate members from smaller parties will likely see the referendum given the go-ahead, resulting in yet more civil disobedience in the five pro-autonomy states. This includes further take-overs and vandalism of state entities, airports and gas installations. There are already signs of pro-Morales activists mounting their own road blockades in order to isolate Santa Cruz, which is the driving force behind the pro-autonomy movement. The net effect of these and Conaldea's own road blockades is likely to be worse shortages of petrol, diesel and liquefied petroleum gas (LPG) in Tarija, Santa Cruz, Beni and Pando, affecting soy, sunflower, sorghum, rice, sugar, cotton and sunflower producers, as well as cattle ranchers and dairy farmers. There is also a risk that the road blockades could collapse YPFB's fuel distribution and storage capacity, bringing to a halt Bolivia's two main refineries: Gualberto Villarroel in Cochabamba and Palmasola in Santa Cruz. Our sources report that pro-government activists are planning to re-take the offices of state entities in the city of Santa Cruz, which is likely to lead to violent confrontations, probably resulting in fatalities.

Any future incidents of disruption to gas exports will increase pressure on the government to order troops to use lethal force to quell the unrest, which would likely re-escalate the unrest.

Although a 'state of siege' was declared in Pando, Morales has so far shown restraint in the use of

the Army and in openly encouraging his supporters to counter the actions of opposition activists. However, any prolonged disruption to gas exports is likely to result in substantial pressure on Morales - from Brazil and Argentina, but also his own ministers - to order troops (already deployed around key gas assets) to use lethal force. Our sources report that some senior military commanders have expressed deep dissatisfaction with Morales. Furthermore, Venezuela's President Hugo Chávez has threatened to provide armed support to pro-Morales militias if Morales is ousted, suggesting that some military leaders have deliberately allowed violence to occur. Many senior Air Force and Navy officers, who also hold important staff positions, hail from among the elites in the half moon states. In contrast, the majority of Army commanders are from the highlands. In 2006 and 2007, Morales reshuffled most top Army commanders to promote those most likely to side with him. Furthermore, there has been a policy of stationing soldiers from the highlands in lowland areas, probably to reduce objections to having to use force against their own communities. Bolivian soldiers are poorly trained to deal with crowd control and lack non-lethal riot equipment, which has led to incidents in the past of live bullets being used instead of relying on methods such as tear gas and baton charges. On 14 September, soldiers deployed to re-take control of an airport in Pando shot and killed two people, including an unarmed evangelical minister who was attempting to mediate between the two sides. More incidents such as this would risk unravelling any agreements reached between regional governors and the central government in the coming weeks and likely lead to a re-escalation of violent and disruptive unrest.

Ahead of elections in late 2010, leaders in pro-autonomy states are likely to ignore the new Constitution and press ahead with creating their own regional institutions. This creates potential contractual risks for investors operating there, especially in the hydrocarbons, utilities and agribusiness sectors. While some of the more radical groups on both sides may resort to small bombings of government buildings or opposition organisations, all-out civil war is

unlikely.

Morales' 67% overall approval in August's recall referendum suggests that his proposed constitution will be passed and he is unlikely to be forced out of office before his terms ends in January 2011, when he is likely to seek re-election for a second (and then potentially third) five-year term. Regional leaders in Santa Cruz, Beni, Pando and Tarija are likely to ignore the new Constitution and press ahead implementing the statutes that were approved in their mid-2008 autonomy referenda, including electing regional assemblies, which will not be recognised by the central government. Private firms, particularly in the hydrocarbons (e.g. Pan American Energy / BP, Petrobras, Repsol, BG Group and Total) and utilities sectors, are likely to come under pressure to deal directly with regional licence-issuing and tax offices rather than the authorities in La Paz. States have also threatened to begin issuing their own quality control and other certification, which will likely affect the dairy, soy, sesame and rice industries; companies in these sectors include Nestlé (Switzerland), Archer Daniels Midland (US) and the Romero Group (Peru). Entities that opt to deal directly with the new regional assemblies, such as financial institutions that provide them with loans, are likely to face discrimination by the central government or expulsion from the country. There is no clear leadership or cohesion being demonstrated within the opposition Podemos party, Conaldea or the pro-autonomy movements in the various states. Indeed, it is likely that some of the recent acts of violent unrest in Tarija have been initiated by dissatisfied civic groups taking advantage of the unstable environment to protest local-level grievances against the central government rather than taking orders from the main autonomy proponents in Santa Cruz. Some of the more radical groups within the broad anti-Morales coalition (especially the right-wing Santa Cruz Youth Union (UCJ)) are likely to employ increasing levels of violence as polarisation along political and racial lines increases, especially in the run-up to presidential elections in late 2010. Since late 2007, there have been a number of small bombings of buildings used by pro-government entities - mostly in the city of Santa

Cruz but also in La Paz. For their part, pro-government supporters have shown a willingness to throw sticks of dynamite at bastions of anti-Morales entities, such as the Chamber of Commerce or Civic Committee in Santa Cruz. Civilian-on-civilian violence is likely to take on a more overt racist nature, such as the highly controversial incident in May 2008 when a dozen pro-Morales indigenous supporters in Sucre were stripped, humiliated and had their traditional weavings and clothes burnt. Nevertheless, for civil war to break out there would have to be organised armed groups on both sides, which is not yet the case. Most of the fighting has been with sticks, stones, Molotov cocktails, slingshots and some home-use hunting guns and Mauser bolt-action rifles used in the 1930s war against Paraguay.

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