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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

Brazil

CONFIDENTIAL

ECONOMIC COMMITTEE

EC/O/68 - 70

July 12, 1968

Brazil: Economic Policy Memorandum

1. The attached Economic Policy Memorandum on Brazil from the Western Hemisphere Department (EC/O/68-70/1, dated July 12, 1968) will be discussed at an Economic Committee Meeting to be scheduled within the next two weeks.

C. F. Owen
Secretary

Attachment

Secretary's Department

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EC/O/68 - 70/1

July 12, 1968

ECONOMIC COMMITTEE

Economic Policy Memorandum from the Western Hemisphere Department

BRAZIL

I. Introduction

1. The Economic Committee, at a special meeting on September 12, 1967 (EC/M/67-24) concluded that, given adequate performance, a proposed lending program of about US$110 million over a 12-18 month period was appropriate on economic grounds. Regarding performance criteria, it was agreed that performance "... would have to be assessed by (a) how Government policy affected the efficiency in the allocation of resources in an inflationary environment, and (b) how effective and consistent efforts were to reduce inflation itself." Moreover, "... the Chairman emphasized the importance of using comprehensive criteria to evaluate Brazil's long-run development strategy and achievements, in addition to specific, but short-term and relatively limited tests ... It was agreed, in view of the prospects of further inflation, that the exchange rate was a highly significant operational test ... (and that) periodic reviews of overall economic management, including fiscal performance, would have to be made."

2. In June 1968, the following paragraph was included in the Bank Strategy Paper:

"Government action in certain key areas will provide in the next few years clues as to the general thrust of economic management. They all relate simultaneously to stabilization, resource allocation and development. Particular attention should be paid to the following:

(a) Success in restraining current expenditures of the Federal Government (improvement needed);

(b) Success in eliminating the deficits of the railroads (improvement needed);

(c) Success in controlling state government expenditures and in transferring expenditure functions from the federal to the local governments (improvement needed);

(d) Economic pricing policies by public enterprises, especially steel (improvement needed) and electric power (continuation of present practice needed);

(e) Maintenance of realistic exchange rates, i.e., frequent adjustments until inflation is eliminated (improvement needed);

(f) Farmgate coffee prices which do not make the production of surpluses profitable (continuation of present practice needed);

(g) Debt management policies preventing the re-emergence of excessive short-term debts (recent deterioration possible but not yet clearly established);

(h) Financial and economic planning which effectively coordinate the intention of the spending agencies with resource availabilities and subordinates them to national priorities (improvement needed);

(i) Channelling of medium and long-term credit to private industry and agriculture at positive, but not excessive, interest rates (improvement needed);

(j) Stability in policy regarding property rights and treatment of foreign and domestic investments (continuation of present practice needed);

(k) Non-inflationary wage policies (continuation of present practice needed)."

3. The above was written at the same time as the attached report of the 1968 economic mission was being prepared; the latter document thus contains the factual and analytic bases for the judgments incorporated into the Bank Strategy Paper. The draft, after having been reviewed by an Economic Committee working party, has been sent to Brazil; we intend to discuss it with the authorities later this summer.

II. Statement of Policy Issues

4. I consider that the principal issues facing the Committee are:

(a) The adequacy of Brazil's performance in the light of the previously agreed criteria.

(b) The relative weights and the interpretation of some of these criteria.

(c) The appropriate Bank lending posture under varying performance assumptions.

(d) Terms for Bank lending and IDA eligibility.

III. Discussion of Policy Issues

5. In spite of the substantial decline in the rate of price increases, 1967 was a disappointing year in that little progress was made in attacking the causes of inflation. Indeed, it will not be surprising if prices in 1968 rise somewhat more than they did last year. Nor is the 1968 program impressive, even though the aggregate monetary targets are reasonable: the mission's report suggests that in the public finances there are too many open questions to make achievement of the program goals likely. Thus, by the criteria which I proposed in September 1967, for judging the stabilization aspects of the 1968 program, namely, that it:

> "... (a) have a realistic chance of being achieved, and
> (b) represent a significant reduction in the real inflationary pressures emanating from the Federal Government,"

performance was poor. This judgment is made even after taking account of the various unforeseen factors listed in the economic report and which fall more under the heading of inadequate planning (partly by the preceding Government) than of incorrect measures.

6. On the other hand, regarding the first criterion agreed upon by the Committee last year, namely, the prevention of distortions in resource allocation while inflation lasted, through price and exchange rate flexibility, the new Government has performed rather better. The exchange rate was devalued twice (February and December) and even though - as we are stressing to the Government - this was still not enough to prevent some deterioration in the average annual real rate, the erosion amounted to less than 4 percent. At the same time, the Government resisted pressures to rescind previous tariff reductions. The Government has also maintained the policy of permitting power rate adjustments and has permitted other public service tariffs to rise with costs. The two areas in which the public enterprise pricing policy was least adequate were steel and railroads, but even in these, price rises of about 22 percent were allowed in February 1968. The issue of railroad rates will be part of the negotiations between the Bank and the Government on the next highway loan (probably in July); we have informed the Government that one of the conditions for the loan will be a program of specific measures needed to improve the economic efficiency of the transport sector (roads, railroads and ports) and the Government has agreed to this as the basis for negotiations.

7. The growing acquaintance of the Bank with the Brazilian economy since 1964 - based on annual economic missions as well as numerous contacts at the project level - increasingly leads to the conclusion that the

country's growth potential will be best realized with a minimum of arbitrary interference in the allocation of resources by controlling particular prices. Similarly, the ability to incur and service debt will be a direct function of realistic exchange rate policies. Consequently, the Bank has been concerned about inflation primarily because of the greater likelihood of such policy-induced distortions appearing when inflationary pressures were great. To the extent that the Government can demonstrate that with the more modest inflation rates now prevailing, it is able to resist pressures to re-introduce the distorting price and exchange rate freezes - let alone the quantitative controls of the past - lack of success in achieving particular price objectives can be viewed with somewhat greater equanimity by the Bank. Nevertheless, success in further reducing inflationary pressures should continue to be counted among the indicators of good economic performance, precisely because with it the probability of new distorting policies should decline. In the meantime, however, our primary concern should be with the avoidance of such policies under conditions of - for Brazil - moderate inflation. At the same time, we should pay increasing attention to what the Government may do to overcome some of the fundamental weaknesses of the economy, which are diagnosed in the economic report. Similarly, wherever possible, we should select projects and attach project and sector conditions that are consistent with this diagnosis and that will help and encourage the Government to overcome these weaknesses.

8. In the Bank Strategy Paper I proposed that the Bank set for itself a minimum annual level of lending of US$50 million which it would try to maintain as long as performance met minimum requirements. Reasonable exchange rate flexibility and pricing policies that do not lead to major new distortions in the allocation of resources should be the prime criterion for this tranche. I also proposed a more ambitious lending program of US$1,000 million in five years - moving from US$75 million in 1968/69 to about US$300 million by 1972/73 - if economic performance substantially exceeded these minimum requirements. The criteria by which performance in excess of the minimum standard should be judged - and according to which the broad magnitudes of Bank lending should be determined (subject to the absence of unplanned project constraints) - are of two kinds: sectoral policies and overall economic management.

9. The projects included in the Five Year Forecast (attached) were, to a considerable extent, selected on the basis of meeting one of two criteria: (a) being suitable for assuring a predetermined minimum lending flow on a reasonably firm schedule and (b) being in sectors in which the Bank's contribution could be institutional and policy-oriented as well as financial. The expected lending of about US$50 million per year for electric power until 1971/72 meets the first criterion. The other projected loans are mostly in the second group. I propose that of these, some US$100 million per year be made primarily on the basis of adequate performance in the

respective sectors, while an additional US$50-100 million per year could be lent after mid-1970 if general economic management is sufficiently encouraging. I consider that two reasons make the relatively heavy emphasis on sectoral criteria appropriate in Brazil: (a) our ability to influence overall economic management is necessarily quite limited (see below, paragraph 18) and (b) some of the main policy issues in Brazil are particularly suitable for this approach since they concern the level and structure of public expenditures in certain sectors, rather than overall revenue and savings deficiencies.

IV. Sectoral Criteria

10. The sectoral criteria selected are, without exception, of sufficient importance to the economy to have a bearing on the structural issues discussed in the economic report. Thus, the lending in the transport sector - 40 percent of our proposed program - will be related not only to the railroad action program to be discussed shortly (see para. 6 above), and thus to the Federal Government's deficits, but also to the shifting of construction and maintenance functions from the Federal Government to State Highway Departments. This measure - already recommended by the Phase I Consultant's Report on Transport - acquires added relevance in view of the economic report's emphasis on the critical imbalance between Federal and State finances.

11. All or part of the proposed lending in the agricultural sector should be made largely contingent on a continued satisfactory coffee policy, i.e., on one which is likely to prevent renewed surplus production. This, too, is consistent with the analysis of the economic report: not only have coffee surpluses in the past gravely upset the stabilization program, but the artificially high price of coffee has prevented shifts in land use to promising alternative crops for exports and domestic consumption.

12. Lending for industrial credit programs to the Bank of the Northeast would have an important impact on the allocation of resources if it helps to induce the BNB to change its present practice of lending at negative interest rates. If successful, the effect of Bank lending here would be relatively large; the proposed loan would be small in relation to the total program cost and would help ensure the efficient use of the public funds channelled to the Northeast through the federal income tax exemption schemes. As the economic report shows, these "Article 34/18" funds are becoming increasingly important. Lending to private investment banks operating in the more developed parts of the country would be justified on sectoral grounds if it is accompanied by a sizable increase in domestic funds channelled toward long-term credit at positive interest rates; it would help improve the unsound structure of industrial finance which has been one of the lasting impediments to effective stabilization policies.

13. There are some other sectors in which project considerations - and the possibility of a gradually growing impact on sectoral policies through larger subsequent loans - play a more important part than overall economic policy considerations. Education and sanitation are in this group. Even here, however, Bank lending can fulfill important general economic management objectives if it accompanies transfers in federal expenditure functions to local governments (see above, para. 10) and supports a growing influence by the Federal Government over the level and composition of the spending of states and municipalities.

V. General Economic Management

14. Achieving all the sectoral aims listed above would go a long way toward improving Brazil's overall economic management. However, certain other criteria are also relevant. Particularly important among these is action to reduce the structural deficiencies of the public sector and, more especially, controlling the growth of federal personnel expenditures. Reducing the size of the federal bureaucracy is as difficult as it is important; if accomplished it would be a major step toward creating confidence in the country's ability to cope with its principal problems and would warrant a larger volume of Bank lending on that account. Other priority criteria may emerge as time passes; the present constraints on project preparation imply that this tranche could only become operative in 1970/71.

15. The proposal to respond to better economic performance by lending a further US$50-100 million per year - in addition to the annual US$100 million tied to sectoral criteria - is made on the understanding that if there were a sharp deterioration in overall management, such as a complete breakdown of the stabilization efforts, the entire lending program would have to be re-examined. This, as well as the need to monitor performance under the minimum criteria and on the sectoral policy conditions listed above, implies a continued need for frequent reappraisals of Brazil's economic policies and prospects.

16. The economic report indicates that Brazil can be expected to have a high debt service level even under quite favorable savings assumptions, and that the ratio would rise even further all through the seventies under assumptions that, while somewhat less favorable, still imply a substantial improvement in the savings effort. I therefore consider that Brazil is eligible for IDA assistance (hard blend) on creditworthiness and performance grounds. Brazil would also be eligible on poverty grounds. The per capita income figure in the Bank Atlas is US$220; our present estimate is that this figure is really closer to US$170-180.

17. The economic report concludes that official financing, on average, of 40-45 percent of project costs - as against an average expected import component of 32 percent in the projects suitable for external financing - would be consistent with balance of payments viability. The proposed Bank/IDA lending for 1968/69 to 1970/71 (project cost estimates are less precise for the last two years) would be roughly consistent with this formula:

	(1) Total Cost	(2) Estimated Import Component	(3) Proposed Bank/IDA Lending	(4) 2:1	(5) 3:1
	(US$ million)			%	%
Power	366	150	150	41	41
Highways	316	75	125	24	40
Ports	75	27	30	36	40
Agriculture and Storage	136	24	55	18	40
Industry and Mining	180	50	50	28	28
Education	30	5	15	17	50
TOTAL	1103	331	425	30	39

18. In recent years the exchanges of opinion and information on economic policy between the Bank and the two successive Brazilian Governments have been extremely cordial and frank. At the same time, the Bank's financial involvement in Brazil has been negligible when measured by the size of Brazilian public investments or by the size of total external financing required and/or received. Under these circumstances, it would be illusory to expect the Bank to be able to influence general economic policies significantly in areas not directly related to our own lending. The experience of the USAID, which has committed and disbursed far larger amounts than the Bank (program and project loans), has been somewhat more favorable to the extent that overall policy undertakings were made. On the other hand, the nature of the bilateral political relationship has in itself limited the effectiveness of the influence on government policy.

19. It seems clear from the diagnosis of the various Bank economic reports of recent years that some of the crucial overall policy matters that can be expected to continue to be of key importance for Brazil's development prospects and creditworthiness will not be easily affected by project loan conditions. It is equally clear that no single lender will carry much weight in Brazil. Finally, the economic report also shows that debt management and the terms and conditions of new loans are of major importance in the next few years because of the rather high initial debt service ratio. Under these circumstances, the Bank should

consider the advisability of a more concerted action between major lenders and the Government of Brazil. I therefore propose that we begin to explore with the Government the pros and cons of convoking a Consultative Group or a similar mechanism, under the auspices of the Bank, even though I consider it quite possible that the Government's reaction may be negative for the time being. The premises under which I would recommend to the Bank to support the formation of such a Group would be that the Government, after a full review of the potential advantages to Brazil as regards volume and terms of external financing, and in full recognition of the implications in terms of economic policy discussions with the Group, unequivocally indicates its desire for the formation of the Group.

VI. Recommendations

20. I recommend that:

(a) Brazil be considered creditworthy for minimum Bank annual lending of US$50 million, provided no major setbacks occur in price and exchange rate policies;

(b) Brazil be considered creditworthy for another US$100 million per year as long as, in addition to (a) above, the aforementioned sectoral performance criteria are met;

(c) Brazil be considered creditworthy for another US$50-100 million per year, approximately, if general economic performance improves substantially;

(d) It be agreed that Brazil be considered eligible for IDA credits on a hard blend basis, provided that the criteria under (b) above are met;

(e) It be agreed that, on economic grounds, local cost financing sufficient to allow external financing to cover 40-45 percent of the total cost of projects financed by official agencies is warranted;

(f) Exploratory talks be initiated with the Government regarding its attitude to a Consultative Group or similar mechanism.

Gerald Alter
Director

Attachments:

Annex 1: Five-Year Forecast

Annex 2: Summary and Conclusions of "Current Economic Position and Prospects of Brazil" (WH-184).

Annex 1

Attachment to: EC/O/68 - 70/1

FIVE-YEAR FORECAST

B R A Z I L

($ Million)

	1968/69 Bank	1968/69 IDA	1968/69 Total	1969/70 Bank	1969/70 IDA	1969/70 Total	1970/71 Bank	1970/71 IDA	1970/71 Total	1971/72 Bank	1971/72 IDA	1971/72 Total	1972/73 Bank	1972/73 IDA	1972/73 Total	Total Bank	Total IDA	Total Total
POWER																200	-	200
Volta Grande (Cemig)	25		25															
Porto Colombia (Furnas)	25		25															
Marimbondo I (Furnas)				50		50												
Marimbondo II (Furnas)							50		50									
Southern Hydro										50		50						
TRANSPORT																380	25	405
Highways I	25		25															
Highways II				50		50												
Sao Paulo Beltway							50		50									
Ports (Rio, Santos, Recife)				30		30												
2 Addtl Transport Projects I										75	25	100						
3 Addtl Transport Projects II													150		150			
AGRICULTURE																85	45	130
Santos Port Storage				5		5												
Agricultural Credit I							30	20	50									
Agricultural Credit II													50	25	75			
INDUSTRY AND MINING																150		150
Iron Ore Export (Hanna/Antunes)				25		25												
Steel (Cosipa)													50		50			
Banco do Nordeste-Ind. Credit				25		25												
Private Finance Companies										50		50						
EDUCATION																	40	40
Education I								15	15									
Education II														25	25			
SANITATION																	25	25
Small City Water Supply											25	25						
UNIDENTIFIED							50		50							50		50
TOTAL	75		75	185		185	180	35	215	175	50	225	250	50	300	865	135	1,000

Annex 2
Attachment to:EC/O/68-70/1

SUMMARY AND CONCLUSIONS

(from draft economic report "Current Economic Position and Prospects of Brazil")

1. On March 15, 1967 the Government headed by Field Marshal Costa e Silva succeeded that of Field Marshal Castello Branco which had ruled for three years, i.e., since the military coup of March 1964. The new Government stated from the outset that its broad economic policies would be a continuation of those of its predecessor, although its choice of instruments and tactics might vary in accordance with the emergence of new situations. Its announced overall objectives continue to be a gradual return to price stability, an acceleration in the rate of economic growth, improvement in Brazil's external credit standing, stimulation of the private sector and a consolidation of the broad range of institutional reforms initiated during 1964-1966. Although the attainment of many of these objectives is proving more lengthy and difficult than had been expected, and is accompanied by setbacks in particular areas, the actions of the new Government during its first year in office have been broadly consistent with these aims. Questions may be raised about the timeliness and effectiveness of particular actions, or about the adequacy and extent of others, but there is no indication that a reversion to the pre-1964 policies is either intended or likely.

2. The incoming Government was faced with a particularly difficult situation in early 1967 because the industrial sector was sinking into a deepening recession, even though price inflation had by no means ended. The Government's response was to pursue, for several months, a deliberately anti-cyclical fiscal policy: certain taxes were reduced and credit restrictions were eased. Economic activity responded well, but the fiscal deficit and the monetary expansion rose substantially above the planned levels. A contributing element to this result were payments for expenditure obligations incurred by the preceding Government. In the second half of the year, attempts were made to curtail the growth of the deficit, but in the absence of effective controls - until October - over the obligational authority of the spending agencies, the success was limited and the Treasury cash deficit in real terms, after declining for three consecutive years, rose from 1-1/2 percent of GNP in 1966 to about 2 percent in 1967. If the 1968 program targets are achieved, this ratio would revert to about 1.6 percent. Wholesale prices (excluding coffee) rose by only 22 percent between December 1966 and December 1967, or by 26 percent on an annual average basis (as against 40 percent in 1966), in spite of the 45 percent expansion in the privately held money supply. Larger food crops contributed heavily to this result, as well as to a GNP growth of over 4 percent in real terms, i.e. fractionally more than in the two preceding years. It is not expected that price rises in 1968 will decelerate further, especially as there is underway some relaxation in the policy which until 1968 had resulted in a gradual decline of private and public sector real wages per capita; what is important is that measures needed for future improvements - many of which can only become fully effective over several years - be taken. These include fiscal and financial as well as specific sectoral measures, many of which the Government is considering.

3. Net foreign reserves fell by about US$100 million. Lower coffee prices and production and marketing difficulties of some agricultural

products contributed to this result, but so did the 16 percent rise in imports, which followed one of 36 percent in 1966. Although imports in excess of the growth in GDP should be aimed for as long as price stabilization is a major problem, import growth rates of this order are evidently not sustainable. Exports of manufactures continued to rise at an encouraging pace, but more than half of the US$47 million increase was in steel and steel products which were sold below costs during the domestic recession in early 1967. Even though the exchange rate was devalued by 23 percent in February 1967 and by a further 18.5 percent in late December, the average rate during the year changed by less than domestic prices for the third consecutive year. The Government has reiterated its intention to pursue a realistic rate policy, but continues to be greatly concerned about the direct price raising effects of devaluations and about currency speculation. Actually, however, the policy of relatively infrequent rate adjustments has probably magnified the problem of periodic speculation against the cruzeiro, and may also have yielded smaller benefits in terms of developing non-coffee exports than would have been obtained from equal, but less spasmodic, rate changes.

4. The full exploitation of Brazil's large potential for non-coffee exports will be a key condition for sustained economic growth. To achieve this, the exchange rate policy must not only offset domestic cost increases but will have to be fully coordinated with other policies affecting the profitability of these exports. At the present unusually high prices cotton is very profitable; if the price should, in a year or two, decline by 10-15 percent, between one fourth and one half of Brazil's production might yield losses at present exchange rates. Even more important is that the relative profitability of coffee not be allowed to rise so much as to reverse the shift in land use that took place in recent years. The policy variables here are the Government's coffee policy as well as the exchange rate. Between 1963/64 and 1965/66 the policies by which the effective prices for coffee exporters and producers were determined resulted in a clear shift of profitability in favor of other crops; since then some reversal has taken place although coffee, at a yield of 10 bags per hectare, is still less profitable than rice, beans or groundnuts. On the other hand profits in the rather promising soybeans and corn production are already made precarious by the present price relations; if further substantial concessions are made to the coffee sector the gains of recent years can easily be lost. (For details, see Vol.II, Annex B). The danger then would be two-fold: (a) non-traditional exports would stagnate and (b) the inflationary impact of the accumulation of unsaleable coffee stocks would undermine the stabilization program. The Government is fully aware of this danger; what remains to be seen is the extent to which the various agencies involved in making the relevant decisions, are able to coordinate their viewpoints.

5. One of the enduring obstacles to stabilization as well as development continues to be the excessive claim of the public sector on resources. For 1968 it is estimated that domestically financed government expenditures may account for almost 31 percent of GNP - 28.8 percent through taxes and 1.8 percent through borrowing - and the prospects are for further increases in this ratio. Under the influence of transitional difficulties the state

governments in 1967 raised the effective rate on the value added tax (ICM) by 25 percent; it is to be hoped that this measure can be reversed and state expenditures be prevented from rising correspondingly. For the Federal Government the dilemma is accentuated by the fact that the 1967 Constitution - left by its predecessor - forces it to transfer large additional resources to the states and municipalities, without giving it much influence over the manner in which these funds are spent. It will be one of the main challenges for the Government to devise ways by which either important federal expenditures functions can be shifted to the local governments that are receiving the additional revenues or the distribution of tax revenues between levels of government is altered. This task will be made even more difficult by virtue of the fact that the present system has one important positive feature which should not be sacrificed: it results in substantial shifts of tax revenues from the richer parts of the country to the less developed Northeast. However, it also results in large - and probably excessive - transfers to the almost uninhabited Amazon regions; it is to be doubted that this allocation of resources conforms to a sound strategy for the long term development of Brazil.

6. Of overriding importance is that the growth of federal current expenditures be curtailed. The Government shares this view and has informed the ministries that between 1968 and 1970 these expenditures will not be permitted to rise in real terms. Besides specific actions planned to reduce the operating losses of the railroads, this goal will only be achieved if a rigid policy of attrition of the federal civil service is enforced. Given legal tenure rights of existing staff, it will be indispensable to prevent the replacement of the bulk of those who die or resign; only thus will it be possible to grant much needed improvements in the remuneration of public servants without further raising the share of the total product absorbed by the Government or sacrificing necessary public investments. Given the present composition of personnel expenditures, a policy of attrition need not impinge unfavorably on development-oriented current expenditures; already the bulk of teachers' salaries, for example, are excluded from the federal budget, being a responsibility of the states and municipalities. Naturally such a policy of attrition will be facilitated if private sector employment opportunities expand more rapidly than they have in recent years.

7. Even with such a policy, present federal investments intentions are probably excessive. There can be no doubt about the usefulness of a large part of them: the needs in power, transport, steel and petroleum, for instance, cannot be disputed. But given the growing share of public resources that is being channelled to the states and that therefore - for the present - must be assumed to be spent without regard to nationally determined priorities, the maintenance of the spending levels planned by the federal agencies would mean depriving the private sector of the possibility to expand its own investments. Even with the cutbacks suggested by the mission, private investments could probably grow no faster than GDP, and only this if by 1970 about 25 percent of the increase in tax revenues saved is re-lent to the private sector.

8. The issue of private sector financing highlights a fundamental feature of Brazil's long term development problems. The size and heterogeneity of the country, as well as its history, militate against a high degree of centralization. Its federal system of government is far from accidental. Even the federal sector itself is by no means monolithic, and might well be less efficient if this were not the case. In it have developed some extremely efficient spending agencies with a considerable degree of autonomy, which has helped them perform their particular functions well. Similarly, at the state and municipal level, some admirably efficient institutions exists, whose effectiveness is enhanced by their independence. The problem arises from the fact that some vital functions of government - such as ensuring price and financial stability - are by their nature of national scope, and are reduced in their effectiveness by the extent of the fragmentation of the decision making in the public sector. The financial planning that is necessary for economic stabilization and for orderly development, especially; when the public sector is large, becomes compromised to the extent that many of the public sector's spending decisions are made independently. In recent years serious attempts have been made to impose some overall consistency and rationality on at least the federal sector and to determine its investments in the context of national priorities. The Ministry of Planning has participated increasingly in the budgetary process, and its long term planning unit (IPEA) has made considerable strides in analyzing and coordinating the activities of numerous agencies. The creation of a Central Bank has also contributed to developing a more realistic integration of fiscal and monetary decisions. But a great deal remains to be done. The Bank of Brazil continues, in many respects, to operate like a commercial bank, but without the constraints imposed on these; the National Development Bank (BNDE) activities are only partially integrated with the overall monetary and fiscal management, and the newly created National Housing Bank (BNH) poses some new problems precisely because large fiscal resources are earmarked for it. The present Government is reacting to these difficulties with vigor and imagination, but it seems clear that no quick or easy solutions can be expected. One aspect of this in which accomplishments to date have been disappointing is the monitoring of the execution of programs; detailed and up to date knowledge about the amounts spent - and their precise purpose - of most public agencies is not available to the Government and this adds greatly to the difficulties of flexible and consistent financial and economic management.

9. During the next few years, substantial increases in Brazil's external financial requirements can be expected. The new government has resisted pressures to reverse the liberalization of import policies initiated by its predecessor, and - if a reasonable growth rate for the economy is to be maintained until inflation is fully controlled - it will be logical to aim for imports to rise faster than GNP. Moreover, a modest improvement in the net foreign reserve position is also aimed for. Thus, in spite of quite favorable export prospects, net capital inflow requirements may rise from about US$350 million in 1967 to some US$550 million by 1970, with gross capital inflows being almost twice as high. Given the volume of loans already committed but undisbursed and the large number of projects suitable

for external financing, these requirements should not present insurmountable difficulties, provided reasonable amounts of local currency financing or non-project loans continue to be provided by official lenders. The direct foreign exchange component of the new projects likely to be committed during 1968-70 is about 32 percent of their total costs; if official lenders, on average, finance 40-45 percent of project costs, no balance of payments difficulties should emerge, as long as project financing proceeds without undue delays and as long as adequate exchange rate policies are followed. From 10.6 percent in 1967, net capital inflows would finance 14.0 percent of gross domestic capital formation by 1970, which still would leave Brazil with one of the highest proportions of domestically financed investments among the developing countries. The projection implies, further, that the share of investment in GDP would rise from 14.7 percent in 1967 to 17.3 percent by 1970.

10. The improvement in recent years in Brazil's external debt profile presages some decline in the debt service ratio until about 1970. From about 31.0 percent in 1967, the ratio of external debt service to current account earnings should decline to some 24.5 percent by 1970. For the longer term the prospects are strong that the ratio will remain high, even though, with adequate exchange rate and other economic policies - yielding annual growth rates of about 5 percent for exports and 4 percent for imports - the current account deficit exclusive of service on capital could decline gradually and disappear by about 1980. The reason why nevertheless the total service on the external debt will continue to rise faster than current account earnings is that if all new borrowing takes place on conventional terms - divided about equally between suppliers and official lenders - interest payment obligations will mount very rapidly. There is thus a strong reason for Brazil to continue to seek some financing on concessional terms during this period. While Brazil is likely to remain creditworthy in the narrow sense of not showing an indefinite expansion of the debt service ratio even without such concessional terms, the continuation of the ratio at such a high level might well be viewed with concern by private lenders. This seriously hampers the freedom to maneuver by the authorities and could force them to lower growth targets than the 6 percent rate assumed here.

From:
Economic Report: "Current Economic Position and Prospects of Brazil"
Report No. WH-184
Western Hemisphere Department