Brazil

BRAZIL

SELECTED ANALYTICAL VARIABLES FOR ECONOMISTS AND MANAGERS

ATLAS PER CAPITA GNP (CUR) (1983)	=1,880
POPULATION IN MILLIONS (1983)	=129.662
LT DEBT OUTSTANDING AND DISBURSED IN MILLIONS (CUR)(1983)	=79,580.05
BALANCE ON CURRENT ACCOUNT IN MILLIONS (1983)	=-6,799

	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
GROWTH OF GDP AGGREGATES (CONST)					GROWTH RATES				
1.GDP	6.94	6.81	249,740	-1.55	0.96	-3.18	4.48	4.26	5.40
2. AGRICULTURE(1)	3.78	4.80	31,286	6.41	-2.47	2.25	4.40	2.37	4.11
3. INDUSTRY(1)	11.04	7.44	81,482	-5.21	0.78	-6.15	6.56	4.27	6.98
4.GDP OUTPUT DEFLATOR	37.81	47.96	100	97.78	96.37	144.46	..	..	..
5.IMPORTS GNFS (NAT. ACCTS.)	9.32	1.67	26,560	-13.47	-5.19	-17.15	8.37	18.29	12.37
6.EXPORTS GNFS (NAT. ACCTS.)	7.44	7.00	21,281	20.74	-8.24	13.08	50.11	-4.53	4.75
7.MERCHANDISE EXPORTS (2)	7.01	7.81	20,132	27.00	-15.12	15.86	24.90	..	..
8.DOMESTIC ABSORPTION	7.01	6.42	255,020	-3.32	1.84	-4.80	-0.20	6.67	5.38
9.INVESTMENT	8.01	5.15	56,264	-15.84	-4.27	-17.43	-1.10	4.34	17.00
10.PER CAP TOTAL CONSUMPTION	3.94	4.34	1,639	-1.99	1.02	-4.17	-2.23	4.73	1.02
11.POPULATION (MIL)	2.72	2.36	121	2.25	2.25	2.25	2.25	2.25	2.25
TRADE PRICE INDICATORS (1980=100)						INDICES			
12.TERMS OF TRADE OF AGR/IND(1)	60.26	93.45	100.00	89.68	79.39	85.24	..	..	..
13.TERMS OF TRADE	126.96	125.45	100.00	85.98	85.00	85.85	..	..	..
14.TERMS OF TRADE (UNCTAD)	152.47	132.98	100.00	84.95	84.43	92.06	..	..	..
15.NOMINAL EFFECTIVE EXCHANGE RATE(3)	..	147.44	100.00	66.76	40.63	16.19	5.68	2.84	..
16.REAL EFFECTIVE EXCHANGE RATE(3)	..	106.38	100.00	122.80	129.49	105.20	105.45	112.64	..
INVESTMENT AND SAVINGS						RATIOS			
17.INVESTMENT/GDP (CURRENT)	26.2	23.9	22.5	21.2	21.2	17.0	..	..	..
18.INVESTMENT/GDP (CONSTANT)	20.7	23.4	22.5	19.3	18.3	15.6	14.7	14.8	16.4
19.DOMESTIC SAVINGS/GDP (CURRENT)	25.3	21.9	20.4	20.9	20.6	19.3	..	..	..
20.DOMESTIC SAVINGS/GDY (CONSTANT)	18.9	20.8	20.4	17.8	15.9	14.8	..	..	..
21.GROSS NAT. SAVINGS/GDP (CURRENT)	24.1	19.1	17.4	17.0	15.5	13.7	..	..	..
22.RESOURCE BALANCE/GDP (CONSTANT)	-2.7	-4.7	-2.1	1.1	0.7	3.6	8.1	5.8	5.1
23.MARG PROPENSITY TO SAVE (CONSTANT)	22.3	19.4	51.8	105.8	-171.0	49.1	..	..	..
24.TERMS OF TRADE ADJ./GDP (CONSTANT)	2.0	2.0	0.0	-1.5	-1.4	-1.6	..	..	..
25.ICOR (CONSTANT)	2.3	3.3	3.0	-14.0	20.3	-5.8	..	..	..

EPD 07/17/85

	HISTORIC DATA		REFE[illegible]CE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
TRADE AND BALANCE OF PAYMENTS						RATIOS			
26.SHARE OF MANUF IN EXPORTS (CUR)(2)	13.9	31.6	38.6	40.6	39.5	49.7	54.2	53.5	53.5
27.IMPORT GDP ELASTICITY	1.3	0.2	0.3	8.7	-5.4	5.4	1.9	4.3	2.3
28.CUR ACCT BALANCE/GDP (CURRENT)(4)	-2.1	-4.4	-5.1	-4.3	-5.8	-3.3	..	..	..
29.RESERVES IN MONTHS OF IMPORTS OF GOODS AND SERVICES(4)	5.5	4.3	2.3	2.3	1.2	1.8	4.8	4.5	4.5
DEBT INDICATORS (5)									
30.LT DEBT SERVICE TO EXPORTS RATIO	25.6	48.9	56.4	56.8	71.6	44.2	38.1	41.9	..
31.LT INT. SERVICE TO EXPORTS RATIO	9.4	20.8	27.1	29.4	39.8	31.5	31.3	36.2	..
32.LT DEBT SERVICE TO GNP RATIO	2.0	4.0	5.4	5.8	6.3	5.5	5.8	..	..
33.DOD. LT PUB DEBT AT VIR/ DOD. TOTAL LT PUB DEBT	27.3	55.8	61.2	67.3	69.6	76.5	..	..	..
34.NET TRANSFERS/TOTAL DISB	61.1	30.1	-16.2	4.4	-12.3	-35.8	-62.9	-133.2	..
35.WORLD BANK DEBT/TOTAL LT DEBT	..	..	3.7	3.6	3.7	4.6	5.2	5.9	..
MONETARY INDICATORS (CURRENT)									
36.CHG IN CLMS GOV/GOV BUDGET BAL(6)	..	70.3	..	..	..	..	..	..	..
37.CLMS GOV/CLMS PRIV SECT(2)	1.3	-12.7	-2.6	-6.7	0.5	8.0	..	..	..
38.MONEY SUPPLY/GDP	19.1	13.7	11.6	11.2	10.5	..	..	..	..
GOVERNMENT ACCT (CURRENT)									
39.DIRECT TAXES/GDP(6)	9.3	10.3	9.6	10.2	11.6	..	..	..	..
40.TOTAL REVENUE/GDP(6)	18.8	21.2	21.1	23.4	24.9	..	..	..	..
41.GOV. BUDGET BALANCE/GDP(6)	-0.2	-1.4	-2.3	-2.3	-2.5	..	..	..	..
42.PUBLIC/TOTAL CONSUMPTION	14.6	11.8	11.0	11.3	12.5	11.7	..	..	..

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NOTE: ALL REFERENCE YEAR VALUE DATA IN US$ 1980 MILLIONS, EXCEPT PER CAP TOTAL CONSUMPTION WHICH IS IN US$.

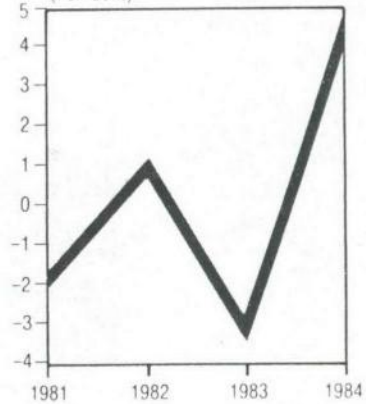
LEGEND: .. INDICATES NOT AVAILABLE
M INDICATES DATA IN MILLIONS

FOOTNOTES:
(1) SERIES STARTS IN 1965.
(2) SERIES STARTS IN 1962.
(3) US$/LOCAL CURRENCY. SERIES STARTS IN 1979. INCREASES INDICATE APPRECIATION; DECREASES INDICATE DEPRECIATION.
(4) SERIES STARTS IN 1966.
(5) SERIES STARTS IN 1970; STOCK AND DEBT SERVICE PAYMENTS ARE BASED ON PROJECTED CONTRACTUAL OBLIGATIONS AT END 1983 PLUS ESTIMATED NEW COMMITMENTS IN 1984-86. FLOWS ARE NET OF RE-SCHEDULING TRANSACTIONS.
(6) SERIES STARTS IN 1970.

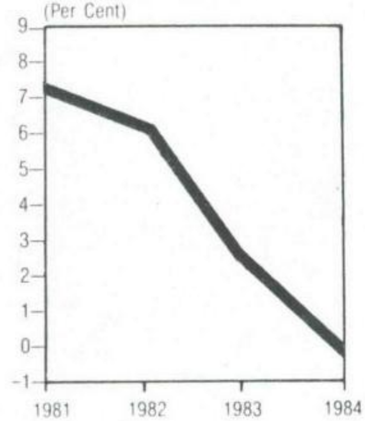
Brazil

Economic Indicators

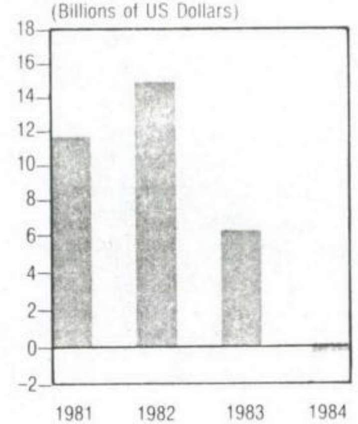
Growth of Gross Domestic Product
(Per Cent)



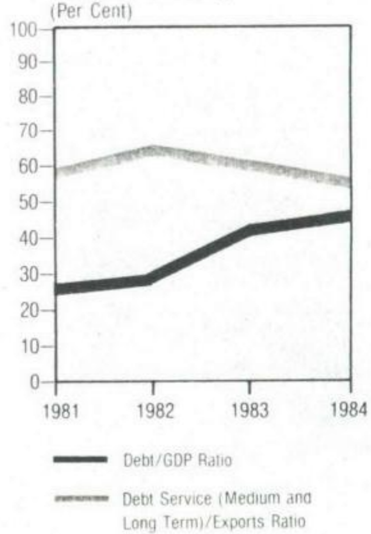
Overall Deficit of the Federal Public Sector Relative to GDP
(Per Cent)



Balance of Payments: Current Account Deficit
(Billions of US Dollars)



Total External Debt (Including short-term)
(Per Cent)



Statistical Profile*

Area (Km²)	*8,511,965*
Population: Total 1984 (73.1% urban)	*131,185,000*
Annual growth rate 1970–84	*2.5*
Birth rate (1980)	*23.3*
General mortality (1980)	*6.8*
Infant mortality (1980)	*68.1*
Life expectancy (1976)	*60.5*
Literacy (1980)	*68.7*
Labor force by sector (1980)	(Percentages)
Agriculture	*29.9*
Industry	*24.4*
Commerce	*9.4*
Services	*16.2*
Others	*20.1*

	1982	1983	1984**
Real production	(Growth rates)		
Total GDP (market prices)	0.9	−3.2	4.5
Agricultural sector	−2.5	2.2	4.3
Mining sector	6.7	14.5	27.3
Manufacturing sector	0.2	−6.3	6.0
Construction sector	0.2	−15.0	1.3
Federal Public Sector	(Percentages of GDP)		
Current revenues	25.4	n.a.	n.a.
Current expenditures	25.7	n.a.	n.a.
Current savings	−0.3	n.a.	n.a.
Capital expenditures	5.9	n.a.	n.a.
Deficit or surplus	−6.2	−2.7	0.2
Money and prices	(Growth rates)		
Consumer prices	97.9	179.2	203.3
Money supply	69.7	95.0	203.5
Exchange rate, average (units of national currency per dollar)	179.5	577.0	1848.0
Balance of payments	(Millions of dollars)		
Merchandise exports (FOB)	20,175	21,899	27,005
Merchandise imports (FOB)	19,395	15,429	13,937
Merchandise balance	780	6,470	13,068
Net services	−15,461	−12,753	−13,074
Current account balance	−14,755	−6,171	166
Official capital	n.a.	n.a.	n.a.
Private capital	n.a.	n.a.	n.a.
Change in net reserves (− increase)	6,529	3,300	−7,000
External public and private debt	(Millions of dollars)		
Disbursed debt (includes unregistered debt)	83,205	91,632	100,228
Debt service (interest and amortization)	19,537	14,410	12,209
	(Percentages)		
Debt service coefficient	86.0	61.0	45.2
Interest coefficient	56.9	43.4	39.6

* Where necessary, the items of information presented in this table are defined in the list of sources appearing on page 216. Any clarification or interpretation of the data should be referred directly to the pertinent source.
** Preliminary estimate.
n.a. Not available

Brazil

Recent Economic Trends

After three consecutive years of recession and declining per capita income resulting from the policies adopted to reduce the growing current account deficit in its balance of payments, Brazil showed encouraging signs of economic recovery in 1984. The 4.5 per cent growth of the real gross domestic product (GDP) significantly reversed the 3.2 per cent decline of 1983, which had been the largest since the Great Depression. To a considerable extent, this recovery was attributable to the manufacturing sector, whose real value added, after decreasing 6.8 per cent in 1983, rebounded by 6 per cent in 1984. While this upturn was mostly linked to higher production of capital and intermediate goods for export markets, available data suggest that the recovery became more general in the final months of the year, partly in response to higher consumer spending. Nevertheless, some industries producing for the domestic market continued to languish in 1984, owing in part to high real interest rates, reduced real wages, and widespread unemployment in many areas. Moreover, the higher level of activity appeared largely to reflect better capacity utilization rather than new investment, especially in the public sector, where restrictive budgetary policies cut the real capital outlays of state enterprises by an estimated 20 per cent.

Agriculture also contributed to the improved 1984 economic performance, since the growth rate of output nearly doubled with respect to 1983 and rose in line with real GDP. This result reflected good weather and improved harvests of cotton, potatoes, rice, corn and sugarcane among other factors. The largest production increase, however, was recorded in the mining sector, whose real value added soared 27.3 per cent, largely because of increased extraction of iron, copper, and bauxite ore and, especially, of petroleum. In fact, oil production rose by a record 40 per cent during 1984 to reach an average of 474,000 barrels per day (bpd). This production enabled Brazil to cover about 50 per cent of its needs, compared with only 15 per cent as recently as 1979.

The production trends summarized above, coupled with an aggressive policy of frequent minidevaluations, also contributed to a significant improvement in Brazil's balance of payments. The improvement was especially evident in merchandise exports, which climbed 23.3 per cent to a record $27 billion. Most of this increase was accounted for by sales of manufactured and semi-manufactured goods, which increased over 37 per cent to about $17.9

billion. The United States, the primary market for Brazilian manufactured exports, absorbed nearly 55 per cent of the total compared with about one-half in the preceding year. At the same time, merchandise imports declined 9.7 per cent to $13.9 billion. The bulk of this decrease was attributable to outlays for oil, which plummeted 13.9 per cent to $6.7 billion, owing not only to the increase in domestic production but also to falling world oil prices, and the widespread substitution of fuel oil by hydroelectric energy in the industrial sector. Non-oil imports, in contrast, decreased 2.9 per cent in 1984. This decline was explainable in part by the existence of considerable idle capacity in the capital goods sector and also by the start-up of a number of large import-substitution projects that reduced import requirements in key areas such as petrochemicals, and aluminum and other non-ferrous metals.

As a consequence of these trends, Brazil recorded an unprecedented $13.1 billion trade surplus in 1984, significantly above the $9 billion target projected at the beginning of the year and double the $6.5 billion level of 1983. Moreover, the results in the trade account were accompanied by a reduction of around 2.5 per cent in the service deficit, which was estimated at $13.1 billion, and permitted Brazil, when net transfers are taken into account, to achieve an estimated current account surplus of $166 million. This outcome constituted a dramatic improvement compared with the $11.6 billion average deficit of the preceding three years.

The positive developments in the current account caused Brazil's external adjustment process to advance at a rapid rate in 1984: virtually all the balance of payments targets established in the Extended Fund Facility Arrangement (EFF) with the International Monetary Fund (IMF) were amply surpassed. Moreover, the $12 billion loan and refinancing agreement negotiated with over 800 creditor banks in January 1984 was of considerable importance in normalizing capital inflows. These facts, coupled with greater-than-anticipated export earnings, enabled Brazil to reduce its short-term debt and substantially increase its holdings of foreign exchange. In 1984, Brazil's net international reserves rose to $3.7 billion, up about $7 billion with respect to December 1983. Finally, the total external debt (including short-term obligations) increased by $10.8 billion to an estimated $102.4 billion by year-end 1984; in part, however, this increase reflected the large accumulation of reserves.

Brazil's significant progress in adjusting its balance of payments in 1984 was somewhat tarnished, however, by the singular lack of success in controlling inflation and the expansion of the monetary aggregates. Measured by the General Price Index (IGP), inflation averaged over 10 per cent a month and reached a record 223.8 per cent by year end, compared with 211 per cent in 1983 and the 103 per cent average growth of 1981–82. The surge in prices was also translated into large increases in the money supply, which soared 203.5 per cent in 12 months, despite the new restrictive measures introduced during the year. Although this result constituted a decline in real terms, it nevertheless far surpassed the initial IMF target of 60 per cent and the revised target of 95 per cent established in September.

Several factors have contributed to Brazil's spiraling inflation since 1982. An important one has clearly been the substantial real devaluation of the cruzeiro, which, while directly stimulating exports and fostering balance of payments adjustment, also strongly influenced the price level. This was especially so in 1983, when the cruzeiro was devalued at a rate considerably faster than that of domestic prices, largely because of the unanticipated 30 per cent maxidevaluation that occurred in February of that year. A more generalized explanation of the escalation of prices, however, must be sought in the increasingly widespread and institutionalized use of indexation procedures throughout the Brazilian economy, which provide nearly automatic mechanisms for restoring nominal values of key economic variables in the current period to their real values in the previous period. For these reasons, Brazil's inflation was widely recognized during 1984 as being largely inertial in nature. It was essentially in this way that the acceleration of prices could be explained within the context of the restrictive monetary, wage, and demand management policies adopted after 1982.

Economic Policies

Perhaps in no other area did inflation control pose such a difficult challenge to economic policy formulation in 1984 than in efforts to lower the nominal fiscal deficit, in particular the "operational" component of the deficit (i.e., the deficit excluding exchange and monetary correction payments on the domestic debt). To that end, measures were adopted to improve tax administration and increase the revenues of the social security system, which had incurred large deficits after 1982 owing to rising unemployment. Controls over current and capital expenditures at all levels of the public sector were also tightened. For the most part, these measures were successful, since an estimated operational surplus equivalent to 0.2 per cent of GDP was achieved in 1984, compared with deficits of 6 and 2.7 per cent in 1982 and 1983, respectively.

Very different results were obtained, however, for accrued monetary correction payments on the domestic debt, the other component of the nominal fiscal deficit; these payments, which had soared from 9.1 per cent of GDP in 1982 to 15.9 per cent in 1983, reached an estimated 20.7 per cent in 1984. Thus, notwithstanding the improvement in the "operational" component, the nominal deficit increased 1.9 percentage points to an estimated 20.5 per cent of GDP in 1984.

The increase in monetary correction payments reflected not only the fact that Brazil's domestic debt is fully indexed and thus increases *pari passu* with inflation, but also the fact that the authorities continued to use open market operations on a massive scale during 1984 in an effort to neutralize the expansionary effects on the monetary base of the larger-than-anticipated inflow of foreign exchange. However, this response served in many ways to make overall monetary management more intractable. Specifically, to capture the volume of resources required, the yields on domestic debt instruments, particularly Readjustable Treasury Bonds (ORTN) and Treasury Bills (LTN), had to be increased. As in 1983, these higher yields exerted continued upward pressures on real interest rates for domestic debt instruments, which, in turn, were transmitted with increasingly shorter lags throughout the financial sector to both deposits and loans. By late 1984, for instance, real interest rates for six month investment bank credits were at least 35 per cent, despite the modest levels of economic activity in most sectors.

Moreover, as real interest rates rose, additional distortions surfaced. First of all, a rising volume of new debt had to be offered just to meet the servicing requirements of existing bonds and bills as they matured or were rolled over; this debt was in addition to the new issues that were required for conducting open market operations. Consequently, instead of providing a solution, the rapid growth of the domestic debt itself was becoming a central issue of economic policy; this fact is clearly revealed by the ratio of the annual increase in domestic debt instruments to GDP, which rose from a relatively stable 1.9 per cent average in 1978–80 to 7.6 per cent in 1983 and, by 1984, reached an estimated 12.9 per cent. At the same time, concern mounted about the "crowding out" effect of open market operations on credit available to the private sector, especially to firms producing essentially for the domestic market.

By late 1984, the continual eroding effect of inflation on real incomes had also intensified pressure for less restrictive wage legislation. To that end, Decree Law 7238 was approved in late October. For workers at the bottom end of the scale, who were earning the equivalent of from one to three minimum wages, it authorized biannual adjustments equal to 100 per cent of the increase in the National Consumer Price Index (INPC) (compared with 80 per cent under the previous law); for workers receiving the equivalent of more than 3 minimum wages, a flat 80 per cent of the increase in the INPC (instead of a decreasing share as under the previous law) was approved. Moreover, all categories of workers were entitled to negotiate additional increases based on productivity gains. While the effect of this law remained somewhat uncertain, it nevertheless appeared to stimulate some increase in consumer spending during the final months of 1984.

At the same time, concern about the inability of existing tight monetary and austerity policies to halt inflation steadily mounted during 1984. For this reason, additional measures were adopted in September in a renewed effort to comply with IMF monetary targets and to obtain improved terms from foreign banks during the third phase of external debt renegotiations, which was scheduled to begin in late 1984. These measures, included, *inter alia*, an increase in the legal reserve requirements on time deposits of the banking system from 10 to 22 per cent; an extension in the minimum duration of money market investments from 10 to 30 days; and increased taxes on profits from overnight money-market operations. Additionally, surcharges on imported goods were slashed from 100 to 30 per cent on some goods and from 30 to 10 per cent on others. Finally, the list of prohibited imports was trimmed by half to 2,000 items in an effort to encourage competition and lower prices.

Despite these and other measures, however, the money supply rose sharply in the final two months of the year, especially in December when an unprecedented increase of 33.6 per cent occurred—an increase that far exceeded the expansionary pressures on the monetary base caused by the inflow of foreign exchange. This result, coupled with continued high inflation in January 1985, led in February to the deferment of Brazil's EFF-agreement until a new economic program for effectively dealing with inflation could be developed by the incoming Government. As a result of the IMF action, the tentative agreement concluded with the creditor banks in early February to restructure about $45 billion in principal payments due between 1985 and 1990 was also suspended.

Outlook

Developments in 1984 indicate that lack of control of inflation is the principal brake on Brazil's fragile economic recovery. Moreover, achieving this objective is clearly the central policy challenge to the new Government that took office in March 1985. The dilemma is clear: the austere adjustment policies of 1982–84, while doing much to produce large trade surpluses, also entailed heavy economic costs in terms of higher unemployment, a decrease in purchasing power and a worsening income distribution. There is little latitude for additional restrictive policies, and it is by no means clear they would work. At the same time, an increase in expenditures is also an impractical alternative since the nation continues to labor under constraints on new external borrowing, while unbridled monetary creation could quickly plunge the country into hyperinflation and, most probably, provoke a public reaction.

Thus, since the clamor to resume growth is becoming increasingly difficult to ignore, it seems likely that the new Government will examine various alternative policies—including proposals for monetary reform and deindexation of the economy—for reducing inflation while minimizing further losses of income and output. Moreover, the new Government's economic strategy and policies will have to be developed quickly, not only in order to restore relations with the IMF and secure the release of pending disbursements, but also to implement the tentative debt renegotiation agreement with the private banks. That agreement is essential if disruptions in capital flows and debt servicing problems are to be avoided in the short term.

Sources of Data in the Statistical Profile:

Area:
Organization of American States, *América en Cifras, 1972—Situación Demográfica: Estado y Movimiento de la Población*.

Population:
The information for the following items was furnished to the IDB by the Banco Central do Brasil, March 1984:
- Birth Rate (per one thousand inhabitants)
- General Mortality Rate (per one thousand inhabitants)
- Infant Mortality Rate (per one thousand live births)
- Years of Life Expectancy
- Literacy Rate

Total: IDB estimate based on information furnished by Instituto Brasileiro de Geografía e Estatística, March 1984.

Labor Force:
Information furnished to the IDB by the Banco Central do Brasil, March 1984.

Real GDP:[1]
1982–83: Information furnished to the IDB by Instituto Brasileiro de Economia, Centro de Contas Nacionais, November 1984.
1984: Fundação Getulio Vargas, *Conjuntura Econômica*, January 1985.

Federal Public Sector:
1982–1983: Information furnished to the IDB by the Banco Central do Brasil.
1984: Banco Central do Brasil, *Informativo Mensual*, January 1985.

Money and Prices:
Information furnished to the IDB by the Banco Central do Brasil, January 1985.

Exchange Rate:
International Monetary Fund, *International Financial Statistics*, March 1985.

Balance of Payments:[1]
1982–84: Banco Central do Brasil, *Brazil Economic Program-Internal and External Adjustment*, March and November 1984 and information furnished by the Banco Central do Brasil, May 1985.

External Public and Private Debt:
The following information has been furnished to the IDB by the Banco Central do Brasil, *Brazil Economic Program—Internal and External Adjustment*, March and November 1984 (includes the unregistered external debt):
- Disbursed debt
- Debt-service (interest and amortization)
  - Debt-service ratio
  - Debt-interest ratio

Debt-service (interest and amortization) as percentage of exports of good and non-factor services.
Interest as percentage of exports of goods and non-factor exports.

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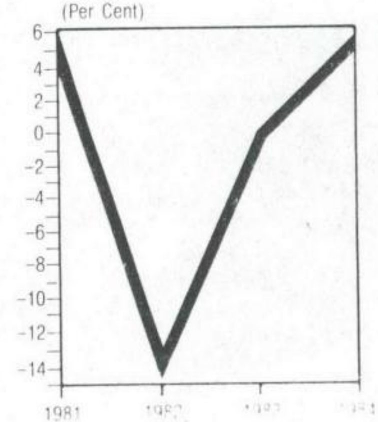
[1] The statistical data used for Brazil might not coincide with the data used in the first part of this report which was provisional.

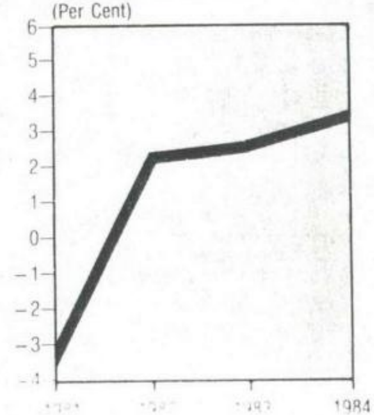
Chile

Economic Indicators

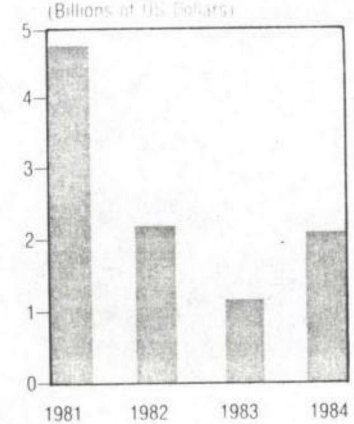
Growth of Gross Domestic Product
(Per Cent)



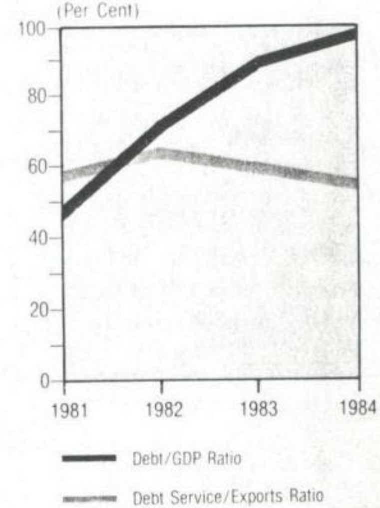
Overall Deficit of the General Government Relative to GDP
(Per Cent)



Balance of Payments Current Account Deficit
(Billions of US Dollars)



Total External Debt
(Per Cent)



FORM NO. 75
(6–83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: Feb. 25, 1986

NAME	ROOM NO.
Messrs. A. Gué	
V. Dubey (4)	N-536
R. Steckhan	
G. Pfeffermann	
N. Carter G. Nankani	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		**URGENT**

REMARKS:

Re: Brazil Medium-Term Strategy Paper

Attached is the version for Mr. Stern.

FROM:	ROOM NO.:	EXTENSION:
R. Gonzalez Cofino	E-928	72031

01 22

CONFIDENTIAL

BRAZIL - MEDIUM-TERM GROWTH STRATEGY

February 24, 1986

CONFIDENTIAL
DRAFT
February 24, 1986

BRAZIL - MEDIUM-TERM GROWTH STRATEGY

A. Current Situation

1. During 1983-85, Brazil succeeded in achieving the external adjustment required to reach a reasonable equilibrium in its balance of payments. After three years of GDP decline, the economy grew by about 4.5% in 1984, while the trade surplus reached US$13 billion and a small current account surplus (US$500 million) was also achieved. In 1985, in spite of high (7%) GDP growth, the trade surplus remained at over US$12 billion, the current account deficit was below 1% of GDP, and gross international reserves remained at a level equivalent to about 8 months of imports. The presence of substantial excess capacity facilitated the year's rapid growth. The recent increase in exports (from US$15.2 billion in 1979 to US$20.2 billion in 1982 and US$25.6 billion in 1985), and the efficient import substitution taking place in petroleum and some industrial subsectors, have contributed substantially to this economic performance. Brazil has thus achieved a unique position among the high-debt countries in having been able to resume economic growth without a deterioration in its balance of payments.

2. The external adjustment, however, was achieved at a substantial domestic cost. To reduce the large current account deficit (US$14.8 billion in 1982), the Government, in 1983, adopted a policy of real devaluations and initiated a set of restrictive monetary and fiscal policies to restrain aggregate demand. A 30% devaluation of the cruzeiro early in 1983 was followed by regular adjustments in the nominal exchange rate that were in line with domestic inflation. The public sector deficit declined from 6.8% of GDP in 1982 to 3.6% in 1983 and 1.6% in 1984. Meanwhile, GDP declined sharply in 1983 and the early months of 1984. The rate of inflation exceeded 200% in both 1983 and 1984, up from a rate of 100% in 1982. The increase in 1983 occurred in large part because of the large devaluation of the cruzeiro, adjustments to public sector prices (which were made to reduce subsidies and the fiscal deficit), and a weather-related increase in agricultural prices. Because of the widespread indexation system, these shocks carried the inflation rate to a new plateau of around 200%.

3. Real interest rates also increased to about 30% per year during this period, in the free segment of the credit market. With the sudden restriction in the amount of foreign financing available, the Government turned to the domestic market to meet its borrowing requirement. The Government's domestic borrowing needs were also increased by the real devaluation of the cruzeiro, which raised the domestic cost of the interest payments on foreign debt. Combined with the tight monetary policy associated with the Government's stabilization program, this increase in borrowing raised free interest rates substantially. High real interest rates, coupled with the fiscal deficit, caused the internal Federal debt to increase rapidly, beginning in 1984 (almost 70% in real terms in 1984, and 45% in 1985).

4. The high GDP growth of 1985 was achieved by relaxing demand policies in the belief that the increased demand could be absorbed by the substantial excess capacity in the economy. The real public sector deficit increased from about 1.6% of GDP in 1984 to an estimated 3.7% in 1985. Generous wage settlements in the organized industrial sectors, which included partial quarterly adjustments to wages, resulted, at least temporarily, in real wage gains of 8-10% for these industries. Monetary policy was accommodating; in fact, some of the expansion in the monetary aggregates that occurred was aimed at reducing interest rates. The real interest rate on Government securities declined from 21% in August to 15% by the end of the year. For the year, as a whole, the monetary aggregates increased faster than the 235% inflation: 251% for the monetary base, 312% for M1, and 262% for M3.

5. The inflation trend is worrisome. The rate of inflation worsened in late 1985 because of the need to raise public sector and other regulated prices that had been held down in previous months and by a drought in the South which damaged food crops and coffee. Inflation reached monthly rates of 11% in November and 13% in December, followed by rates of 16% and about 14% in January and February of 1986, respectively. The Government is now taking steps to bring the present inflation rate down (see paras. 8, 29). It is critical to do so promptly, to restore confidence that inflation is not out of control. While inflation to date has not yet halted growth, we do not believe that rates of the magnitude prevailing today would be consistent with long-term economic development.

B. Stabilization and Development Strategy

Stabilization Options

6. As indicated above, the present inflation situation is precarious. There are forces which, unless checked, would provide an even stronger inflation stimulus in the not too distant future. First, excess capacity is being used up in many industries. Unless substantial new investment occurs soon, the economy will face serious supply constraints, starting probably in 1987. Second, because real wages are still below their pre-recession levels, there are pressures to increase wages further and protect wages from higher future inflation. Third, the poor agricultural harvest expected as a result of the drought is already being reflected, via price speculation, in the general price index. Finally, public sector tariffs and prices, many of which were held down in 1985 in the effort to control inflation, will need to be raised in 1986 in order to reduce the public sector deficit.

7. Therefore, getting inflation down substantially in the next few months from the rate prevailing today--an annualized average rate for the November-February period of about 350%--would require a prompt, comprehensive effort, including restrictive fiscal and monetary policies as well as additional food imports. Even if the Government succeeds in bringing inflation down--to, say, 250-280%--it should be recognized that maintaining such a level would be possible, but likely to be difficult, over the medium-term. The system reacts very quickly to new, negative shocks, and the indexation system makes it hard to bring inflation down, once the shock is reflected in the price index. Moreover, the small size

of the monetary base relative to GDP (about 2%) and the high liquidity of Government bonds have complicated monetary policy. Furthermore, the political pressures on the Government, in this election year, to follow expansionary policies or to moderate the degree of fiscal and monetary restraint are large.

8. Consequently, we are concerned about the Government's ability to hold inflation down through a gradualist approach. However, we believe that the Government, which is still in the first year of its administration and is publicly committed to growth with a gradual reduction of inflation, should be given a chance to do the job. The Government has adopted what seems to be a serious program to reduce the fiscal deficit, including, inter alia, the separation of the Bank of Brazil from the Central Bank and the transfer to the fiscal budget of expenditures previously financed by the monetary authorities. The preliminary information available up to now indicates that a net repurchase of Government bonds has taken place in January and the first half of February, in contrast with the sharp increase in domestic public debt which prevailed until December. The Government has also decided to increase food imports substantially in 1986, with a view to reversing the speculative increase in food prices caused in December and January by the prospects of a very poor, weather-related crop this year. If, however, through these and other measures (see paras. 29-30) the Government does not succeed in bringing inflation down to a level substantially below the January monthly rate of 16%, there will be a need for more radical actions, involving decisions such as a monetary reform and a change in the indexation system.

Development Strategy Objectives

9. Brazil needs to (a) maintain a GDP growth rate of at least 6.5% per year in order to improve living standards and generate enough employment growth (at least 4% per annum) to hire new entrants into the labor force and reabsorb those affected by the recent recession; and (b) improve its creditworthiness position, by reducing its debt service and debt to export ratios by at least 25% by 1990 (with continued improvement in the 1990s), so that it can resume full debt service payments on its foreign debt in the early 1990s, with normal access to credit markets. There are strong domestic pressures to reverse the deterioration in living standards of the recent recession, when per capita income fell 12% and social programs were curtailed; to date, the economic recovery has restored about half of this drop in per capita income, and unemployment levels seem to have declined during 1985. At the same time, sustained economic growth requires control of inflation. As indicated above, the Government has preferred up to now to follow a gradual approach to domestic stabilization because of its conviction that an additional recession would be inconsistent with political stability. The Government realizes, however, that a failure to reduce inflation below the current level would undermine confidence and would require more drastic internal adjustment policies, even if they cause a temporary reduction in growth rates. In addition, it is accepted that the country's creditworthiness position must improve. Its foreign debt of over US$100 billion is some 3.7 times the annual amount of export earnings, and interest payments of about US$11 billion per year represent about 40% of exports. If amortization on its bilateral and commercial bank debt were also being paid, Brazil's debt service ratio today would be about 80%. In summary, relatively rapid economic growth will be required to improve Brazil's domestic conditions and external standing. To be sustainable over the long term, such growth would have to be accompanied by a successful domestic adjustment effort.

Implications for Economic Change

10. GDP growth of such a magnitude involves expanding agricultural and industrial production for both domestic and international markets. Brazil's agricultural and industrial sectors are dynamic, employ modern techniques, and are relatively efficient. Given their responsiveness to profitable opportunities, providing sufficient market incentives, through maintenance of appropriate exchange rates and price signals, should be sufficient to stimulate production. For the agricultural sector, which has been subjected to periodic Government interventions in the market, freer commercial policies are particularly critical.

11. Substantial increases in investment and savings will be needed. Excess capacity, which has sustained the economic recovery to date, is starting to disappear in some industrial sectors, and the investment/GDP ratio, which was only 16-17% in 1983-84, will have to increase to about 23% by the end of the decade. The corresponding savings effort will be large, especially now that domestic savings must compensate for more modest foreign resource availability than existed in the growth period of the 1970s, and about 5% of GDP is being transferred abroad to pay interest on existing debt.

12. Investment, in effect, will have to be more efficient than in the 1970s, in view of the overall resource scarcity, and there will be no scope for building large plants far in advance of demand. The large infrastructure projects and industrial plants which drained Government resources in the 1970s, however, can now be used to support production at a relatively low cost. Together, these factors are likely to imply a moderate ICOR of about 3.

13. Raising investment and savings will not be easy. It will require controlling inflation, which, at today's rates, is detrimental to new investment. It also will require a large adjustment in the public sector, to scale back the size and scope of Government operations, increase their efficiency, and--most importantly--increase public savings and reduce the overall fiscal deficit. Finally, it will require financial reform of the banking system, to rationalize operations and reduce financial segmentation of credit markets. All of these efforts should help to increase both private and public savings and channel these savings to productive investment at lower real interest rates than now prevail. In the long run, they should also shift the responsibility for economic expansion to the private sector, and focus the Government's activities more on the provision of infrastructure and social services. In numerical terms, private investment should be expected to increase from 68% of total investment today to about 74% by the end of the decade. Private savings, in turn, would be used increasingly to fund private investment, rather than Government spending.

14. The present environment is not conducive to increased investment. Without a substantial drop in the inflation rate of the past few months, it is unlikely that significant private sector investment in new capacity would be forthcoming. At this point, high interest rates appear to be less of a deterrent to investment than uncertainty associated with the present inflation trend. Some investment has been occurring, even at present interest rates of about 25%, in industries where there are high profits to be made. Many businesses are very liquid, and the stock market has risen to the point where apparently it is attractive for firms to raise

equity funds from the market and invest. However, unless the Government can demonstrate that it can control inflation, the impetus for long-term investments will be missing.

15. Continued export growth remains an economic necessity for Brazil, in terms of markets, financing of needed imports, and its creditworthiness position. Improving the ability of Brazilian producers to compete externally also generates price and quality benefits for domestic consumers. For instance, with real export growth of 4.5% per year through the end of the decade, Brazil could continue to pay interest and could gradually resume amortization payments to commercial banks by the early 1990s. Regaining its ability to borrow on the international financial markets is fairly critical for Brazil, if it is to follow a rapid growth strategy.

16. Important structural changes have taken place in Brazil's trade accounts in recent years, which should make it easier to continue generating trade surpluses exceeding US$12 billion per year for the remainder of the decade. With an established exchange rate policy designed to keep Brazilian products competitive, businesses now recognize the export market as an important source of sales. In addition, imports have dropped from a level of almost US$23 billion in 1980 to slightly over US$13 billion in 1985. While imports are expected to increase with the resumption of economic growth, considerable efficient import substitution has occurred in both industrial products and in petroleum. We expect imports by 1989 to be only as high, in current U.S. dollars, as they were in 1980, even with a nominal growth in non-oil imports of over 20% per year. The recent fall in oil prices, if sustained, would reinforce this import trend.

C. Proposed Medium-Term Adjustment and Growth Program

17. The country has already made some of the adjustments needed for sustained economic growth in the present international environment. With considerable excess capacity arising from the recession, Brazil was able to grow in 1984 and 1985, despite high inflation rates, high real interest rates, and a growing uncertainty about future inflation. However, sustained growth of 7-8% per year for the longer-run, with the large increases in investment and savings that it entails, requires a substantial stabilization effort and significant development policy reforms. Stabilization policy options are discussed, together with the 1986 Government program, in Section D. The other key macro-economic and sectoral policies are summarized in the following paragraphs, and specified in more detail--including the required timing--in the Policy Matrix in Annex II and in the Sectoral Policies Summary in Annex III.

18. Industry and Trade. Domestic markets for Brazilian manufacturers are protected by often high nominal tariffs and extensive non-tariff barriers, even after substantial reforms in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Implicit effective protection, as measured by direct price comparisons, is on average moderate (44% in 1980-81, according to the most recent study). There has been impressive recent growth in manufactured exports, which increased from US$8.4 billion in 1980 to US$15.1 billion in 1984. Although excessive protection has affected the efficiency of industry in Brazil less than in many other developing

countries, there is still room for substantial improvement in this respect. While, as indicated above, average effective protection is relatively moderate, the level of protection is much higher for some inefficient subsectors. And although the proportion of imports subject to the application of the Law of Similars has been substantially reduced over the last year, the Law still affects items which enjoy tariff reductions under the existing preferential import regimes. In summary, an overall reform of the existing tariff and non-tariff protection systems would be conducive to a more efficient incentive structure. But such reform is less urgent--and industrial competitiveness is less dependent upon it--than in almost all other high-debt countries.

Trade *

19. The key policy requirement for further export expansion and efficient import substitution is an exchange rate policy which will maintain international competitiveness for Brazilian products. The present commitment to an exchange rate policy of periodic devaluations equal to domestic inflation appears appropriate; at a minimum, the present parity between the cruzeiro and U.S. dollar should be maintained in real terms. Maintaining productivity growth and limiting increases in real wages are also important for industrial strategy. Brazil should ideally undertake a comprehensive reform of its incentive structure. This should include the "free trade" policy for agricultural products referred to in the following paragraph; the simplification and strengthening of the drawback system; the simplification of import procedures; and the overall reform and rationalization of the import protection system--comprising the gradual elimination of non-tariff restrictions and of tariff exemptions, and also the gradual reform of the tariff structure with a view to reducing its dispersion and to maintaining an overall moderate tariff level of about 40%. As indicated in Section E below, the Government is not likely to undertake in the immediate future the overall reform of the import protection system, but might decide to adopt the other recommended policy measures, including the "free trade" for agricultural products. This would imply that the overall program would be less than optimal. But, if substantial progress is made in all other key policy areas, the program would still be consistent with long-term sustained growth of production and exports. (The industry and trade policy measures indicated in detail in Annex IIA are those that are likely to be undertaken in the near future; other recommended policies are described in Annex IIB.)

20. <u>Agriculture</u>. Agricultural expansion is fundamental for achieving the production and export increases of the "moderate-growth" option. Agricultural growth has been erratic--5% annual growth rates in the 1970s were followed by stagnation of output in the early 1980s--and Government policies in the sector have been characterized by costly credit programs to compensate for adverse trade and pricing policies, as well as periodic market interventions to stabilize domestic supply and prices. The key to realizing the sector's full potential is a policy framework that will make agriculture profitable without credit subsidies, interventionist trade policies and production-based taxation. This process was initiated when the Government decided in 1983, in the context of the First Agriculture Sector Loan, to phase out most negative real interest rates on rural credit. The proposed program for agriculture would further reduce credit subsidies and finance those remaining through the fiscal budget; phase out food price controls and the wheat subsidy (while implementing targeted food assistance programs); simplify regulations for export registration, import licensing, and foreign exchange controls governing trade of agricultural commodities; and promote the rapid growth of production and exports through

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free-trade policy for key agricultural products (rice, corn, soybeans, cotton, and beans), subject to minimum price guarantees, market safeguards and Government stock management. Provision would also be made for reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

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21. Energy. By accelerating petroleum exploration and production as well as by promoting energy substitution and conservation, Brazil has significantly reduced its oil imports from US$10-11 billion in 1980-82 to about US$5 billion in 1985. Because of the weak international oil market and the country's resource constraints, further import substitution in energy, which will help increase production and reduce imports, must be cost-effective. Consequently, Brazil's strategy for the energy sector should focus on appropriate pricing policies, especially for petroleum products, alcohol, and electricity, to better reflect economic costs; coordination of energy investments being made or regulated by the Government; and systematic application of economic criteria to investment decisions. A coordinated investment and financial rehabilitation plan for the power sector, which has been approved by the Government and is now being appraised as the framework for the proposed Power Sector Loan, would insure adequate provision of electricity to support the country's growth without further draining Government resources.

22. Investment and Savings. Private sector expansion depends in part on the elimination of the public sector deficit in order to reduce Government claims on credit resources. It also would be helped by appropriate industrial, agricultural, and trade policies (see paras. 18-20); provision of tax incentives for private investment, such as accelerated depreciation for new plant and equipment; and freer allocation of credit at reasonable interest rates.

23. There is considerable scope for increasing public savings. Higher tax revenues should be coupled with expenditure containment. The gradual elimination of subsidies for wheat and sugar/alcohol, as well as for agricultural credit (except for a limited number of special groups, like small farmers in the Northeast), would make important contributions in this respect. While priority infrastructure and social programs should be maintained, utilizing low-cost methods for providing these services, emphasizing maintenance and rehabilitation over new construction, and limiting real wage increases to productivity gains would lower per unit costs. Application of economic criteria to new investment projects, as well as better coordination and monitoring of Federal investments by the Planning Ministry, would screen out unnecessary investments and prevent future operating difficulties. The state enterprises also need regular tariff increases to cover operating costs and finance expansion; consequently, the Government would have to avoid postponing tariff adjustments to slow down inflation. Better tariff policies, coupled with financial restructuring, are important for improving the financial viability of two basically efficient parastatal sectors--electric power and steel. Selective privatization of state enterprises, particularly those which the Government does not seem to run efficiently or which only by accident are under Government ownership, would also help improve public sector efficiency.

24. Balance of Payments. Servicing its large external debt is a major consideration in Brazil's balance of payments strategy. Resumption of growth at rates averaging about 7-8% per year would raise the demand for

imports and consequently add to the pressure on foreign exchange earnings. The country's balance of payments strategy, therefore, must include the following components:

(a) Continued rapid export growth, through an exchange rate policy which at least maintains in real terms the present parity between the cruzeiro and the U.S. dollar, and adoption of other trade measures stated above.

(b) Continued rescheduling of commercial bank and Paris Club debt coming due through the end of the decade. Brazil would benefit most from a reduction in the spread (until now at 2% over LIBOR) on commercial bank debt, since each percentage point drop in the interest rate would yield savings of about US$800 million annually. The maturity and grace periods of the restructured debt should not be less than in the 1984 agreement (9 and 5 years, respectively).

(c) Development of a medium-term strategy for new external borrowing (official and commercial) which is consistent with the country's growth strategy and its ability to repay.

(d) Reexamination of Government incentives to foreign private investment, which has dropped from US$1.5 billion in 1979 to less than US$1.0 billion in 1984-85.

25. Fiscal and Financial Reform. Brazil's financial and fiscal systems no longer meet the needs of a country which must increase its savings and investment rates substantially, relying on the private sector as the major productive agent, and must manage both stabilization and growth in a complex economy. The reforms in this area are critical for improving resource mobilization and allocation to support agricultural and industrial growth, and for increasing the Government's fiscal and monetary control over a system which has become unwieldy and virtually impossible to understand in entirety. Among the recommended changes--some of which are already being implemented by the Government--are the consolidation of all fiscal expenditures in the Federal Budget; the separation of the Central Bank and the Bank of Brazil functions; the progressive elimination of the prevailing segmentation of credit markets; and tax reforms directed toward channeling savings toward productive investment through encouraging the long-term holding of financial assets, while reducing the overly large disparities in taxation across income levels and types.

26. Public Sector Management. The existing management problems within the public sector stem from public sector expansion in the 1970s. Since 1980, the Government has made numerous efforts to bring expenditures, including those of the large state enterprise sector, under better control. The objectives in this part of the program are to improve the overall efficiency of the public sector by establishing a Treasury Secretariat in the Finance Ministry, which would have operational control of the unified fiscal budget; strengthen the Planning Ministry's departments dealing with the planning and monitoring of public investment and current expenditures; undertake operational audits and action plans to improve the efficiency of public enterprises; and improve economic information and accounting control systems. These improvements should be combined with efforts to increase the pipeline of public investment projects to support future growth objectives, an endeavor which has been discouraged by the present moratorium on new projects.

27. Social Development. A major casualty of the recession and debt crisis has been the social programs, including poverty alleviation and reduction of regional disparities. The program in this area would be aimed at restoring appropriate levels of education and health services, and improving their cost efficiency; and at improving the productivity and income levels of the Northeast population, in both urban and rural areas. The priority to be attached to these areas would be in line with the proposed shift in emphasis, within the public sector, from productive activities to infrastructure and social services, and with the parallel enhancement of the private sector as the main agent for the development of productive activities.

D. Action Plan for 1986

1986 Government Program (Stabilization).

28. In early January, the Government initiated an economic program for 1986 to promote increased stability with growth and a sound balance of payments position. It provided for, inter alia: (a) a 6% GDP growth rate; (b) periodic devaluations equivalent to domestic inflation; (c) limitation of the real annual rate of increase of domestic public debt to 6%; (d) reduction in the operational deficit of the public sector, which was then thought to have been about 3.0% of GDP in 1985, to 0.5% in 1986; (e) a US$12.5 billion trade surplus and a US$600 million current account deficit; and (f) a 160% monetary expansion. The 1986 public sector budget assumed an inflation of 140% from December 1985 to December 1986.

29. The program is already out-of-date. It was developed before the drought and recent spurt in inflation, and predated the fall in oil prices and increase in coffee prices. The Government is in the process of revising the program and has already announced some of the changes. To reduce the temporary spurt in inflation of the past few months, the Government has initiated a plan to import about US$1.5 billion (financed at least in part by higher coffee earnings and oil savings) in food to dampen the agricultural price increase. It is tightening fiscal and monetary control. The monetary authorities have raised the reserve requirement on passbook savings accounts and have tightened the regulations on consumer credit. The Government plans to hold to its original 1986 budget in nominal terms for the next few months, and does not intend to issue bonds through April. The tax measures introduced at the end of 1985 appear to be generating more revenues than expected, thus providing more room to balance the budget. As indicated in para. 8, preliminary estimates show a net repurchase by the Government of public debt in January and February, a marked change from the real increase in outstanding debt in 1985. Further repurchases may be facilitated by the increased reserve requirement on savings accounts, which are now available for the Central Bank's use. Although the operational deficit for 1985 is higher than expected, the Government's original plan to reduce the deficit to 0.5% of GDP still holds. It also will be exercising better institutional control over fiscal policy; the Central Bank is being separated from the Bank of Brazil, thus ending the latter's status as a monetary authority, and the newly created Treasury Secretariat within the Finance Ministry will centralize control of all Federal Government expenditures. To implement the large reduction in

the fiscal deficit, the Government is maintaining its plans to increase public sector tariffs, and is studying ways to reduce the wheat and alcohol subsidies. These corrective price increases could be compensated in part by passing some of the drop in oil prices to consumers, provided that the pass-through does not unduly affect public sector revenues or the adjustment of retail alcohol prices, which are now tied to the price of gasoline.

30. We are reviewing the adequacy and consistency of the program and should be completing the assessment in March. The program contains important elements for a gradualist approach to stabilization--virtual elimination of the fiscal deficit, limitation of the real increase in public sector debt to the GDP growth rate, and corrective actions to reduce price distortions. The Government has also indicated that the program will include wage restraint--holding real wage gains to the growth in productivity--and a prudent monetary policy. It is not yet clear to us what the prospects are for achieving through this program a reduction of inflation rates substantially below the January peak. We expect to have a clearer view next month, after the return to headquarters of a mission which is now examining these issues in Brazil.

31. If the program referred to above fails to stabilize prices at a lower inflation rate than that prevailing today, stronger action would need to be taken. The program above would then become the preparatory stage for stronger actions like a monetary reform and a change in the indexation system. To be successful, these actions require prior elimination of the fiscal deficit and correction of price distortions. Wage adjustments, which are now staggered over a six-month period, would also need to be ?? synchronized prior to the monetary reform. At the time of the changeover, nominal interest rates on outstanding financial contracts would have to be adjusted to take into account the drop in inflation. A temporary wage and price freeze might be needed. It should be noted that experience with this kind of shock treatment is limited, and its impact on economic behavior and growth is not fully known. Therefore, it is difficult to recommend such a program until it is clear that inflation cannot be controlled with the standard policy prescriptions. This radical approach would also be apt to reduce growth temporarily; to some extent, increased foreign assistance at this point would ameliorate some of the adjustment difficulties.

Other Recommended 1986 Actions

32. The 1986 action plan also includes the following proposed sector policies in agriculture, industry and trade, energy, financial and fiscal reform, public sector management and investment, and external debt management. All are components of the proposed medium-term adjustment program. Measures to be implemented after 1986, with the proposed timing, are listed in Annex IIA. The measures listed below concerning Industry and Trade do not include the policies referred to in Annex IIB, which are not likely to be adopted this year.

Agriculture

-Introduction of free trade policy for key 1986-87 crops (rice, corn, soybeans, cotton, and beans) within a system of market safeguards to avoid extreme price fluctuations.

-First stage of the phase-out of food price controls and wheat subsidy, and implementation of targeted food assistance programs.

- Initial actions for the revision and simplification of trade regulations (export registration, import licensing, and foreign exchange controls) for agricultural commodities.

- Reduction of interest rate subsidies and budgetary provision for costs of the remaining subsidies.

Industry and Trade

- Maintenance of present exchange rate policy.

- Strengthening of the drawback system.

- Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making.

Energy

- Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect economic costs and promote efficient energy production and use. Electricity tariffs in 1986 should be, on the average, about 30% higher in real terms than in 1985; retail alcohol prices should be close to an efficiency parity with gasoline, with the remaining subsidies included specifically in the budget; and oil derivatives should at a minimum be priced at international levels.

- Initiation of financial rehabilitation of the power sector, together with balanced resource allocation and improved system reliability.

- Reassessment of the alcohol program, including, in particular, the improvement of agricultural and industrial productivity in existing alcohol facilities.

Fiscal and Financial Reform

- Budget consolidation with budgetary provision for wheat, sugar, and agricultural credit subsidies.

- Transfer of decentralized funds to the Treasury budget.

- Separation of functions between the Central Bank and the Bank of Brazil.

Public Sector Management and Investment

- Improved operational control of budgetary operations, through the Treasury Secretariat and SEPLAN.

- Strengthening and expanded operation, in SEPLAN, of investment planning and project evaluation mechanisms.

- Introduction of a system in the Planning Ministry for performance evaluation of public enterprises, development of rehabilitation programs, and selective privatization measures.

- Annual Government review of public sector investments with reference to medium-term investment priorities and control of the public sector deficit.

Private Investment and Savings

-Promotion of investment efficiency through sectoral adjustment policies for agriculture and energy, and through promotion of industrial exports.

-Encouragement of increased private savings and investment through reduction in public sector deficit and in segmentation and undue regulation of banking system; through tax measures such as accelerated depreciation and through control of inflation, which would lower interest rates and reduce uncertainty.

External Debt Management

-Rescheduling of principal on commercial bank and Paris Club debt falling due in 1986 on terms commensurate with ability to repay, and preparation for a subsequent rescheduling agreement covering payments falling due in 1987-90.

-Planned annual program of official and commercial borrowings.

E. The Brazilian Position

33. Many of the key policy directions suggested in this paper have been discussed extensively by Bank staff with the Brazilian authorities, with positive results, in connection with proposed Bank loans. We have reached agreement on several important policy issues related to the lending program proposed for 1986 concerning Agricultural Commercialization Policy, Energy, Public Sector Investment, Fiscal and Financial Reform, Public Sector Management (including, in particular, mechanisms and procedures for screening and monitoring public investment) and Social Development. There are some policy areas in which no decision has been taken yet by the Government, or in which the adopted decisions do not go far enough. These include trade policy, particularly concerning the manufacturing sector; fuel prices--on which disagreements might emerge in the near future; agricultural credit terms, particularly for the Northeast; and the stabilization program (see paras. 29-31) and other policy issues (referred to in para. 36 below) which we have not yet discussed fully with the Government.

34. The most important remaining long-term issue concerns trade policy aspects related mainly to the manufacturing sector. We had reached agreement on the full program included in Annex IIB with a Working Group formed by the Government to prepare the proposed Export Development II project. At the political level, however, the question has become controversial. The Ministry of Foreign Affairs has indicated that any unilateral decision on trade policy now would undermine Brazil's position in the GATT and other trade talks. The industrial establishment has traditionally been opposed to liberalized trade, although its views are probably changing with the increased importance of exports and better knowledge of anomalies which benefit some manufacturers at the expense of others. Policy reform in this area is likely to be slow; however, as explained above, satisfactory growth and creditworthiness improvements can occur without such a reform in the next several years. As was noted above, the Government has agreed in principle--in connection with the proposed Agricultural Sector Loan--to establish "free trade" for agricultural products and to undertake other policy reforms in that sector, all of which should encourage substantial increases in agricultural production and exports.

35. In another major policy area the Government has now corrected--or has a plan to correct--most of the distortions introduced by the freeze of public sector prices adopted for several months earlier this year. One important exception to this has been up to now the price of petroleum derivatives, some of which (fuel oil, naphtha, and LPG) are still below international levels. (It is not clear yet how the Government's fuel pricing policy will be affected by the recent decline in international oil prices.)

36. Other structural issues which have not yet been discussed fully with the Government include the required incentives for private investment and savings (on which additional ESW would be required, particularly concerning tax policy), and the ways to proceed concerning external debt management and incentives to foreign investment. We are now starting the discussion with the Government of the scope and time-phasing of further reductions of agricultural credit subsidies.

F. Growth Scenarios

37. The recommended adjustment program would permit Brazil to grow rapidly enough to make up for the recent drop in employment and living standards, in order to continue the economic progress begun in the 1970s, but would require a strong political will. If the Government adopts the entire adjustment program, GDP growth of about 8% per year--the "high-growth" scenario--would be possible with the support of additional foreign resources. If the Government adopts most of the adjustment program--the most likely case--then GDP growth would be somewhat lower--say, about 7% per year (the "moderate-growth" scenario). This scenario assumes that the Government would stop short of some major policy reform, such as comprehensive trade liberalization or agricultural commercial policy reform. In the least favorable "low-growth" scenario, GDP growth would be 4-5% per year at most, with the implementation of a smaller adjustment program spread over a longer period.

38. The "low-growth" scenario represents a minimum level of effort by the Government to maintain growth and prevent inflation from escalating further. It is difficult to specify all of the elements of this scenario. However, we foresee the Government doing the following: (a) executing a realistic foreign exchange rate policy, which would at least maintain the present parity, in real terms, between the cruzeiro and the U.S. dollar, but failing to implement the reforms proposed in this paper for agricultural and industrial policies; (b) holding inflation to a new plateau--of, say, around 300-325%--which would be higher than the 1983-85 levels (200-235%) but somewhat lower than the rates prevailing in January and February of this year; (c) reducing the operational fiscal deficit, but failing to achieve the full reduction (to 0.5% of GDP) now planned for 1986; (d) avoiding the introduction of new distortions in the economy, but resorting to temporary price and wage controls from time to time; and (e) only partially implementing other policies proposed in this paper (such as those related to the reform of public enterprises, to the preparation and monitoring of public investment programs, and to the energy sector) and at a pace slower than the one envisaged in the two higher-growth options. With the widespread indexation (which permits resource allocation favorable to growth even with high inflation) and a determined Government effort to

prevent inflation from escalating further, there is likely to be enough business confidence to grow for a limited period of time at something like 4-5%, which is much less than the country's potential rate. However, the risks are large. As noted earlier, shocks outside the Government's control would disturb this fragile equilibrium. In addition, social pressures arising from the recession, particularly because of the still high unemployment and underemployment levels (see para. 39), could make this scenario politically unviable, and the present Government, or its successor, might be tempted to move toward more populist policies less conducive to inflation control and long-term growth. On the whole, while this "low-growth" scenario might prevail for a few years, it would be very difficult for Brazil to maintain over the long term.

39. In the "low-growth" scenario, Brazil would need to run a positive current account balance as well as a large trade surplus to service its external debt, because no "new money" would be likely to be forthcoming from commercial banks and the Bank's annual lending program would be reduced from about US$1.5 billion presently to about US$1 billion per year or less. Exports would grow modestly. With an export growth rate averaging 2.4% in real terms between 1985-90, a moderate increase in non-oil imports would be feasible as long as Brazil continues an active energy substitution program and reduces oil imports in real terms. Creditworthiness indicators would improve substantially, and consumption per capita would increase about 3% annually. However, existing unemployment and underemployment would not be reduced significantly. GDP growth of 5% would generate about 2.5-3.0% annual employment growth at normal rates of productivity change, which would only be sufficient to absorb new entrants to the labor force. In order to reemploy the estimated 4.5-5.0 million persons who were negatively affected by the recession and who still have not found productive jobs, more rapid economic growth is required.

40. The recommended adjustment program would stimulate faster economic growth in a more stable domestic environment. Unlike the effort reflected in the "low-growth" option, this recommended program requires greater success in the immediate future in bringing monthly inflation rates down to an annualized rate of about 250-280%, and larger subsequent efforts to reduce that rate through either a gradualist approach or more radical means. If the Government also adopts the overall medium-term approach envisaged in this paper, but delays the implementation of some proposed decisions (say, those related to the suggested trade policy reform), the Brazilian economy could grow at an annual rate--about 7%--that would make it possible to reduce unemployment substantially. This scenario is characterized as the "moderate-growth" option. "New money" and increased agricultural and manufactured exports would permit higher imports and investment. The relatively high GDP growth rate would allow per capita consumption to increase at about 4% per year. Rapid growth would also strengthen the capacity to service the debt. Traditional creditworthiness indicators, while improving by a third over the decade, are not substantially better than in the "low-growth" option. In this "moderate-growth" option, the country is incurring more debt to support the structural adjustment process and to raise more quickly employment and the living standards of the population. In general terms, however, Brazil's creditworthiness--as reflected not only in the traditional creditworthiness indicators, but also in the Government's readiness to adopt needed policy reforms to promote growth, stabilization, and external balance--is significantly improved. (The scenario is, of course, contingent on an accommodating external environment, particularly no increase in protectionism in OECD countries.)

41. If the Government puts forth maximum effort and adopts the entire recommended program, the economy could grow even faster. The "high-growth" option shows GDP growing at about 8% per year, and per capita consumption, at about 5% per year. Slightly larger net foreign capital inflows from multilateral, bilateral, and private sources would facilitate the process. As in the "moderate-growth" option, the country's creditworthiness would improve at a satisfactory rate.

42. Both the "moderate-" and "high-growth" scenarios, as indicated above, require a substantial stabilization effort. The large increases in investment and savings rates and continued export growth required for economic growth of 7-8% annually depend on control of inflation as well as other policies, as described below. Exchange rate policy and other trade-promoting measures (see paras. 18-19) would keep Brazilian products competitive in international markets, and the freeing of agricultural prices, with Government intervention in the market limited to safeguards against extreme price fluctuations (see para. 20), would give an additional boost to agricultural production and exports. Together, these policies would stimulate growth, thus providing the profit incentive for higher investment. Policies to reduce undue regulation and segmentation in the financial markets (see para. 25) and elimination of the public sector deficit would make more credit available to the private sector for investment purposes, at a lower cost than exists today. Tax policies, such as accelerated depreciation, would also provide an investment stimulus. A permanent drop in inflation (see paras. 28-31) and a clear Government commitment to conservative fiscal and monetary policies would be likely to increase the private savings available for investment, as well as raise the attractiveness of productive, versus financial, investments. Increases in public savings through improving the internal cash generation capability of public enterprises, higher Treasury revenues, and expenditure containment, including a reduction in subsidies, are an important part of the savings effort (see para. 23). It should be noted that, in all three scenarios, the domestic savings transferred abroad as factor payments on a net basis (mainly interest) would continue to be substantial (3-4% of GDP), although their relative importance, as a proportion of total savings and of GDP, would diminish gradually.

43. A number of factors would also improve the marginal efficiency of capital, particularly in the "high-growth" scenario, but also, to a somewhat lesser degree, under the "moderate-growth" option. Increased domestic competition and increasing exposure to international markets, as well as the transfer of technology through foreign private investment and capital goods imports, would raise the productivity of private capital. Public sector investments are also likely to be more efficient, with the application of economic criteria to new investment projects and with new infrastructure capacity to be built in line with, instead of ahead of, demand. In addition, the large infrastructure projects started in the 1970s are now coming on stream, enabling the country to benefit from the heavy investment costs incurred earlier.

44. Taken together, these and other policies in the recommended program would stimulate high savings and investment rates (investment would rise from 18% of GDP in 1985 to 24% by the late 1980s, with savings increasing proportionately) and a relatively low long-term ICOR of 2.9, thereby generating GDP growth of about 8% per year in the "high-growth" scenario. If trade liberalization or agricultural commercial policy reform is delayed--the most likely "moderate-growth" scenario--the investment rate

would be slightly lower (23%) and the ICOR slightly higher (3.2), thus reducing GDP growth to about 7% per year. With a smaller package of policy reforms (the "low-growth" option), the potential for growth is lowest (5% per year), investment would increase only to 19% of GDP, and the ICOR would remain high (3.8). Foreign borrowing also would vary according to country effort. As the adjustment effort intensifies, more foreign borrowing not only would be beneficial to growth but would also soften the domestic adjustment effort required.

G. The Role of the IMF

45. An IMF stand-by agreement to replace the Extended Fund Facility has not materialized, so there is currently no formal arrangement for IMF monitoring of fiscal, monetary and balance of payments performance. The Government has indicated that (for the present) it does not intend to pursue stand-by arrangements, although it is keeping the Fund informed on matters of economic policy and the implementation of its program. We would seek to maintain close cooperation with the Fund in implementing our proposed country program, both on operational matters such as the fiscal and monetary provisions required for programs supported by the Bank and the wider policy and management issues of common interest and concern.

46. Fund participation in the assessment of Brazil's economic program would facilitate the Government's negotiations with the international banking community and the Paris Club. After substantial "involuntary lending" in 1983 and 1984, commercial banks did not have to consider "new money" for Brazil in 1985 because of its improved balance of payments position. Independent of "new money", however, Brazil needs to reschedule the existing debt of commercial banks, probably at least until 1990. The banks had until recently maintained that, if they were to reschedule existing debt or make new commitments, Brazil would need to agree to a stand-by arrangement with the Fund. Now, it appears probable that a one-year agreement will soon be reached with the banks to reschedule the 1985 debt and roll over 1986 debt until early 1987.

47. The Government intends to begin negotiations to reschedule its official bilateral debt after completing the rescheduling agreement with commercial banks. In anticipation of such an agreement with Paris Club creditors, the Government has stopped payments on bilateral debt. Usually, rescheduling is conditional upon an IMF agreement. Therefore, the absence of a Fund agreement will probably complicate the negotiations.

H. Monitoring

48. The proposed procedures for assessing the Government's policies are described below. Our evaluation of the Government's short- and medium-term economic program would provide the framework for Bank lending, and could also be used by the Government in its discussions with commercial banks on co-financing. Subsequent assessment of the Government's program would proceed at two levels:

(a) Before submitting a policy loan to the Board, Bank staff would review Brazil's economic performance, to ascertain whether the program is on track. A positive conclusion would be needed in order to submit each policy loan to the Board.

(b) Specific policy reforms would be supported by individual loans, such as those reported in the following table:

Policy Area	Monitoring Instruments
A. Industry and Trade	Export Development Loans* Industrial Restructuring Loans
B. Agriculture	Agriculture Sector Loans Agriculture Credit Loans
C. Energy	Power Sector Loans Transportation Sector Loans
D. Investment and Savings:	
1. Public Sector Investment and Savings	Public Sector Management Loans Public Sector Review missions Overall Bank economic assessments IMF reporting
2. Private Sector Investment and Savings	Overall Bank economic assessments IMF reporting
E. Balance of Payments	Overall Bank economic assessments IMF reporting
F. Fiscal and Financial Reform	Financial Sector Reform Loans
G. Public Sector Management	Public Sector Management Loans
H. Stabilization	IMF reporting
I. Social Development	Education Sector Loans Health Sector Loans Northeast Rural Devt. Loans Northeast Small and Medium Scale Industry Loans

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* Under the "high-growth" option only.

49. The overall economic assessment of the program and the periodic evaluation of progress in its execution would be undertaken by economic missions, including public investment and sectoral missions. The work is expected to be done in close coordination with IMF staff. The monitoring to be performed by the Bank, in connection with proposed loans, would also be used to recommend cofinancing for specified priority projects.

50. Whenever possible, the policy loans would be based upon policy actions taken before Board presentation, with further progress being a condition for processing subsequent loans in the sector (and for maintaining the level of the expanded overall lending program). In a few instances, as in the proposed FY86 Agricultural Sector Loan, the loan would be disbursed in two tranches, with policy conditionality attached to both of them.

I. Financing Requirements

51. Increased external support would be essential to the success of the medium-term adjustment program under the "moderate-" and "high-growth" options. Under the "low-growth" scenario, Brazil would need only about US$1.0 billion per year in medium- and long-term net capital inflows over the next five years. Since we are not sure that commercial banks would resume lending to Brazil under this "low-growth" scenario, we have assumed that the multilateral and bilateral institutions would provide most of the required new resources. Faster growth with adjustment, as described in the "moderate-growth" option, would require on average an additional US$4.1 billion per year in net disbursements--US$0.6 billion from the World Bank, US$2.5 billion from commercial banks, and US$1.0 billion from other sources. If even higher GDP growth is attained (the "high-growth" option), an additional US$1.0 billion per year in net M&LT inflows would be needed. (Alternatively, Brazil could choose to maximize exports but, instead of raising GDP growth to 8%, could opt to reduce the rate of debt accumulation. In our view, this is not the preferred option, since rapid employment growth is important and the country's creditworthiness position improves substantially even with more borrowing.) Annex I provides the details for this section.

52. World Bank Financing. The Bank's support is based on a graduated-response posture. Annual lending in 1986-90 varies between US$1.0 billion under the "low-growth" option and US$2.0 billion under the "moderate-growth" alternative. These commitment levels would be consistent with annual total gross disbursements of, respectively, US$1.1 and US$1.7 billion from the entire Brazil loan portfolio, and annual total net disbursements of US$0.4 and US$1.0 billion. The proposed lending under the "low-growth" option would make the Bank's relative exposure in Brazil decline to below 10% of our overall portfolio by 1990, while under the "moderate-growth" scenario, Brazil's share in the Bank portfolio would increase to slightly over 11%. The specific lending level for each year would depend upon the degree to which the required reforms are adopted and implemented, and would in practice be determined by the extent to which policy reforms associated with specific loans are put into effect. Co-financing would be an important component of an expanded program, in order to attract commercial bank funds for priority projects.

53. The Bank's current program for Brazil envisages an annual US$1.5 billion lending level. The program for FY86-87 includes three large quick-disbursing loans. All other operations in the program are more traditional, and slower-disbursing, project and sector loans. Most of the increase required to reach the expanded US$2.0 billion level referred to above would come from additional policy-based operations in support of the

Government's adjustment program; they could include additional agricultural sector loans, sectoral financial rehabilitation loans, and possibly industrial restructuring and trade-related operations. The additional lending would also include increases in our program for education (particularly vocational training) and health to support the social content of the adjustment program.

54. If the Brazilian Government is willing to adopt the full adjustment package, then Bank lending levels could reach US$2.5 billion per year (the "high-growth" scenario). A series of policy-based loans, for example, in support of comprehensive trade reform could be added to the lending program. These lending magnitudes would increase the Brazilian share of the overall Bank portfolio to 13% by 1990.

55. Other Sources of Financing. The "low-growth" option requires virtually no "new money" from commercial banks and a very low level of net inflows from other sources. As indicated above, however, to maintain a growth rate high enough to reduce unemployment and underemployment substantially, Brazil would indeed need net medium-term financing from the commercial banks (as well as adequate short-term credit lines). According to the "moderate-growth" projections presented in this paper, such inflows should reach an average annual level of about US$2.5 billion in 1986-90, which would be equivalent to a 3.5% annual increase in their nominal exposure (but to about a 4% reduction of their exposure in real terms). It is also estimated that the "moderate-growth" option would require about US$1.5 billion per year in net inflows from suppliers, official export agencies and the IDB, and about US$1.1 billion per year in foreign direct investment. IDB lending to middle-income countries like Brazil, while constrained by present institutional policies, is assumed to expand substantially. Under the "high-growth" option, net new commercial bank lending would average almost US$3.0 billion per year for the next five years, and net inflows from other sources (apart from the World Bank), about US$1.7 billion.

Table 1. BRAZIL--HISTORICAL DATA

	1980	1981	1982	1983	1984	1985*
Real GDP Growth Rate Per Annum	7.2	-1.6	0.9	-3.2	4.5	7.0
Debt to Exports Ratio 1/	3.2	3.1	4.1	3.9	3.4	3.7
Interest Payments to Exports Ratio (%) 2/	34.0	40.3	52.1	43.4	37.0	39.9
Total Debt to GDP Ratio (%) 3/	27.9	28.9	31.9	44.3	47.2	47.2
Interest Payments to GDP Ratio (%) 4/	3.0	3.7	4.4	4.9	5.4	5.1
Debt Service Ratio (%) 5/	64.2	69.1	90.7	58.4 6/	72.3	80.5
Terms of Trade (1983=100)	119.8	111.8	106.6	100.0	107.7	113.1
Real Growth Rates of: Imports	-12.3	-5.3	-13.4	-20.7	-0.3	4.4
Exports	23.6	21.6	-10.4	15.3	25.9	-2.3
Current Account Deficit (US$ Billions)	-12.4	-11.0	-14.8	-6.1	.5	-1.3
Interest Payments (US$ Billions)	7.5	10.3	12.6	10.3	11.4	10.9

1/ Total debt, including short-term, as a proportion of Exports of Goods and NFS

2/ Total interest payments, including short-term, as a percentage of Exports of Goods and NFS

3/ Total debt, including short-term, as a proportion of GDP

4/ Total interest payments, including short-term, as a percentage of GDP

5/ Total interest payments plus amortization on M&LT debt (before rescheduling) as a percentage of Exports of Goods and NFS

6/ Includes only amortization actually paid

* Estimate

Table 2: BRAZIL - PROJECTIONS OF KEY VARIABLES - "HIGH GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	8.0	8.0	6.1	8.1	8.1	8.0
GDP per Capita - 1985 $US	1553.9	1642.4	1736.4	1836.0	1943.7	2058.2	2734.7
GNP Growth Rate	7.2	9.4	8.6	8.5	8.4	8.5	8.2
GNP per Capita - 1985 $US 1/	1468.4	1571.9	1670.5	1772.9	1881.9	1999.0	2680.0
Consumption per Capita Growth Rate	6.4	4.9	4.4	5.3	5.1	6.6	5.8
Private Investment to GDP Ratio	12.3	14.4	16.1	16.9	17.7	17.7	17.7
Public Investment to GDP Ratio	5.7	5.6	5.9	6.1	6.3	6.3	6.3
Public to Private Investment Ratio	46.3	38.9	36.6	36.1	35.6	35.6	35.6
Private Savings to GDP Ratio	14.6	14.7	15.6	15.9	16.7	16.7	17.4
Public Savings to GDP Ratio	2.8	4.8	5.6	6.1	6.3	6.3	6.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	12.3	12.4	13.3	14.6	16.8	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	5.3	6.5	7.3	7.9	8.2
Exports of GNFS/GDP (%)	12.7	12.1	11.8	11.8	11.8	11.9	11.8
Imports of Goods Real Growth Rate	4.4	21.6	21.9	16.3	14.8	11.9	8.4
Imports of GNFS/GDP (%)	7.8	8.3	8.9	9.3	9.6	10.0	10.0
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.5	109.8	116.0	122.9	130.9	161.0
DOD/GDP (%) 4/	47.2	42.2	38.4	34.9	31.8	29.1	19.5
DOD/X Ratio	3.7	3.5	3.2	3.0	2.7	2.4	1.7
DS/X (%)	80.5	79.5	72.4	63.9	59.0	49.3	29.4
Interest Payments/GDP (%) 4/	5.1	3.9	3.5	3.2	2.9	2.6	1.8

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

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TABLE 3: BRAZIL FINANCING REQUIREMENTS AND SOURCES (HIGH GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,233)	(2,405)	(3,321)	(3,882)	(4,265)
Direct Foreign Investment (Net)		807	792	1,275	1,457	1,737	1,916
MLT	Gross Disbursements	10,625	15,632	17,845	18,824	19,854	19,764
	Amortization	9,593	12,033	12,583	12,597	12,821	11,516
	Net Disbursements	1,032	3,599	5,262	6,227	7,033	8,248
1) World Bank	Commitments	1,500	2,500	2,500	2,500	2,500	2,500
	Gross Disbursements	800	1,646	2,126	2,216	2,297	2,387
	Amortization	400	418	542	637	931	1,170
	Net Disbursements	400	1,228	1,584	1,579	1,366	1,217
2) Other Multilateral	Commitments	275	800	800	800	800	800
	Gross Disbursements	297	290	366	456	572	662
	Amortization	136	157	173	186	214	260
	Net Disbursements	161	133	193	270	358	402
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,400	1,400	1,400
	Gross Disbursements	1,093	1,646	1,420	1,478	1,460	1,443
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	817	767	744
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,500	1,600	1,600	1,650	1,650
	Gross Disbursements	1,565	1,510	1,705	1,704	1,673	1,650
	Amortization	1,142	975	882	902	899	958
	Net Disbursements	423	535	823	802	774	692
6) Commercial Banks(1)	Commitments	6,797	10,470	12,180	12,952	13,842	13,615
	Gross Disbursements	6,797	10,470	12,180	12,952	13,842	13,615
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	930	1,939	2,843	3,855	5,282
Other Capital		(200)	(1,600)	(1,968)	(2,285)	(2,785)	(3,478)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(1,022)	(1,238)	(1,389)	(1,537)	(1,926)
Net Flows (as percentage of GDP)		0.482	1.454	1.838	1.873	1.817	1.832

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 4: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (HIGH GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,533	7,117	8,696	10,062	11,279
Other Multilateral	1,942	2,075	2,268	2,538	2,896	3,298
Official Export Credits	6,256	7,068	7,851	8,668	9,435	10,179
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,450	8,273	9,075	9,849	10,541
Commercial Banks	66,467	67,397	69,336	72,179	76,034	81,316
Total Medium and Long-Term DOD	89,581	93,180	98,442	104,669	111,702	119,950

Table 5: BRAZIL - PROJECTIONS OF KEY VARIABLES - "MODERATE GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	7.1	7.1	7.1	7.1	7.1	7.2
GDP per Capita - 1985 $US	1553.9	1627.8	1705.5	1787.2	1874.8	1967.0	2505.9
GNP Growth Rate	7.2	8.4	7.6	7.5	7.4	7.5	7.4
GNP per Capita - 1985 $US 1/	1468.4	1557.3	1639.5	1724.5	1813.9	1909.2	2453.5
Consumption per Capita Growth Rate	6.4	4.0	4.3	4.3	4.2	5.4	5.1
Private Investment to GDP Ratio	12.3	14.4	15.2	16.0	16.9	16.9	17.7
Public Investment to GDP Ratio	5.7	5.6	5.8	6.0	6.1	6.1	6.3
Public to Private Investment Ratio	46.3	38.9	38.2	37.5	36.1	36.1	35.6
Private Savings to GDP Ratio	14.6	14.6	14.9	15.3	16.0	16.3	17.3
Public Savings to GDP Ratio	2.8	4.8	5.5	6.0	6.1	6.1	6.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	12.3	13.1	14.2	15.7	18.1	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	4.0	4.6	5.3	5.9	7.3
Exports of GNFS/GDP (%)	12.7	12.2	11.9	11.7	11.5	11.5	11.4
Imports of Goods Real Growth Rate	4.4	21.5	12.9	11.3	10.7	8.6	7.8
Imports of GNFS/GDP (%)	7.8	8.4	8.6	8.9	9.1	9.2	9.7
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.7	109.1	114.5	120.8	126.8	155.8
DOD/GDP (%) 4/	47.2	42.7	38.8	35.4	32.4	29.5	20.6
DOD/X Ratio	3.7	3.5	3.3	3.0	2.8	2.6	1.8
DS/X (%)	80.5	79.6	73.6	66.0	61.7	52.8	31.9
Interest Payments/GDP (%) 4/	5.1	4.0	3.6	3.3	3.0	2.6	1.9

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

TABLE 6: BRAZIL FINANCING REQUIREMENTS AND SOURCES (MODERATE GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,503)	(1,660)	(2,284)	(3,052)	(2,621)
Direct Foreign Investment (Net)		807	794	879	1,063	1,247	1,429
MLT	Gross Disbursements	10,625	15,542	16,993	17,909	19,073	17,175
	Amortization	9,593	12,032	12,583	12,597	12,770	11,405
	Net Disbursements	1,032	3,510	4,410	5,312	6,303	5,770
1) World Bank	Commitments	1,500	2,000	2,000	2,000	2,000	2,000
	Gross Disbursements	800	1,348	1,626	1,716	1,797	1,887
	Amortization	400	418	542	637	889	1,086
	Net Disbursements	400	930	1,084	1,079	908	801
2) Other Multilateral	Commitments	275	275	500	500	500	500
	Gross Disbursements	297	280	315	351	404	446
	Amortization	136	156	173	186	214	241
	Net Disbursements	161	124	142	165	190	205
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,300	1,300	1,300
	Gross Disbursements	1,093	1,646	1,420	1,448	1,380	1,343
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	787	687	644
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,400	1,600	1,600	1,600	1,600
	Gross Disbursements	1,565	1,480	1,655	1,684	1,658	1,600
	Amortization	1,142	975	882	902	890	950
	Net Disbursements	423	505	773	782	768	650
6) Commercial Banks(1)	Commitments	6,797	10,718	11,929	12,692	13,824	11,892
	Gross Disbursements	6,797	10,718	11,929	12,692	13,824	11,892
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,178	1,688	2,583	3,837	3,559
Other Capital		(200)	(1,400)	(1,847)	(2,274)	(2,597)	(2,700)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(865)	(856)	(1,128)	(1,335)	(1,383)
Net Flows (as percentage of GDP)		0.482	1.430	1.569	1.641	1.688	1.341

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 7: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (MODERATE GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,235	6,319	7,398	8,306	9,107
Other Multilateral	1,933	2,057	2,199	2,364	2,554	2,759
Official Export Credits	6,256	7,068	7,851	8,638	9,325	9,969
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,420	8,193	8,975	9,743	10,393
Commercial Banks	66,467	67,645	69,333	71,916	75,753	79,312
Total Medium and Long-Term DOD	89,572	93,082	97,492	102,804	109,107	114,877

Table 8: BRAZIL - PROJECTIONS OF KEY VARIABLES - "LOW GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	5.0	5.0	5.0	5.0	5.0	5.1
GDP per Capita - 1985 $US	1553.9	1596.8	1640.9	1686.4	1734.9	1784.9	2059.2
GNP Growth Rate	7.2	6.2	5.5	5.5	5.4	5.5	5.3
GNP per Capita - 1985 $US 1/	1468.4	1526.2	1576.0	1626.2	1678.4	1733.6	2022.5
Consumption per Capita Growth Rate	6.4	2.5	3.4	3.3	3.5	3.4	3.2
Private Investment to GDP Ratio	12.3	13.7	13.7	13.7	13.7	13.7	13.7
Public Investment to GDP Ratio	5.7	5.3	5.3	5.3	5.3	5.3	5.3
Public to Private Investment Ratio	46.3	38.7	38.7	38.7	38.7	38.7	38.7
Private Savings to GDP Ratio	14.6	14.2	14.2	14.4	14.6	14.8	14.3
Public Savings to GDP Ratio	2.8	4.3	5.0	5.0	5.0	5.0	5.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	13.1	14.4	16.0	17.8	19.9	23.3
Exports of Goods Real Growth Rate	-2.3	2.5	2.4	2.4	2.4	2.5	3.3
Exports of GNFS/GDP (%)	12.7	12.4	12.2	12.0	11.8	11.6	10.6
Imports of Goods Real Growth Rate	4.4	12.7	5.3	5.2	5.2	5.2	5.3
Imports of GNFS/GDP (%)	7.8	8.0	8.0	8.0	7.9	7.9	8.2
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	103.0	104.7	105.7	106.3	106.2	100.7
DOD/GDP (%) 4/	47.2	42.8	38.7	34.6	30.8	27.2	16.2
DOD/X Ratio	3.7	3.4	3.2	2.9	2.6	2.3	1.5
DS/X (%)	80.5	79.5	74.0	66.9	62.7	53.4	29.5
Interest Payments/GDP (%) 4/	5.1	4.1	3.7	3.3	3.0	2.5	1.5

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

TABLE 9: BRAZIL FINANCING REQUIREMENTS AND SOURCES (LOW GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(83)	539	1,352	2,011	3,265
Direct Foreign Investment (Net)		807	798	887	977	966	1,054
MLT	Gross Disbursements	10,625	13,767	14,323	13,589	13,204	11,104
	Amortization	9,593	12,031	12,583	12,597	12,641	11,115
	Net Disbursements	1,032	1,736	1,740	992	563	(11)
1) World Bank	Commitments	1,500	1,000	1,000	1,000	1,000	1,000
	Gross Disbursements	800	1,028	1,051	1,066	1,062	1,057
	Amortization	400	418	542	637	805	920
	Net Disbursements	400	610	509	429	257	137
2) Other Multilateral	Commitments	275	250	250	250	250	250
	Gross Disbursements	297	273	273	273	264	266
	Amortization	136	155	173	186	214	226
	Net Disbursements	161	118	100	87	50	40
3) Official Export Credits	Commitments	1,000	750	750	750	750	750
	Gross Disbursements	1,093	1,481	980	898	780	793
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	647	343	237	87	94
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	850	850	850	850	900
	Gross Disbursements	1,565	1,315	1,155	974	908	875
	Amortization	1,142	975	882	902	845	841
	Net Disbursements	423	340	273	72	63	34
6) Commercial Banks(1)	Commitments	6,797	9,600	10,816	10,360	10,180	8,106
	Gross Disbursements	6,797	9,600	10,816	10,360	10,180	8,106
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	60	575	251	193	(227)
Other Capital		(200)	(1,400)	(1,647)	(1,986)	(2,182)	(2,930)
IMF (Net)		0	(535)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(516)	(593)	(646)	(792)	(883)
Net Flows (as percentage of GDP)		0.482	0.721	0.643	0.325	0.163	(0.003)

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 10: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (LOW GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	4,915	5,424	5,853	6,110	6,247
Other Multilateral	1,970	2,088	2,188	2,275	2,325	2,365
Official Export Credits	6,256	6,903	7,246	7,483	7,570	7,664
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Suppliers Credits	6,915	7,255	7,528	7,600	7,663	7,697
Commercial Banks	66,467	66,527	67,102	67,353	67,546	67,319
Total Medium and Long-Term DOD	89,609	91,345	93,085	94,077	94,640	94,629

BRAZIL - PROPOSED MEDIUM-TERM ADJUSTMENT AND GROWTH PROGRAM

Moderate-Growth Option

Main Goals: (1) To maintain growth rates in 1986-90 which are high enough to provide employment to new entrants in the labor force, and to a number of currently underemployed workers equivalent to 2% of the labor force per year. Target average growth rate 7% per year.

(2) To improve the country's creditworthiness, consistent with a reduction of the debt to export ratio from 3.7 in 1985 to 2.6 in 1990, and 1.8 in 1995.

(3) To reduce domestic inflation substantially by 1990.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
A. BALANCE OF PAYMENTS								
1. Exchange Rate Policy	Maintain international competitiveness	Devaluation of 30% in 1983; subsequent full adjustment to domestic inflation	+Maintenance of competitive exchange rate policy through periodic adjustments which are at least equal to the difference between domestic and international inflation	*	*	*	*	*
2. Trade Balance	Maintain trade surplus levels consistent with growth and stabilization objectives and with gradual reduction of debt service ratios	Exchange rate policy and other measures required to achieve an annual US$12 billion trade surplus in 1984 and 1985	+Policies on Industry and Trade, Agriculture and Energy (See B, C and D)	*	*	*	*	*
3. Debt Management	Debt rescheduling to reduce adjustment pressures, 1986-90 limited new borrowing in amounts consistent with stability and growth objectives, and with gradual reduction of debt service ratio to sustainable level by around 1990	Annual arrangements for rescheduling principal payment, 1982-85.	+Rescheduling of principal on old commercial debt falling due 1986-90 (multi-year rescheduling, with improvement of terms over the 1984-85 agreement, would be preferable)	*	*	*	*	*
		Controlled and limited new borrowing, 1982-84. No new commercial borrowing 1985.	+Planned annual programs of official and commercial borrowing	*	*	*	*	*
4. Direct Investment	Resumption of direct investment inflows to complement domestic investment	-	+Review of foreign investment and technology transfer policies		*			
			+Policy changes as required			*		

+ Denotes policies essential to adjustment program.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
B. INDUSTRY AND TRADE								
1. Exchange Rate Policy	Maintain international competitiveness	-	See A.1					
2. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 13% annually, to permit import expansion while covering debt service	Liberalization of duty drawback system for exporters, extension of drawback system on limited basis to indirect exporters and removal of fiscal export subsidy (credito premio)	+Strengthening of export promotion through improvements in quality control and certification; marketing, design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures		*			
			+Simplification of indirect drawback system		*			
			+Elimination of remaining indirect taxes on exports			*		
3. Export Financing	Rationalize and extend financing arrangements for exports	Reduction of subsidy element in pre-shipment export financing	Strengthening of export credit insurance		*			
4. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Elimination of tariff surcharges; reduction in average tariff level and in number of items subject to "suspended imports"; increased flexibility in external financing requirements for imports; liberalization of firms, import programs for annual imports up to US$100,000; increased autonomy to CACEX's field offices; and elimination of foreign credit financing as a criterion for the application of the Law of Similars	+Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making	*	*			
Bank support		(Export Development I, FY84)	ESW on Industry and Trade	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
C. AGRICULTURE								
1. Agricultural Credit	Rationalization of rural credit system	Elimination of negative real interest rates, Center-South (1983) and agreement on reductions in North-Northeast (1985)	+Budgetary provision for costs of interest rate subsidies (equalization costs for Federal and State banks, monetary correction shortfall North-Northeast)	*				
			+Elimination of negative real interest rates in North-Northeast, except special target groups			*		
			+Market interest rates in Center-South, except special areas				*	
			Market interest rates in North-Northeast, except special target groups					*
			+Full fiscal provision for remaining subsidies		*	*	*	*
2. Trade and Pricing	Trade liberalization and development of efficient marketing system	-	+Introduction of free trade policy for 1986-87 crops, within defined price limits	*				
			+Phase-out food price controls and wheat subsidy, implement targeted food assistance programs	*	*	*		
			Reopen access to external futures trading, remove tax on domestic futures trading	*				
			Establish legal/regulatory framework for storage warrants, bankers acceptance matters in bonded agricultural commodities	*				
			+Revision, simplification of trade regulations (export registration, import licensing, and foreign exchange controls) for agricultural commodities	*				
			Establish agricultural price data system		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
			+Full free trade arrangements for key agricultural products (rice, corn, soybeans, cotton, and beans) subject to minimum price guarantees, market safeguards and government stock management		*		*	
			Start domestic futures market for major agricultural commodities and bankers acceptance trading		*			
			Integrated data systems for CACEX, Central Bank			*		
			Improved crop forecasting and stock information systems		*	*		
3. Taxation	Minimize tax disincentives to agricultural export growth	-	+Reform of system of agricultural taxation			*	*	*
Bank Support		(Agriculture Credit and Export Loan, FY83)	Agriculture Sector II	*				
			Agriculture Credit I	*				
			Agriculture Sector III		*			
			Agriculture Credit II			*		
			Agricultural Credit III					*
			Cofinancing	*	*	*		*
			ESW on Agriculture	*	*	*		
D. ENERGY								
1. Energy Development and Conservation	Cost-effective development of domestic energy resources	Reassessment of energy investment priorities (1985)	Development of a long-term energy efficiency plan		*			
			+Pricing policies promoting efficient domestic energy use	*	*	*	*	*
2. Electric Power	Realistic investment and financial plans and implementation	Formulation and initiation of Investment Program for Financial Plan for 1984-88; real tariff increases	+Financial rehabilitation; balanced resource allocation, improved system reliability, tariffs to be brought into line with long-run marginal costs	*	*	*		
3. Alcohol	Improve efficiency of alcohol production in context of lower petroleum prices		+Reassessment of alcohol program, with emphasis on increasing productivity and on pricing policy to cover costs	*				

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
Bank Support		(Power Transmission, Conservation and Distribution loans, FY85)	Power Transmission		*			
			Power Sector I	*				
			Power Sector II		*			
			Transport Sector I		*			
			Energy Conservation			*		
			Transport Sector II					*
			Cofinancing	*	*			
E. INVESTMENT AND SAVINGS								
1. Public Sector Investment	Program limited, with specified exceptions, to completion of high-priority rehabilitation-recovery programs	Increased supervision of public sector, including state enterprise, investment programs; real reductions in 1983-84.	+Annual Government review and monitoring of public sector investment in context of multi-year investment program, and improved economic evaluation of new projects (with continuing Bank review and progress reporting)	*	*	*	*	*
			+Channelling of new external funds into key areas of rehabilitation and/or priority new investment	*	*	*	*	*
2. Private Investment	Increase market incentives for private sector investment in new productive assets to support target GDP growth	-	Promotion of investment efficiency through sectoral adjustment policies (see B,C,D)	*	*	*	*	*
			+Encouragement of increased investment through banking and financial reforms (see F.3 and 5) and stabilization measures (H)	*	*	*	*	*
3. Savings	Major increases in savings available for private investment	Reductions achieved in Government spending and deficit financing, 1983-85.	+Stabilization measures further reducing the deficit and the disincentives to save (see H)	*	*	*		
			Preparation of tax measures to promote savings	*				
			Implementation of tax incentives for savings		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
F. FISCAL AND FINANCIAL REFORM								
1. Budget Consolidation	Establish basis for improved fiscal management	Creation of Treasury Secretariat to manage budget transactions	+Budgetary provision for wheat, sugar and agricultural credit subsidies	*				
		Inclusion in 1986 budget of most quasi-fiscal items formerly in the "monetary" budget	+Transfer of decentralized funds to Treasury budget	*				
			+Completion of process of budget budget consolidation		*			
2. Monetary Authorities	Strengthen basis for monetary policy formulation and management	-	+Law defining functions of Banco do Brasil		*			
			+Transfer to Banco do Brazil or BNDES of Central Bank's development banking functions		*			
			+Establishment of Banco Central as sole monetary authority		*			
			Transfer to Treasury of responsibility for Federal public debt		*			
			+Greater independence for the Central Bank (legislative or constitutional provision)			*		
3. Banks	Restore the institutional base for growth in savings and private investment	-	+Reduction in compulsory lending for certain sectors by commercial banks, and in reserve requirements	*	*	*		
			Reform of state and regional development banks		*	*	*	
			Strengthening of investment banks		*	*	*	
			Reform of state commercial banks			*	*	
			Legislation and regulations to govern a liberalized, integrated banking and financial system				*	*
								*

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Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
4. Housing Finance	Stabilize and support housing investment		+Reform of the housing finance system		*			
5. Financial Markets	Strimulate flow of funds for private investment		New regulations for financial markets, including tax reforms		*	*		
			Establishment of "Brazil Fund" to encourage foreign portfolio investment		*	*		
			New regulations for financial conglomerates			*		
6. Tax Reform	Increased tax revenues in a more efficient and equitable system		Program to reduce tax exemptions and allowances	*	*			
			Tax reform to encourage longer-term holdings of financial assets	*	*			
			Tax measures to reduce wedge between borrowing and lending rates		*			
			+Major tax and transfer reform at Federal, State and municipal levels			*	*	
Bank Support			Financial Sector Reform I	*				
			Financial Sector Reform II		*			
			Financial Sector Reform III			*		
			Financial Sector Reform IV				*	
			Cofinancing	*	*	*	*	
			ESW on the Financial System		*		*	
G. PUBLIC SECTOR MANAGEMENT								
1. Fiscal Administration	Efficient arrangement of Government funds, including debt operations	Establishment of National Treasury Secretariat in the Finance Ministry (See F.1)	+Fully operational control of budget operations, through Treasury and SEPLAN (SOF)	*				
2. Integrated Management System (SEPLAN)	Strengthening of Federal information, planning, policy research, programming budgeting, policy information, evaluation and reporting	-	+Strengthening and expanded operation of:					
			- general and sector planning and project evaluation (IPLAN)	*	*	*	*	*
			- multi-year investment planning—CPPG	*	*	*	*	*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
3. State Enterprise Management	Development of flexibility and efficiency in the state enterprise system, with privatization of some enterprises	SEST supervision of state enterprise operations (since 1980)	+Introduction of system for performance evaluation	*				
			+Development of rehabilitation programs for selected state enterprises	*	*	*		
			+Implementation of finance and rehabilitation programs	*	*	*	*	*
			Selective privatization of enterprises directly or via capital markets	*	*	*	*	*
4. Statistical Development	Information systems development: national and regional statistics	-	Initiation of IBGE development program to expand national and regional information base		*			
			Interim development of national account and public finance research (FGV)		*	*		
			Development of integrated national/regional statistical operations			*	*	*
5. Financial Control			Strengthening of audit systems (SECIN &/or Tribunal da Contas)	*	*	*		
Bank Support			Public Sector Management Loan	*				
			Public Sector Management II				*	
			ESW on Public Investment and public enterprises	*	*	*	*	*

H. STABILIZATION

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
1. Government expenditure	No real increase in current or capital investment outlays, but a shift away from state enterprise activity into priority social programs	Real reduction in state enterprise expenditures; emergency social program introduced 1985	+Reductions in Govt. and state enterprise operating expenditures, including personnel costs; extra provision for maintenance, financial rehabilitation, completion of priority investments; careful evaluation of new investment proposals involving Government or state enterprises	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
2. Taxation	Increase in (recovery of) net tax revenues to 1970s ratios	Measures to restore and increase income tax revenues (increase equivalent to 1.7% of GDP proposed)	+Further short-term adjustments to increase revenue collection and reduce cost of tax exemptions and allowances	*	*	*	*	
			Major reform of tax and incentive systems and mechanisms for revenue sharing			*	*	
3. Other Revenues	Public sector prices, levies to cover cost of services.	Some real increases in 1985	+Public sector prices to increase in real terms; social security and similar charges to be adjusted to cover programs' costs	*	*	*	*	
4. Subsidies	(See F.1)							
5. Public sector deficit	Reduce public sector deficit (broadly defined) to normal financing range	"Operational" deficit cut from 6.8 to estimated 2.8% of GDP, between 1982 and 1985	+Reduction of "operational" fiscal deficit to 1% of GDP	*				
			+Further improvements in fiscal performance, according to targets to be agreed annually, to secure gradual decline in ratio of total public debt to GDP		*	*	*	*
6. Monetary Policy	Expansion consistent with agreed stabilization targets	Short periods of tight monetary restraint, 1981-84.	+Meeting annual monetary targets based upon expected growth and inflation	*	*	*	*	*
7. Incomes policy	Real wage increases linked to productivity growth, to increase employment opportunities	Successful efforts to reduce real wages in 1983-84, some real wage recovery in 1985.	+Wage policy limiting increase in real wages to productivity gains	*	*	*	*	*
8. Indexation	Reduction of the inflation mechanisms implied by the Government indexation system, while avoiding distortions that might be caused by inflation if Indexation is eliminated	-	+Preparation of detailed program on how to deal with indexation and related issues	*				
			+Implementation of the program		*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
I. SOCIAL & REGIONAL PRIORITIES								
1. Social Adjustment	Recovery from social costs of economic recession through programs designed to reduce poverty, improve income distribution and promote employment rhgough economic growth	Social sector priority program in nutrition, health, education, housing, water supply, small-scale agriculture and job creation (1985)	Preparation and implementation of plans of expanded, more cost-effective and efficiently delivered health, education and other social services	*	*	*	*	*
2. Regional Development	Increase employment and incomes, and promote sustained growth in the Northeast region	New rural development programs for the Northeast (1985)	Preparation of comprehensive, multi-sectoral Northeast regional development program	*				
			Phased implementation in line with domestic and external reserve availability		*	*	*	*
Bank Support			Education Sector Loan				*	
			Health Sector Loan					*
			NE lending program (rural development, industries, irrigation, education, health)	*	*	*	*	*
			ESW on health and education programs and NE regional development	*				

BRAZIL - A PROPOSED COMPREHENSIVE, MEDIUM-TERM PROGRAM
FOR TRADE LIBERALIZATION

Area	Policy Objectives	Further Recommended Measures
1. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 15% annually, to permit import expansion while covering debt service	Formulation and initial steps in implementation (see below) of a multi-year program for export expansion and trade policy rationalization Implementation of GATT Code for subsidies
2. Export Financing	Rationalize and extend financing arrangements for exports	Provision of access to financing to all exporters at internationally competitive rates, consistent with GATT Subsidy Code
3. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Specification of import rationalization objectives, identification and consideration of specific measures to reduce anomalies in policies and procedures affecting different categories of producer, with implementation subject to balance-of-payments situation; results of ongoing studies of effective protection; and results of trade negotiations Implementation of GATT codes for Customs Valuation and Anti-Dumping Elimination of most items from the list of "Import Suspension" Liberalization of firms' annual import programs, eliminating discrimination by products and providing automatic approval for firms importing up to a pre-determined value. (Import programs would be used as a tool to control imports only in the event of a balance of payments crisis). Reduction or elimination of most tariff exemptions schemes, and reduction of scope of application of Law of Similars Reduction of tariff levels and dispersion to a nominal average of about 40% range, with perhaps half the items in the 30-40% range, a minimum tariff of 10% and a maximum of 85% (including IOF tax) Gradual phasing-out of non-tariff restrictions, so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariffs
Bank support		Export Development II Export Development III Industrial Restructuring I Industrial Restructuring II Cofinancing ESW on Industry and Trade

SECTOR POLICIES

A. Industrial and Trade Policies

1. Domestic markets for Brazilian manufactures are protected by quite high nominal tariffs and extensive non-tariff barriers, even after substantial reform in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Its international competitive strengths are demonstrated by the impressive increase in manufactured exports in recent years, from US$8.4 billion in 1980 to US$15.1 billion in 1984. Another indication has been the very limited growth of import demand when the Brazilian drawback system was liberalized, with Bank support, to establish a "free trade" regime for export production.

2. The most recent thorough study of nominal and effective protection for Brazilian manufacturing, for 1980-81, shows high nominal tariffs (an average of 99%, and 133% for consumer goods) but relatively low effective protection as measured by direct price comparisons (an average of 44% and 36% for consumer goods). The averages for Brazil do conceal substantial dispersion in both nominal and effective protection. In 1980-81, for example, the nominal tariff approached 200% for apparel, beverages and tobacco, although the implicit effective protection estimates for these products were 26%, -1% and 6%, respectively. Implicit effective protection was negative in the mining non-metallic minerals, transportation equipment, paper and rubber industries, but exceeded 100% for electrical equipment and pharmaceutical products.

3. Brazil has taken some recent measures to reduce restrictions on trade. The September 1984 tariff reforms included the removal of sucharges imposed in the 1970s and reduced the unweighted average nominal tariff to 51%. The trade-weighted average tariff was already much lower, at 30%, in 1975, and came down to about 22% in 1984. Non-tariff barriers, which have been more important than tariffs in regulating imports, were also reduced in 1984 when the list of prohibited imports was cut from 4,435 to 2,081 items and other rules and administrative requirements were somewhat relaxed.

4. The extent to which recent measures have reduced levels and dispersion in effective protection, if at all, should become clear when a major new study, financed under our first Export Development Loan, is completed, probably by mid-year. This study will, we expect, provide the basis for consideration by the Government of further trade policy measures.

5. In view of the above, we see trade policy reform for industrial products at this stage as a desirable but not immediately essential component of an economic adjustment program for Brazil. The key requirement today is the continuation of exchange rate policies which will keep manufactured exports competitive and growing. The Bank will continue to press for trade policy reforms, which the Government is expected to consider later this year.

6. Measures to promote further improvements in industrial efficiency include, in the area of export development:

- strengthening of export promotion through enhanced quality control and certification procedures; marketing design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures;

- simplification of indirect drawback system;

- elimination of remaining indirect taxes on exports.

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Shifting the responsibility for industrial production, at the margin, from the public to the private sector would also help.

7. The import regime would benefit from simplification and increased automaticity in official (CACEX) import procedures and the decentralization of decision-making.

8. Subsequent steps towards import rationalization should focus on areas shown to benefit from high levels of effective protection, as demonstrated by direct price comparisons, and therefore imposing high costs on other manufacturing and the economy in general. A more comprehensive, longer-term approach would seek the rationalization of import policies across the board, emphasizing:

- implementation of GATT customs valuation and anti-dumping codes;

- elimination of most items from the import suspension list;

- liberalization and eventual elimination of company annual import programs, except as emergency measures;

- reduction or elimination of most tariff exemption schemes and applications of the Law of Similars;

- reduction of nominal tariff levels and dispersion, with up to half of all items in the 30-40% range;

- further phasing-out of non-tariff restrictions so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariff system.

B. Agricultural Sector Policies

9. Brazilian agriculture registered strong though unbalanced growth in the 1970s, at an average of 5% annually, but in the 1980s, output stagnated and agricultural investment declined. 22 Except for credit programs, Government agricultural policies have acted as disincentives to

investment, especially for staple crops. Subsidized credit promoted increases in production, but at high cost and with heavy emphasis on high-input commercial agriculture and special development programs (alcohol, Cerrado agriculture, the Amazon frontier) requiring large fiscal incentives. The crisis-induced reduction of agricultural credit, early in the 1980s, was not compensated by other policy changes. Adverse trade and pricing policies, high taxation and industrial protection continued. Intervention in agricultural trade and minimum price arrangements have provided more uncertainty than support.

10. Agricultural expansion is critical for growth. The key to realizing the full potential of the agriculture sector is a policy framework that will make all forms of production and exports profitable without credit subsidies, interventionist trade policies and production-based taxation. This is central to Bank agriculture sector lending to Brazil and conforms with Government policy objectives as expressed in the National Development Plan. The first sector loan supported the Government decision to phase out negative real interest rates on rural credit. The second would support significant and complementary moves towards a more liberal pricing policy for agriculture.

11. In the area of agricultural credit, the required policy measures are:

- budgetary provision for interest rate subsidies, in 1986;
- subsequently, full fiscal provision for all remaining subsidies;
- elimination of negative real interest rates in the North-Northeast, except for selected target groups;
- market interest rates in the Center-South, except in special areas.

12. Agricultural trade and pricing policies should provide for:

- the initiation of a free trade policy for key 1986-87 crops, within defined limits;
- the phasing-out of food price controls and the wheat subsidy, along with the implementation of targeted food assistance programs;
- rationalization of trade regulations for agricultural commodities;
- a free-trade policy for key agricultural commodities, subject to minimum price guarantees, market safeguards and Government stock management.

13. In addition, provision should be made for a reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

C. Energy Sector Policies

14. Over the past decade, Brazil has been diversifying its energy base and stressing conservation. By accelerating petroleum exploration and production, as well as encouraging energy substitution and conservation, Brazil has significantly reduced oil imports. Investments in hydro-electric plants and in alcohol production have expanded Brazil's energy resources, and recent natural gas discoveries will add to the diversification strategy. With the present world oil price prospects and the country's resource constraints, two general principles should guide future development of the sector: (a) energy development of domestic fuels should be coordinated, to avoid excess duplication or over-expansion of supply relative to market demand; and (b) economic criteria should be strictly applied to energy investments, and pricing should reflect market forces.

15. Brazil is not a low-cost producer of petroleum. While the current production target of 740,000 bbl/day by 1989 seems to be cost-effective with present oil price projections of US$20/bbl, the cost of future investments, particularly in the deep-offshore areas of the Campos basin, must be carefully scrutinized and the pricing of petroleum derivatives (notably fuel oil, LPG, and naphtha) should more adequately reflect international prices. Alcohol development is also susceptible to weakening oil prices. Brazil's alcohol program is now being reassessed by the Government. The entire incentive system for producing and consuming alcohol needs to be reviewed. Productivity improvements in existing facilities are critical. Since domestic retail gasoline prices are likely to fall because of the low international prices, it is all the more important to raise the retail alcohol price to its parity with gasoline, in order to reduce subsidies and encourage alcohol conservation. Finally, in order to insure adequate provision of electricity for expanding business and residential consumption without draining the Government budget, the financial condition of the power sector must be improved, and priority transmission and distribution investments which were delayed because of the recession should be completed.

16. The following sector policies would support production and reduce imports:

(a) Development of a long-term energy plan for coordinated production and consumption of energy resources.

(b) Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect opportunity costs and therefore promote efficient domestic energy production and use.

(c) Financial rehabilitation of the power sector through higher tariffs, improved debt/equity ratios, and other means, and completion of priority investments to improve system reliability.

(d) Emphasis on agricultural and industrial productivity improvements in alcohol production, with strong limitations on expansion of capacity in new or high-cost regions of the country.

D. Financial and Fiscal Reform

17. In the mid-1960s, financial and fiscal reforms played a fundamental role in economic stabilization in laying the basis for a period of extraordinarily rapid economic growth. Two decades later, however, inflation is well over 200% a year, real free market interest rates (on the order of 25% to 30%) are higher than the returns that can be earned on investments in real assets, financial markets are fragmented, and the portfolios of many major financial institutions are of doubtful quality. There is a growing consensus in Brazil that reforms similar in scope to those of the 1960s are again required.

18. Monetary and Fiscal Reform. Financial reform, carried out in close coordination with fiscal reform, could play an important role in completing both economic stabilization and the adjustment of the economy to changed international economic conditions. Three major objectives of financial reform would be: (i) more effective monetary and fiscal control; (ii) enhanced stability of the financial system; and (iii) increased efficiency in mobilizing and allocating resources. High real interest rates can be attacked directly through tax reforms and reductions in compulsory lending at below-market rates; they can be addressed indirectly by reducing uncertainty about future financial policies, and by measures resulting in improved monetary control. Financial reform alone cannot bring down real interest rates to sustainable levels. But it can reinforce other measures critical to economic stabilization and structural adjustment.

19. The Government has stated its intention to unify Brazil's federal budgets (those of Treasury, the Monetary Authorities and the state enterprises) and is redefining the roles of the National Treasury, the Central Bank, and the Bank of Brazil. The goal would be to establish a clear separation between the conduct of monetary and fiscal policy and achieve better discipline over public expenditure. The Government has already taken several major steps toward this goal. It has consolidated, within the Federal Government budget, most fiscal expenditures previously financed through the monetary budget. A new Secretariat of the Treasury is being established in the Finance Ministry to administer the overall fiscal budget and to unify thousand of special funds that have been managed independently up to now by government agencies. It has ended the Bank of Brazil's status as a monetary authority; other changes, including the transfer of the Central Bank's development banking functions to the Bank of Brazil and BNDES and its responsibility for the Federal debt to the Treasury, are expected shortly.

Tax Reform

20. The tax system is also badly in need of reform. Some activities are still undertaxed or not taxed at all. Taxation varies significantly

property, wealth, and inheritance. Fiscal incentives have proliferated, they not only erode revenues, but also reduce the ability to influence investment and accentuate the lack of equity in the overall tax system. In order to prepare a broader tax reform the Government established a Tax Commission in March 1985. The main objectives of the reform are increasing state and local government autonomy on taxation, using the tax system to direct savings more to productive investment than to financial transactions, and improving the progressivity of the tax system.

21. While the Commission's recommendations will not be fully implemented for several years, some steps appear feasible before then. As part of the fiscal adjustment for 1986, significant changes to the tax system are already being made. They include an increase in the progressiveness of the personal income tax, taxation of all forms of interest income, and reduction of the lag between the accrual of corporate tax liability and payment of the tax.

22. The following sector policies would not only improve the Government's monetary and fiscal control but would also help mobilize savings and channel them to productive investment, by improving the financial system, reducing intermediation costs, and broadening and rationalizing the tax base. As noted above, many of these measures are already being implemented by the Government.

(a) Budget consolidation:

Budgetary provision for wheat, sugar and agricultural credit subsidies; transfer of decentralized funds to Treasury budget; completion of process of budget consolidation; and redefinition of the functions of the Bank of Brazil.

(b) Monetary policy management:

Transfer to Bank of Brazil or BNDES of the Central Bank's development banking functions; establishment of Central Bank as the sole monetary authority; transfer to the Treasury of responsibility for the Federal public debt; and greater independence for the Central Bank.

(c) Financial system improvements:

Reduction in compulsory lending for certain sectors by commercial banks and in reserve requirements in line with the decrease in the fiscal deficit; strengthening and reform of the state and regional banking system; reform of the housing finance system; and new regulations for financial markets and for financial conglomerates.

(d) Tax reform:

Program to reduce tax exemptions and allowances;
encouragement of longer-term holding of financial assets through differential tax rates; reduction of the wedge between borrowing and lending rates; and reorganization of tax and transfer system between Federal, State and municipal levels.

E. Public Sector Management

23. Management problems stem from the expansion of the public sector in the 1970s as the Government sought to maintain investment and growth in a difficult external environment, counter inflationary trends for which growing public sector deficits were themselves largely responsible, and meet a variety of competing and sometimes conflicting social objectives. Public expenditures expanded primarily through the monetary budget, which was handled by the Central Bank and used increasingly to channel development and welfare expenditures through subsidized credit programs and other subsidy arrangements. Public sector prices were held down in the attempt to restrain inflation. State enterprises were encouraged to borrow overseas for ambitious investment programs, and to borrow more to support a deteriorating balance of payments.

24. Since 1980, in an environment of recession, rising inflation and severe constraints on both external and domestic borrowing, the Government has made strenuous efforts to bring public expenditures under better control. There has been a substantial reduction in the public sector's operational deficit and borrowing requirements, from an estimated 6.6% of GDP in 1982 to about 3% in 1985. The aim in 1986 is to reduce this deficit to 0.5% of GDP.

25. The Government is strengthening public sector management in several key areas:

- the establishment of a National Treasury Secretariat to administer Government funds more effectively,
- strengthening Federal information, planning, policy research, programming, budgeting, evaluation and reporting systems,
- improved programming and screening procedures for public investment projects, and
- the introduction of performance evaluation systems, rehabilitation programs and selective privatization programs for the state enterprise sector.

26. These measures, together with programs also to be supported by the Bank for the development of information systems and financial control, have the potential for greatly improved management of the public sector. At the same time, it is important to begin rebuilding the pipeline for new, economically viable public investment projects, particularly in physical and social infrastructure, in order to support medium-term growth.

BRAZIL - EXPANDED FIVE-YEAR LENDING PROGRAM

(FY86-90)

FY86

	US$ Million	
Electric Power Sector	0.0	
Agricultural Sector II	400.0	
Northeast Rural Development	171.0	
Alcohol Development	175.0	
Agricultural Credit	150.0	
Upper and Middle Sao Francisco Irrigation	56.0	
Salvador Metropolitan	49.0	
Northeast Rural Development	185.0	
Agricultural Extension	155.0	
Santa Catarina Market Towns	24.5	(10)
Northeast Urban Reconstruction (Flood)	100.0	(1,465.5)

FY87

Public Sector Management	25.0	
Northeast Education Policy	10.0	
Financial Reform I	300.0	
Rural Electrification II	175.0	
Northeast Health - Primary	50.0	
Industrial Skills Vocational Training	100.0	
Urban Transport IV	200.0	
Electric Power Sector II (S)	400.0	
Irrigation Engineering (S)	45.0	
State Highway Sector Maintenance	150.0	
Agricultural Sector III	350.0	(12)
Northeast Rural Development V	200.0	(2,005.0)
Export Development II (R)	200.0	
Alcohol Development II (R)	175.0	
Agricultural Research III (R)	100.0	
Natural Gas (R)	50.0	(5)
Minas Gerais Forestry (R)	20.0	(545.0)

FY88

Northeast Irrigation	200.0	
Financial Reform II	200.0	
Industrial Restructuring	250.0	
Power Distribution (S)	300.0	
Electric Power Sector II (S)	400.0	
Livestock Disease Control (S)	50.0	
Cerrado Transport	100.0	
Rural Telecommunications	100.0	
FEPASA Railways II	100.0	
Northeast Rural Development VI	100.0	
Northeast Rural Development VII	100.0	(12)
Northeast Education	150.0	(2,050.0)
Rubber Development (R)	60.0	
Ports II (R)	100.0	
Health/Population (R)	40.0	(4)
Urban Sector (R)	200.0	(400.0)

FY89	US$ Million	
Agricultural Sector IV	300.0	
Education Sector (S)	100.0	
Northeast Irrigation (S)	100.0	
Feeder Roads IV (S)	150.0	
Rural Water and Sanitation (S)	100.0	
Industrial Restructuring II (S)	300.0	
Northeast Small and Medium Cities (S)	100.0	
Technology Development (S)	100.0	
Electric Power Sector III	400.0	
Northeast Small Industries	150.0	(11)
Financial Reform III	200.0	(2,000.0)
Export Development III (R)	300.0	

FY90		
Water and Sewerage (S)	150.0	
Rural Electrification III (S)	200.0	
Medium Cities (S)	50.0	
Gas Exploration/Development (S)	150.0	
Agricultural Credit (S)	300.0	
Transport Sector (S)	200.0	
Electric Power Sector IV (S)	300.0	
Grande Carajas (S)	150.0	
Development Banking (S)	200.0	
Oil Palm Development (S)	100.0	(11)
Agricultural Credit (S)	200.0	(2,000.0)

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CONFIDENTIAL
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February 4, 1986

BRAZIL - MEDIUM-TERM GROWTH STRATEGY

→ Brazil RB.

A. Current Situation

1. During 1983-85, Brazil succeeded in achieving the external adjustment required to reach a reasonable equilibrium in its balance of payments. After three years of GDP decline, the economy grew by about 4.5% in 1984, while the trade surplus reached US$13 billion and a small current account surplus (US$500 million) was also achieved. In 1985, in spite of high (7-8%) GDP growth, the trade surplus remained at over US$12 billion, the current account deficit was below 1% of GDP, and gross international reserves remained at a level equivalent to about 8 months of imports. The presence of substantial excess capacity facilitated the year's rapid growth. The large increase in exports achieved in recent years (from US$15.2 billion in 1979 to US$27.0 billion in 1984), and the efficient import substitution taking place in petroleum and some industrial subsectors, have contributed substantially to this economic performance, and should also help Brazil maintain acceptable growth rates in future years. Brazil has thus achieved a unique position among the high-debt countries, in having been able to resume economic growth without a deterioration in its balance of payments.

2. The external adjustment was not, however, accompanied by a parallel domestic achievement. Inflation increased from 40% to about 100% a year in 1979-82, because of the oil shock, demand pressures, and subsequent devaluation. Inflation escalated again to over 200% in 1983, as a result of the large devaluation in early 1983 and agricultural supply shortages. There was also intense pressure on the financial system when external sources of financing evaporated and the Government turned to domestic capital markets. Public debt increased rapidly in 1982-83, as the impact of the fiscal deficit was aggravated by devaluation, which raised the real cost both of foreign debt and domestic debt carrying the option of exchange correction. While there were no large shocks in 1984-85, prior to the drought at the very end of 1985, indexation has made it difficult to bring inflation down. Furthermore, prices now seem to react quickly to new supply or demand shocks, after several years of high inflation. The rate of inflation remains above 200% annually, and real market interest rates are still about 25% per year, although they have fallen in recent months. Both factors introduce an element of uncertainty into investment planning, at a time when substantial increases in productive investment will soon be needed. Consequently, while inflation to date has not halted growth, its future effect is worrisome and a serious effort to control inflation is warranted.

3. In spite of the inflationary pressures, Brazil's productive structure has in recent years been demonstrably more efficient and competitive than that of other heavily indebted countries in the LAC region. The speed with which Brazilian industry adapted itself in 1983-84 to the need to increase exports was indeed remarkable, as has been also in recent years the export performance of agriculture. There is still room, however, for providing additional incentives for increasing agricultural and industrial exports through appropriate policies designed for this purpose.

B. Development Strategy

Objectives

4. Brazil needs to (a) maintain a GDP growth rate of at least 6.5% per year in order to improve living standards and generate enough employment growth (at least 4% per annum) to hire new entrants into the labor force and reabsorb those affected by the recent recession; and (b) improve its creditworthiness position, by reducing its debt service and debt to export ratios by at least 25% by 1990 (with continued improvement in the 1990s), so that it can resume amortization payments on existing debt in the early 1990s. There are strong domestic pressures to reverse the deterioration in living standards of the recent recession, when per capita income fell 12% and social programs were curtailed. The Government's commitment to growth stems from the conviction that an additional recession would not be consistent with political stability. Therefore, while growth requires control of inflation, the Government has preferred up to now to follow a gradual approach to domestic stabilization. The Government realizes, however, that a further substantial acceleration of inflation would make it necessary to adopt more drastic internal adjustment policies, even if that causes a temporary reduction in growth rates. At the same time, it is accepted that the country's creditworthiness position must improve. Its foreign debt of over US$100 billion is some 3.7 times the annual amount of export earnings, and interest payments of about US$11 billion per year represent about 40% of exports. If amortization on its commercial bank debt were also being paid, Brazil's debt service ratio today would be about 80%. In summary, moderately rapid economic growth will be required to improve Brazil's domestic conditions and external standing. To be sustainable over the long term, such growth would have to be accompanied by a successful domestic adjustment effort.

Implications for Economic Change

5. GDP growth of such a magnitude involves expanding agricultural and industrial production for both domestic and international markets. Brazil's agricultural and industrial sectors are dynamic, employ modern techniques, and are relatively efficient. Given their responsiveness to profitable opportunities, providing sufficient market incentives, through maintenance of appropriate exchange rates and price signals, should be sufficient to stimulate production. For the agricultural sector, which has been subjected to periodic Government interventions in the market, freer commercial policies are particularly critical.

6. Substantial increases in investment and savings will be needed. Excess capacity, which has sustained the economic recovery to date, is starting to disappear in some industrial sectors, and the investment/GDP ratio, which was only 16-17% in 1983-84, will have to increase to about 23% by the end of the decade. The corresponding savings effort will be large, especially now that domestic savings must compensate for more modest foreign resource availability than existed in the growth period of the 1970s.

7. Investment, in effect, will have to be more efficient than in the 1970s, in view of the overall resource scarcity, and there will be no scope for building large plants far in advance of demand. The large infrastructure projects and industrial plants which drained Government resources in the 1970s, however, can now be used to support production at a relatively low cost. Together, these factors imply a moderate ICOR of about 3.

8. Raising investment and savings will not be easy. It will require a large adjustment in the public sector, to scale back the size and scope of Government operations, increase their efficiency, and--most importantly--increase public savings and reduce the overall fiscal deficit. It will also require controlling inflation, which, at today's rate of 235%, is detrimental to new investment both because of the associated uncertainty and high real interest rates. Finally, it will require financial reform of the banking system, to rationalize operations and reduce financial segmentation of credit markets. All of these efforts should help to increase both private and public savings and channel these savings to productive investment at lower real interest rates than now prevail. They should also gradually shift the responsibility for economic expansion to the private sector, and limit the Government's role to the provision of infrastructure and social services. In numerical terms, private investment is expected to increase from 68% of total investment today to about 74% by the end of the decade. Private savings, in turn, will be used increasingly to fund private investment, rather than Government spending as is the case today.

9. Continued export growth remains an economic necessity for Brazil, in terms of markets, financing of needed imports, and its creditworthiness position. Improving the ability of Brazilian producers to compete externally also generates price and quality benefits for domestic consumers. With real export growth of 4.5% per year through the end of the decade, Brazil could continue to pay interest and could gradually resume amortization payments to commercial banks by the early 1990s. Regaining its ability to borrow on the international financial markets is fairly critical for Brazil, if it is to follow a rapid growth strategy.

10. Important structural changes have taken place in Brazil's trade accounts in recent years, which make it easier to continue generating trade surpluses exceeding US$12 billion per year for the remainder of the decade. With an established exchange rate policy designed to keep Brazilian products competitive, businesses now recognize the export market as an important source of sales. In addition, imports have dropped from a level of almost US$23 billion in 1980 to slightly over US$13 billion in 1985. While imports are expected to increase with the resumption of economic growth, considerable import substitution has occurred in both industrial products and in petroleum. We expect imports by 1989 to be only as high as they were in 1980, even with a nominal growth in non-oil imports of over 20% per year. The recent fall in oil prices, if sustained, would reinforce this import trend.

C. Proposed Medium-Term Adjustment and Growth Program

11. The Government is committed to the resumption of economic growth and social development with better control of inflation and an economic environment favorable to private initiative. It has the clear mandate of the electorate for this strategy, and has just laid out its 1986 program, centered around a large reduction of the operational deficit of the public sector, from 3% of GDP to 0.5%. For the longer run, it has set a target of average annual rates of GDP growth of 6%, and a shifting role for the public sector.

12. We believe that Brazil could maintain an annual growth rate of about 5% over the next 5-10 years without additional major policy initiatives, even with some slippage in the extent of the Government's intended control of the fiscal deficit. Brazil has a large, generally efficient economic system, and businessmen who have demonstrated their capacity to respond to opportunities, to reduce costs to meet competition, and to adapt to changing circumstances. In addition, the present Government, like its predecessors, is pragmatic and is willing to take steps, as needed, to correct problems which threaten to undermine the economy. For the 5%, "low-growth", scenario to hold, the Government would have to maintain efforts to control inflation, although no major reduction is foreseen, and would have to follow an exchange rate policy of periodic devaluations at least equivalent to the difference between domestic and international inflation.

13. With more comprehensive policy reform, we believe that higher GDP growth would be possible if accompanied by moderate infusions of new foreign borrowing. The adjustment program recommended below (and in Annex IIA) would raise GDP growth to 7% on average. It is characterized as the "moderate-growth" scenario. If trade reform is added to this adjustment program (see para. 15 and Annex IIB), GDP growth rates of 8% per year--the "high-growth" scenario--would be possible with the support of additional foreign resources. Both scenarios contrast sharply with the 5%, "low growth" scenario, which reflects a smaller adjustment program spread over a longer period and less foreign borrowing.

Macro-Economic and Sectoral Policies

14. The key sectoral policies required to implement the "moderate-growth" scenario are summarized in the following paragraphs, and specified in more detail--including the required timing--in the Policy Matrix in Annex IIA and in the Sectoral Policies Summary in Annex III.

15. Industry and Trade. Domestic markets for Brazilian manufacturers are protected by often high nominal tariffs and extensive non-tariff barriers, even after substantial reforms in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Implicit effective protection, as measured by direct price comparisons, is on average moderate (44% in 1980-81, according to the most recent study). There has been impressive recent growth in manufactured exports, which increased from US$6.6 billion in 1979 to US$15.1 billion in 1984. The key policy requirement for further export

expansion and efficient import substitution is an exchange rate policy which will maintain international competitiveness for Brazilian products. The present commitment to an exchange rate policy of periodic devaluations equal to domestic inflation appears appropriate; at a minimum, the present parity between the cruzeiro and U.S. dollar should be maintained in real terms. Other measures should include some simplification of import regulations, further improvements to the drawback system, and, as indicated in the following paragraph, "free trade" policies for key agricultural products. With these policies, Brazilian export growth is expected to be sufficient to generate trade surpluses of US$12-15 billion per year for the rest of the decade and to permit a substantial increase in non-oil imports, when combined with additional foreign borrowing. While this program is being implemented, we would continue to encourage the Brazilians to proceed with the broader package of trade policy reforms envisaged within the "high-growth" scenario and spelled out in Annex IIB.

16. Agriculture. Agricultural expansion is fundamental for achieving the production and export increases of the "moderate-growth" option. Agricultural growth has been erratic--5% annual growth rates in the 1970s were followed by stagnation of output in the early 1980s--and Government policies in the sector have been characterized by costly credit programs to compensate for adverse trade and pricing policies, as well as periodic market interventions to stabilize domestic supply and prices. The key to realizing the sector's full potential is a policy framework that will make agriculture profitable without credit subsidies, interventionist trade policies and production-based taxation. This process was initiated when the Government decided in 1983, in the context of the First Agriculture Sector Loan, to phase out negative real interest rates on rural credit. The proposed program for agriculture would further reduce credit subsidies and finance those remaining through the fiscal budget; phase out food price controls and the wheat subsidy (while implementing targeted food assistance programs); rationalize trade regulations for agricultural commodities; and promote the rapid growth of production and exports through free-trade policy for key agricultural products, subject to minimum price guarantees, market safeguards and Government stock management. Provision would also be made for reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

17. Energy. Over the past decade, by accelerating petroleum exploration and production as well as by promoting energy substitution and conservation, Brazil has significantly reduced its oil imports from US$10-11 billion in 1980-82 to about US$5 billion in 1985. Because of the weak international oil market and the country's resource constraints, further import substitution and conservation of energy products, which will help increase production and reduce imports, must be cost-effective. Consequently, Brazil's strategy for the energy sector should focus on appropriate pricing policies, especially for petroleum products, alcohol, and electricity, to better reflect economic costs, coordination of energy investments being made or regulated by the Government, and systematic application of economic criteria to investment decisions. A coordinated investment and financial rehabilitation plan for the power sector, which has been approved by the Government and is now being appraised as the framework for the proposed FY87s Power Sector Loan, would insure adequate provision of electricity to support the country's growth without further draining Government resources.

18. Investment and Savings. Public sector adjustments are critical to the national investment and savings effort. Reducing Government claims on resources through elimination of the public sector deficit and improving the operation of the public sector, including the public enterprises, already have high priority in the Government's program. The systematic screening and monitoring of Federal investments by the Planning Ministry, and the strengthening and selective privatization of public enterprises are being planned, with Bank assistance. At the same time, appropriate industrial, agricultural, and trade policies (see paras. 15-16), provision of tax incentives for private investment, and freer allocation of credit should help to stimulate private sector expansion. The public share of total investment is expected to decline, from an estimated 32% in 1984-85 to 26% by 1990. And with the elimination of the public sector deficit, public savings will more adequately cover public investment.

19. Stabilization. The proposed policies in this area would be directed towards progressively reducing inflation. The program would include, inter alia, a substantial reduction of the public sector deficit and of the rate of increase of the domestic public debt, to levels consistent with the desired gradual reduction in inflation and with the credit availability required for the financing of private investment; the maintenance, on a continuous basis, of monetary and incomes policies compatible with increased internal stability; and the preparation and implementation of a program for dealing with the price stabilization problems posed by the widespread indexation of the Brazilian economy.

20. Balance of Payments. Servicing its large external debt is a major consideration in Brazil's balance of payments strategy. Resumption of growth at rates averaging about 7% per year would raise the demand for imports and consequently add to the pressure on foreign exchange earnings. The country's balance of payments strategy, therefore, must include the following components:

(a) Continued rapid export growth, through an exchange rate policy which at least maintains in real terms the present parity between the cruzeiro and the U.S. dollar, and adoption of other trade measures stated above.

(b) Continued rescheduling of commercial bank and Paris Club debt coming due through the end of the decade, at terms--for both rescheduled and new debt--which are in line with its debt servicing capacity. Brazil would benefit most from a reduction in the spread (now at 2% over LIBOR) on commercial bank debt, since each percentage point drop in the interest rate would yield savings of about US$800 million annually. However, the maturity and grace periods of the restructured debt should not be less than in the 1984 agreement (9 and 5 years, respectively).

(c) Development of a medium-term strategy for new external borrowing (official and commercial) which is consistent with the country's growth strategy and its ability to repay.

(d) Reexamination of Government incentives to foreign private investment, which has dropped from US$1.5 billion in 1979 to less than US$1.0 billion in 1984-85.

21. Fiscal and Financial Reform. Brazil's financial and fiscal systems no longer meet the needs of a country which must increase its savings and investment rates substantially, relying on the private sector as the major productive agent, and must manage both stabilization and growth in a complex economy. The reforms in this area are critical for improving resource mobilization and allocation to support agricultural and industrial growth, and for increasing the Government's fiscal and monetary control over a system which has become unwieldy and virtually impossible to understand in entirety. Among the recommended changes--some of which are already being implemented by the Government--are the consolidation of all fiscal expenditures in the Federal Budget; the separation of the Central Bank and the Bank of Brazil functions; the progressive elimination of the prevailing segmentation of credit markets; and tax reforms directed toward channeling savings toward productive investment through encouraging the long-term holding of financial assets, while reducing the overly large disparities in taxation across income levels and types.

22. Public Sector Management. The existing management problems within the public sector stem from public sector expansion in the 1970s. Since 1980, the Government has made numerous efforts to bring expenditures, including those of the large state enterprise sector, under better control. The objectives in this part of the program are to improve the overall efficiency of the public sector by establishing a Treasury Secretariat in the Finance Ministry, which would have operational control of the unified fiscal budget; strengthen the Planning Ministry's departments dealing with the planning and monitoring of public investment and current expenditures; undertake operational audits and action plans to improve the efficiency of public enterprises; and improve economic information and accounting control systems.

23. Social Development. A major casualty of the recession and debt crisis has been the social programs, including poverty alleviation and reduction of regional disparities. The program in this area would be aimed at restoring appropriate levels of education and health services, and improving their cost efficiency; and at improving the productivity and income levels of the Northeast population, in both urban and rural areas. The priority to be attached to these areas would be in line with the proposed shift in emphasis, within the public sector, from productive activities to infrastructure and social services, and with the parallel enhancement of the private sector as the main agent for the development of productive activities.

D. Action Plan for 1986

1986 Government Program

24. The Government has initiated an economic program for 1986 to promote increased stability with growth and a sound balance of payments position. It provides for, inter alia: (a) a 6% GDP growth rate; (b) periodic devaluations equivalent to domestic inflation; (c) limitation of

the real annual rate of increase of domestic public debt to 6%; (d) reduction in the operational deficit of the public sector from about 3.0% of GDP in 1985 to 0.5% in 1986; (e) a US$12.5 billion trade surplus and a US$600 million current account deficit; and (f) a 160% monetary expansion. The 1986 public sector budget assumes an inflation of 140% from December 1985 to December 1986.

25. The reduction in the operational deficit of the public sector would leave small residual deficits in the central, state and local government accounts and a balance in those of the state enterprises as a whole, decentralized agencies, and other funds and programs. The improvements would be secured by increases in taxation and public sector tariffs, the sale of state enterprise assets (with initial provision for the privatization of 13 enterprises plus sales of shares in 4 of the largest companies), and the rationalization of public expenditures. Part of the total savings would be offset by increased expenditures for social priorities to improve nutrition, general food supply and other basic needs and make better provision for agrarian reform, irrigation and other Northeast development projects, and for urban public transport.

26. We are now in the process of assessing the program. It is a serious program and, if sustained, would reduce public sector pressures on the system and contribute positively to the stabilization process, allowing for at least some reduction in real interest rates and setting the stage for a gradual reduction in inflation. The potential problems include the political difficulties, in an election year, of securing all the proposed adjustments; the crop failures in 1985-86 which have already raised agricultural prices and which will increase agricultural imports by over US$1.0 billion; and the possibility of capacity constraints in some industrial sectors while investment in new capacity is still low. Since the target inflation rate appears to be too optimistic, the monetary expansion target would not be consistent with GDP growth of 6%. At the same time, real wage growth, which was estimated at about 10% in 1985, needs to be held to the rate of productivity growth. Finally, other measures to encourage new private sector investment may be needed to supplement the expected reduction in the real rate of interest. Already, the Government has doubled the depreciation allowance for investment in new plant and equipment this year and the next.

27. Since, as indicated above, several aspects of the 1986 program need to be examined further, we have agreed with the Government to undertake a joint review of the program with a view to eliminating inconsistencies. This review should be completed in February, would include, inter alia, revised fiscal and balance of payments estimates, and would be discussed by us with Fund staff.

28. It should be noted also that inflation in January reached 16.2% after accelerating in November and December to a monthly rate of 13%, which areabove the already high rates prevailing in the same months of the previous year (on average, 11% per month). This acceleration has been caused mainly by a substantial real increase in food prices, determined by weather-affected, greatly-reduced crops in the South and Southeast of Brazil. The Government expects to bring food prices down to lower levels by next March, through a substantial increase (of more than US$1 billion)

in food imports. We have indicated to the Government that if the upward trend of price increases is not reversed soon, other corrective measures would have to be adopted. The situation in this respect will also be examined during the joint review referred to in the previous paragraph, and the conclusions of this analysis will be incorporated in the final draft of this paper.

Other Recommended 1986 Actions

29. The 1986 action plan also includes the following proposed sector policies in agriculture, industry and trade, energy, financial and fiscal reform, public sector management and investment, and external debt management. All are components of the proposed medium-term adjustment program. Measures to be implemented after 1986, with the proposed timing, are listed in Annex II.

Agriculture

-Introduction of free trade policy for key 1986-87 crops, within defined price limits.

-First stage of the phase-out of food price controls and wheat subsidy, and implementation of targeted food assistance programs.

-Rationalization of trade regulations for agricultural commodities.

-Budgetary provision for costs of remaining interest rate subsidies.

Industry and Trade

-Maintenance of present exchange rate policy.

-Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making.

Energy

-Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect economic costs and promote efficient energy production and use.

-Financial rehabilitation of the power sector, together with balanced resource allocation and improved system reliability.

-Reassessment of the alcohol program, including, in particular, the improvement of agricultural and industrial productivity in existing alcohol facilities.

Fiscal and Financial Reform

-Budget consolidation with budgetary provision for wheat, sugar, and agricultural credit subsidies.

-Transfer of decentralized funds to Treasury budget.

-*De facto* separation of functions between the Central Bank and the Bank of Brazil, and preparation of a law to formalize such separation.

Public Sector Management and Investment	-Improved operational control of budgetary operations, through Treasury Secretariat and SEPLAN.
	-Strengthening and expanded operation, in SEPLAN, of investment planning and project evaluation mechanisms.
	-Introduction of system for performance evaluation of public enterprises, development of rehabilitation programs, and selective privatization measures.
	-Annual Government-monitored program of public sector investment with reference to multi-year investment program.
Private Investment and Savings	-Promotion of investment efficiency through sectoral adjustment policies for agricultural, industry and trade, and energy (above).
	-Encouragement of increased private savings and investment through banking, financial, and stabilization measures (above).
External Debt Management	-Rescheduling of principal on commercial bank and Paris Club debt falling due in 1986 on terms commensurate with ability to repay, and preparation for a subsequent rescheduling agreement covering payments falling due in 1987-90.
	-Planned annual program of official and commercial borrowings.

E. The Brazilian Position

30. Many of the key policy directions suggested in this paper have been discussed extensively by Bank staff with the Brazilian authorities, with positive results, in connection with proposed Bank loans. We have reached agreement on most aspects of the programs proposed for 1986--and on most of the overall objectives for the longer term--concerning Agriculture, Energy, Public Sector Investment, Fiscal and Financial Reform, Public Sector Management (including, in particular, mechanisms and procedures for screening and monitoring public investment) and Social Development. There are, however, some policy areas in which no decision has been taken yet by the Government, or in which the adopted decisions do not go far enough. These include trade policy, particularly concerning the manufacturing sector, and fuel prices--on which disagreements may emerge in the near future--and policy issues (referred to in para. 33 below) which we have not yet discussed fully with the Government. Further discussions are also proceeding on the Government's stabilization policy (see para. 34 below).

31. The most important remaining long-term issue concerns trade policy aspects related mainly to the manufacturing sector. We had reached agreement on the full program included in Annex IIB with a Working Group formed by the Government to prepare the proposed Export Development II project. At the political level, however, the question has become controversial. The Ministry of Foreign Affairs has indicated that any unilateral decision on trade policy now would undermine Brazil's position in the GATT and other trade talks. The industrial establishment has traditionally been opposed to liberalized trade, although its views are probably changing with the increased importance of exports and better knowledge of anomalies which benefit some manufacturers at the expense of others. Policy reform in this area is likely to be slow; however, as explained above, satisfactory growth and creditworthiness improvements can occur without such a reform in the next several years. As was noted above, the Government has agreed in principle--in connection with the proposed Agricultural Sector Loan--to establish "free trade" for agricultural products and to undertake other policy reforms in that sector, all of which should encourage substantial increases in agricultural production and exports. Taking into account this overall situation, we propose to proceed with the "moderate-growth" scenario and with the levels of external financial support--from the Bank and other sources--associated with it. If, and only if, the Government decides to undertake a comprehensive trade policy reform, we would consider the "high-growth" scenario as viable, and would be prepared to recommend the higher level of external financial support consistent with it.

32. In another major policy area the Government has now corrected--or has a plan to correct--most of the distortions introduced by the freeze of public sector prices adopted for several months earlier this year. One important exception to this is the price of petroleum derivatives, some of which (fuel oil, naphtha, and LPG) are still below international levels.

33. Other structural issues which have not yet been discussed fully with the Government include the required incentives for private investment and savings (on which additional ESW would be required, particularly concerning tax policy), and the ways to proceed concerning external debt management and incentives to foreign investment. We are now discussing the time-phasing of the reduction of agricultural credit subsidies with the Government, in the context of an agricultural credit project, several Northeast rural development projects, and the proposed Agricultural Sector Loan. (A decision in this matter is expected within the next few weeks and will be included in the final draft of this paper.)

34. As explained above, we are in the process of assessing the Government's 1986 economic program, which adopts a gradual approach to reducing inflation. It is our preliminary conclusion that, at best, the 1986 program would hold inflation to its present level, with a gradual reduction to follow beginning in 1987, once the effects of the 1986 reduction of the fiscal deficit--including an expected substantial increase in the availability of savings for financing private investment--are fully felt. There are clear risks in this strategy. The political demands in this election year could weaken the Government's resolve for fiscal

restraint, although some cushion has apparently been built into the deficit targets to allow for higher Government spending. In addition, the occurrence of more unexpected shocks outside the Government's direct control, such as the 1985 drought in the South, could make it difficult to stabilize inflation at present levels. A major acceleration in inflation would clearly undermine the gradualist approach. If such an acceleration does occur, there is growing recognition within the country that more drastic approaches, including monetary reform and a major change in the indexation system, would be needed. We would support such a position, if the gradualist approach is not effective. It should be noted, however, that, because of the possible effects on financial markets, the Government is not likely to accept publicly now, domestically or vis-a-vis the international community, that such an alternative could be considered in the foreseeable future.

F. Growth Scenarios

35. The choice for Brazil is not growth or stagnation. Rather, it is how much growth to strive for. The recommended adjustment program would permit Brazil to grow rapidly enough to make up for the recent drop in employment and living standards to continue the economic progress begun in the 1970s, but would require a strong political will.

36. As noted earlier, Brazil's economy has the potential to grow about 5% per year over the next 5-10 years, without the Government undertaking any major additional policy reforms beyond the directions indicated in its 1986 program. No "new money" would be likely to be obtained from commercial banks, and the Bank's annual lending program would be reduced from present levels of US$1.5 billion to about US$1 billion per year or less. Therefore, in this "low growth" alternative, Brazil would need to run a positive current account balance as well as a large trade surplus to service its external debt. Exports would grow modestly. With an export growth rate averaging 2.4% in real terms between 1985-90, a moderate increase in non-oil imports would be feasible as long as Brazil continues an active energy substitution program and reduces oil imports in real terms. Creditworthiness indicators would improve substantially. However, although consumption per capita would increase about 3.2% annually, no significant reduction in unemployment and underemployment would occur. Because of this, we believe that the "low-growth" option, even if theoretically feasible in economic terms, would not be viable politically over the medium term.

37. The recommended adjustment program, together with larger inflows of new foreign resources, would stimulate faster economic growth in a more stable domestic environment. This scenario is characterized as the "moderate-growth" option. "New money" and increased agricultural and manufactured exports would permit higher imports and investment. Major employment and social gains would be possible, with a growth in per capita consumption of about 4.4% per year. Rapid growth would also strengthen the capacity to service the debt. Traditional creditworthiness indicators,

while improving by a third over the decade, are not substantially better than in the "low-growth" option. In this "moderate-growth" option, the country is incurring more debt to support the structural adjustment process and to raise more quickly the living standards of the population. In general terms, however, Brazil's creditworthiness--as reflected in the Government's readiness to adopt needed policy reforms to promote growth, stabilization, and external balance--is significantly improved. (The scenario is, of course, contingent on an accommodating external environment, particularly no increase in protectionism in OECD countries.)

38. If the Government proceeds more quickly with the proposed trade liberalization measures than is now expected, the economy could grow even faster. The "high-growth" option shows GDP growing at 8% per year, and per capita consumption, at 5.2% per year. The additional opening of the economy, with high export and import growth, would provide the vehicle for raising productivity and investment further. Larger net foreign capital inflows from multilateral, bilateral, and private sources to support trade liberalization would facilitate the process. As in the "moderate-growth" option, the country's creditworthiness would improve at a satisfactory rate.

39. Inflation in both the "moderate-" and "high-growth" scenarios is assumed to be moderating, with a gradualist stabilization program. If such an approach proves to be ineffective, more radical steps, such as a substantial modification to the indexation system and monetary reform, would be needed and the growth projections would have to be revised downward for at least a year, to take the adjustment into account. The difference in growth rates across the three scenarios reflects growing economic efficiency, which are expected to follow from the adoption of policy and institutional reforms. Therefore, the long-run ICOR falls from about 3.8 in the "low-growth" option to 3.2 in the "moderate-growth" and 2.9 in the "high-growth" options. As the adjustment effort intensifies, more foreign borrowing not only would be beneficial to growth but would also soften the domestic adjustment effort required.

G. The Role of the IMF

40. An IMF stand-by agreement to replace the Extended Fund Facility has not materialized, so there is currently no formal arrangement for IMF monitoring of fiscal, monetary and balance of payments performance. The Government has indicated that (for the present) it does not intend to pursue stand-by arrangements, although it is keeping the Fund informed on matters of economic policy and the implementation of its program. We would seek to maintain close cooperation with the Fund in implementing our proposed country program, both on operational matters such as the fiscal and monetary provisions required for programs supported by the Bank and the wider policy and management issues of common interest and concern.

41. Fund participation in the assessment of Brazil's economic program would facilitate the Government's negotiations with the international banking community and the Paris Club. After substantial "involuntary lending" in 1983 and 1984, commercial banks did not have to consider "new money" for Brazil in 1985 because of its improved balance of payments position. Independent of "new money", however, Brazil needs to reschedule the existing debt of commercial banks, probably at least until 1990. The banks had until recently maintained that, if they were to reschedule existing debt or make new commitments, Brazil would need to agree to a stand-by arrangement with the Fund. Now, it appears probable that a one-year agreement will soon be reached with the banks to reschedule the 1985 debt and roll over 1986 debt until early 1987.

42. The Government intends to begin negotiations to reschedule its official bilateral debt after completing the rescheduling agreement with commercial banks. In anticipation of such an agreement with Paris Club creditors, the Government has stopped payments on bilateral debt. Usually, rescheduling is conditional upon an IMF agreement. Therefore, the absence of a Fund agreement will probably complicate the negotiations.

H. Monitoring

43. The proposed procedures for assessing the Government's policies are described below. Our evaluation of the Government's short- and medium-term economic program would provide the framework for Bank lending, and could also be used by the Government in its discussions with commercial banks on co-financing. Subsequent assessment of the Government's program would proceed at two levels:

(a) Before submitting a policy loan to the Board, Bank staff would review Brazil's economic performance, to ascertain whether the program is on track. A positive conclusion would be needed in order to submit each policy loan to the Board.

(b) Specific policy reforms would be supported by individual loans, such as those reported in the following table:

Policy Area	Monitoring Instruments
A. Industry and Trade	Export Development Loans* Industrial Restructuring Loans
B. Agriculture	Agriculture Sector Loans Agriculture Credit Loans

C. Energy	Power Sector Loans Transportation Sector Loans
D. Investment and Savings:	
1. Public Sector Investment and Savings	Public Sector Management Loans Public Sector Review missions Overall Bank economic assessments IMF reporting
2. Private Sector Investment and Savings	Overall Bank economic assessments IMF reporting
E. Balance of Payments	Overall Bank economic assessments IMF reporting
F. Fiscal and Financial Reform	Financial Sector Reform Loans
G. Public Sector Management	Public Sector Management Loans
H. Stabilization	IMF reporting
I. Social Development	Education Sector Loans Health Sector Loans Northeast Rural Devt. Loans Northeast Small and Medium Scale Industry Loans

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* Under the "high-growth" option only.

44. The overall economic assessment of the program and the periodic evaluation of progress in its execution would be undertaken by economic missions, including public investment and sectoral missions. The work is expected to be done in close coordination with IMF staff. The monitoring to be performed by the Bank, in connection with proposed loans, would also be used to recommend cofinancing for specified priority projects.

45. Whenever possible, the policy loans would be based upon policy actions taken before Board presentation, with further progress being a condition for processing subsequent loans in the sector (and for maintaining the level of the expanded overall lending program). In a few instances, as in the proposed FY86 Agricultural Sector Loan, the loan would be disbursed in two tranches, with policy conditionality attached to both of them.

I. Financing Requirements

46. Increased external support would be essential to the success of the medium-term adjustment program under the "moderate-" and "high-growth" options. Under the "low-growth" scenario, Brazil would need only about US$1.0 billion per year in medium- and long-term net capital inflows over the next five years. Since we are not sure that commercial banks would resume lending to Brazil under this "low-growth" scenario, we have assumed that the multilateral and bilateral institutions would provide most of the required new resources. Faster growth with adjustment, as described in the "moderate-growth" option, would require on average an additional US$4.1 billion per year in net disbursements--US$0.6 billion from the World Bank, US$2.5 billion from commercial banks, and US$1.0 billion from other sources. If even higher GDP growth is attained (the "high-growth" option), an additional US$1.0 billion per year in net M&LT inflows would be needed. (Alternatively, Brazil could choose to maximize exports but, instead of raising GDP growth to 8%, could opt to reduce the rate of debt accumulation. In our view, this is not the preferred option, since rapid employment growth is important and the country's creditworthiness position improves substantially even with more borrowing.) Annex I provides the details for this section.

47. World Bank Financing. The Bank's support is based on a graduated-response posture. Annual lending in 1986-90 varies between US$1.0 billion under the "low-growth" option and US$2.0 billion under the "moderate-growth" alternative. These commitment levels would be consistent with average annual gross disbursements of, respectively, US$1.1 and US$1.7 billion from the entire Brazil loan portfolio, and annual net disbursements of US$0.4 and US$1.0 billion. The proposed lending under the "low-growth" option would make the Bank's relative exposure in Brazil decline to below 10% of our overall portfolio by 1990, while under the "moderate-growth" scenario, Brazil's share in the Bank portfolio would increase to slightly over 11%. The specific lending level for each year would depend upon the degree to which the required reforms are adopted and implemented, and would in practice be determined by the extent to which policy reforms associated with specific loans are put into effect. Co-financing would be an important component of an expanded program, in order to attract commercial bank funds for priority projects.

48. The Bank's current program for Brazil envisages an annual US$1.5 billion lending level. The program for FY86-87 includes three large quick-disbursing loans, for a total amount of US$1.2 billion. All other operations in the program are more traditional, and slower-disbursing, project and sector loans. Most of the increase required to reach the expanded US$2.0 billion level referred to above would come from additional policy-based operations, including additional agricultural sector loans, sectoral financial rehabilitation loans, and possibly industrial restructuring operations. The additional lending would also include increases in our program for education (particularly vocational training) and health to support the social content of the adjustment program.

49. If the Brazilian Government is also willing to commit itself to a comprehensive program of trade reform in addition to the other policy changes, then Bank lending levels could reach US$2.5 billion per year (the "high-growth" scenario). A series of policy-based loans in support of trade reform would be added to the lending program. These lending magnitudes would increase the Brazilian share of the overall Bank portfolio to 13% by 1990.

50. Other Sources of Financing. The "low-growth" option requires virtually no "new money" from commercial banks and a very low level of net inflows from other sources. As indicated above, however, to maintain a growth rate high enough to reduce unemployment and underemployment substantially, Brazil would indeed need net medium-term financing from the commercial banks (as well as adequate short-term credit lines). According to the "moderate-growth" projections presented in this paper, such inflows should reach an average annual level of about US$2.6 billion in 1986-90, which would be equivalent to a 3.5% annual increase in their nominal exposure (but to about a 4% reduction of their exposure in real terms). It is also estimated that the "moderate-growth" option would require about US$1.5 billion per year in net inflows from suppliers, official export agencies and the IDB, and about US$1.1 billion per year in foreign direct investment. IDB lending to middle-income countries like Brazil, while constrained by present institutional policies, is assumed to expand substantially. Under the "high-growth" option, net new commercial bank lending would average almost US$3.0 billion per year for the next five years, and net inflows from other sources (apart from the World Bank), about US$1.7 billion.

Table 1. BRAZIL--HISTORICAL DATA

		1980	1981	1982	1983	1984	1985*
Real GDP Growth Rate Per Annum		7.2	-1.6	0.9	-3.2	4.5	7.0
Debt to Exports Ratio 1/		3.2	3.1	4.1	3.9	3.4	3.7
Interest Payments to Exports Ratio (%) 2/		34.0	40.3	52.1	43.4	37.0	39.9
Total Debt to GDP Ratio (%) 3/		27.9	28.9	31.9	44.3	47.2	47.2
Interest Payments to GDP Ratio (%) 4/		3.0	3.7	4.4	4.9	5.4	5.1
Debt Service Ratio (%) 5/		64.2	69.1	90.7	58.4 6/	72.3	80.5
Terms of Trade (1983=100)		119.8	111.8	106.6	100.0	107.7	113.1
Real Growth Rates of:	Imports	-12.3	-5.3	-13.4	-20.7	-0.3	4.4
	Exports	23.6	21.6	-10.4	15.3	25.9	-2.3
Current Account Deficit (US$ Billions)		-12.4	-11.0	14.8	-6.1	.5	-1.3
Interest Payments (US$ Billions)		7.5	10.3	12.6	10.3	11.4	10.9

1/ Total debt, including short-term, as a proportion of Exports of Goods and NFS

2/ Total interest payments, including short-term, as a percentage of Exports of Goods and NFS

3/ Total debt, including short-term, as a proportion of GDP

4/ Total interest payments, including short-term, as a percentage of GDP

5/ Total interest payments plus amortization on M&LT debt as a percentage of Exports of Goods and NFS

6/ Includes only amortization actually paid.

* Estimate

Table 2: BRAZIL - PROJECTIONS OF KEY VARIABLES - "HIGH GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	8.0	8.0	8.1	8.1	8.1	8.0
GDP per Capita - 1985 $US	1553.9	1642.4	1736.4	1836.0	1943.7	2058.2	2734.7
GNP Growth Rate	7.2	9.4	8.6	8.5	8.4	8.5	8.2
GNP per Capita - 1985 $US 1/	1468.4	1571.9	1670.5	1772.9	1881.9	1999.0	2680.0
Consumption per Capita Growth Rate	6.4	4.9	4.4	5.3	5.1	6.6	5.8
Private Investment to GDP Ratio	12.3	14.4	16.1	16.9	17.7	17.7	17.7
Public Investment to GDP Ratio	5.7	5.6	5.9	6.1	6.3	6.3	6.3
Public to Private Investment Ratio	46.3	38.9	36.6	36.1	35.6	35.6	35.6
Private Savings to GDP Ratio	14.6	14.7	15.6	15.9	16.7	16.7	17.4
Public Savings to GDP Ratio	2.8	4.8	5.6	6.1	6.3	6.3	6.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	12.3	12.4	13.3	14.6	16.8	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	5.3	6.5	7.3	7.9	8.2
Exports of GNFS/GDP (%)	12.7	12.1	11.8	11.8	11.8	11.9	11.8
Imports of Goods Real Growth Rate	4.4	21.6	21.9	16.3	14.8	11.9	8.4
Imports of GNFS/GDP (%)	7.8	8.3	8.9	9.3	9.6	10.0	10.0
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.5	109.8	116.0	122.9	130.9	161.0
DOD/GDP (%) 4/	47.2	42.2	38.4	34.9	31.8	29.1	19.5
DOD/X Ratio	3.7	3.5	3.2	3.0	2.7	2.4	1.7
DS/X (%)	80.5	79.5	72.4	63.9	59.0	49.3	29.4
Interest Payments/GDP (%) 4/	5.1	3.9	3.5	3.2	2.9	2.6	1.8

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

TABLE 3: BRAZIL FINANCING REQUIREMENTS AND SOURCES (HIGH GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,233)	(2,405)	(3,321)	(3,882)	(4,265)
Direct Foreign Investment (Net)		807	792	1,275	1,457	1,737	1,916
MLT	Gross Disbursements	10,625	15,632	17,845	18,824	19,854	19,764
	Amortization	9,593	12,033	12,583	12,597	12,821	11,516
	Net Disbursements	1,032	3,599	5,262	6,227	7,033	8,248
1) World Bank	Commitments	1,500	2,500	2,500	2,500	2,500	2,500
	Gross Disbursements	800	1,646	2,126	2,216	2,297	2,387
	Amortization	400	418	542	637	931	1,170
	Net Disbursements	400	1,228	1,584	1,579	1,366	1,217
2) Other Multilateral	Commitments	275	800	800	800	800	800
	Gross Disbursements	297	290	366	456	572	662
	Amortization	136	157	173	186	214	260
	Net Disbursements	161	133	193	270	358	402
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,400	1,400	1,400
	Gross Disbursements	1,093	1,646	1,420	1,478	1,460	1,443
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	817	767	744
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,500	1,600	1,600	1,650	1,650
	Gross Disbursements	1,565	1,510	1,705	1,704	1,673	1,650
	Amortization	1,142	975	882	902	899	958
	Net Disbursements	423	535	823	802	774	692
6) Commercial Banks(1)	Commitments	6,797	10,470	12,180	12,952	13,842	13,615
	Gross Disbursements	6,797	10,470	12,180	12,952	13,842	13,615
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	930	1,939	2,843	3,855	5,282
Other Capital		(200)	(1,600)	(1,968)	(2,285)	(2,785)	(3,478)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(1,022)	(1,238)	(1,389)	(1,537)	(1,926)
Net Flows (as percentage of GDP)		0.482	1.454	1.838	1.873	1.817	1.832

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 4: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (HIGH GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,533	7,117	8,696	10,062	11,279
Other Multilateral	1,942	2,075	2,268	2,538	2,896	3,298
Official Export Credits	6,256	7,068	7,851	8,668	9,435	10,179
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,450	8,273	9,075	9,849	10,541
Commercial Banks	66,467	67,397	69,336	72,179	76,034	81,316
Total Medium and Long-Term DOD	89,581	93,180	98,442	104,669	111,702	119,950

Table 5: BRAZIL - PROJECTIONS OF KEY VARIABLES - "MODERATE GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	7.1	7.1	7.1	7.1	7.1	7.2
GDP per Capita - 1985 $US	1553.9	1627.8	1705.5	1787.2	1874.8	1967.0	2505.9
GNP Growth Rate	7.2	8.4	7.6	7.5	7.4	7.5	7.4
GNP per Capita - 1985 $US 1/	1468.4	1557.3	1639.5	1724.5	1813.9	1909.2	2453.5
Consumption per Capita Growth Rate	6.4	4.0	4.3	4.3	4.2	5.4	5.1
Private Investment to GDP Ratio	12.3	14.4	15.2	16.0	16.9	16.9	17.7
Public Investment to GDP Ratio	5.7	5.6	5.8	6.0	6.1	6.1	6.3
Public to Private Investment Ratio	46.3	38.9	38.2	37.5	36.1	36.1	35.6
Private Savings to GDP Ratio	14.6	14.6	14.9	15.3	16.0	16.3	17.3
Public Savings to GDP Ratio	2.8	4.8	5.5	6.0	6.1	6.1	6.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	12.3	13.1	14.2	15.7	18.1	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	4.0	4.6	5.3	5.9	7.3
Exports of GNFS/GDP (%)	12.7	12.2	11.9	11.7	11.5	11.5	11.4
Imports of Goods Real Growth Rate	4.4	21.5	12.9	11.3	10.7	8.6	7.8
Imports of GNFS/GDP (%)	7.8	8.4	8.6	8.9	9.1	9.2	9.7
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.7	109.1	114.5	120.8	126.8	155.8
DOD/GDP (%) 4/	47.2	42.7	38.8	35.4	32.4	29.5	20.6
DOD/X Ratio	3.7	3.5	3.3	3.0	2.8	2.6	1.8
DS/X (%)	80.5	79.6	73.6	66.0	61.7	52.8	31.9
Interest Payments/GDP (%) 4/	5.1	4.0	3.6	3.3	3.0	2.6	1.9

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

TABLE 6: BRAZIL FINANCING REQUIREMENTS AND SOURCES (MODERATE GROWTH OPTION
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,503)	(1,660)	(2,284)	(3,052)	(2,621)
Direct Foreign Investment (Net)		807	794	879	1,063	1,247	1,429
MLT	Gross Disbursements	10,625	15,542	16,993	17,909	19,073	17,175
	Amortization	9,593	12,032	12,583	12,597	12,770	11,405
	Net Disbursements	1,032	3,510	4,410	5,312	6,303	5,770
1) World Bank	Commitments	1,500	2,000	2,000	2,000	2,000	2,000
	Gross Disbursements	800	1,348	1,626	1,716	1,797	1,887
	Amortization	400	418	542	637	889	1,086
	Net Disbursements	400	930	1,084	1,079	908	801
2) Other Multilateral	Commitments	275	275	500	500	500	500
	Gross Disbursements	297	280	315	351	404	446
	Amortization	136	156	173	186	214	241
	Net Disbursements	161	124	142	165	190	205
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,300	1,300	1,300
	Gross Disbursements	1,093	1,646	1,420	1,448	1,380	1,343
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	787	687	644
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,400	1,600	1,600	1,600	1,600
	Gross Disbursements	1,565	1,480	1,655	1,684	1,658	1,600
	Amortization	1,142	975	882	902	890	950
	Net Disbursements	423	505	773	782	768	650
6) Commercial Banks(1)	Commitments	6,797	10,718	11,929	12,692	13,824	11,892
	Gross Disbursements	6,797	10,718	11,929	12,692	13,824	11,892
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,178	1,688	2,583	3,837	3,559
Other Capital		(200)	(1,400)	(1,847)	(2,274)	(2,597)	(2,700)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(865)	(856)	(1,128)	(1,335)	(1,383)
Net Flows (as percentage of GDP)		0.482	1.430	1.569	1.641	1.688	1.341

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 7: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (MODERATE GROWTH OPTION)

(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,235	6,319	7,398	8,306	9,107
Other Multilateral	1,933	2,057	2,199	2,364	2,554	2,759
Official Export Credits	6,256	7,068	7,851	8,638	9,325	9,969
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,420	8,193	8,975	9,743	10,393
Commercial Banks	66,467	67,645	69,333	71,916	75,753	79,312
Total Medium and Long-Term DOD	89,572	93,082	97,492	102,804	109,107	114,877

Table 8: BRAZIL - PROJECTIONS OF KEY VARIABLES - "LOW GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	5.0	5.0	5.0	5.0	5.0	5.1
GDP per Capita - 1985 $US	1553.9	1596.8	1640.9	1686.4	1734.9	1784.9	2059.2
GNP Growth Rate	7.2	6.2	5.5	5.5	5.4	5.5	5.3
GNP per Capita - 1985 $US 1/	1468.4	1526.2	1576.0	1626.2	1678.4	1733.6	2022.5
Consumption per Capita Growth Rate	6.4	2.5	3.4	3.3	3.5	3.4	3.2
Private Investment to GDP Ratio	12.3	13.7	13.7	13.7	13.7	13.7	13.7
Public Investment to GDP Ratio	5.7	5.3	5.3	5.3	5.3	5.3	5.3
Public to Private Investment Ratio	46.3	38.7	38.7	38.7	38.7	38.7	38.7
Private Savings to GDP Ratio	14.6	14.2	14.2	14.4	14.6	14.8	14.3
Public Savings to GDP Ratio	2.8	4.3	5.0	5.0	5.0	5.0	5.3
Trade Indicators 2/							
Trade Surplus (US$ billions)	12.1	13.1	14.4	16.0	17.8	19.9	23.3
Exports of Goods Real Growth Rate	-2.3	2.5	2.4	2.4	2.4	2.5	3.3
Exports of GNFS/GDP (%)	12.7	12.4	12.2	12.0	11.8	11.6	10.6
Imports of Goods Real Growth Rate	4.4	12.7	5.3	5.2	5.2	5.2	5.3
Imports of GNFS/GDP (%)	7.8	8.0	8.0	8.0	7.9	7.9	8.2
Creditworthiness Indicators 2/ 3/							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	103.0	104.7	105.7	106.3	106.2	100.7
DOD/GDP (%) 4/	47.2	42.8	38.7	34.6	30.8	27.2	16.2
DOD/X Ratio	3.7	3.4	3.2	2.9	2.6	2.3	1.5
DS/X (%)	80.5	79.5	74.0	66.9	62.7	53.4	29.5
Interest Payments/GDP (%) 4/	5.1	4.1	3.7	3.3	3.0	2.5	1.5

Footnotes:

1/ GNP per Capita was converted into $US using a period average exchange rate. Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

2/ Exports and imports include that of goods and non-factor services.

3/ Debt includes public and publicly guaranteed, private non-guaranteed and short term debt.

4/ Calculation assumes maintenance of the real exchange rate.

TABLE 9: BRAZIL FINANCING REQUIREMENTS AND SOURCES (LOW GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(83)	539	1,352	2,011	3,265
Direct Foreign Investment (Net)		807	798	887	977	966	1,054
MLT	Gross Disbursements	10,625	13,767	14,323	13,589	13,204	11,104
	Amortization	9,593	12,031	12,583	12,597	12,641	11,115
	Net Disbursements	1,032	1,736	1,740	992	563	(11)
1) World Bank	Commitments	1,500	1,000	1,000	1,000	1,000	1,000
	Gross Disbursements	800	1,028	1,051	1,066	1,062	1,057
	Amortization	400	418	542	637	805	920
	Net Disbursements	400	610	509	429	257	137
2) Other Multilateral	Commitments	275	250	250	250	250	250
	Gross Disbursements	297	273	273	273	264	266
	Amortization	136	155	173	186	214	226
	Net Disbursements	161	118	100	87	50	40
3) Official Export Credits	Commitments	1,000	750	750	750	750	750
	Gross Disbursements	1,093	1,481	980	898	780	793
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	647	343	237	87	94
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	850	850	850	850	900
	Gross Disbursements	1,565	1,315	1,155	974	908	875
	Amortization	1,142	975	882	902	845	841
	Net Disbursements	423	340	273	72	63	34
6) Commercial Banks(1)	Commitments	6,797	9,600	10,816	10,360	10,180	8,106
	Gross Disbursements	6,797	9,600	10,816	10,360	10,180	8,106
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	60	575	251	193	(227)
Other Capital		(200)	(1,400)	(1,647)	(1,986)	(2,182)	(2,930)
IMF (Net)		0	(535)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(516)	(593)	(646)	(792)	(883)
Net Flows (as percentage of GDP)		0.482	0.721	0.643	0.325	0.163	(0.003)

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in gross disbursements equal to net disbursements.

TABLE 10: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (LOW GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	4,915	5,424	5,853	6,110	6,247
Other Multilateral	1,970	2,088	2,188	2,275	2,325	2,365
Official Export Credits	6,256	6,903	7,246	7,483	7,570	7,664
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,255	7,528	7,600	7,663	7,697
Commercial Banks	66,467	66,527	67,102	67,353	67,546	67,319
Total Medium and Long-Term DOD	89,609	91,345	93,085	94,077	94,640	94,629

BRAZIL - PROPOSED MEDIUM-TERM ADJUSTMENT AND GROWTH PROGRAM

Moderate-Growth Option

Main Goals: (1) To maintain growth rates in 1986-90 which are high enough to provide employment to new entrants in the labor force, and to a number of currently underemployed workers equivalent to 2% of the labor force per year. Target average growth rate 7% per year.

(2) To improve the country's creditworthiness, consistent with a reduction of the debt to export ratio from 3.7 in 1985 to 2.6 in 1990, and 1.8 in 1995.

(3) To reduce domestic inflation substantially by 1990.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
A. BALANCE OF PAYMENTS								
1. Exchange Rate Policy	Maintain international competitiveness	Devaluation of 30% in 1983; subsequent full adjustment to domestic inflation	+Maintenance of competitive exchange rate policy through periodic adjustments which are at least equal to the difference between domestic and international inflation	*	*	*	*	*
2. Trade Balance	Maintain trade surplus levels consistent with growth and stabilization objectives and with gradual reduction of debt service ratios	Exchange rate policy and other measures required to achieve an annual US$12 billion trade surplus in 1984 and 1985	+Policies on Industry and Trade, Agriculture and Energy (See B, C and D)	*	*	*	*	*
3. Debt Management	Debt rescheduling to reduce adjustment pressures, 1986-90 limited new borrowing in amounts consistent with stability and growth objectives, and with gradual reduction of debt service ratio to sustainable level by around 1990	Annual arrangements for rescheduling principal payment, 1982-85.	+Rescheduling of principal on old commercial debt falling due 1986-90 (multi-year rescheduling, with improvement of terms over the 1984-85 agreement, would be preferable)	*	*	*	*	*
		Controlled and limited new borrowing, 1982-84. No new commercial borrowing 1985.	+Planned annual programs of official and commercial borrowing	*	*	*	*	*
4. Direct Investment	Resumption of direct investment inflows to complement domestic investment	-	+Review of foreign investment and technology transfer policies		*			
			+Policy changes as required			*		

+ Denotes policies essential to adjustment program.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
B. INDUSTRY AND TRADE								
1. Exchange Rate Policy	Maintain international competitiveness .	-	See A.1					
2. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 13% annually, to permit import expansion while covering debt service	Liberalization of duty drawback system for exporters, extension of drawback system on limited basis to indirect exporters and removal of fiscal export subsidy (credito premio)	+Strengthening of export promotion through improvements in quality control and certification; marketing, design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures		*			
			+Simplification of indirect drawback system		*			
			+Elimination of remaining indirect taxes on exports			*		
3. Export Financing	Rationalize and extend financing arrangements for exports	Reduction of subsidy element in pre-shipment export financing	Strengthening of export credit insurance		*			
4. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Elimination of tariff surcharges; reduction in average tariff level and in number of items subject to "suspended imports"; increased flexibility in external financing requirements for imports; liberalization of firms, import programs for annual imports up to US$100,000; increased autonomy to CACEX's field offices; and elimination of foreign credit financing as a criterion for the application of the Law of Similars	+Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making	*	*			
Bank support		(Export Development I, FY84)	ESW on Industry and Trade	*	*	*		

C. AGRICULTURE

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
1. Agricultural Credit	Rationalization of rural credit system	Elimination of negative real interest rates, Center-South (1983) and agreement on reductions in North-Northeast (1985)	+Budgetary provision for costs of interest rate subsidies (equalization costs for Federal and State banks, monetary correction shortfall North-Northeast)	*				
			+Elimination of negative real interest rates in North-Northeast, except special target groups			*		
			+Market interest rates in Center-South, except special areas				*	
			Market interest rates in North-Northeast, except special target groups					*
			+Full fiscal provision for remaining subsidies		*	*	*	*
2. Trade and Pricing	Trade liberalization and development of efficient marketing system	-	+Introduction of free trade policy for 1986-87 crops, within defined price limits	*				
			+Phase-out food price controls and wheat subsidy, implement targeted food assistance programs	*	*	*		
			Reopen access to external futures trading, remove tax on domestic futures trading	*				
			Establish legal/regulatory framework for storage warrants, bankers acceptance matters in bonded agricultural commodities	*				
			+Rationalization of trade regulations for agricultural commodities	*				
			Establish agricultural price data system		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
			+Full free trade arrangements for key agricultural products, subject to minimum price guarantees, market safeguards and government stock management		*		*	
			Start domestic futures market for major agricultural commodities and bankers acceptance trading		*			
			Integrated data systems for CACEX, Central Bank			*		
			Improved crop forecasting and stock information systems		*	*		
3. Taxation	Minimize tax disincentives to agricultural export growth	-	+Reform of system of agricultural taxation			*	*	*
Bank Support		(Agriculture Credit and Export Loan, FY83)	Agriculture Sector II	*				
			Agriculture Credit I	*				
			Agriculture Sector III		*			
			Agriculture Credit II			*		
			Agricultural Credit III					*
			Cofinancing	*	*	*		*
			ESW on Agriculture	*	*	*		
D. ENERGY								
1. Energy Development and Conservation	Cost-effective development of domestic energy resources	Reassessment of energy investment priorities (1985)	Development of a long-term energy efficiency plan		*			
			+Pricing policies promoting efficient domestic energy use	*	*	*	*	*
2. Electric Power	Realistic investment and financial plans and implementation	Formulation and initiation of Investment Program for Financial Plan for 1984-88; real tariff increases	+Financial rehabilitation; balanced resource allocation, improved system reliability, tariffs to be brought into line with long-run marginal costs	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
Bank Support		(Power Transmission, Conservation and Distribution loans, FY85)	Power Transmission		*			
			Power Sector I	*				
			Power Sector II		*			
			Transport Sector I		*			
			Energy Conservation			*		
			Transport Sector II					*
			Cofinancing	*	*			
E. INVESTMENT AND SAVINGS								
1. Public Sector Investment	Program limited, with specified exceptions, to completion of high-priority rehabilitation-recovery programs	Increased supervision of public sector, including state enterprise, investment programs; real reductions in 1983-84.	+Annual Government-monitored program of public sector investment in context of multi-year investment programs (with continuing Bank review and progress reporting)	*	*	*	*	*
			+Channelling of new external funds into key areas of rehabilitation and/or priority new investment	*	*	*	*	*
2. Private Investment	Increase market incentives for private sector investment in new productive assets to support target GDP growth	-	Promotion of investment efficiency through sectoral adjustment policies (see B,C,D)	*	*	*	*	*
			+Encouragement of increased investment through banking and financial reforms (see F.3 and 5) and stabilization measures (H)	*	*	*	*	*
3. Savings	Major increases in savings available for private investment	Reductions achieved in Government spending and deficit financing, 1983-85.	+Stabilization measures further reducing the deficit and the disincentives to save (see H)	*	*	*		
			Preparation of tax measures to promote savings	*				
			Implementation of tax incentives for savings		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
F. FISCAL AND FINANCIAL REFORM								
1. Budget Consolidation	Establish basis for improved fiscal management	Creation of Treasury Secretariat to manage budget transactions	+Budgetary provision for wheat, sugar and agricultural credit subsidies	*				
		Inclusion in 1986 budget of most quasi-fiscal items formerly in the "monetary" budget	+Transfer of decentralized funds to Treasury budget	*				
			+Completion of process of budget budget consolidation		*			
2. Monetary Authorities	Strengthen basis for monetary policy formulation and management	-	+Law defining functions of Banco do Brasil		*			
			+Transfer to Banco do Brazil or BNDES of Central Bank's development banking functions		*			
			+Establishment of Banco Central as sole monetary authority		*			
			Transfer to Treasury of responsibility for Federal public debt		*			
			+Greater independence for the Central Bank (legislative or constitutional provision)			*		
3. Banks	Restore the institutional base for growth in savings and private investment	-	+Reduction in compulsory lending for certain sectors by commercial banks, and in reserve requirements	*	*	*		
			Reform of state and regional development banks		*	*	*	
			Strengthening of investment banks		*	*	*	
			Reform of state commercial banks			*	*	
			Legislation and regulations to govern a liberalized, integrated banking and financial system				*	* *

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
4. Housing Finance	Stabilize and support housing investment		+Reform of the housing finance system		*			
5. Financial Markets	Strimulate flow of funds for private investment		New regulations for financial markets, including tax reforms		*	*		
			Establishment of "Brazil Fund" to encourage foreign portfolio investment		*	*		
			New regulations for financial conglomerates			*		
6. Tax Reform	Increased tax revenues in a more efficient and equitable system		Program to reduce tax exemptions and allowances	*	*			
			Tax reform to encourage longer-term holdings of financial assets	*	*			
			Tax measures to reduce wedge between borrowing and lending rates		*			
			+Major tax and transfer reform at Federal, State and municipal levels			*	*	
Bank Support			Financial Sector Reform I	*				
			Financial Sector Reform II		*			
			Financial Sector Reform III			*		
			Financial Sector Reform IV				*	
			Cofinancing	*	*	*	*	
			ESW on the Financial System		*		*	
G. PUBLIC SECTOR MANAGEMENT								
1. Fiscal Administration	Efficient arrangement of Government funds, including debt operations	Establishment of National Treasury Secretariat in the Finance Ministry (See F.1)	+Fully operational control of budget operations, through Treasury and SEPLAN (SOF)	*				
2. Integrated Management System (SEPLAN)	Strengthening of Federal information, planning, policy research, programming budgeting, policy information, evaluation and reporting	-	+Strengthening and expanded operation of:					
			- general and sector planning and project evaluation (IPLAN)	*	*	*	*	*
			- multi-year investment planning--CPPG	*	*	*	*	*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
3. State Enterprise Management	Development of flexibility and efficiency in the state enterprise system, with privatization of some enterprises	SEST supervision of state enterprise operations (since 1980)	+Introduction of system for performance evaluation	*				
			+Development of rehabilitation programs for selected state enterprises	*	*	*		
			+Implementation of finance and rehabilitation programs	*	*	*	*	*
			Selective privatization of enterprises directly or via capital markets	*	*	*	*	*
4. Statistical Development	Information systems development: national and regional statistics	-	Initiation of IBGE development program to expand national and regional information base		*			
			Interim development of national account and public finance research (FGV)		*	*		
			Development of integrated national/regional statistical operations			*	*	*
5. Financial Control			Strengthening of audit systems (SECIN &/or Tribunal da Contas)	*	*	*		
Bank Support			Public Sector Management Loan	*				
			Public Sector Management II				*	
			ESW on Public Investment and public enterprises	*	*	*	*	*
H. STABILIZATION								
1. Government expenditure	No real increase in current or capital investment outlays, but a shift away from state enterprise activity into priority social programs	Real reduction in state enterprise expenditures; emergency social program introduced 1985	+Reductions in Govt. and state enterprise operating expenditures, including personnel costs; extra provision for maintenance, financial rehabilitation, completion of priority investments; careful evaluation of new investment proposals involving Government or state enterprises	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
2. Taxation	Increase in (recovery of) net tax revenues to 1970s ratios	Measures to restore and increase income tax revenues (increase equivalent to 1.7% of GDP proposed)	+Further short-term adjustments to increase revenue collection and reduce cost of tax exemptions and allowances	*	*	*	*	
			Major reform of tax and incentive systems and mechanisms for revenue sharing			*	*	
3. Other Revenues	Public sector prices, levies to cover cost of services.	Some real increases in 1985	+Public sector prices to increase in real terms; social security and similar charges to be adjusted to cover programs'costs	*	*	*	*	
4. Subsidies	(See F.1)							
5. Public sector deficit	Reduce public sector deficit (broadly defined) to normal financing range	"Operational" deficit cut from 6.8 to estimated 2.8% of GDP, between 1982 and 1985	+Reduction of "operational" fiscal deficit to 1% of GDP	*				
			+Further improvements in fiscal performance, according to targets to be agreed annually, to secure gradual decline in ratio of total public debt to GDP		*	*	*	*
6. Monetary Policy	Expansion consistent with agreed stabilization targets	Short periods of tight monetary restraint, 1981-84.	+Meeting annual monetary targets based upon expected growth and inflation	*	*	*	*	*
7. Incomes policy	Real wage increases linked to productivity growth, to increase employment opportunities	Successful efforts to reduce real wages in 1983-84, some real wage recovery in 1985.	+Public sector wage policy consistent with no increase in real wage bill in 1986-87	*	*	*	*	*
8. Indexation	Reduction of the inflation mechanisms implied by the Government indexation system, while avoiding distortions that might be caused by inflation if indexation is eliminated	-	+Preparation of detailed program on how to deal with indexation and related issues	*				
			+Implementation of the program		*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
I. SOCIAL & REGIONAL PRIORITIES								
1. Social Adjustment	Recovery from social costs of economic recession through programs designed to reduce poverty, improve income distribution and promote employment rhgough economic growth	Social sector priority program in nutrition, health, education, housing, water supply, small-scale agriculture and job creation (1985)	Preparation and implementation of plans of expanded, more cost-effective and efficiently delivered health, education and other social services	*	*	*	*	*
2. Regional Development	Increase employment and incomes, and promote sustained growth in the Northeast region	New rural development programs for the Northeast (1985)	Preparation of comprehensive, multi-sectoral Northeast regional development program	*				
			Phased implementation in line with domestic and external reserve availability		*	*	*	*
Bank Support			Education Sector Loan				*	
			Health Sector Loan					*
			NE lending program (rural development, industries, irrigation, education, health)	*	*	*	*	*
			ESW on health and education programs and NE regional development	*				

ANNEX
January [illegible], 1986

BRAZIL - A PROPOSED COMPREHENSIVE, MEDIUM-TERM PROGRAM FOR TRADE LIBERALIZATION

Area	Policy Objectives	Further Recommended Measures
1. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 15% annually, to permit import expansion while covering debt service	Formulation and initial steps in implementation (see below) of a multi-year program for export expansion and trade policy rationalization
		Implementation of GATT Code for subsidies
2. Export Financing	Rationalize and extend financing arrangements for exports	Provision of access to financing to all exporters at internationally competitive rates, consistent with GATT Subsidy Code
3. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Specification of import rationalization objectives, identification and consideration of specific measures to reduce anomalies in policies and procedures affecting different categories of producer, with implementation subject to balance-of-payments situation; results of ongoing studies of effective protection; and results of trade negotiations
		Implementation of GATT codes for Customs Valuation and Anti-Dumping
		Elimination of most items from the list of "Import Suspension"
		Liberalization of firms' annual import programs, eliminating discrimination by products and providing automatic approval for firms importing up to a pre-determined value. (Import programs would be used as a tool to control imports only in the event of a balance of payments crisis).
		Reduction or elimination of most tariff exemptions schemes, and reduction of scope of application of Law of Similars
		Reduction of tariff levels and dispersion to a nominal average of about 40% range, with perhaps half the items in the 30-40% range, a minimum tariff of 10% and a maximum of 85% (including IOF tax)
		Gradual phasing-out of non-tariff restrictions, so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariffs
Bank support		Export Development II Export Development III Industrial Restructuring I Industrial Restructuring II Cofinancing ESW on Industry and Trade

SECTOR POLICIES

A. Industrial and Trade Policies

1. Domestic markets for Brazilian manufactures are protected by quite high nominal tariffs and extensive non-tariff barriers, even after substantial reform in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Its international competitive strengths are demonstrated by the impressive increase in manufactured exports in recent years, from US$6.6 billion in 1979 to US$15.1 billion in 1984. Another indication has been the very limited growth of import demand when the Brazilian drawback system was liberalized, with Bank support, to establish a "free trade" regime for export production.

2. The most recent thorough study of nominal and effective protection for Brazilian manufacturing, for 1980-81, shows high nominal tariffs (an average of 99%, and 133% for consumer goods) but relatively low effective protection as measured by direct price comparisons (an average of 44% and 36% for consumer goods). The averages for Brazil do conceal substantial dispersion in both nominal and effective protection. In 1980-81, for example, the nominal tariff approached 200% for apparel, beverages and tobacco, although the implicit effective protection estimates for these products were 26%, -1% and 6%, respectively. Implicit effective protection was negative in the mining non-metallic minerals, transportation equipment, paper and rubber industries, but exceeded 100% for electrical equipment and pharmaceutical products.

3. Brazil has taken some recent measures to reduce restrictions on trade. The September 1984 tariff reforms included the removal of sucharges imposed in the 1970s and reduced the unweighted average nominal tariff to 51%. The trade-weighted average tariff was already much lower, at 30%, in 1975, and came down to about 22% in 1984. Non-tariff barriers, which have been more important than tariffs in regulating imports, were also reduced in 1984 when the list of prohibited imports was cut from 4,435 to 2,081 items and other rules and administrative requirements were somewhat relaxed.

4. The extent to which recent measures have reduced levels and dispersion in effective protection should become clear when a major new study, financed under our first Export Development loan, is completed, probably by mid-year. This study will, we expect, provide the basis for consideration by the Government of further trade policy measures.

5. In view of the above, we see trade policy reform for industrial products at this stage as a desirable but not immediately essential component of an economic adjustment program for Brazil. The key requirement is the continuation of exchange rate policies which will keep manufactured exports competitive and growing.

6. Measures to promote further improvements in industrial efficiency include, in the area of export development:

- strengthening of export promotion through enhanced quality control and certification procedures; marketing design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures;

- simplification of indirect drawback system;

- elimination of remaining indirect taxes on exports.

7. The import regime would benefit from simplification and increased automaticity in official (CACEX) import procedures and the decentralization of decision-making.

8. Subsequent steps towards import rationalization should focus on areas shown to benefit from high levels of effective protection, as demonstrated by direct price comparisons, and therefore imposing high costs on other manufacturing and the economy in general. A more comprehensive, longer-term approach would seek the rationalization of import policies across the board, emphasizing:

- implementation of GATT customs valuation and anti-dumping codes;

- elimination of most items from the import suspension list;

- liberalization and eventual elimination of company annual import programs, except as emergency measures;

- reduction or elimination of most tariff exemption schemes and applications of the Law of Similars;

- reduction of nominal tariff levels and dispersion, with up to half of all items in the 30-40% range;

- further phasing-out of non-tariff restrictions so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariff system.

B. Agricultural Sector Policies

9. Brazilian agriculture registered strong though unbalanced growth in the 1970s, at an average of 5% annually, but in the 1980s, output stagnated and agricultural investment declined. Except for credit programs, Government agricultural policies have acted as disincentives to investment, especially for staple crops. Subsidized credit promoted increases in production, but at high cost and with heavy emphasis on high-input commercial agriculture and special development programs (alcohol, Cerrado agriculture, the Amazon frontier) requiring large fiscal

incentives. The crisis-induced reduction of agricultural credit, early in the 1980s, was not compensated by other policy changes. Adverse trade and pricing policies, high taxation and industrial protection continued. Intervention in agricultural trade and minimum price arrangements have provided more uncertainty than support.

10. Agricultural expansion is critical for growth. The key to realizing the full potential of the agriculture sector is a policy framework that will make all forms of production and exports profitable without credit subsidies, interventionist trade policies and production-based taxation. This is central to Bank agriculture sector lending to Brazil and conforms with Government policy objectives as expressed in the National Development Plan. The first sector loan supported the Government decision to phase out negative real interest rates on rural credit. The second would support significant and complementary moves towards a more liberal pricing policy for agriculture.

11. In the area of agricultural credit, the required policy measures are:

- budgetary provision for interest rate subsidies, in 1986;
- subsequently, full fiscal provision for all remaining subsidies;
- elimination of negative real interest rates in the North-Northeast, except for selected target groups;
- market interest rates in the Center-South, except in special areas.

12. Agricultural trade and pricing policies should provide for:

- the initiation of a free trade policy for key 1986-87 crops, within defined limits;
- the phasing-out of food price controls and the wheat subsidy, along with the implementation of targeted food assistance programs;
- rationalization of trade regulations for agricultural commodities;
- a free-trade policy for key agricultural commodities, subject to minimum price guarantees, market safeguards and Government stock management.

13. In addition, provision should be made for a reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

C. Energy Sector Policies

14. Over the past decade, Brazil has been diversifying its energy base and stressing conservation. By accelerating petroleum exploration and production, as well as encouraging energy substitution and conservation, Brazil has significantly reduced oil imports. Investments in hydro-electric plants and in alcohol production have expanded Brazil's energy resources, and recent natural gas discoveries will add to the diversification strategy. With the present world oil price prospects and the country's resource constraints, two general principles should guide future development of the sector: (a) energy development of domestic fuels should be coordinated, to avoid excess duplication or over-expansion of supply relative to market demand; and (b) economic criteria should be strictly applied to energy investments, and pricing should reflect market forces.

15. Brazil is not a low-cost producer of petroleum. While the current production target of 740,000 bbl/day by 1989 seems to be cost-effective with present oil price projections, the cost of future investments, particularly in the deep-offshore areas of the Campos basin, must be carefully scrutinized and the pricing of petroleum derivatives (notably fuel oil, LPG, and naphtha) should more adequately reflect international prices. Alcohol development is also susceptible to weakening oil prices. Brazil's alcohol program is economically viable in the biggest producing areas of the country, though not in the traditional sugar-producing areas in the Northeast. Therefore, further development should be oriented toward productivity improvements in existing facilities rather than toward building new plants, and alcohol conservation encouraged through increasing its retail price relative to that of gasoline. Finally, in order to insure adequate provision of electricity for expanding business and residential consumption without draining the Government budget, the financial condition of the power sector must be improved, and priority transmission and distribution investments which were delayed because of the recession should be completed.

16. The following sector policies would support production and reduce imports:

(a) Development of a long-term energy plan for coordinated production and consumption of energy resources.

(b) Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect opportunity costs and therefore promote efficient domestic energy production and use.

(c) Financial rehabilitation of the power sector through higher tariffs, improved debt/equity ratios, and other means, and completion of priority investments to improve system reliability.

(d) Emphasis on agricultural and industrial productivity improvements in alcohol production, with strong limitations on expansion of capacity in new or high-cost regions of the country.

D. Financial and Fiscal Reform

17. In the mid-1960s, financial and fiscal reforms played a fundamental role in economic stabilization in laying the basis for a period of extraordinarily rapid economic growth. Two decades later, however, inflation is over 200% a year, real free market interest rates (on the order of 25% to 30%) are higher than the returns that can be earned on investments in real assets, financial markets are fragmented, and the portfolios of many major financial institutions are of doubtful quality. There is a growing consensus in Brazil that reforms similar in scope to those of the 1960s are again required.

18. Monetary and Fiscal Reform. Financial reform, carried out in close coordination with fiscal reform, could play an important role in completing both economic stabilization and the adjustment of the economy to changed international economic conditions. Three major objectives of financial reform would be: (i) more effective monetary and fiscal control; (ii) enhanced stability of the financial system; and (iii) increased efficiency in mobilizing and allocating resources. High real interest rates can be attacked directly through tax reforms and reductions in compulsory lending at below-market rates; they can be addressed indirectly by reducing uncertainty about future financial policies, and by measures resulting in improved monetary control. Financial reform alone cannot bring down real interest rates to sustainable levels. But it can reinforce other measures critical to economic stabilization and structural adjustment.

19. The Government has stated its intention to unify Brazil's federal budgets (those of Treasury, the Monetary Authorities and the state enterprises) and is also proceeding to redefine the roles of the National Treasury, the Central Bank, and the Bank of Brazil. The goal would be to establish a clear separation between the conduct of monetary and fiscal policy and achieve better discipline over public expenditure. The Government has already taken a major step forward by consolidating, within the Federal Government budget, most fiscal expenditures previously financed through the monetary budget, and by limiting any fiscal expenditure by the Central Bank or Bank of Brazil to that contained in the budget. A new Secretariat of the Treasury is being established in the Finance Ministry to administer the overall fiscal budget and to unify thousand of special funds that have been managed independently up to now by government agencies.

Tax Reform

20. The tax system is also badly in need of reform. Some activities are still undertaxed or not taxed at all. Taxation varies significantly across sectors or sources of incomes. There is almost no taxation on property, wealth, and inheritance. Fiscal incentives have proliferated, they not only erode revenues, but also reduce the ability to influence investment and accentuate the lack of equity in the overall tax system. In order to prepare a broader tax reform the Government established a Tax Commission in March 1985. The main objectives of the reform which the Bank supports are increasing state and local government autonomy on taxation, using the tax system to direct savings more to productive investment than to financial transactions, and improving the tax system as a policy instrument for improving the income distribution and for balanced regional development.

21. While the Commission's recommendations will not be fully implemented for several years, some steps appear feasible before then. As part of the fiscal adjustment for 1986, significant changes to the tax system are already being made. They include an increase in the progressiveness of the personal income tax, taxation of all forms of interest income at a uniform rate, and reduction of the lag between the accrual of corporate tax liability and payment of the tax.

22. The following sector policies would not only improve the Government's monetary and fiscal control but would also help mobilize savings and channel them to productive investment, by improving the financial system, reducing intermediation costs, and broadening and rationalizing the tax base:

(a) Budget consolidation:

Budgetary provision for wheat, sugar and agricultural credit subsidies; transfer of decentralized funds to Treasury budget; completion of process of budget consolidation; and redefinition of the functions of the Bank of Brazil.

(b) Monetary policy management:

Transfer to Bank of Brazil or BNDES of the Central Bank's development banking functions; establishment of Central Bank as the sole monetary authority; transfer to the Treasury of responsibility for the Federal public debt; and greater independence for the Central Bank.

(c) Financial system improvements:

Reduction in compulsory lending for certain sectors by commercial banks and in reserve requirements; strengthening and reform of the state and regional banking system; reform of the housing finance system; and new regulations for financial markets and for financial conglomerates.

(d) Tax reform:

Program to reduce tax exemptions and allowances; encouragement of longer-term holding of financial assets through differential tax rates; reduction of the wedge between borrowing and lending rates; and reorganization of tax and transfer system between Federal, State and municipal levels.

E. Public Sector Management

23. Management problems stem from the expansion of the public sector in the 1970s as the Government sought to maintain investment and growth in a difficult external environment, counter inflationary trends for which growing public sector deficits were themselves largely responsible, and meet a variety of competing and sometimes conflicting social objectives. Public expenditures expanded primarily through the monetary budget, which was handled by the Central Bank and used increasingly to channel development and welfare expenditures through subsidized credit programs and other subsidy arrangements. Public sector prices were held down in the attempt to restrain inflation. State enterprises were encouraged to borrow overseas for ambitious investment programs, and to borrow more to support a deteriorating balance of payments.

24. Since 1980, in an environment of recession, rising inflation and severe constraints on both external and domestic borrowing, the Government has made strenuous efforts to bring public expenditures under better control. There has been a substantial reduction in the public sector's operational deficit and borrowing requirements, from an estimated 6.6% of GDP in 1982 to about 3% in 1985. The aim in 1986 is to reduce this deficit to 0.5% of GDP.

25. The Government proposes to strengthen public sector management in several key areas, with Bank finance for:

- the establishment of a National Treasury Secretariat to administer Government funds more effectively,

- strengthening Federal information, planning, policy research, programming, budgeting, evaluation and reporting systems,

- improved programming and screening procedures for public investment projects, and

- the introduction of performance evaluation systems, rehabilitation programs and selective privatization programs for the state enterprise sector.

26. These measures, together with programs also to be supported by the Bank for the development of information systems and financial control, have the potential for greatly improved management of the public sector.

BRAZIL - EXPANDED FIVE-YEAR LENDING PROGRAM

(FY86-90)

FY86	US$ Million	
Electric Power Sector	0.0	
Agricultural Sector II	400.0	
Northeast Rural Development	171.0	
Alcohol Development	175.0	
Agricultural Credit	150.0	
Upper and Middle Sao Francisco Irrigation	56.0	
Salvador Metropolitan	49.0	
Northeast Rural Development	185.0	
Agricultural Extension	155.0	
Santa Catarina Market Towns	24.5	(10)
Northeast Urban Reconstruction (Flood)	100.0	(1,465.5)

FY87		
Public Sector Management	25.0	
Northeast Education Policy	10.0	
Financial Reform I	300.0	
Rural Electrification II	175.0	
Northeast Health - Primary	50.0	
Industrial Skills Vocational Training	100.0	
Urban Transport IV	200.0	
Electric Power Sector II (S)	400.0	
Irrigation Engineering (S)	45.0	
State Highway Sector Maintenance	150.0	
Agricultural Sector III	350.0	(12)
Northeast Rural Development V	200.0	(2,005.0)
Export Development II (R)	200.0	
Alcohol Development II (R)	175.0	
Agricultural Research III (R)	100.0	
Natural Gas (R)	50.0	(5)
Minas Gerais Forestry (R)	20.0	(545.0)

FY88		
Northeast Irrigation	200.0	
Financial Reform II	200.0	
Industrial Restructuring	250.0	
Power Distribution (S)	300.0	
Electric Power Sector II (S)	400.0	
Livestock Disease Control (S)	50.0	
Cerrado Transport	100.0	
Rural Telecommunications	100.0	
FEPASA Railways II	100.0	
Northeast Rural Development VI	100.0	
Northeast Rural Development VII	100.0	(12)
Northeast Education	150.0	(2,050.0)
Rubber Development (R)	60.0	
Ports II (R)	100.0	
Health/Population (R)	40.0	(4)
Urban Sector (R)	200.0	(400.0)

FY89	US$ Million	
Agricultural Sector IV	300.0	
Education Sector (S)	100.0	
Northeast Irrigation (S)	100.0	
Feeder Roads IV (S)	150.0	
Rural Water and Sanitation (S)	100.0	
Industrial Restructuring II (S)	300.0	
Northeast Small and Medium Cities (S)	100.0	
Technology Development (S)	100.0	
Electric Power Sector III	400.0	
Northeast Small Industries	150.0	(11)
Financial Reform III	200.0	(2,000.0)
Export Development III (R)	300.0	

FY90		
Water and Sewerage (S)	150.0	
Rural Electrification III (S)	200.0	
Medium Cities (S)	50.0	
Gas Exploration/Development (S)	150.0	
Agricultural Credit (S)	300.0	
Transport Sector (S)	200.0	
Electric Power Sector IV (S)	300.0	
Grande Carajas (S)	150.0	
Development Banking (S)	200.0	
Oil Palm Development (S)	100.0	(11)
Agricultural Credit (S)	200.0	(2,000.0)

January 16, 1986

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Brazil RB.

DATE: January 31, 1986

TO: Mr. Roberto Gonzalez Cofino, LC2BR

FROM: S. Rajapatirana, VPERS

EXTENSION: 33773

SUBJECT: Draft Baker Initiative Country Study - Brazil

Attached is a copy of ERS staff comments on your December 23 draft Baker Initiative paper on Brazil. We thought that it might be useful to you to have our reactions and comments on this draft paper prior to your preparation of the Brazil paper to be sent to the Managing Committee.

Attachment

cc: Messrs. A. Choksi (CPD), H. Cortes (VPERS), A. Gelb (DRDME), K. Jay (VPERS), C. Obidegwu (EPDCO)

1-31-86

Comments on the Draft Baker Initiative Country Study: Brazil

Alan Gelb, DRD

I. THE CURRENT SITUATION

Main Policy Responses.

During the period 1977-83 Brazil's terms of trade nearly halved. The average real interest rate payable on medium and long-term debt increased from -4 percent in 1977 to around 11 percent in 1982 before beginning to decline. The consequent terms of trade losses and increased factor payments were equivalent to 8 percent of GDP. Initially, much of this external deterioration was financed by running large current account deficits--4.6 percent of GDP over 1979-82--but by 1983 the cutoff of international lending forced rapid adjustment. By 1984 one indicator of the extent of adjustment--the terms of trade loss plus factor payments increase plus improvement in the current account (all relative to 1977)-- reached the equivalent of 10 percent of GDP.

This adjustment required:

(a) a trade surplus, and

(b) the transfer of the excess of income over absorption to the public sector to enable it to service external debt (which was 80 percent public).

Three sets of policies have been important:

(i) A substantial real depreciation was effected in 1983, wages were cut and credit policy tightened. These expenditure switching and reducing policies aimed to effect the trade surplus.

(ii) The public sector turned to domestic capital markets as fiscal adjustment lagged the drying-up of foreign finance. This caused rapid growth of the domestic public debt.

(iii) By permitting domestic assets and foreign debts to be offset, the government socialised exchange risk in the Central Bank. This reduced the impact of the maxidevaluation of 1983 on private debtors.

Adjustment-External.

The above combination of measures has led to a remarkable turnaround on the external account. In 1980-82 the current account deficit averaged $13 billion or 4.7 percent of GDP. In 1984-85 the average current account has been almost balanced, with a small deficit in 1985 following a small surplus in 1984. The real exchange rate against the dollar depreciated from 100 in 1977 to around 65 in 1985, following the 1983 maxidevaluation and the policy since then of continuous devaluation against the dollar at the rate of domestic inflation. Trade surpluses of around $12 billion have facilitated interest service on debt; although external debt increased in 1984, this reflected the reconstitution of reserves from extremely low levels.

Brazil's external performance was effected through export expansion (the share of industrial exports in output almost doubled in 1982-84) and severe import compression. The latter was made possible by the maturation of major investments in key import-substituting industries as well as by depressed domestic demand (especially investment which has a higher import content) and tighter import controls.

Adjustment-Domestic.

The domestic picture has been more clouded. In the process of adjustment, Brazil moved into recession at least as severe as that in the

1930's. The trough was reached in 1983. Recovery in 1984 involved growth of 4.5 percent and was export-led. Expansion of 7 percent in 1985 was consumption-led; domestic investment, estimated at 18 percent of GDP in 1985, has not recovered substantially from its long slide, from 26 percent in 1977 to 16 percent in 1984.

In the recession real wages fell some 20 percent from peak levels; they have recently somewhat recovered (real wage increases are estimated at about 13 percent) but are still below previous levels. Public-sector wages appear to have been especially squeezed, with adjustment lagging accelerating inflation; there is now great pressure for their increase.1/

Brazil is therefore now in a state of recovery, but one which appears to be fairly fragile. The following factors are important in assessing the immediate outlook:

1. Inflation and Interest Rates.

Brazilian inflation has accelerated in step-jumps, from 40 percent to 100 percent in 1979-81 and then to a new plateau of 200-220 percent since 1983. The inflation tax has not changed too much, so that any rise in the real public deficit has had to be financed by selling bonds and bills. The narrowly-defined money stock is small relative to GDP, with liquidity largely being provided by other financial assets held on a 24-hour basis or subject to repurchase agreements. Most of the non-monetary assets have their principal

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1/ Wages are indexed with a lag, so that accelerating inflation has been associated with a fall in the real wage. More important may have been the severity of the recession; despite indexation, Brazilian wages seem to be quite responsive to labor market conditions. Recent pressure to shift from 6-monthly to quarterly adjustment could again cause inflation to accelerate.

corrected by an index of monetary correction (ORTN) or by the exchange rate. As government turned to the domestic financial market (see below) real interest rates soared, to average 23 percent for working capital in 1982-84. In the first half of 1985 interest rates reached unprecedented levels. Since August they have fallen somewhat but are still very high.

The impact of these high rates has been felt mainly by public sector firms and the housing system. The private corporate sector was able to adjust remarkably rapidly after 1981 by trimming payrolls and working capital and cutting pay, and may now be in a net creditor position. However, high real rates inhibit investment, as does the fear that an acceleration of inflation (which could take place for a variety of reasons) would lead to even higher real rates.1/

It is also feared that its increasing domestic debt might lead the government to change the rules of ORTN indexation. High real interest rates thus substantially reflect a credibility problem, which in turn relates to the failure to adjust fiscal policy more promptly towards a contractionary stance, as is further discussed below.

2. Investment and Growth.

The output and real wage increases of 1984-85 have been made possible largely through increases in the rate of capacity utilisation. Perhaps surprisingly (in view of the depth of the recession), many industrial sectors now appear to be hitting "full" capacity levels, and shortages have begun to

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1/ Factors which could cause inflation to accelerate include: failure to carry out the fiscal package recently announced, a shift to quarterly wage indexation, adjustment of controlled prices, a poor harvest and the exhaustion of spare capacity.

emerge. Therefore, in assessing the prospects for growth even in the short-medium term, both the level of investment and the efficiency with which the capital stock can be employed are key variables.

3. The Fiscal Deficit.

The Federal budget balance is of little analytical value in its own right. Estimates of the consolidated public setor deficit are only available on a consistent basis after 1981. A number of definitions and concepts have been used, reflecting the problems involved in applying standard constructs to the Brazilian situation.

The "nominal" public sector deficit now represents around 25 percent of GDP. Most of this is, however, made up of monetary and exchange correction on outstanding public debt. The nominal deficit therefore tends to rise, relative to GDP, as inflation accelerates, and is not the most useful concept for analysing fiscal policy. One measure which has recently been calculated by the Central Bank computes the deficit as the increase in the real value of the outstanding stock of public debt, and includes the Monetary Authorities as part of the "public sector"[1/] On this measure, the public deficit decreased from 6.5 percent of GDP in 1982 to 4.5 percent in 1984, and is estimated at 2.9 percent in 1985. Real depreciation sharply raised the ratio of domestic and foreign public debt to GDP in 1983. The domestic public debt is now about 20 percent of GDP and the foreign public debt is about 30 percent; real

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1/ An extended discussion of the various public deficit concepts is beyond the scope of this paper. Excluding the Monetary Authorities changes the Central Bank deficit estimate only slightly. It then is close in concept to the "operational deficit" of the IMF which excludes monetary and exchange correction from the nominal deficit and also excludes the Monetary Authorities. The estimate of the nominal deficit given in the text follows the IMF definition. Computed as the nominal increase in all public debt converted into cruzeiros at the beginning and end of period, the nominal deficit is about 50 percent of GDP.

interest charges are therefore now about 5-6 percent of GDP so that the noninterest fiscal balance (excluding correction of debt) is in substantial surplus.1/

4. The Current Gradualist Approach to Stabilisation.

On November 28 government presented a series of measures through which it expected to cut the deficit (as measured above) from 2.9 percent of 1985 GDP to 0.5 percent of projected 1986 GDP. Its package included significant tax and public pricing reforms, containment of central government and other public sector expenditures and also provided for a doubling in real terms of the "social priorities" program. Sizeable sales of public enterprise stock are also envisaged, as is liberalisation of trade in agricultural products.

Alternative, more radical, approaches featuring a monetary reform a la Argentina or Israel are currently being debated, but the implementation of such a reform seems unlikely unless inflation accelerates sharply or the recovery is reversed. The probability of some such scenario is not negligible. There is the prospect that inflation will again accelerate, which will undermine confidence, reduce willingness to hold public debt and so raise real interest rates and stifle investment and growth. The Baker paper should make reference to such a scenario consider the short term macroeconomic effects of increased lending.

1/ Over the past two years central government domestic borrowing has substituted for public enterprise domestic borrowing. The more visible Treasury debt has thus grown at about 32 percent in real terms whereas real public enterprise debt has been constant. This may have contributed to a perception that total public debt was expanding more rapidly than it actually has been.

II. POLICIES FOR ADJUSTMENT.

The Role of External Finance.

If the external nominal debt were to remain constant and the real exchange rate were held constant, Brazil's debt/GDP ratio would probably fall at about 10-percent per year. Although it is difficult to estimate the optimal debt/GDP ratio, this suggests that some financing from external sources above the level suggested by the 1984-85 current account is a reasonable option from the long-run perspective.

In the present situation the potential contribution of increased external finance is two-fold. First, it would permit an increase in imports and allow some relaxation of the contractionary and regulatory measures needed to effect the present trade surplus. Second, it would ease the difficulties posed by the domestic transfer problem, namely (i) the depressed level of public investment some of which is essential for structural adjustment (for example, electrical transmission lines) and (ii) public sector pressure on domestic financial markets. This is undermining confidence and inhibiting vital private investment.

The Policy Recommendations.

The impact of external funding would be large only if accompanied by measures to raise the efficiency of domestic resource use. This brings us to the measures set out on pp 6 and 7 and in Annex 1 of the Baker paper. They cover a very wide set of issues; indeed, it is difficult to think of any major area omitted from the list. Together with their timing as set out in Annex I they would represent an important shift in the nature of Brazilian economic policy and institutions over the next five years.

The policies proposed in the Baker paper are sensible; indeed, as noted, most are being addressed in ongoing dialog between Brazil and the

Bank. Some seem optimistic. For example, selective privatisation of public enterprises (para 14--as opposed to just selling a minority shareholding); reform of the Monetary Authorities (para 16--it is not apparent that the Bank of Brazil's costs render it potentially competitive without continuing subsidies and its status as the largest traded stock limits the measures which can be taken); reducing inflation to 20 percent by 1990 (para 18--without a successful monetary reform which is not set out as an option in the paper).

On the other hand, some of the recommendations could perhaps be strengthened. Why should negative real interest rates persist for rural credit until 1988? Would not a rapid move to full market rates be more compatible with a speedy transition of the Bank of Brazil? Could the schedule for policy changes to encourage direct investment not be accelerated?

To what extent is such a very broad set of measures monitorable as a whole? Is the intention to have a two-level monitoring system, with certain key (and monitorable) variables forming a core and others being mainly associated with specific Bank loans? While the paper identifies the relationship between Bank policy-based projects and areas of policy reform, the absence of specific criteria is notable in Annex I.

Further, is Brazil willing to have the Fund monitor key aspects of its program? What would be the Bank's response if in such key areas (for example, the public sector deficit) Brazil was not in compliance yet in project-specific areas (such as agricultural credit) it was? Could cofinancing for such a project reasonably be expected from commercial banks?

The paper does not make clear the link between policy change and economic performance. Realistically, this is hard to do in quantitative terms, but there are strong assumptions underlying the policy-growth link as further noted below.

There may be inconsistency between policies and projections; policies to promote exports and efficient import substitution (p6) include devaluation equal to domestic inflation or, in Annex I, at least equal to the differential of inflation over foreign rates. Over 5-10 years there is a substantial difference in these options. Real exchange rate policy affects the prospects of reducing domestic real interest rates and therefore the growth of public debt. It also affects the evolution of the projected debt-GDP ratio.

III. INDICATORS AND PROJECTIONS.

The paper presents three projections: high (8 percent), medium (7 percent)and low (5 percent) GDP growth. In these projections it is assumed that capital inflows are constrained by debt-export and debt-service ratios.[1/] The high-growth scenario, where real exports grow at 7-8 percent after 1987, envisages continuing current account deficits of $2.5-4 billion while the low growth scenario, where exports grow at only 2-3 percent, requires current surpluses after 1986. In the medium case exports grow at about 6 percent and current deficits are in the $ 1-3 billion range. The low-growth scenario represents a situation characterised by no major policy reforms, a constant real exchange rate and no "new money" from commercial banks.

The high-growth scenario assumes timely adoption of <u>all</u> required policy reforms and real exchange devaluation at the rate of international inflation. The "most likely" medium-growth scenario assumes all policy

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1/ In all projections debt/export ratios evolve in a similar manner, declining steadily from 3.7 in 1985 to 1.5 - 1.8 by 1995.

reforms except trade liberalisation; instead, there is some simplification of trade policy.

For comparison, the Brazilian government's own growth target is only 6 percent. GDP growth was projected at 6.6 percent rising to 6.9 percent after 1990 by the Region in the recent EPD country survey and this was modified to 6.1 per cent rising to 6.3 percent by EPD. Comparable export growth projections were: Region: 5.4 rising to 7.2 percent and EPD 5.1 rising to 6 percent. In general, these estimates are between the medium and low scenarios in the Baker paper.

One reason for the difference in GDP growth rates in the Baker scenarios is the greater volume of external financing made possible by higher exports. The other is an efficiency effect, assumed to follow the adoption of the policy reforms. The average ICOR varies from about 3 to 3.3 over the scenarios.[1/] This permits extra growth without cost in terms of consumption--it would seem that the efficiency assumptions following from the policy package are responsible for about 1 percent extra growth. Any such assumption on the effects of the reforms should be made explicit.

Policies and scenarios may not be consistent. If world inflation is, say, 5 percent, in dollar terms GDP growth is actually only 3 percent in the high and 2 percent in the medium-growth scenarios because of the real exchange rate policy assumed to be needed to encourage exports and accompany liberalisation (see para 9). Therefore, in dollar terms GDP actually grows less in the high and medium scenarios than in the low-growth scenario. This is inconsistent with Table 2, which does not allow for real exchange rate

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1/ In 1973-1980 the ICOR was 3.3.

effects; debt/GDP and similar ratios would grow far more rapidly in the above scenarios.

A related point is that the scenarios assume the same terms-of-trade sequence over time (a slight improvement), although one of the goals of real devaluation is to improve competitiveness and sales abroad. This is consistent only if Brazilian exports are seen as totally supply- constrained, which, even without an increase in protectionism, is unlikely for such diverging export growth rates.

The transition from 1985 to 1986 also raises some questions. The 44 percent marginal savings rate seems optimistic. It might be difficult to effect 22 percent import growth without undermining the confidence needed for stabilisation. Given supply lags, is it really feasible for Brazil to grow at 8 percent even if investment picks up? Growth in 1986-87 is mainly dependent on the success of the stabilisation policy phase; this needs more emphasis.

IV. CONCLUSION.

Overall, the paper is rather upbeat, though its policy suggestions are sound. It does not place sufficient emphasis on the primacy of the stabilisation-confidence issue and does not address the possibility that Brazil will need to undertake a radical monetary reform, with all the legal and other ramifications. It assumes that the government is willing to undertake wideranging policy reforms in a relatively short space of time, under the pressure of continual elections. The moderate-growth scenario is above the government's projections. There may be some inconsistency between policy recommendations and the projected creditworthiness indicators. Finally, there needs to be further discussion between the Bank and the Brazilian government on the precise content of a stabilisation plan and its monitoring, and more thought on the relationship between the monitoring of the various parts of such a broad policy package and the set of proposals which could be presented to commercial banks.

[illegible]ZIL
SELECTED ANALYTICAL VARIA[illegible]S FOR ECONOMISTS AND MANAGERS

ATLAS PER CAPITA GNP (CUR) (1984)	=1,710
POPULATION IN MILLIONS (1984)	=132.582
LT DEBT OUTSTANDING AND DISBURSED IN MILLIONS (CUR)(1984)	=87,012.80
BALANCE ON CURRENT ACCOUNT IN MILLIONS (1984)	=53

	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
GROWTH OF GDP AGGREGATES (CONST)									
					GROWTH RATES				
1.GDP	6.94	6.81	249,740	-1.55	0.96	-3.18	4.50	7.00	5.59
2. AGRICULTURE(1)	3.78	4.80	31,286	6.41	-2.47	2.25	3.92	4.50	4.00
3. INDUSTRY(1)	11.04	7.44	81,482	-5.21	0.78	-6.15	5.82	8.50	7.10
4.GDP OUTPUT DEFLATOR	37.81	47.96	100	97.78	96.37	144.46	207.90	..	..
5.IMPORTS GNFS (NAT. ACCTS.)	9.32	1.67	26,560	-13.47	-5.19	-17.15	8.86	5.50	19.70
6.EXPORTS GNFS (NAT. ACCTS.)	7.44	7.00	21,281	20.74	-8.24	13.08	20.12	-2.00	2.42
7.MERCHANDISE EXPORTS (2)	7.01	7.81	20,132	27.00	-15.12	15.86	24.90	..	..
8.DOMESTIC ABSORPTION	7.01	6.42	255,020	-3.32	1.84	-4.80	2.96	8.43	6.22
9.INVESTMENT	8.01	5.15	56,264	-15.84	-4.27	-17.43	4.69	1.10	17.31
10.PER CAP TOTAL CONSUMPTION	3.94	4.34	1,639	-1.99	1.02	-4.17	0.38	7.40	1.99
11.POPULATION (MIL)	2.72	2.36	121	2.25	2.25	2.25	2.25	2.25	2.25
TRADE PRICE INDICATORS (1980=100)									
					INDICES				
12.TERMS OF TRADE OF AGR/IND(1)	60.26	93.45	100.00	89.68	79.39	85.24	..	..	
13.TERMS OF TRADE	126.96	125.45	100.00	85.98	85.00	85.85	102.55	..	..
14.TERMS OF TRADE (UNCTAD)	152.47	132.98	100.00	84.95	84.43	92.06	94.57	..	..
15.NOMINAL EFFECTIVE EXCHANGE RATE(3)	..	147.44	100.00	66.76	40.63	16.19	5.68	7.01	..
16.REAL EFFECTIVE EXCHANGE RATE(3)	..	106.38	100.00	122.80	129.49	105.20	105.53	104.90	..
INVESTMENT AND SAVINGS									
					RATIOS				
17.INVESTMENT/GDP (CURRENT)	26.2	23.9	22.5	21.2	21.[illegible]	17.0	15.7	..	
18.INVESTMENT/GDP (CONSTANT)	20.7	23.4	22.5	19.3	18.3	15.6	15.6	14.7	16.4
19.DOMESTIC SAVINGS/GDP (CURRENT)	25.3	21.9	20.4	20.9	20.6	19.3	21.2	..	
20.DOMESTIC SAVINGS/GDY (CONSTANT)	18.9	20.8	20.4	17.8	15.9	14.8	17.9	..	
21.GROSS NAT. SAVINGS/GDP (CURRENT)	24.1	19.5	17.4	17.0	15.5	13.7	15.8	..	
22.RESOURCE BALANCE/GDP (CONSTANT)	-2.7	-4.7	-2.1	1.1	0.7	3.6	4.9	4.0	2.6
23.MARG PROPENSITY TO SAVE (CONSTANT)	22.3	19.4	51.8	105.8	-171.0	49.1	65.4	..	
24.TERMS OF TRADE ADJ./GDP (CONSTANT)	2.0	2.0	0.0	-1.5	-1.4	-1.6	0.3	..	
25.ICOR (CONSTANT)	2.3	3.3	3.0	-14.0	20.3	-5.8	..	..	

	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
TRADE AND BALANCE OF PAYMENTS					RATIOS				
26. SHARE OF MANUF IN EXPORTS (CUR)(2)	13.9	31.6	38.6	40.6	39.5	41.5	45.3	53.6	55.6
27. IMPORT GDP ELASTICITY	1.3	0.2	0.3	8.7	-5.4	5.4	2.0	0.8	3.5
28. CUR ACCT BALANCE/GDP (CURRENT)(4)	-2.1	-4.4	-5.1	-4.3	-5.8	-3.3	0.0	..	..
29. RESERVES IN MONTHS OF IMPORTS OF GOODS AND SERVICES(4)	5.5	4.3	2.3	2.3	1.2	1.8	4.7	..	..
DEBT INDICATORS (5)									
30. LT DEBT SERVICE TO EXPORTS RATIO	25.6	48.9	56.4	56.8	71.6	43.9	50.7	41.3	34.9
31. LT INT. SERVICE TO EXPORTS RATIO	9.4	20.8	27.1	29.4	39.8	31.5	28.2	33.4	27.6
32. LT DEBT SERVICE TO GNP RATIO	2.0	4.0	5.4	5.8	6.3	5.4	7.7	..	
33. DOD. LT PUB DEBT AT VIR/ DOD. TOTAL LT PUB DEBT	27.3	55.8	61.2	67.3	69.6	70.0	79.1	..	
34. NET TRANSFERS/TOTAL DISB	61.1	30.1	-16.2	4.4	-12.3	-45.9	-54.9	8.0	15.5
35. WORLD BANK DEBT/TOTAL LT DEBT	..	..	3.7	3.6	3.7	4.6	5.3	6.2	6.9
MONETARY INDICATORS (CURRENT)									
36. CHG IN CLMS GOV/GOV BUDGET BAL(6)	..	42.6	..	..	..	..	..	..	..
37. CLMS GOV/CLMS PRIV SECT(2)	1.3	-6.9	-2.6	-6.7	0.5	8.0	-14.1	..	..
38. MONEY SUPPLY/GDP	19.1	13.3	11.2	11.2	10.4	10.4	11.6	..	..
GOVERNMENT ACCT (CURRENT)									
39. DIRECT TAXES/GDP(6)	9.3	10.3	9.6	10.2	11.6	..	..	..	..
40. TOTAL REVENUE/GDP(6)	18.8	21.2	21.1	23.4	24.9	..	..	..	..
41. GOV. BUDGET BALANCE/GDP(6)	0.2	-1.4	-2.3	-2.3	-2.5	..	..	..	..
42. PUBLIC/TOTAL CONSUMPTION	14.6	11.8	11.0	11.3	12.5	11.7	..	..	..

EPD 12/23/85

NOTE: ALL REFERENCE YEAR VALUE DATA IN US$ 1980 MILLIONS, EXCEPT PER CAP TOTAL CONSUMPTION WHICH IS IN US$.
LEGEND: .. INDICATES NOT AVAILABLE
M INDICATES DATA IN MILLIONS

FOOTNOTES:
(1) SERIES STARTS IN 1965.
(2) SERIES STARTS IN 1962.
(3) US$/LOCAL CURRENCY. SERIES STARTS IN 1979. INCREASES INDICATE APPRECIATION; DECREASES INDICATE DEPRECIATION.
(4) SERIES STARTS IN 1966.
(5) SERIES STARTS IN 1970; STOCK AND DEBT SERVICE PAYMENTS ARE BASED ON PROJECTED CONTRACTUAL OBLIGATIONS AT END 1984 PLUS ESTIMATED NEW COMMITMENTS IN 1985-86.
(6) SERIES STARTS IN 1970.

MANAGEMENT SUPPLEMENT
SAVEM TABLES
SELECTED DEBT INDICATORS
1975-1986

BRAZIL

	1975	1980	1981	1982	1983	1984 /a	1985 /b	1986 /c
I. VALUES (in current US$, billions)								
1. Long Term debt (LT)	23.5	56.5	64.6	73.0	78.7	87.0	90.3	93.1
2. Short Term debt (ST)	..	13.5	15.3	17.5	14.2	13.2	12.8	13.0
3. Total Debt (DOD)	23.5	70.0	79.9	90.5	92.9	100.2	103.1	106.1
4. Interest (INT)	2.05	7.85	10.31	11.50	9.27	10.15	10.91	10.0
5. Amortization	2.24	6.82	7.40	7.48	2.83	2.31	2.25	2.3
6. XGS, (nominal)	9.95	23.29	26.99	23.49	24.37	30.26	28.55	31.3
II. RATIOS (percent)								
7. DOD/XGS	236.4	300.7	296.2	385.3	381.1	331.1	361.2	338.9
8. TDS/XGS	43.2	63.0	65.6	80.8	49.6	41.2	46.1	39.3
9. INT/XGS	20.6	33.7	38.2	49.0	38.0	33.5	38.2	32.0
III. GROWTH RATES (nominal)								
10. DOD (% change)	22.6	16.5	14.2	13.2	2.6	7.9	2.9	2.9
IV. VULNERABILITY COEFFICIENTS								
11. VIR/DOD (%)	68.4	76.1	79.8	81.3	79.8	84.6	93.2	93.1
12. Concessional/DOD (%)	7.4	2.3	1.9	1.8	1.6	1.4	1.4	1.3
13. Preferred Creditors/DOD (%)	6.7	4.4	4.3	4.5	5.5	6.2	7.0	8.0
14. Average Cost of Funds (%)	9.6	12.1	13.8	13.5	10.1	10.5	10.7	9.6
15. ST/DOD (%)	..	19.3	19.2	19.3	15.3	13.2	12.4	12.3
16. Average Maturity (yrs)	9.4	7.9	7.9	8.9	8.0	7.5	7.5	7.6

Memorandum Item: /d	1975	1980	1981	1982	1983	1984 /a	1985 /b	1986 /c
Use of IMF Credit: (in US$, millions)			0.0	550.2	2644.3	4185.4	4205.0	..
Service Charges:			0.0	0.4	95.9	276.3	346.4	848.4
(Repurchases)			0.0	0.0	0.0	0.0	0.0	515.1
(Charges)			0.0	0.4	95.9	276.3	346.4	333.3

a. Preliminary.
b. Estimated.
c. Projected.
d. Use of IMF Credit for 1985 shows the status through October 1985; repurchases and charges for 1985 and 1986 are projections based on the Use of IMF Credit at end-1984.

12/17/85

Table 2-8: GDP, TRADE AND BOP INDICATORS FOR BRAZIL, 1970-95

Bank Region: Latin America and Caribbean
WDR Region: Major exporters of manufactures
Projections prepared by: Coutinho
Date: 12.02.85

Percent change p.a.	Bil.$ 1980	1973-80	1980-83	1984	1985	1986	1986-90	1990-95
1. GDP	249.740	6.8	-1.1	4.5	7.0	5.6	6.1	6.3
2. * GDP	249.740	6.8	-1.1	4.5	7.0	5.6	6.6	6.9
3. * GDP Per Capita +	2.059	4.3	-3.2	2.3	4.7	3.4	4.4	4.9
4. Export Volumes (fob,customs basis)	20.132	5.5	4.0	20.1	-2.3	2.5	5.1	6.0
5. Manufactures	7.770	13.8	4.5	35.0	-6.8	1.9	6.4	8.5
6. Non-Fuel Prim.	12.005	2.4	0.9	10.2	1.4	2.9	4.0	3.8
7. Fuels	0.358	-7.6	56.7	10.2	1.4	2.9	5.2	4.1
8. * Export Volumes (fob,customs basis)	20.132	5.5	4.0	20.1	-2.3	2.5	5.4	7.2
9. * Manufactures	7.770	13.8	4.5	35.0	-6.8	1.9	6.4	9.6
10. * Non-Fuel Prim.	12.005	2.4	0.9	10.2	1.4	2.9	4.7	5.2
11. * Fuels	0.358	-7.6	56.7	10.2	1.4	2.9	4.7	5.2
12. Import Volumes (cif)	24.949	-0.4	-10.5	-6.1	5.9	20.0	9.2	7.2
13. * Import Volumes (cif)	24.948	-0.4	-10.5	-2.0	5.9	20.0	9.9	8.3
14. Terms of Trade	1.000	-3.4	-0.7	1.3	-1.3	6.5	0.7	1.4
15. * Ex-post Import Elasticity	0.100	-0.1	10.0	-0.4	0.8	3.6	1.5	1.2

Bill. US $	1973	1980	1983	1984	1985	1986	1990	1995
16. Trade Balance (BOP basis)	-0.061	-2.811	6.486	13.114	11.129	10.104	11.081	8.758
17. * Trade Balance (BOP basis)	-0.061	-2.811	6.486	13.100	13.200	13.100	19.400	29.600
18. Cur. Acc. Bal.(incl. Off. Trans.)	-2.158	-12.793	-6.799	0.053	-3.371	-4.291	n.p.	n.p.
19. * Cur. Acc. Bal.(incl. Off. Trans.)	-2.158	-12.793	-6.799	0.053	-1.300	-1.295	1.387	0.805
Ratios (in %)								
20. Current Account/GDP	-2.7	-5.1	-3.3	0.0	-1.5	-1.6	n.p.	n.p.
21. * Current Account/GDP	-2.7	-5.1	-3.3	0.0	-0.6	-0.5	-0.3	0.1
22. Debt Service Ratio	26.9	56.4	43.1	50.7	41.3	34.9	n.p.	n.p.
23. * Debt Service Ratio	26.9	56.4	43.1	50.7	41.3	34.9	48.3	33.4

* Indicates the country economist's projection. If no revisions are made, then the corresponding EPD figures are given

\+ GDP p.c. level in 1980 is expressed in thousands of US $; n.p. = not projected.

Country Notes.

Assumptions : a) Coffee is expected to lose grounds while soybean, other agriculture and iron will grow rapidly; b) inflation kept under control; c) import liberalization starts in 1986; d) real exchange rate stabilized; e) external debt is rescheduled

*** Trade balance projections use the Region's trade prices (1984 import U.V.=-8%; latest CPP Report thereafter).***

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1-21-86

Draft Baker Initiative Brief: Brazil

Alan Gelb, DRD

I. THE CURRENT SITUATION

Main Policy Responses.

During the period 1977-83 Brazil's terms of trade nearly halved. The average real interest rate payable on medium and long-term debt increased from -4 percent in 1977 to around 11 percent in 1982 before beginning to decline. The consequent terms of trade losses and increased factor payments were equivalent to 8 percent of GDP. Initially, much of this external deterioration was financed by running large current account deficits--4.6 percent of GDP over 1979-82--but by 1983 the cutoff of international lending forced rapid adjustment. By 1984 one indicator of the extent of adjustment--the terms of trade loss plus factor payments increase plus improvement in the current account (all relative to 1977)-- reached the equivalent of 10 percent of GDP.

This adjustment required:

(a) a trade surplus, and

(b) the transfer of the excess of income over absorption to the public sector to enable it to service external debt (which was 80 percent public).

Three sets of policies have been important:

(i) A substantial real depreciation was effected in 1983, wages were cut and credit policy tightened. These expenditure switching and reducing policies aimed to effect the trade surplus.

(ii) The public sector turned to domestic capital markets as fiscal adjustment lagged the drying-up of foreign finance. This caused rapid growth of the domestic public debt.

(iii) By permitting domestic assets and foreign debts to be offset, the government socialised exchange risk in the Central Bank. This reduced the impact of the maxidevaluation of 1983 on private debtors.

Adjustment-External.

The above combination of measures has led to a remarkable turnaround on the external account. In 1980-82 the current account deficit averaged $13 billion or 4.7 percent of GDP. In 1984-85 the average current account has been almost balanced, with a small deficit in 1985 following a small surplus in 1984. The real exchange rate against the dollar depreciated from 100 in 1977 to around 65 in 1985, following the 1983 maxidevaluation and the policy since then of continuous devaluation against the dollar at the rate of domestic inflation. Trade surpluses of around $12 billion have facilitated interest service on debt; although external debt increased in 1984, this reflected the reconstitution of reserves from extremely low levels.

Brazil's external performance was effected through export expansion (the share of industrial exports in output almost doubled in 1982-84) and severe import compression. The latter was made possible by the maturation of major investments in key import-substituting industries as well as by depressed domestic demand (especially investment which has a higher import content) and tighter import controls.

Adjustment-Domestic.

The domestic picture has been more clouded. In the process of adjustment, Brazil moved into recession at least as severe as that in the

1930's. The trough was reached in 1983. Recovery in 1984 involved growth of 4.5 percent and was export-led. Expansion of 7 percent in 1985 was consumption-led; domestic investment, estimated at 18 percent of GDP in 1985, has not recovered substantially from its long slide, from 26 percent in 1977 to 16 percent in 1984.

In the recession real wages fell some 20 percent from peak levels; they have recently somewhat recovered (real wage increases are estimated at about 13 percent) but are still below previous levels. Public-sector wages appear to have been especially squeezed, with adjustment lagging accelerating inflation; there is now great pressure for their increase.[1]

Brazil is therefore now in a state of recovery, but one which appears to be fairly fragile. The following factors are important in assessing the immediate outlook:

1. Inflation and Interest Rates.

Brazilian inflation has accelerated in step-jumps, from 40 percent to 100 percent in 1979-81 and then to a new plateau of 200-220 percent since 1983. The inflation tax has not changed too much, so that any rise in the real public deficit has had to be financed by selling bonds and bills. The narrowly-defined money stock is small relative to GDP, with liquidity largely being provided by other financial assets held on a 24-hour basis or subject to repurchase agreements. Most of the non-monetary assets have their principal

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1/ Wages are indexed with a lag, so that accelerating inflation has been associated with a fall in the real wage. More important may have been the severity of the recession; despite indexation, Brazilian wages seem to be quite responsive to labor market conditions. Recent pressure to shift from 6-monthly to quarterly adjustment could again cause inflation to accelerate.

corrected by an index of monetary correction (ORTN) or by the exchange rate. As government turned to the domestic financial market (see below) real interest rates soared, to average 23 percent for working capital in 1982-84. In the first half of 1985 interest rates reached unprecedented levels. Since August they have fallen somewhat but are still very high.

The impact of these high rates has been felt mainly by public sector firms and the housing system. The private corporate sector was able to adjust remarkably rapidly after 1981 by trimming payrolls and working capital and cutting pay, and may now be in a net creditor position. However, high real rates inhibit investment, as does the fear that an acceleration of inflation (which could take place for a variety of reasons) would lead to even higher real rates.1/

It is also feared that its increasing domestic debt might lead the government to change the rules of ORTN indexation. High real interest rates thus substantially reflect a credibility problem, which in turn relates to the failure to adjust fiscal policy more promptly towards a contractionary stance, as is further discussed below.

2. Investment and Growth.

The output and real wage increases of 1984-85 have been made possible largely through increases in the rate of capacity utilisation. Perhaps surprisingly (in view of the depth of the recession), many industrial sectors now appear to be hitting "full" capacity levels, and shortages have begun to

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1/ Factors which could cause inflation to accelerate include: failure to carry out the fiscal package recently announced, a shift to quarterly wage indexation, adjustment of controlled prices, a poor harvest and the exhaustion of spare capacity.

emerge. Therefore, in assessing the prospects for growth even in the short-medium term, both the level of investment and the efficiency with which the capital stock can be employed are key variables.

3. The Fiscal Deficit.

The Federal budget balance is of little analytical value in its own right. Estimates of the consolidated public setor deficit are only available on a consistent basis after 1981. A number of definitions and concepts have been used, reflecting the problems involved in applying standard constructs to the Brazilian situation.

The "nominal" public sector deficit now represents around 25 percent of GDP. Most of this is, however, made up of monetary and exchange correction on outstanding public debt. The nominal deficit therefore tends to rise, relative to GDP, as inflation accelerates, and is not the most useful concept for analysing fiscal policy. One measure which has recently been calculated by the Central Bank computes the deficit as the increase in the real value of the outstanding stock of public debt, and includes the Monetary Authorities as part of the "public sector"[1/] On this measure, the public deficit decreased from 6.5 percent of GDP in 1982 to 4.5 percent in 1984, and is estimated at 2.9 percent in 1985. Real depreciation sharply raised the ratio of domestic and foreign public debt to GDP in 1983. The domestic public debt is now about 20 percent of GDP and the foreign public debt is about 30 percent; real

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1/ An extended discussion of the various public deficit concepts is beyond the scope of this paper. Excluding the Monetary Authorities changes the Central Bank deficit estimate only slightly. It then is close in concept to the "operational deficit" of the IMF which excludes monetary and exchange correction from the nominal deficit and also excludes the Monetary Authorities. The estimate of the nominal deficit given in the text follows the IMF definition. Computed as the nominal increase in all public debt converted into cruzeiros at the beginning and end of period, the nominal deficit is about 50 percent of GDP.

interest charges are therefore now about 5-6 percent of GDP so that the noninterest fiscal balance (excluding correction of debt) is in substantial surplus.1/

4. The Current Gradualist Approach to Stabilisation.

On November 28 government presented a series of measures through which it expected to cut the deficit (as measured above) from 2.9 percent of 1985 GDP to 0.5 percent of projected 1986 GDP. Its package included significant tax and public pricing reforms, containment of central government and other public sector expenditures and also provided for a doubling in real terms of the "social priorities" program. Sizeable sales of public enterprise stock are also envisaged, as is liberalisation of trade in agricultural products.

Alternative, more radical, approaches featuring a monetary reform a la Argentina or Israel are currently being debated, but the implementation of such a reform seems unlikely unless inflation accelerates sharply or the recovery is reversed. The probability of some such scenario is not negligible. There is the prospect that inflation will again accelerate, which will undermine confidence, reduce willingness to hold public debt and so raise real interest rates and stifle investment and growth. The Baker paper should make reference to such a scenario consider the short term macroeconomic effects of increased lending.

II. POLICIES FOR ADJUSTMENT.

1/ Over the past two years central government domestic borrowing has substituted for public enterprise domestic borrowing. The more visible Treasury debt has thus grown at about 32 percent in real terms whereas real public enterprise debt has been constant. This may have contributed to a perception that total public debt was expanding more rapidly than it actually has been.

The Role of External Finance.

If the external nominal debt were to remain constant and the real exchange rate were held constant, Brazil's debt/GDP ratio would probably fall at about 10-percent per year. Although it is difficult to estimate the optimal debt/GDP ratio, this suggests that some financing from external sources above the level suggested by the 1984-85 current account is a reasonable option from the long-run perspective.

In the present situation the potential contribution of increased external finance is two-fold. First, it would permit an increase in imports and allow some relaxation of the contractionary and regulatory measures needed to effect the present trade surplus. Second, it would ease the difficulties posed by the domestic transfer problem, namely (i) the depressed level of public investment some of which is essential for structural adjustment (for example, electrical transmission lines) and (ii) public sector pressure on domestic financial markets. This is undermining confidence and inhibiting vital private investment.

The Policy Recommendations.

The impact of external funding would be large only if accompanied by measures to raise the efficiency of domestic resource use. This brings us to the measures set out on pp 6 and 7 and in Annex 1 of the Baker paper. They cover a very wide set of issues; indeed, it is difficult to think of any major area omitted from the list. Together with their timing as set out in Annex I they would represent an important shift in the nature of Brazilian economic policy and institutions over the next five years.

The policies proposed in the Baker paper are sensible; indeed, as noted, most are being addressed in ongoing dialog between Brazil and the Bank. Some seem optimistic. For example, selective privatisation of public

Questions:

enterprises (para 14--as opposed to just selling a minority shareholding); reform of the Monetary Authorities (para 16--it is not apparent that the Bank of Brazil's costs render it potentially competitive without continuing subsidies and its status as the largest traded stock limits the measures which can be taken); reducing inflation to 20 percent by 1990 (para 18--without a successful monetary reform which is not set out as an option in the paper).

On the other hand, some of the recommendations could perhaps be strengthened. Why should negative real interest rates persist for rural credit until 1988? Would not a rapid move to full market rates be more compatible with a speedy transition of the Bank of Brazil? Could the schedule for policy changes to encourage direct investment not be accelerated?

To what extent is such a very broad set of measures monitorable as a whole? Is the intention to have a two-level monitoring system, with certain key (and monitorable) variables forming a core and others being mainly associated with specific Bank loans? While the paper identifies the relationship between Bank policy-based projects and areas of policy reform, the absence of specific criteria is notable in Annex I.

Further, is Brazil willing to have the Fund monitor key aspects of its program? What would be the Bank's response if in such key areas (for example, the public sector deficit) Brazil was not in compliance yet in project-specific areas (such as agricultural credit) it was? Could cofinancing for such a project reasonably be expected from commercial banks?

The paper does not make clear the link between policy change and economic performance. Realistically, this is hard to do in quantitative terms, but there are strong assumptions underlying the policy-growth link as further noted below.

There may be inconsistency between policies and projections; policies to promote exports and efficient import substitution (p6) include devaluation equal to domestic inflation or, in Annex I, at least equal to the differential of inflation over foreign rates. Over 5-10 years there is a substantial difference in these options. Real exchange rate policy affects the prospects of reducing domestic real interest rates and therefore the growth of public debt. It also affects the evolution of the projected debt-GDP ratio.

III. INDICATORS AND PROJECTIONS.

The paper presents three projections: high (8 percent), medium (7 percent)and low (5 percent) GDP growth. In these projections it is assumed that capital inflows are constrained by debt-export and debt-service ratios.[1/] The high-growth scenario, where real exports grow at 7-8 percent after 1987, envisages continuing current account deficits of $2.5-4 billion while the low growth scenario, where exports grow at only 2-3 percent, requires current surpluses after 1986. In the medium case exports grow at about 6 percent and current deficits are in the $ 1-3 billion range with no "new money" from commercial banks.

The low-growth scenario represents a situation characterised by no major policy reforms and a constant real exchange rate. The high-growth scenario assumes timely adoption of all required policy reforms and real exchange devaluation at the rate of international inflation. The "most

1/ In all projections debt/export ratios evolve in a similar manner, declining steadily from 3.7 in 1985 to 1.5 - 1.8 by 1995.

likely" medium-growth scenario assumes all policy reforms except trade liberalisation; instead, there is some simplification of trade policy.

For comparison, the Brazilian government's own growth target is only 6 percent. GDP growth was projected at 6.6 percent rising to 6.9 percent after 1990 by the Region in the recent EPD country survey and this was modified to 6.1 per cent rising to 6.3 percent by EPD. Comparable export growth projections were: Region: 5.4 rising to 7.2 percent and EPD 5.1 rising to 6 percent. In general, these estimates are between the medium and low scenarios in the Baker paper.

One reason for the difference in GDP growth rates in the Baker scenarios is the greater volume of external financing made possible by higher exports. The other is an efficiency effect, assumed to follow the adoption of the policy reforms. The average ICOR varies from about 3 to 3.3 over the scenarios.1/ This permits extra growth without cost in terms of consumption--it would seem that the efficiency assumptions following from the policy package are responsible for about 1 percent extra growth. Any such assumption on the effects of the reforms should be made explicit. JCon

Policies and scenarios may not be consistent. If world inflation is, say, 5 percent, in dollar terms GDP growth is actually only 3 percent in the high and 2 percent in the medium-growth scenarios because of the real exchange rate policy assumed to be needed to encourage exports and accompany liberalisation (see para 9). Therefore, in dollar terms GDP actually grows less in the high and medium scenarios than in the low-growth scenario. This is inconsistent with Table 2, which does not allow for real exchange rate

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1/ In 1973-1980 the ICOR was 3.3.

effects; debt/GDP and similar ratios would grow far more rapidly in the above scenarios.

A related point is that the scenarios assume the same terms-of-trade sequence over time (a slight improvement), although one of the goals of real devaluation is to improve competitiveness and sales abroad. This is consistent only if Brazilian exports are seen as totally supply- constrained, which, even without an increase in protectionism, is unlikely for such diverging export growth rates.

The transition from 1985 to 1986 also raises some questions. The 44 percent marginal savings rate seems optimistic. It might be difficult to effect 22 percent import growth without undermining the confidence needed for stabilisation. Given supply lags, is it really feasible for Brazil to grow at 8 percent even if investment picks up? Growth in 1986-87 is mainly dependent on the success of the stabilisation policy phase; this needs more emphasis.

IV. CONCLUSION.

Overall, the paper is rather upbeat, though its policy suggestions are sound. It does not place sufficient emphasis on the primacy of the stabilisation-confidence issue and does not address the possibility that Brazil will need to undertake a radical monetary reform, with all the legal and other ramifications. It assumes that the government is willing to undertake wideranging policy reforms in a relatively short space of time, under the pressure of continual elections. The moderate-growth scenario is above the government's projections. There may be some inconsistency between policy recommendations and the projected creditworthiness indicators. Finally, there needs to be further discussion between the Bank and the Brazilian government on the precise content of a stabilisation plan and its monitoring, and more thought on the relationship between the monitoring of the various parts of such a broad policy package and the set of proposals which could be presented to commercial banks.

AZIL

SELECTED ANALYTICAL VARIA S FOR ECONOMISTS AND MANAGERS

ATLAS PER CAPITA GNP (CUR) (1984)	-1,710
POPULATION IN MILLIONS (1984)	=132.582
LT DEBT OUTSTANDING AND DISBURSED IN MILLIONS (CUR)(1984)	=87,012.80
BALANCE ON CURRENT ACCOUNT IN MILLIONS (1984)	=53

	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973 1980	1980	1981	1982	1983	1984	1985	1986
GROWTH OF GDP AGGREGATES (CONST)					GROWTH RATES				
1. GDP	6.94	6.81	249,740	-1.55	0.96	-3.18	4.50	7.00	5.59
2. AGRICULTURE(1)	3.78	4.80	31,286	6.41	-2.47	2.25	3.92	4.50	4.00
3. INDUSTRY(1)	11.04	7.44	81,482	-5.21	0.78	-6.15	5.82	8.50	7.10
4. GDP OUTPUT DEFLATOR	37.81	47.96	100	97.78	96.37	144.46	207.90	..	..
5. IMPORTS GNFS (NAT. ACCTS.)	9.32	1.67	26,560	-13.47	-5.19	-17.15	8.86	5.50	19.70
6. EXPORTS GNFS (NAT. ACCTS.)	7.44	7.00	21,281	20.74	-8.24	13.08	20.12	-2.00	2.42
7. MERCHANDISE EXPORTS (2)	7.01	7.81	20,132	27.00	-15.12	15.86	24.90	..	..
8. DOMESTIC ABSORPTION	7.01	6.42	255,020	-3.32	1.84	-4.80	2.96	8.43	6.22
9. INVESTMENT	8.01	5.15	56,264	-15.84	-4.27	-17.43	4.69	1.10	17.33
10. PER CAP TOTAL CONSUMPTION	3.94	4.34	1,639	-1.99	1.02	-4.17	0.38	7.40	1.99
11. POPULATION (MIL)	2.72	2.36	121	2.25	2.25	2.25	2.25	2.25	2.25
TRADE PRICE INDICATORS (1980=100)					INDICES				
12. TERMS OF TRADE OF AGR/IND(1)	60.26	93.45	100.00	89.68	79.39	85.24	..	..	..
13. TERMS OF TRADE	126.96	125.45	100.00	85.98	85.00	85.85	102.55	..	..
14. TERMS OF TRADE (UNCTAD)	152.47	132.98	100.00	84.95	84.43	92.06	94.57	..	..
15. NOMINAL EFFECTIVE EXCHANGE RATE(3)	..	147.44	100.00	66.76	40.63	16.19	5.68	7.01	..
16. REAL EFFECTIVE EXCHANGE RATE(3)	..	106.38	100.00	122.80	129.49	105.20	105.53	104.90	..
INVESTMENT AND SAVINGS					RATIOS				
17. INVESTMENT/GDP (CURRENT)	26.2	23.9	22.5	21.2	21.[illegible]	17.0	15.7	..	..
18. INVESTMENT/GDP (CONSTANT)	20.7	23.4	22.5	19.3	18.3	15.6	15.6	14.7	16.4
19. DOMESTIC SAVINGS/GDP (CURRENT)	25.3	21.9	20.4	20.9	20.6	19.3	21.2	..	..
20. DOMESTIC SAVINGS/GDY (CONSTANT)	18.9	20.8	20.4	17.8	15.9	14.8	17.9	..	..
21. GROSS NAT. SAVINGS/GDP (CURRENT)	24.1	19.5	17.4	17.0	15.5	13.7	15.8	..	..
22. RESOURCE BALANCE/GDP (CONSTANT)	-2.7	-4.7	-2.1	1.1	0.7	3.6	4.9	4.0	[illegible].6
23. MARG PROPENSITY TO SAVE (CONSTANT)	22.3	19.4	51.8	105.8	-171.0	49.1	65.4	..	..
24. TERMS OF TRADE ADJ./GDP (CONSTANT)	2.0	2.0	0.0	-1.5	-1.4	-1.6	0.3	..	..
25. ICOR (CONSTANT)	2.3	3.3	3.0	-14.0	20.3	-5.8	..	..	..

EPD 12/23/85

MANAGEMENT SUPPLEMENT
SAVEM TABLES
SELECTED DEBT INDICATORS
1975-1986

BRAZIL

	1975	1980	1981	1982	1983	1984 /a	1985 /b	1986 /c
I. VALUES (in current US$, billions)								
1. Long Term debt (LT)	23.5	56.5	64.6	73.0	78.7	87.0	90.3	93.1
2. Short Term debt (ST)	..	13.5	15.3	17.5	14.2	13.2	12.8	13.0
3. Total Debt (DOD)	23.5	70.0	79.9	90.5	92.9	100.2	103.1	106.1
4. Interest (INT)	2.05	7.85	10.31	11.50	9.27	10.15	10.91	10.0
5. Amortization	2.24	6.82	7.40	7.48	2.83	2.31	2.25	2.3
6. XGS, (nominal)	9.95	23.29	26.99	23.49	24.37	30.26	28.55	31.3
II. RATIOS (percent)								
7. DOD/XGS	236.4	300.7	296.2	385.3	381.1	331.1	361.2	338.9
8. TDS/XGS	43.2	63.0	65.6	80.8	49.6	41.2	46.1	39.3
9. INT/XGS	20.6	33.7	38.2	49.0	38.0	33.5	38.2	32.0
III. GROWTH RATES (nominal)								
10. DOD (% change)	22.6	16.5	14.2	13.2	2.6	7.9	2.9	2.9
IV. VULNERABILITY COEFFICIENTS								
11. VIR/DOD (%)	68.4	76.1	79.8	81.3	79.8	84.6	93.2	93.1
12. Concessional/DOD (%)	7.4	2.3	1.9	1.8	1.6	1.4	1.4	1.3
13. Preferred Creditors/DOD (%)	6.7	4.4	4.3	4.5	5.5	6.2	7.0	8.0
14. Average Cost of Funds (%)	9.6	12.1	13.8	13.5	10.1	10.5	10.7	9.6
15. ST/DOD (%)	..	19.3	19.2	19.3	15.3	13.2	12.4	12.3
16. Average Maturity (yrs)	9.4	7.9	7.9	8.9	8.0	7.5	7.5	7.6
Memorandum Item: /d								
Use of IMF Credit: (in US$, millions)			0.0	550.2	2644.3	4185.4	4205.0	..
Service Charges:			0.0	0.4	95.9	276.3	346.4	848.4
(Repurchases)			0.0	0.0	0.0	0.0	0.0	515.1
(Charges)			0.0	0.4	95.9	276.3	346.4	333.3

a. Preliminary.
b. Estimated.
c. Projected.
d. Use of IMF Credit for 1985 shows the status through October 1985; repurchases and charges for 1985 and 1986 are projections based on the Use of IMF Credit at end-1984.

12/17/85

Table 2-8: GDP, TRADE AND BOP INDICATORS FOR BRAZIL, 1970-95

Bank Region: Latin America and Caribbean
WDR Region: Major exporters of manufactures

Projections prepared by: Coutinho

Date: 12.02.85

	Percent change p.a.	Bil.$ 1980	1973-80	1980-83	1984	1985	1986	1986-90	1990-95
1.	GDP	249.740	6.8	-1.1	4.5	7.0	5.6	6.1	6.3
2.	* GDP	249.740	6.8	-1.1	4.5	7.0	5.6	6.6	6.9
3.	* GDP Per Capita +	2.059	4.3	-3.2	2.3	4.7	3.4	4.4	4.9
4.	Export Volumes (fob,customs basis)	20.132	5.5	4.0	20.1	-2.3	2.5	5.1	6.0
5.	Manufactures	7.770	13.8	4.5	35.0	-6.8	1.9	6.4	8.5
6.	Non-Fuel Prim.	12.005	2.4	0.9	10.2	1.4	2.9	4.0	3.8
7.	Fuels	0.358	-7.6	56.7	10.2	1.4	2.9	5.2	4.1
8.	* Export Volumes (fob,customs basis)	20.132	5.5	4.0	20.1	-2.3	2.5	5.4	7.2
9.	* Manufactures	7.770	13.8	4.5	35.0	-6.8	1.9	6.4	9.6
10.	* Non-Fuel Prim.	12.005	2.4	0.9	10.2	1.4	2.9	4.7	5.2
11.	* Fuels	0.358	-7.6	56.7	10.2	1.4	2.9	4.7	5.2
12.	Import Volumes (cif)	24.949	-0.4	-10.5	-6.1	5.9	20.0	9.2	7.2
13.	* Import Volumes (cif)	24.948	-0.4	-10.5	-2.0	5.9	20.0	9.9	8.3
14.	Terms of Trade	1.000	-3.4	-0.7	1.3	-1.3	6.5	0.7	1.4
15.	* Ex-post Import Elasticity	0.100	-0.1	10.0	-0.4	0.8	3.6	1.5	1.2

	Bill. US $	1973	1980	1983	1984	1985	1986	1990	1995
16.	Trade Balance (BOP basis)	-0.061	-2.811	6.486	13.114	11.129	10.104	11.081	8.758
17.	* Trade Balance (BOP basis)	-0.061	-2.811	6.486	13.100	13.200	13.100	19.400	29.600
18.	Cur. Acc. Bal.(incl. Off. Trans.)	-2.158	-12.793	-6.799	0.053	-3.371	-4.291	n.p.	n.p.
19.	* Cur. Acc. Bal.(incl. Off. Trans.)	-2.158	-12.793	-6.799	0.053	-1.300	-1.295	-1.387	0.805
	Ratios (in %)								
20.	Current Account/GDP	-2.7	-5.1	-3.3	0.0	-1.5	-1.6	n.p.	n.p.
21.	* Current Account/GDP	-2.7	-5.1	-3.3	0.0	-0.6	-0.5	-0.3	-0.1
22.	Debt Service Ratio	26.9	56.4	43.1	50.7	41.3	34.9	n.p.	n.p.
23.	* Debt Service Ratio	26.9	56.4	43.1	50.7	41.3	34.9	48.3	33.4

* Indicates the country economist's projection. If no revisions are made, then the corresponding EPD figures are given.
\+ GDP p.c. level in 1980 is expressed in thousands of US $; n.p. = not projected.

Country Notes.

EPDGL/ 1. 9.86

Assumptions : a) Coffee is expected to lose grounds while soybean, other agriculture and iron will grow rapidly; b) inflation kept under control; c) import liberalization starts in 1986; d) real exchange rate stabilized; e) external debt is rescheduled.
*** Trade balance projections use the Region's trade prices (1984 import U.V.=-8%; latest CPP Report thereafter).***

CONFIDENTIAL
D R A F T
January 21, 1986

BRAZIL - MEDIUM-TERM GROWTH STRATEGY

A. Current Situation

1. During 1983-85, Brazil succeeded in achieving the external adjustment required to reach a reasonable equilibrium in its balance of payments. After three years of GDP decline, the economy grew by about 4.5% in 1984, while the trade surplus reached US$13 billion and a small current account surplus (US$500 million) was also achieved. In 1985, in spite of high (7-8%) GDP growth, the trade surplus remained at over US$12 billion, the current account deficit was below 1% of GDP, and gross international reserves remained at a level equivalent to about 8 months of imports. The presence of substantial excess capacity facilitated the year's rapid growth. The large increase in exports achieved in recent years (from US$15.2 billion in 1979 to US$27.0 billion in 1984), and the efficient import substitution taking place in petroleum and some industrial subsectors, have contributed substantially to this economic performance, and should also help Brazil maintain acceptable growth rates in future years. Brazil has thus achieved a unique position among the high-debt countries, in having been able to resume economic growth without a deterioration in its balance of payments.

2. The external adjustment was not, however, accompanied by a parallel domestic achievement. Inflation increased from 40% to about 100% a year in 1979-82, because of the oil shock, demand pressures, and subsequent devaluation. Inflation escalated again to over 200% in 1983, as a result of the large devaluation in early 1983 and agricultural supply shortages. There was also intense pressure on the financial system when external sources of financing evaporated and the Government turned to domestic capital markets. Public debt increased rapidly in 1982-83, as the impact of the fiscal deficit was aggravated by devaluation, which raised the real cost both of foreign debt and domestic debt carrying the option of exchange correction. While there were no large shocks in 1984-85, indexation has made it difficult to bring inflation down. Furthermore, prices now seem to react quickly to new supply or demand shocks, after several years of high inflation. The rate of inflation remains above 200% annually, and real interest rates are still high, although they have fallen in recent months. Both factors introduce an element of uncertainty into investment planning, at a time when substantial increases in productive investment will soon be needed. Consequently, while inflation to date has not halted growth, its future effect is worrisome and a serious effort to control inflation is warranted.

Fiscal def. ↑
effect on real r?
how much?
why?
to?
??

3. In spite of the inflationary pressures, Brazil's productive structure has in recent years been demonstrably more efficient and competitive than that of other heavily indebted countries in the LAC region. The speed with which Brazilian industry adapted itself in 1983-84 to the need to increase exports was indeed remarkable, as has been also in recent years the export performance of agriculture. There is still room, however, for providing additional incentives for increasing agricultural and industrial exports through appropriate policies designed for this purpose.

B. Development Strategy

Objectives

4. Brazil needs to (a) maintain a GDP growth rate of at least 6.5% per year in order to improve living standards and generate enough employment growth (at least 4% per annum) to hire new entrants into the labor force and reabsorb those affected by the recent recession; and (b) improve its creditworthiness position, by reducing its debt service and debt to export ratios by at least 25% by 1990 (with continued improvement in the 1990s), so that it can resume amortization payments on existing debt in the early 1990s. There are strong domestic pressures to reverse the deterioration in living standards of the recent recession, when per capita income fell 12% and social programs were curtailed. The Government's commitment to growth stems from the conviction that an additional recession would not be consistent with political stability. Therefore, while growth requires control of inflation, the Government has preferred up to now to follow a gradual approach to domestic stabilization. The Government realizes, however, that a further substantial acceleration of inflation would make it necessary to adopt more drastic internal adjustment policies, even if that causes a temporary reduction in growth rates. At the same time, it is accepted that the country's creditworthiness position must improve. Its foreign debt of over US$100 billion is some 3.7 times the annual amount of export earnings, and interest payments of about US$11 billion per year represent about 40% of exports. If amortization on its commercial bank debt were also being paid, Brazil's debt service ratio today would be about 80%. In summary, moderately rapid economic growth will be required to improve Brazil's domestic conditions and external standing. To be sustainable over the long term, such growth would have to be accompanied by a successful domestic adjustment effort.

from what to what?

Implications for Economic Change

5. GDP growth of such a magnitude involves expanding agricultural and industrial production for both domestic and international markets. Brazil's agricultural and industrial sectors are dynamic, employ modern techniques, and are relatively efficient. Given their responsiveness to profitable opportunities, providing sufficient market incentives, through maintenance of appropriate exchange rates and price signals, should be sufficient to stimulate production. For the agricultural sector, which has been subjected to periodic Government interventions in the market, freer commercial policies are particularly critical.

6. Substantial increases in investment and savings will be needed. Excess capacity, which has sustained the economic recovery to date, is starting to disappear in some industrial sectors, and the investment/GDP ratio, which was only 16-17% in 1983-84, will have to increase to about 23% by the end of the decade. The corresponding savings effort will be large, especially now that domestic savings must compensate for more modest foreign resource availability than existed in the growth period of the 1970s.

7. Investment, in effect, will have to be more efficient than in the 1970s, in view of the overall resource scarcity, and there will be no scope for building large plants far in advance of demand. The large infrastructure projects and industrial plants which drained Government resources in the 1970s, however, can now be used to support production at a relatively low cost. Together, these factors imply a moderate ICOR of about 3.

Is this a ↓ from the past?

8. Raising investment and savings will not be easy. It will require a large adjustment in the public sector, to scale back the size and scope of Government operations, increase their efficiency, and--most importantly--increase public savings and reduce the overall fiscal deficit. It will also require controlling inflation, which, at today's rate of 235%, is detrimental to new investment both because of the associated uncertainty and high real interest rates. Finally, it will require financial reform of the banking system, to rationalize operations and reduce financial segmentation of credit markets. All of these efforts should help to increase both private and public savings and channel these savings to productive investment at lower real interest rates than now prevail. They should also gradually shift the responsibility for economic expansion to the private sector, and limit the Government's role to the provision of infrastructure and social services. In numerical terms, private investment is expected to increase from 68% of total investment today to about 74% by the end of the decade. Private savings, in turn, will be used increasingly to fund private investment, rather than Government spending as is the case today.

how? to?

how will these come about?

9. Continued export growth remains an economic necessity for Brazil, in terms of markets, financing of needed imports, and its creditworthiness position. Improving the ability of Brazilian producers to compete externally also generates price and quality benefits for domestic consumers. With real export growth of 4.5% per year through the end of the decade, Brazil could continue to pay interest and could gradually resume amortization payments to commercial banks by the early 1990s. Regaining its ability to borrow on the international financial markets is fairly critical for Brazil, if it is to follow a rapid growth strategy.

10. Important structural changes have taken place in Brazil's trade accounts in recent years, which make it easier to continue generating trade surpluses exceeding US$12 billion per year for the remainder of the decade. With an established exchange rate policy designed to keep Brazilian products competitive, businesses now recognize the export market as an important source of sales. In addition, imports have dropped from a level of almost US$23 billion in 1980 to slightly over US$13 billion in 1985. While imports are expected to increase with the resumption of economic growth, considerable import substitution has occurred in both industrial products and in petroleum. We expect imports by 1989 to be only as high as they were in 1980, even with a nominal growth in non-oil imports of over 20% per year.

policies??

absolute?
not efficient
large subsidies.

if this is based on 'high' or 'moderate' scenarios, give nos. eg for investments, exports etc.

C. Proposed Medium-Term Adjustment and Growth Program

11. The Government is committed to the resumption of economic growth and social development with better control of inflation and an economic environment favorable to private initiative. It has the clear mandate of the electorate for this strategy, and has just laid out its 1986 program, centered around a large reduction of the operational deficit of the public sector. For the longer run, it has set a target of annual rates of GDP growth of not less than 6%, and a shifting role for the public sector. ?

how much?

12. We believe that Brazil could maintain an annual growth rate of about 5% over the next 5-10 years without additional major policy initiatives, even with some slippage in the extent of the Government's intended control of the fiscal deficit. Brazil has a large, generally efficient economic system, and businessmen who have demonstrated their capacity to respond to opportunities, to reduce costs to meet competition, and to adapt to changing circumstances. In addition, the present Government, like its predecessors, is pragmatic and is willing to take steps, as needed, to correct problems which threaten to undermine the economy. For the 5%, "low-growth", scenario to hold, the Government would have to hold inflation to its present level, although no major reduction is foreseen, and would have to follow an exchange rate policy of periodic devaluations at least equivalent to the difference between domestic and international inflation.

how likely is this given wage indexation?

that's it?

13. With more comprehensive policy reform, we believe that higher GDP growth would be possible if accompanied by moderate infusions of new foreign borrowing. The adjustment program recommended below (and in Annex IIA) would raise GDP growth to 7% on average. It is characterized as the "moderate-growth" scenario. If trade reform is added to this adjustment program (see para. 15 and Annex IIB), GDP growth rates of 8% per year--the "high-growth" scenario--would be possible with the support of additional foreign resources. Both scenarios contrast sharply with the 5%, "low growth" scenario, which reflects a smaller adjustment program spread over a longer period and less foreign borrowing.

Macro-Economic and Sectoral Policies

over the next 5 years?

14. The key sectoral policies required to implement the "moderate-growth" scenario are summarized in the following paragraphs, and specified in more detail--including the required timing--in the Policy Matrix in Annex IIA and in the Sectoral Policies Summary in Annex III.

15. Industry and Trade. Domestic markets for Brazilian manufacturers are protected by often high nominal tariffs and extensive non-tariff barriers, even after substantial reforms in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Implicit effective protection, as measured by direct price comparisons, is on average moderate, and there has been impressive recent growth in manufactured exports. Sectoral policies to promote exports and efficient import substitution consist of continuation of the

how much

how much?

present exchange rate policy of periodic devaluations equal to domestic inflation, some simplification of import regulations, further improvements to the drawback system, and, as indicated in the following paragraph, "free trade" policies for key agricultural products. With these policies, Brazilian export growth is expected to be sufficient to generate trade surpluses of US$12-15 billion per year for the rest of the decade and to permit a substantial increase in non-oil imports, when combined with additional foreign borrowing. While this program is being implemented, we would continue to encourage the Brazilians to proceed with the broader package of trade policy reforms envisaged within the "high-growth" scenario and spelled out in Annex IIB.

Indus + agric. or only indus?

16. Agriculture. Agricultural expansion is fundamental for achieving the production and export increases of the "moderate-growth" option. Agricultural growth has been erratic--high growth in the 1970s was followed by stagnation of output in the early 1980s--and Government policies in the sector have been characterized by costly credit programs to compensate for adverse trade and pricing policies, as well as periodic market interventions to stabilize domestic supply and prices. The key to realizing the sector's full potential is a policy framework that will make agriculture profitable without credit subsidies, interventionist trade policies and production-based taxation. This process was initiated when the Government decided in 1983, in the context of the First Agriculture Sector Loan, to phase out negative real interest rates on rural credit. The proposed program for agriculture would further reduce credit subsidies and finance those remaining through the fiscal budget; phase out food price controls and the wheat subsidy (while implementing targeted food assistance programs); rationalize trade regulations for agricultural commodities; and promote the rapid growth of production and exports through free-trade policy for key agricultural products, subject to minimum price guarantees, market safeguards and Government stock management. Provision would also be made for reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

? How restrictive is this?

What does this mean?

17. Energy. Over the past decade, by accelerating petroleum exploration and production as well as by promoting energy substitution and conservation, Brazil has significantly reduced its oil imports from US$10-11 billion in 1980-82 to about US$5 billion in 1985. Because of the weak international oil market and the country's resource constraints, further import substitution and conservation of energy products, which will help increase production and reduce imports, must be cost-effective. Consequently, Brazil's strategy for the energy sector should focus on appropriate pricing policies, especially for petroleum products, alcohol, and electricity, to better reflect economic costs, coordination of energy investments being made or regulated by the Government, and systematic application of economic criteria to investment decisions. A coordinated investment and financial rehabilitation plan for the power sector, which has been approved by the Government and is now being appraised as the framework for the proposed FY87s Power Sector Loan, would insure adequate provision of electricity to support the country's growth without further draining Government resources.

Subsidies to Alcohol prodn a major drain on budget? Other energy subsidies?

What about high real i?

18. Investment and Savings. Public sector adjustments are critical to the national investment and savings effort. Reducing Government claims on resources through elimination of the public sector deficit and improving the operation of the public sector, including the public enterprises, already have high priority in the Government's program. The systematic screening and monitoring of Federal investments by the Planning Ministry, and the strengthening and selective privatization of public enterprises are being planned, with Bank assistance. At the same time, appropriate industrial, agricultural, and trade policies (see paras. 15-16), provision of tax incentives for private investment, and better allocation of credit to private, relative to public, users should help to stimulate private sector expansion. The public share of total investment is expected to decline, from an estimated 32% in 1984-85 to 26% by 1990. And with the elimination of the public sector deficit, public savings will more adequately cover public investment. ?

how much?

Thus the first mention of this? By when? Assuming what?

19. Stabilization. The proposed policies in this area would be directed towards progressively reducing inflation. The program would include, inter alia, a substantial reduction of the public sector deficit and of the rate of increase of the domestic public debt, to levels consistent with the desired gradual reduction in inflation and with the credit availability required for the financing of private investment; the maintenance, on a continuous basis, of monetary and incomes policies compatible with increased internal stability; and the preparation and implementation of a program for dealing with the price stabilization problems posed by the widespread indexation of the Brazilian economy.

??

Do we know what we are talking about here? Current status?

20. Balance of Payments. Servicing its large external debt is a major consideration in Brazil's balance of payments strategy. Resumption of growth at rates averaging about 7% per year would raise the demand for imports and consequently add to the pressure on foreign exchange earnings. The country's balance of payments strategy, therefore, must include the following components:

how much?

(a) Continued rapid export growth, through maintenance of its present exchange rate policy (cruzeiro devaluations in line with domestic inflation) and adoption of other trade measures stated above.

(b) Continued rescheduling of commercial bank and Paris Club debt coming due through the end of the decade, at terms--for both rescheduled and new debt--which are in line with its debt servicing capacity. Minimum terms on commercial bank debt should consist of nine-year maturities, five years of grace, and an interest rate of about 1% over LIBOR.

What does this mean?

(c) Development of a medium-term strategy for new external borrowing (official and commercial) which is consistent with the country's growth strategy and its ability to repay.

(d) Reexamination of Government incentives to foreign private investment, which has dropped from US$1.5 billion in 1979 to less than US$1.0 billion in 1984-85.

??

Reform?

21. Fiscal and Financial Reform. Brazil's financial and fiscal systems no longer meet the needs of a country which must increase its savings and investment rates substantially, relying on the private sector as the major productive agent, and must manage both stabilization and growth in a complex economy. The reforms in this area are critical for improving resource mobilization and allocation to support agricultural and industrial growth, and for increasing the Government's fiscal and monetary control over a system which has become unwieldy and virtually impossible to understand in entirety. Among the recommended changes--some of which are already being implemented by the Government--are the consolidation of all fiscal expenditures in the Federal Budget; the separation of the Central Bank and the Bank of Brazil functions; the progressive elimination of the prevailing segmentation of credit markets; and tax reforms directed toward channeling savings toward productive investment through encouraging the long-term holding of financial assets, while reducing the overly large disparities in taxation across income levels and types.

22. Public Sector Management. The existing management problems within the public sector stem from public sector expansion in the 1970s. Since 1980, the Government has made numerous efforts to bring expenditures, including those of the large state enterprise sector, under better control. The objectives in this part of the program are to improve the overall efficiency of the public sector by establishing a Treasury Secretariat in the Finance Ministry, which would have operational control of the unified fiscal budget; strengthen the Planning Ministry's departments dealing with the planning and monitoring of public investment and current expenditures; undertake operational audits and action plans to improve the efficiency of public enterprises; and improve economic information and accounting control systems.

23. Social Development. A major casualty of the recession and debt crisis has been the social programs, including poverty alleviation and reduction of regional disparities. The program in this area would be aimed at restoring appropriate levels of education and health services, and improving their cost efficiency; and at improving the productivity and income levels of the Northeast population, in both urban and rural areas. The priority to be attached to these areas would be in line with the proposed shift in emphasis, within the public sector, from productive activities to infrastructure and social services, and with the parallel enhancement of the private sector as the main agent for the development of productive activities.

D. Action Plan for 1986

1986 Government Program

24. The Government has initiated an economic program for 1986 to promote increased stability with growth and a sound balance of payments position. It provides for, inter alia: (a) a 6% GDP growth rate; (b) periodic devaluations equivalent to domestic inflation; (c) limitation of

the real annual rate of increase of domestic public debt to 6%; (d) reduction in the operational deficit of the public sector from about 3.0% of GDP in 1985 to 0.5% in 1986; (e) a US$12.5 billion trade surplus and a US$600 million current account deficit; and (f) a 160% monetary expansion. The 1986 public sector budget assumes an inflation of 140% from December 1985 to December 1986. Compounded 220% pa for 1st 3 qtrs. of 1985 - Big reduction

25. The reduction in the operational deficit of the public sector would leave small residual deficits in the central, state and local government accounts and a balance in those of the state enterprises as a whole, decentralized agencies, and other funds and programs. The improvements would be secured by increases in taxation and public sector tariffs, the sale of state enterprise assets (with initial provision for the privatization of 13 enterprises plus sales of shares in 4 of the largest companies), and the rationalization of public expenditures. Part of the total savings would be offset by increased expenditures for social priorities to improve nutrition, general food supply and other basic needs and make better provision for agrarian reform, irrigation and other Northeast development projects, and for urban public transport.

from 220% to 10%?

26. We are now in the process of assessing the program. It is a serious program and, if sustained, would reduce public sector pressures on the system and contribute positively to the stabilization process, allowing for at least some reduction in real interest rates and setting the stage for a gradual reduction in inflation. The potential problems include the political difficulties, in an election year, of securing all the proposed adjustments; the crop failures in 1985-86 which have already raised agricultural prices and which will increase agricultural imports by over US$1.0 billion; and the possibility of capacity constraints in some industrial sectors while investment in new capacity is still low. Since the target inflation rate appears to be too optimistic, the monetary expansion target would not be consistent with GDP growth of 6%. At the same time, real wage growth, which was estimated at about 10% in 1985, needs to be held to the rate of productivity growth. Finally, other measures to encourage new private sector investment may be needed to supplement the expected reduction in the real rate of interest. Already, the Government has doubled the depreciation allowance for investment in new plant and equipment this year and the next.

27. Since, as indicated above, the inflation and monetary expansion levels envisaged in the 1986 program need to be reexamined, we have agreed with the Government to undertake a joint review of the program with a view to eliminating inconsistencies. This review should be completed by early February, and would include, inter alia, revised fiscal and balance of payments estimates. After discussing them with Fund staff, these revised estimates would be included in the final draft of this paper.

28. It should be noted also that inflation accelerated in November and December--and probably in January--to a monthly rate of 13%, which is above the already high rates prevailing in the same months of the previous year (on average, 11% per month). This acceleration has been caused mainly by a substantial real increase in food prices, determined by weather-affected,

greatly-reduced crops in the South and Southeast of Brazil. The Government expects to bring food prices down to lower levels by next March, through a substantial increase (of more than US$1 billion) in food imports. We have indicated to the Government that if the upward trend of price increases is not reversed soon, other corrective measures would have to be adopted. The situation in this respect will also be examined in late January, during the joint review referred to in the previous paragraph, and the conclusions of this analysis will be incorporated in the final draft of this paper.

Other Recommended 1986 Actions

29. The 1986 action plan also includes the following proposed sector policies in agriculture, industry and trade, energy, financial and fiscal reform, public sector management and investment, and external debt management. All are components of the proposed medium-term adjustment program. Measures to be implemented after 1986, with the proposed timing, are listed in Annex II.

Agriculture

-Introduction of free trade policy for key 1986-87 crops, within defined price limits.

-First stage of the phase-out of food price controls and wheat subsidy, and implementation of targeted food assistance programs. from what to what level?

-Rationalization of trade regulations for agricultural commodities.

-Budgetary provision for costs of remaining interest rate subsidies.

Industry and Trade

-Maintenance of present exchange rate policy.

-Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making.

Energy

-Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect economic costs and promote efficient energy production and use. how much?

-Financial rehabilitation of the power sector, together with balanced resource allocation and improved system reliability.

-Focus on improving agricultural and industrial productivity improvements in existing alcohol facilities, with limitations on new plants. Surely alcohol is even more inefficient now that oil prices have ↓.

Fiscal and Financial Reform

-Budget consolidation with budgetary provision for wheat, sugar, and agricultural credit subsidies.

-Transfer of decentralized funds to Treasury budget.

-*De facto* separation of functions between the Central Bank and the Bank of Brazil, and preparation of a law to formalize such separation.

Public Sector Management and Investment	-Improved operational control of budgetary operations, through Treasury Secretariat and SEPLAN.
	-Strengthening and expanded operation, in SEPLAN, of investment planning and project evaluation mechanisms.
	-Introduction of system for performance evaluation of public enterprises, development of rehabilitation programs, and selective privatization measures.
	-Annual Government-monitored program of public sector investment with reference to multi-year investment program.
Private Investment and Savings	-Promotion of investment efficiency through sectoral adjustment policies for agricultural, industry and trade, and energy (above).
	-Encouragement of increased private savings and investment through banking, financial, and stabilization measures (above).
External Debt Management	-Rescheduling of principal on commercial bank and Paris Club debt falling due in 1986 on terms commensurate with ability to repay, and preparation for a subsequent rescheduling agreement covering payments falling due in 1987-90.
	-Planned annual program of official and commercial borrowings.

E. The Brazilian Position

30. Many of the key policy directions suggested in this paper have been discussed extensively by Bank staff with the Brazilian authorities, with positive results, in connection with proposed Bank loans. We have reached agreement on most aspects of the programs proposed for 1986--and on most of the overall objectives for the longer term--concerning Agriculture, Energy, Public Sector Investment, Fiscal and Financial Reform, Public Sector Management (including, in particular, mechanisms and procedures for screening and monitoring public investment) and Social Development. There are, however, some policy areas in which no decision has been taken yet by the Government, or in which the adopted decisions do not go far enough. These include trade policy, particularly concerning the manufacturing sector, and fuel prices--on which disagreements may emerge in the near future--and policy issues (referred to in para. 33 below) which we have not yet discussed fully with the Government. Further discussions are alsoproceeding on the Government's stabilization policy (see para. 34 below).

31. The most important remaining long-term issue concerns trade policy aspects related mainly to the manufacturing sector. We had reached agreement on the full program included in Annex IIB with a Working Group formed by the Government to prepare the proposed Export Development II project. At the political level, however, the question has become controversial. The Ministry of Foreign Affairs has indicated that any unilateral decision on trade policy now would undermine Brazil's position in the GATT and other trade talks. The industrial establishment has traditionally been opposed to liberalized trade, although its views are probably changing with the increased importance of exports and better knowledge of anomalies which benefit some manufacturers at the expense of others. Policy reform in this area is likely to be slow; however, as explained above, satisfactory growth and creditworthiness improvements can occur without such a reform in the next several years. As was noted above, the Government has agreed in principle--in connection with the proposed Agricultural Sector Loan--to establish "free trade" for agricultural products and to undertake other policy reforms in that sector, all of which should encourage substantial increases in agricultural production and exports. Taking into account this overall situation, we propose to proceed with the "moderate-growth" scenario and with the levels of external financial support--from the Bank and other sources--associated with it. If, and only if, the Government decides to undertake a comprehensive trade policy reform, we would consider the "high-growth" scenario as viable, and would be prepared to recommend the higher level of external financial support consistent with it.

No! Resources will shift to manufacturing because of continued protection there.

32. In another major policy area the Government has now corrected--or has a plan to correct--most of the distortions introduced by the freeze of public sector prices adopted for several months earlier this year. One important exception to this is the price of petroleum derivatives, some of which (fuel oil, naphtha, and LPG) are still below international levels.

33. Other structural issues which have not yet been discussed fully with the Government include the time-phasing of the elimination of credit subsidies (which we and the Government have agreed to review in December 1986); the required incentives for private investment and savings (on which additional ESW would be required, particularly concerning tax policy); and the ways to proceed concerning external debt management and incentives to foreign investment.

34. As explained above, we are in the process of assessing the Government's 1986 economic program, which adopts a gradual approach to reducing inflation. It is our preliminary conclusion that, at best, the 1986 program would hold inflation to its present level, with a gradual reduction to follow beginning in 1987, once the effects of the 1986 reduction of the fiscal deficit--including an expected substantial increase in the availability of savings for financing private investment--are fully felt. There are clear risks in this strategy. The political demands in this election year could weaken the Government's resolve for fiscal restraint, although some cushion has apparently been built into the deficit targets to allow for higher Government spending. In addition, the occurrence of more unexpected shocks outside the Government's direct

control, such as the 1985 drought in the South, could make it difficult to stabilize inflation at present levels. A major acceleration in inflation would clearly undermine the gradualist approach. If such an acceleration does occur, there is growing recognition within the country that more drastic approaches, including monetary reform and a major change in the indexation system, would be needed. We would support such a position, if the gradualist approach is not effective. It should be noted, however, that, because of the possible effects on financial markets, the Government is not likely to accept publicly now, domestically or vis-a-vis the international community, that such an alternative could be considered in the foreseeable future.

publicly.

F. Growth Scenarios

35. The choice for Brazil is not growth or stagnation. Rather, it is how much growth to strive for. The recommended adjustment program would permit Brazil to grow rapidly enough to make up for the recent drop in employment and living standards to continue the economic progress begun in the 1970s, but would require a strong political will.

36. As noted earlier, Brazil's economy has the potential to grow about 5% per year over the next 5-10 years, without the Government undertaking any major additional policy reforms beyond the directions indicated in its 1986 program. No "new money" would be likely to be obtained from commercial banks, and the Bank's annual lending program would be reduced from present levels of US$1.5 billion to about US$1 billion per year or less. Therefore, in this "low growth" alternative, Brazil would need to run a positive current account balance as well as a large trade surplus to service its external debt. Exports would grow modestly. With an export growth rate averaging 2.4% in real terms between 1985-90, a moderate increase in non-oil imports would be feasible as long as Brazil continues an active energy substitution program and reduces oil imports in real terms. Creditworthiness indicators would improve substantially. However, although consumption per capita would increase about 3.2% annually, no significant reduction in unemployment and underemployment would occur. Because of this, we believe that the "low-growth" option, even if theoretically feasible in economic terms, would not be viable politically over the medium term.

37. The recommended adjustment program, together with larger inflows of new foreign resources, would stimulate faster economic growth in a more stable domestic environment. This scenario is characterized as the "moderate-growth" option. "New money" and increased agricultural and manufactured exports would permit higher imports and investment. Major employment and social gains would be possible, with a growth in per capita consumption of about 4.4% per year. Rapid growth would also strengthen the capacity to service the debt. Traditional creditworthiness indicators,

Savings rate
Exports growth } must emphasize these in the discussion

while improving by a third over the decade, are not substantially better than in the "low-growth" option. In this "moderate-growth" option, the country is incurring more debt to support the structural adjustment process and to raise more quickly the living standards of the population. In general terms, however, Brazil's creditworthiness--as reflected in the Government's readiness to adopt needed policy reforms to promote growth, stabilization, and external balance--is significantly improved. (The scenario is, of course, contingent on an accommodating external environment, particularly no increase in protectionism in OECD countries.)

38. If the Government proceeds more quickly with the proposed trade liberalization measures than is now expected, the economy could grow even faster. The "high-growth" option shows GDP growing at 8% per year, and per capita consumption, at 5.2% per year. The additional opening of the economy, with high export and import growth, would provide the vehicle for raising productivity and investment further. Larger net foreign capital inflows from multilateral, bilateral, and private sources to support trade liberalization would facilitate the process. As in the "moderate-growth" option, the country's creditworthiness would improve at a satisfactory rate.

how much?

39. Inflation in both the "moderate-" and "high-growth" scenarios is assumed to be moderating, with a gradualist stabilization program. If such an approach proves to be ineffective, more radical steps, such as a substantial modification to the indexation system and monetary reform, would be needed and the growth projections would have to be revised downward for at least a year, to take the adjustment into account.

G. The Role of the IMF

40. Bank support for the adjustment program would not depend on a stand-by agreement between Brazil and the IMF. The Government, while willing to undertake a substantial stabilization effort, has indicated that it does not intend--probably for domestic political reasons--to reach formal agreement with the Fund. However, it does intend to keep the Fund informed about the features and implementation of its program. If Brazil adopts a viable short- and medium-term economic program, but does not reach an operational agreement with the Fund, we believe that the Bank should still try to assist Brazil with an expanded lending program and with the mobilization of commercial banks' resources. This would probably require, however, an agreement to have the Fund monitor performance in the fiscal, monetary and balance-of-payments policy areas. It should be noted that cooperation between the staff of the Bank and the Fund concerning Brazil has improved substantially over the last few months, particularly concerning the flow of information and the interchange of technical opinions.

Would macroeconomic stability be assumed?

41. Some type of Fund participation in the assessment of Brazil's economic program would also simplify the country's relationships with the international banking community and Paris Club members. After substantial "involuntary lending" in 1983 and 1984, commercial banks did not have to provide any "new money" to Brazil in 1985, because of its overall high level of foreign exchange reserves. Independent of "new money", however, Brazil needs to reschedule the existing debt of commercial banks, probably until the early 1990s. Until very recently, the commercial banks had maintained the position that, if they were to reschedule existing debt or provide "new money", Brazil would first have to agree on a standy-by arrangement with the Fund. Now, however, representatives of some large banks have indicated to Bank staff that they would also accept the monitoring by the Fund of agreed fiscal, monetary and balance-of-payments targets, without necessarily requiring a formal stand-by arrangement. The Government has just reopened discussions with the commercial banks; it has indicated that it would seek to reschedule 1985-86 debt with the banks, if multi-year rescheduling for a longer period is not possible.

42. In anticipation of a new rescheduling agreement with Paris Club lenders, the Government has stopped paying debt service on its bilateral debt. Traditionally, such rescheduling is conditional upon an IMF agreement. Therefore, the absence of a Fund agreement will also complicate these negotiations.

H. Monitoring

43. The proposed monitoring system is described below. We have requested from the Government a general policy statement, laying out the basic elements of its short- and medium-term economic program. Our evaluation of the program would form the core of a report which would be distributed to the Board, as the basis for Bank lending, and by the Government to commercial banks, as the framework for co-financing. The monitoring would then proceed at two levels:

(a) Before submitting a policy loan to the Board, Bank staff would review Brazil's economic performance in terms of its stated objectives and policy actions, to ascertain whether the program is on track. A positive conclusion would be needed in order to submit each policy loan to the Board.

(b) Specific policy reforms would be supported by individual loans, such as those reported in the following table:

Policy Area	Monitoring Instruments
A. Industry and Trade	Export Development Loans* Industrial Restructuring Loans
B. Agriculture	Agriculture Sector Loans Agriculture Credit Loans

C. Energy	Power Sector Loans Transportation Sector Loans
D. Investment and Savings:	
1. Public Sector Investment and Savings	Public Sector Management Loans Public Sector Review missions Overall Bank economic assessments IMF surveillance
2. Private Sector Investment and Savings	Overall Bank economic assessments IMF surveillance
E. Balance of Payments	Overall Bank economic assessments IMF surveillance
F. Fiscal and Financial Reform	Financial Sector Reform Loans
G. Public Sector Management	Public Sector Management Loans
H. Stabilization	IMF surveillance
I. Social Development	Education Sector Loans Health Sector Loans Northeast Rural Devt. Loans Northeast Small and Medium Scale Industry Loans

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* Under the "high-growth" option only.

44. Appropriate economic indicators, by which the program could be assessed, would include both stabilization and growth-oriented measures. Savings, investment, and balance of payment indicators would reflect economic outcomes, while the exchange rate, monetary base expansion, growth of the real net domestic public debt, real domestic market interest rates, the wage bill of the public sector, fiscal deficit, growth in public savings and investment, and tariff increases might be among the indicators used to measure the extent of Government control of economic parameters. If required, a subset of these could be designated as "monitorable" targets.

45. The overall economic assessment of the program and the periodic program monitoring would be undertaken by economic missions, including public investment and sectoral missions. The work would be done in close coordination with IMF staff if--as is assumed here--the Fund is involved in the surveillance of Brazilian performance, with or without a stand-by arrangement. The monitoring to be performed by the Bank in connection with proposed loans would also be used to recommend cofinancing for specified priority projects. Whenever possible, these loans would be based upon policy actions taken before Board presentation, with further progress being a condition for processing subsequent loans in the sector (and for maintaining the level of the expanded overall lending program). In a few instances, as in the proposed FY86 Agricultural Sector Loan, the loan would be disbursed in two tranches, with policy conditionality attached to both of them.

I. Financing Requirements

46. Increased external support would be essential to the success of the medium-term adjustment program under the "moderate-" and "high-growth" options. Under the "low-growth" scenario, Brazil would need only about US$1.0 billion per year in medium- and long-term net capital inflows over the next five years, with virtually no "new money" from commercial banks. Faster growth with adjustment, as described in the "moderate-growth" option, would require on average an additional US$4.1 billion per year in net disbursements--US$0.6 billion from the World Bank, US$2.5 billion from commercial banks, and US$1.0 billion from other sources. If even higher GDP growth is attained (the "high-growth" option), an additional US$1.0 billion per year in net M&LT inflows would be needed. (Alternatively, Brazil could choose to maximize exports but, instead of raising GDP growth to 8%, could opt to reduce the rate of debt accumulation. In our view, this is not the preferred option, since rapid employment growth is important and the country's creditworthiness position improves substantially even with more borrowing.) Annex I provides the details for this section.

47. World Bank Financing. The Bank's support is based on a graduated-response posture. Annual lending in 1986-90 varies between US$1.0 billion under the "low-growth" option and US$2.0 billion under the "moderate-growth" alternative. These commitment levels would be consistent with average annual gross disbursements of, respectively, US$1.1 and US$1.7 billion from the entire Brazil loan portfolio, and annual net disbursements of US$0.4 and US$1.0 billion. The proposed lending under the "low-growth" option would make the Bank's relative exposure in Brazil decline to below 10% of our overall portfolio by 1990, while under the "moderate-growth" scenario, Brazil's share in the Bank portfolio would increase to slightly over 11%. The specific lending level for each year would depend upon the degree to which the required reforms are adopted and implemented, and would in practice be determined by the extent to which policy reforms associated with specific loans are put into effect. Co-financing would be an important component of an expanded program, in order to attract commercial bank funds for priority projects.

48. The Bank's current program for Brazil envisages an annual US$1.5 billion lending level. The program for FY86-87 includes three large quick-disbursing loans, for a total amount of US$1.2 billion. All other operations in the program are more traditional, and slower-disbursing, project and sector loans. Most of the increase required to reach the expanded US$2.0 billion level referred to above would come from additional policy-based operations, including additional agricultural sector loans, sectoral financial rehabilitation loans, and possibly industrial restructuring operations. The additional lending would also include increases in our program for education (particularly vocational training) and health to support the social content of the adjustment program.

49. If the Brazilian Government is also willing to commit itself to a comprehensive program of trade reform in addition to the other policy changes, then Bank lending levels could reach US$2.5 billion per year (the "high-growth" scenario). A series of policy-based loans in support of trade reform would be added to the lending program. These lending magnitudes would increase the Brazilian share of the overall Bank portfolio to 13% by 1990.

50. Other Sources of Financing. The "low-growth" option requires virtually no "new money" from commercial banks and a very low level of net inflows from other sources. As indicated above, however, to maintain a growth rate high enough to reduce unemployment and underemployment substantially, Brazil would indeed need net medium-term financing from the commercial banks (as well as adequate short-term credit lines). According to the "moderate-growth" projections presented in this paper, such inflows should reach an average annual level of about US$2.6 billion in 1986-90, which would be equivalent to a 3.5% annual increase in their nominal exposure (but to about a 4% reduction of their exposure in real terms). It is also estimated that the "moderate-growth" option would require about US$1.5 billion per year in net inflows from suppliers, official export agencies and the IDB, and about US$1.1 billion per year in foreign direct investment. IDB lending to middle-income countries like Brazil, while constrained by present institutional policies, is assumed to expand substantially. Under the "high-growth" option, net new commercial bank lending would average almost US$3.0 billion per year for the next five years, and net inflows from other sources (apart from the World Bank), about US$1.7 billion.

Table 1. BRAZIL--HISTORICAL DATA

	1980	1981	1982	1983	1984	1985*
Real GDP Growth Rate Per Annum	7.2	-1.6	0.9	-3.2	4.5	7.0
Debt to Exports Ratio 1/	3.2	3.1	4.1	3.9	3.4	3.7
Interest Payments to Exports Ratio (%) 2/	34.0	40.3	52.1	43.4	37.0	39.9
Total Debt to GDP Ratio (%) 3/	27.9	28.9	31.9	44.3	47.2	47.2
Interest Payments to GDP Ratio (%) 4/	3.0	3.7	4.4	4.9	5.4	5.1
Debt Service Ratio (%) 5/	64.2	69.1	90.7	58.4 6/	72.3	80.5
Terms of Trade (1983=100)	119.8	111.8	106.6	100.0	107.7	113.1
Real Growth Rates of: Imports	-12.3	-5.3	-13.4	-20.7	-0.3	4.4
Exports	23.6	21.6	-10.4	15.3	25.9	-2.3
Current Account Deficit (US$ Billions)	-12.4	-11.0	14.8	-6.1	.5	-1.3
Interest Payments (US$ Billions)	7.5	10.3	12.6	10.3	11.4	10.9

1/ Total debt, including short-term, as a proportion of Exports of Goods and NFS

2/ Total interest payments, including short-term, as a percentage of Exports of Goods and NFS

3/ Total debt, including short-term, as a proportion of GDP

4/ Total interest payments, including short-term, as a percentage of GDP

5/ Total interest payments plus amortization on M&LT debt as a percentage of Exports of Goods and NFS

6/ Includes only amortization actually paid.

* Estimate

Table 2: BRAZIL - PROJECTIONS OF KEY VARIABLES - "HIGH GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	8.0	8.0	8.1	8.1	8.1	8.0
GDP per Capita - 1985 $US	1553.9	1642.4	1736.4	1836.0	1943.7	2058.2	2734.7
GNP Growth Rate	7.2	9.4	8.6	8.5	8.4	8.5	8.2
GNP per Capita - 1985 $US	1468.4	1571.9	1670.5	1772.9	1881.9	1999.0	2680.0
Consumption per Capita Growth Rate	6.4	4.9	4.4	5.3	5.1	6.6	5.8
Private Investment to GDP Ratio	12.3	14.4	16.1	16.9	17.7	17.7	17.7
Public Investment to GDP Ratio	5.7	5.6	5.9	6.1	6.3	6.3	6.3
Public to Private Investment Ratio	46.3	38.9	36.6	36.1	35.6	35.6	35.6
Private Savings to GDP Ratio	16.6	16.7	15.6	15.9	16.7	16.7	17.6
Public Savings to GDP Ratio	2.8	4.8	5.6	6.1	6.3	6.3	6.3
Trade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	12.4	13.3	14.6	16.8	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	5.3	6.5	7.3	7.9	8.2
Exports of GNFS/GDP (%)	12.7	12.1	11.8	11.8	11.8	11.9	11.8
Imports of Goods Real Growth Rate	4.4	21.6	21.9	16.3	14.8	11.9	8.4
Imports of GNFS/GDP (%)	7.8	8.3	8.9	9.3	9.6	10.0	10.0
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.5	109.8	116.0	122.9	130.9	161.0
DOD/GDP (%)	47.2	42.2	38.4	34.9	31.8	29.1	19.5
DOD/X Ratio	3.7	3.5	3.2	3.0	2.7	2.4	1.7
DS/X (%)	80.5	79.5	72.4	63.9	59.0	49.3	29.4
Interest Payments/GDP (%)	5.1	3.9	3.5	3.2	2.9	2.6	1.8

Notes :

1. Debt includes public and publicly guaranteed, private non-guaranteed and short term debt
2. Exports and imports include that of goods and non-factor services.
3. GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

TABLE 3: BRAZIL FINANCING REQUIREMENTS AND SOURCES (HIGH GROWTH OPTION
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,233)	(2,405)	(3,321)	(3,882)	(4,265)
Direct Foreign Investment (Net)		807	792	1,275	1,457	1,737	1,916
MLT	Gross Disbursements	10,625	15,632	17,845	18,824	19,854	19,764
	Amortization	9,593	12,033	12,583	12,597	12,821	11,516
	Net Disbursements	1,032	3,599	5,262	6,227	7,033	8,248
1) World Bank	Commitments	1,500	2,500	2,500	2,500	2,500	2,500
	Gross Disbursements	800	1,646	2,126	2,216	2,297	2,387
	Amortization	400	418	542	637	931	1,170
	Net Disbursements	400	1,228	1,584	1,579	1,366	1,217
2) Other Multilateral	Commitments	275	800	800	800	800	800
	Gross Disbursements	297	290	366	456	572	662
	Amortization	136	157	173	186	214	260
	Net Disbursements	161	133	193	270	358	402
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,400	1,400	1,400
	Gross Disbursements	1,093	1,646	1,420	1,478	1,460	1,443
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	817	767	744
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,500	1,600	1,600	1,650	1,650
	Gross Disbursements	1,565	1,510	1,705	1,704	1,673	1,650
	Amortization	1,142	975	882	902	899	958
	Net Disbursements	423	535	823	802	774	692
6) Commercial Banks(1)	Commitments	6,797	10,470	12,180	12,952	13,842	13,615
	Gross Disbursements	6,797	10,470	12,180	12,952	13,842	13,615
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	930	1,939	2,843	3,855	5,282
Other Capital		(200)	(1,600)	(1,968)	(2,285)	(2,785)	(3,478)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(1,022)	(1,238)	(1,389)	(1,537)	(1,926)
Net Flows (as percentage of GDP)		0.482	1.454	1.838	1.873	1.817	1.832

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in "new" money inflows equal to net disbursements.

TABLE 4: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (HIGH GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,533	7,117	8,696	10,062	11,279
Other Multilateral	1,942	2,075	2,268	2,538	2,896	3,298
Official Export Credits	6,256	7,068	7,851	8,668	9,435	10,179
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,450	8,273	9,075	9,849	10,541
Commercial Banks	66,467	67,397	69,336	72,179	76,034	81,316
Total Medium and Long-Term DOD	89,581	93,180	98,442	104,669	111,702	119,950

Table 5: BRAZIL - PROJECTIONS OF KEY VARIABLES - "MODERATE GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
ational Accounts Indicators							
GDP Growth Rate	7.0	7.1	7.1	7.1	7.1	7.1	7.2
GDP per Capita - 1985 $US	1553.9	1627.8	1705.5	1787.2	1974.8	1967.0	2505.9
GNP Growth Rate	7.2	8.4	7.6	7.5	7.4	7.5	7.4
GNP per Capita - 1985 $US	1468.4	1557.3	1639.5	1724.5	1813.9	1909.2	2453.5
Consumption per Capita Growth Rate	6.4	4.0	4.3	4.3	4.2	5.4	5.1
Private Investment to GDP Ratio	12.3	14.4	15.2	16.0	16.9	16.9	17.7
Public Investment to GDP Ratio	5.7	5.6	5.8	6.0	6.1	6.1	6.3
Public to Private Investment Ratio	46.3	38.9	38.2	37.5	36.1	36.1	35.6
Private Savings to GDP Ratio	14.6	16.6	14.9	15.3	16.0	16.3	17.3
Public Savings to GDP Ratio	2.8	4.8	5.5	6.0	6.1	6.1	6.3
ade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	13.1	14.2	15.7	18.1	29.1
Exports of Goods Real Growth Rate	-2.3	2.5	4.0	4.6	5.3	5.9	7.3
Exports of GNFS/GDP (%)	12.7	12.2	11.9	11.7	11.5	11.5	11.4
Imports of Goods Real Growth Rate	4.4	21.5	12.9	11.3	10.7	8.6	7.8
Imports of GNFS/GDP (%)	7.8	8.4	8.6	8.9	9.1	9.2	9.7
editworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.7	109.1	114.5	120.8	126.8	155.8
DOD/GDP (%)	47.2	42.7	38.8	35.4	32.4	29.5	20.6
DOD/X Ratio	3.7	3.5	3.3	3.0	2.8	2.6	1.8
DS/X (%)	80.5	79.6	73.6	66.0	61.7	52.8	31.9
Interest Payments/GDP (%)	5.1	4.0	3.6	3.3	3.0	2.6	1.9

Notes :

1. Debt includes public and publicly guaranteed, private non-guaranteed and short term debt
2. Exports and imports include that of goods and non-factor services.
3. GNP per Capita was converted into $US using a period average exchange rate.Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

TABLE 6: BRAZIL FINANCING REQUIREMENTS AND SOURCES (MODERATE GROWTH OPTIO
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,503)	(1,660)	(2,284)	(3,052)	(2,621)
Direct Foreign Investment (Net)		807	794	879	1,063	1,247	1,429
MLT	Gross Disbursements	10,625	15,542	16,993	17,909	19,073	17,175
	Amortization	9,593	12,032	12,583	12,597	12,770	11,405
	Net Disbursements	1,032	3,510	4,410	5,312	6,303	5,770
1) World Bank	Commitments	1,500	2,000	2,000	2,000	2,000	2,000
	Gross Disbursements	800	1,348	1,626	1,716	1,797	1,887
	Amortization	400	418	542	637	889	1,086
	Net Disbursements	400	930	1,084	1,079	908	801
2) Other Multilateral	Commitments	275	275	500	500	500	500
	Gross Disbursements	297	280	315	351	404	446
	Amortization	136	156	173	186	214	241
	Net Disbursements	161	124	142	165	190	205
3) Official Export Credits	Commitments	1,000	1,300	1,300	1,300	1,300	1,300
	Gross Disbursements	1,093	1,646	1,420	1,448	1,380	1,343
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	812	783	787	687	644
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	1,400	1,600	1,600	1,600	1,600
	Gross Disbursements	1,565	1,480	1,655	1,684	1,658	1,600
	Amortization	1,142	975	882	902	890	950
	Net Disbursements	423	505	773	782	768	650
6) Commercial Banks(1)	Commitments	6,797	10,718	11,929	12,692	13,824	11,892
	Gross Disbursements	6,797	10,718	11,929	12,692	13,824	11,892
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,178	1,688	2,583	3,837	3,559
Other Capital		(200)	(1,400)	(1,847)	(2,274)	(2,597)	(2,700)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(865)	(856)	(1,128)	(1,335)	(1,383)
Net Flows (as percentage of GDP)		0.482	1.430	1.569	1.641	1.688	1.341

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in "new" money inflows equal to net disbursements.

TABLE 7: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (MODERATE GROWTH OPTION) (US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	5,235	6,319	7,398	8,306	9,107
Other Multilateral	1,933	2,057	2,199	2,364	2,554	2,759
Official Export Credits	6,256	7,068	7,851	8,638	9,325	9,969
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,420	8,193	8,975	9,743	10,393
Commercial Banks	66,467	67,645	69,333	71,916	75,753	79,312
Total Medium and Long-Term DOD	89,572	93,082	97,492	102,804	109,107	114,877

Table 8: BRAZIL - PROJECTIONS OF KEY VARIABLES - "LOW GROWTH" OPTION

	1985	1986	1987	1988	1989	1990	1995
National Accounts Indicators							
GDP Growth Rate	7.0	5.0	5.0	5.0	5.0	5.0	5.1
GDP per Capita - 1985 $US	1553.9	1596.8	1640.9	1686.4	1734.9	1784.9	2059.2
GNP Growth Rate	7.2	6.2	5.5	5.5	5.4	5.5	5.3
GNP per Capita - 1985 $US	1468.4	1526.2	1576.0	1626.2	1678.4	1733.6	2022.5
Consumption per Capita Growth Rate	6.4	2.5	3.4	3.3	3.5	3.4	3.2
Private Investment to GDP Ratio	12.3	13.7	13.7	13.7	13.7	13.7	13.7
Public Investment to GDP Ratio	5.7	5.3	5.3	5.3	5.3	5.3	5.3
Public to Private Investment Ratio	46.3	38.7	38.7	38.7	38.7	38.7	38.7
Private Savings to GDP Ratio	14.6	14.2	14.2	14.4	14.6	14.8	14.3
Public Savings to GDP Ratio	2.8	4.3	5.0	5.0	5.0	5.0	5.3
Trade Indicators							
Trade Surplus (US$ billions)	12.1	13.1	14.4	16.0	17.8	19.9	23.3
Exports of Goods Real Growth Rate	-2.3	2.5	2.4	2.4	2.4	2.5	3.3
Exports of GNFS/GDP (%)	12.7	12.4	12.2	12.0	11.8	11.6	10.6
Imports of Goods Real Growth Rate	4.4	12.7	5.3	5.2	5.2	5.2	5.3
Imports of GNFS/GDP (%)	7.8	8.0	8.0	8.0	7.9	7.9	8.2
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	103.0	104.7	105.7	106.3	106.2	100.7
DOD/GDP (%)	47.2	42.8	38.7	34.6	30.8	27.2	16.2
DOD/X Ratio	3.7	3.4	3.2	2.9	2.6	2.3	1.5
DS/X (%)	80.5	79.5	74.0	66.9	62.7	53.4	29.5
Interest Payments/GDP (%)	5.1	4.1	3.7	3.3	3.0	2.5	1.5

Notes :

1. Debt includes public and publicly guaranteed, private non-guaranteed and short term debt
2. Exports and imports include that of goods and non-factor services.
3. GNP per Capita was converted into $US using a period average exchange rate. Not comparable with World Bank Atlas figures which were obtained using as conversion factor a three year moving average axchange rate.

TABLE 9: BRAZIL FINANCING REQUIREMENTS AND SOURCES (LOW GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(83)	539	1,352	2,011	3,265
Direct Foreign Investment (Net)		807	798	887	977	966	1,054
MLT	Gross Disbursements	10,625	13,767	14,323	13,589	13,204	11,104
	Amortization	9,593	12,031	12,583	12,597	12,641	11,115
	Net Disbursements	1,032	1,736	1,740	992	563	(11)
1) World Bank	Commitments	1,500	1,000	1,000	1,000	1,000	1,000
	Gross Disbursements	800	1,028	1,051	1,066	1,062	1,057
	Amortization	400	418	542	637	805	920
	Net Disbursements	400	610	509	429	257	137
2) Other Multilateral	Commitments	275	250	250	250	250	250
	Gross Disbursements	297	273	273	273	264	266
	Amortization	136	155	173	186	214	226
	Net Disbursements	161	118	100	87	50	40
3) Official Export Credits	Commitments	1,000	750	750	750	750	750
	Gross Disbursements	1,093	1,481	980	898	780	793
	Amortization	1,011	834	637	661	693	699
	Net Disbursements	82	647	343	237	87	94
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Commitments	1,100	850	850	850	850	900
	Gross Disbursements	1,565	1,315	1,155	974	908	875
	Amortization	1,142	975	882	902	845	841
	Net Disbursements	423	340	273	72	63	34
6) Commercial Banks(1)	Commitments	6,797	9,600	10,816	10,360	10,180	8,106
	Gross Disbursements	6,797	9,600	10,816	10,360	10,180	8,106
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	60	575	251	193	(227)
Other Capital		(200)	(1,400)	(1,647)	(1,986)	(2,182)	(2,930)
IMF (Net)		0	(535)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(516)	(593)	(646)	(792)	(883)
Net Flows (as percentage of GDP)		0.482	0.721	0.643	0.325	0.163	(0.003)

(1) A 1986-90 rescheduling of amortization payments to commercial banks will result in "new" money inflows equal to net disbursements.

TABLE 10: BRAZIL PROJECTIONS OF DEBT OUTSTANDING AND DISBURSED (LOW GROWTH OPTION)
(US$ Millions)

CATEGORY	1985	1986	1987	1988	1989	1990
World Bank	4,305	4,915	5,424	5,853	6,110	6,247
Other Multilateral	1,970	2,088	2,188	2,275	2,325	2,365
Official Export Credits	6,256	6,903	7,246	7,483	7,570	7,664
Other Official Net	3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits	6,915	7,255	7,528	7,600	7,663	7,697
Commercial Banks	66,467	66,527	67,102	67,353	67,546	67,319
Total Medium and Long-Term DOD	89,609	91,345	93,085	94,077	94,640	94,629

BRAZIL - PROPOSED MEDIUM-TERM ADJUSTMENT AND GROWTH PROGRAM

Moderate-Growth Option.

Main Goals: (1) To maintain growth rates in 1986-90 which are high enough to provide employment to new entrants in the labor force, and to a number of currently underemployed workers equivalent to 2% of the labor force per year. Target average growth rate 7% per year.

(2) To improve the country's creditworthiness, consistent with a reduction of the debt to export ratio from 3.7 in 1985 to 2.6 in 1990, and 1.8 in 1995.

(3) To reduce domestic inflation substantially by 1990.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
A. BALANCE OF PAYMENTS								
1. Exchange Rate Policy	Maintain international competitiveness	Devaluation of 30% in 1983; subsequent full adjustment to domestic inflation	+Maintenance of competitive exchange rate policy through periodic adjustments which are at least equal to the difference between domestic and international inflation	*	*	*	*	*
2. Trade Balance	Maintain trade surplus levels consistent with growth and stabilization objectives and with gradual reduction of debt service ratios	Exchange rate policy and other measures required to achieve an annual US$12 billion trade surplus in 1984 and 1985	+Policies on Industry and Trade, Agriculture and Energy (See B, C and D)	*	*	*	*	*
3. Debt Management	Debt rescheduling to reduce adjustment pressures, 1986-90 limited new borrowing in amounts consistent with stability and growth objectives, and with gradual reduction of debt service ratio to sustainable level by around 1990	Annual arrangements for rescheduling principal payment, 1982-85.	+Rescheduling of principal on old commercial debt falling due 1986-90 (multi-year rescheduling, with improvement of terms over the 1984-85 agreement, would be preferable)	*	*	*	*	*
		Controlled and limited new borrowing, 1982-84. No new commercial borrowing 1985.	+Planned annual programs of official and commercial borrowing	*	*	*	*	*
4. Direct Investment	Resumption of direct investment inflows to complement domestic investment	-	+Review of foreign investment and technology transfer policies		*			
			+Policy changes as required			*		

+ Denotes policies essential to adjustment program.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
B. INDUSTRY AND TRADE								
1. Exchange Rate Policy	Maintain international competitiveness	-	See A.1					
2. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 13% annually, to permit import expansion while covering debt service	Liberalization of duty drawback system for exporters, extension of drawback system on limited basis to indirect exporters and removal of fiscal export subsidy (credito premio)	+Strengthening of export promotion through improvements in quality control and certification; marketing, design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures		*			
			+Simplification of indirect drawback system		*			
			+Elimination of remaining indirect taxes on exports			*		
3. Export Financing	Rationalize and extend financing arrangements for exports	Reduction of subsidy element in pre-shipment export financing	Strengthening of export credit insurance		*			
4. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Elimination of tariff surcharges; reduction in average tariff level and in number of items subject to "suspended imports"; increased flexibility in external financing requirements for imports; liberalization of firms, import programs for annual imports up to US$100,000; increased autonomy to CACEX's field offices; and elimination of foreign credit financing as a criterion for the application of the Law of Similars	+Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making	*	*			
Bank support		(Export Development I, FY84)	ESW on Industry and Trade	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
C. AGRICULTURE								
1. Agricultural Credit	Rationalization of rural credit system	Elimination of negative real interest rates, Center-South (1983) and agreement on reductions in North-Northeast (1985)	+Budgetary provision for costs of interest rate subsidies (equalization costs for Federal and State banks, monetary correction shortfall North-Northeast)	*				
			+Elimination of negative real interest rates in North-Northeast, except special target groups			*		
			+Market interest rates in Center-South, except special areas				*	
			Market interest rates in North-Northeast, except special target groups					*
			+Full fiscal provision for remaining subsidies		*	*	*	*
2. Trade and Pricing	Trade liberalization and development of efficient marketing system	-	+Introduction of free trade policy for 1986-87 crops, within defined price limits	*				
			+Phase-out food price controls and wheat subsidy, implement targeted food assistance programs	*	*	*		
			Reopen access to external futures trading, remove tax on domestic futures trading	*				
			Establish legal/regulatory framework for storage warrants, bankers acceptance matters in bonded agricultural commodities	*				
			+Rationalization of trade regulations for agricultural commodities	*				
			Establish agricultural price data system		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
			+Full free trade arrangements for key agricultural products, subject to minimum price guarantees, market safeguards and government stock management		*		*	
			Start domestic futures market for major agricultural commodities and bankers acceptance trading		*			
			Integrated data systems for CACEX, Central Bank			*		
			Improved crop forecasting and stock information systems		*	*		
3. Taxation	Minimize tax disincentives to agricultural export growth	-	+Reform of system of agricultural taxation			*	*	*
Bank Support		(Agriculture Credit and Export Loan, FY83)	Agriculture Sector II	*				
			Agriculture Credit I	*				
			Agriculture Sector III		*			
			Agriculture Credit II			*		
			Agricultural Credit III					*
			Cofinancing	*	*	*		*
			ESW on Agriculture	*	*	*		
D. ENERGY								
1. Energy Development and Conservation	Cost-effective development of domestic energy resources	Reassessment of energy investment priorities (1985)	Development of a long-term energy efficiency plan		*			
			+Pricing policies promoting efficient domestic energy use	*	*	*	*	*
2. Electric Power	Realistic investment and financial plans and implementation	Formulation and initiation of Investment Program for Financial Plan for 1984-88; real tariff increases	+Financial rehabilitation; balanced resource allocation, improved system reliability, tariffs to be brought into line with long-run marginal costs	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
Bank Support		(Power Transmission, Conservation and Distribution loans, FY85)	Power Transmission		*			
			Power Sector I	*				
			Power Sector II		*			
			Transport Sector I		*			
			Energy Conservation			*		
			Transport Sector II					*
			Cofinancing	*	*			
E. INVESTMENT AND SAVINGS								
1. Public Sector Investment	Program limited, with specified exceptions, to completion of high-priority rehabilitation-recovery programs	Increased supervision of public sector, including state enterprise, investment programs; real reductions in 1983-84.	+Annual Government-monitored program of public sector investment in context of multi-year investment programs (with continuing Bank review and progress reporting)	*	*	*	*	*
			+Channelling of new external funds into key areas of rehabilitation and/or priority new investment	*	*	*	*	*
2. Private Investment	Increase market incentives for private sector investment in new productive assets to support target GDP growth	-	Promotion of investment efficiency through sectoral adjustment policies (see B,C,D)	*	*	*	*	*
			+Encouragement of increased investment through banking and financial reforms (see F.3 and 5) and stabilization measures (H)	*	*	*	*	*
3. Savings	Major increases in savings available for private investment	Reductions achieved in Government spending and deficit financing, 1983-85.	+Stabilization measures further reducing the deficit and the disincentives to save (see H)	*	*	*		
			Preparation of tax measures to promote savings	*				
			Implementation of tax incentives for savings		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
F. FISCAL AND FINANCIAL REFORM								
1. Budget Consolidation	Establish basis for improved fiscal management	Creation of Treasury Secretariat to manage budget transactions	+Budgetary provision for wheat, sugar and agricultural credit subsidies	*				
		Inclusion in 1986 budget of most quasi-fiscal items formerly in the "monetary" budget	+Transfer of decentralized funds to Treasury budget	*				
			+Completion of process of budget budget consolidation		*			
2. Monetary Authorities	Strengthen basis for monetary policy formulation and management	-	+Law defining functions of Banco do Brasil		*			
			+Transfer to Banco do Brazil or BNDES of Central Bank's development banking functions		*			
			+Establishment of Banco Central as sole monetary authority		*			
			Transfer to Treasury of responsibility for Federal public debt		*			
			+Greater independence for the Central Bank (legislative or constitutional provision)			*		
3. Banks	Restore the institutional base for growth in savings and private investment	-	+Reduction in compulsory lending for certain sectors by commercial banks, and in reserve requirements	*	*	*		
			Reform of state and regional development banks		*	*	*	
			Strengthening of investment banks		*	*	*	
			Reform of state commercial banks			*	*	
			Legislation and regulations to govern a liberalized, integrated banking and financial system				*	* *

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
4. Housing Finance	Stabilize and support housing investment		+Reform of the housing finance system		*			
5. Financial Markets	Strimulate flow of funds for private investment		New regulations for financial markets, including tax reforms		*	*		
			Establishment of "Brazil Fund" to encourage foreign portfolio investment		*	*		
			New regulations for financial conglomerates			*		
6. Tax Reform	Increased tax revenues in a more efficient and equitable system		Program to reduce tax exemptions and allowances	*	*			
			Tax reform to encourage longer-term holdings of financial assets	*	*			
			Tax measures to reduce wedge between borrowing and lending rates		*			
			+Major tax and transfer reform at Federal, State and municipal levels			*	*	
			Financial Sector Reform I	*				
Bank Support			Financial Sector Reform II		*			
			Financial Sector Reform III			*		
			Financial Sector Reform IV				*	
			Cofinancing	*	*	*	*	
			ESW on the Financial System		*		*	
G. PUBLIC SECTOR MANAGEMENT								
1. Fiscal Administration	Efficient arrangement of Government funds, including debt operations	Establishment of National Treasury Secretariat in the Finance Ministry (See F.1)	+Fully operational control of budget operations, through Treasury and SEPLAN (SOF)	*				
2. Integrated Management System (SEPLAN)	Strengthening of Federal information, planning, policy research, programming budgeting, policy information, evaluation and reporting	-	+Strengthening and expanded operation of:					
			- general and sector planning and project evaluation (IPLAN)	*	*	*	*	*
			- multi-year investment planning--CPPG	*	*	*	*	*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
3. State Enterprise Management	Development of flexibility and efficiency in the state enterprise system, with privatization of some enterprises	SEST supervision of state enterprise operations (since 1980)	+Introduction of system for performance evaluation	*				
			+Development of rehabilitation programs for selected state enterprises	*	*	*		
			+Implementation of finance and rehabilitation programs	*	*	*	*	*
			Selective privatization of enterprises directly or via capital markets	*	*	*	*	*
4. Statistical Development	Information systems development: national and regional statistics	-	Initiation of IBGE development program to expand national and regional information base		*			
			Interim development of national account and public finance research (FGV)		*	*		
			Development of integrated national/regional statistical operations			*	*	*
5. Financial Control			Strengthening of audit systems (SECIN &/or Tribunal da Contas)	*	*	*		
Bank Support			Public Sector Management Loan	*				
			Public Sector Management II				*	
			ESW on Public Investment and public enterprises	*	*	*	*	*
H. STABILIZATION								
1. Government expenditure	No real increase in current or capital investment outlays, but a shift away from state enterprise activity into priority social programs	Real reduction in state enterprise expenditures; emergency social program introduced 1985	+Reductions in Govt. and state enterprise operating expenditures, including personnel costs; extra provision for maintenance, financial rehabilitation, completion of priority investments; careful evaluation of new investment proposals involving Government or state enterprises	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
2. Taxation	Increase in (recovery of) net tax revenues to 1970s ratios	Measures to restore and increase income tax revenues (increase equivalent to 1.7% of GDP proposed)	+Further short-term adjustments to increase revenue collection and reduce cost of tax exemptions and allowances	*	*	*	*	
			Major reform of tax and incentive systems and mechanisms for revenue sharing			*	*	
3. Other Revenues	Public sector prices, levies to cover cost of services.	Some real increases in 1985	+Public sector prices to increase in real terms; social security and similar charges to be adjusted to cover programs'costs	*	*	*	*	
4. Subsidies	(See F.1)							
5. Public sector deficit	Reduce public sector deficit (broadly defined) to normal financing range	"Operational" deficit cut from 6.8 to estimated 2.8% of GDP, between 1982 and 1985	+Reduction of "operational" fiscal deficit to 1% of GDP	*				
			+Further improvements in fiscal performance, according to targets to be agreed annually, to secure gradual decline in ratio of total public debt to GDP		*	*	*	*
6. Monetary Policy	Expansion consistent with agreed stabilization targets	Short periods of tight monetary restraint, 1981-84.	+Meeting annual monetary targets based upon expected growth and inflation	*	*	*	*	*
7. Incomes policy	Real wage increases linked to productivity growth, to increase employment opportunities	Successful efforts to reduce real wages in 1983-84, some real wage recovery in 1985.	+Public sector wage policy consistent with no increase in real wage bill in 1986-87	*	*	*	*	*
8. Indexation	Reduction of the inflation mechanisms implied by the Government indexation system, while avoiding distortions that might be caused by inflation if indexation is eliminated	-	+Preparation of detailed program on how to deal with indexation and related issues	*				
			+Implementation of the program		*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
I. SOCIAL & REGIONAL PRIORITIES								
1. Social Adjustment	Recovery from social costs of economic recession through programs designed to reduce poverty, improve income distribution and promote employment rhgough economic growth	Social sector priority program in nutrition, health, education, housing, water supply, small-scale agriculture and job creation (1985)	Preparation and implementation of plans of expanded, more cost-effective and efficiently delivered health, education and other social services	*	*	*	*	*
2. Regional Development	Increase employment and incomes, and promote sustained growth in the Northeast region	New rural development programs for the Northeast (1985)	Preparation of comprehensive, multi-sectoral Northeast regional development program	*				
			Phased implementation in line with domestic and external reserve availability		*	*	*	*
Bank Support			Education Sector Loan				*	
			Health Sector Loan					*
			NE lending program (rural development, industries, irrigation, education, health)	*	*	*	*	*
			ESW on health and education programs and NE regional development	*				

BRAZIL - A PROPOSED COMPREHENSIVE, MEDIUM-TERM PROGRAM
FOR TRADE LIBERALIZATION

Area	Policy Objectives	Further Recommended Measures
1. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 15% annually, to permit import expansion while covering debt service	Formulation and initial steps in implementation (see below) of a multi-year program for export expansion and trade policy rationalization
		Implementation of GATT Code for subsidies
2. Export Financing	Rationalize and extend financing arrangements for exports	Provision of access to financing to all exporters at internationally competitive rates, consistent with GATT Subsidy Code
3. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Specification of import rationalization objectives, identification and consideration of specific measures to reduce anomalies in policies and procedures affecting different categories of producer, with implementation subject to balance-of-payments situation; results of ongoing studies of effective protection; and results of trade negotiations
		Implementation of GATT codes for Customs Valuation and Anti-Dumping
		Elimination of most items from the list of "Import Suspension"
		Liberalization of firms' annual import programs, eliminating discrimination by products and providing automatic approval for firms importing up to a pre-determined value. (Import programs would be used as a tool to control imports only in the event of a balance of payments crisis).
		Reduction or elimination of most tariff exemptions schemes, and reduction of scope of application of Law of Similars
		Reduction of tariff levels and dispersion to a nominal average of about 40% range, with perhaps half the items in the 30-40% range, a minimum tariff of 10% and a maximum of 85% (including IOF tax)
		Gradual phasing-out of non-tariff restrictions, so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariffs
Bank support		Export Development II Export Development III Industrial Restructuring I Industrial Restructuring II Cofinancing ESW on Industry and Trade

SECTOR POLICIES

A. Industrial and Trade Policies

1. Domestic markets for Brazilian manufactures are protected by quite high nominal tariffs and extensive non-tariff barriers, even after substantial reform in September 1984. Manufacturing production, however, is competitive and apparently efficient over a wide range of subsectors. Its international competitive strengths are demonstrated by the impressive increase in manufactured exports in recent years, from US$6.6 billion in 1979 to US$15.1 billion in 1984. Another indication has been the very limited growth of import demand when the Brazilian drawback system was liberalized, with Bank support, to establish a "free trade" regime for export production.

2. The most recent thorough study of nominal and effective protection for Brazilian manufacturing, for 1980-81, shows high nominal tariffs (an average of 99%, and 133% for consumer goods) but relatively low effective protection as measured by direct price comparisons (an average of 44% and 36% for consumer goods). The averages for Brazil do conceal substantial dispersion in both nominal and effective protection. In 1980-81, for example, the nominal tariff approached 200% for apparel, beverages and tobacco, although the implicit effective protection estimates for these products were 26%, -1% and 6%, respectively. Implicit effective protection was negative in the mining non-metallic minerals, transportation equipment, paper and rubber industries, but exceeded 100% for electrical equipment and pharmaceutical products.

3. Brazil has taken some recent measures to reduce restrictions on trade. The September 1984 tariff reforms included the removal of sucharges imposed in the 1970s and reduced the unweighted average nominal tariff to 51%. The trade-weighted average tariff was already much lower, at 30%, in 1975, and came down to about 22% in 1984. Non-tariff barriers, which have been more important than tariffs in regulating imports, were also reduced in 1984 when the list of prohibited imports was cut from 4,435 to 2,081 items and other rules and administrative requirements were somewhat relaxed.

4. The extent to which recent measures have reduced levels and dispersion in effective protection should become clear when a major new study, financed under our first Export Development loan, is completed, probably by mid-year. This study will, we expect, provide the basis for consideration by the Government of further trade policy measures.

5. In view of the above, we see trade policy reform for industrial products at this stage as a desirable but not immediately essential component of an economic adjustment program for Brazil. The key requirement is the continuation of exchange rate policies which will keep manufactured exports competitive and growing.

6. Measures to promote further improvements in industrial efficiency include, in the area of export development:

- strengthening of export promotion through enhanced quality control and certification procedures; marketing design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures;

- simplification of indirect drawback system;

- elimination of remaining indirect taxes on exports.

7. The import regime would benefit from simplification and increased automaticity in official (CACEX) import procedures and the decentralization of decision-making.

8. Subsequent steps towards import rationalization should focus on areas shown to benefit from high levels of effective protection, as demonstrated by direct price comparisons, and therefore imposing high costs on other manufacturing and the economy in general. A more comprehensive, longer-term approach would seek the rationalization of import policies across the board, emphasizing:

- implementation of GATT customs valuation and anti-dumping codes;

- elimination of most items from the import suspension list;

- liberalization and eventual elimination of company annual import programs, except as emergency measures;

- reduction or elimination of most tariff exemption schemes and applications of the Law of Similars;

- reduction of nominal tariff levels and dispersion, with up to half of all items in the 30-40% range;

- further phasing-out of non-tariff restrictions so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and modified tariff system.

B. Agricultural Sector Policies

9. Brazilian agriculture registered strong though unbalanced growth in the 1970s, at an average of 5% annually, but in the 1980s, output stagnated and agricultural investment declined. Except for credit programs, Government agricultural policies have acted as disincentives to investment, especially for staple crops. Subsidized credit promoted increases in production, but at high cost and with heavy emphasis on high-input commercial agriculture and special development programs (alcohol, Cerrado agriculture, the Amazon frontier) requiring large fiscal

incentives. The crisis-induced reduction of agricultural credit, early in the 1980s, was not compensated by other policy changes. Adverse trade and pricing policies, high taxation and industrial protection continued. Intervention in agricultural trade and minimum price arrangements have provided more uncertainty than support.

10. Agricultural expansion is critical for growth. The key to realizing the full potential of the agriculture sector is a policy framework that will make all forms of production and exports profitable without credit subsidies, interventionist trade policies and production-based taxation. This is central to Bank agriculture sector lending to Brazil and conforms with Government policy objectives as expressed in the National Development Plan. The first sector loan supported the Government decision to phase out negative real interest rates on rural credit. The second would support significant and complementary moves towards a more liberal pricing policy for agriculture.

11. In the area of agricultural credit, the required policy measures are:

- budgetary provision for interest rate subsidies, in 1986;
- subsequently, full fiscal provision for all remaining subsidies;
- elimination of negative real interest rates in the North-Northeast, except for selected target groups;
- market interest rates in the Center-South, except in special areas.

12. Agricultural trade and pricing policies should provide for:

- the initiation of a free trade policy for key 1986-87 crops, within defined limits;
- the phasing-out of food price controls and the wheat subsidy, along with the implementation of targeted food assistance programs;
- rationalization of trade regulations for agricultural commodities;
- a free-trade policy for key agricultural commodities, subject to minimum price guarantees, market safeguards and Government stock management.

13. In addition, provision should be made for a reform of agricultural taxation policies, to minimize disincentives to agricultural export growth.

C. Energy Sector Policies

14. Over the past decade, Brazil has been diversifying its energy base and stressing conservation. By accelerating petroleum exploration and production, as well as encouraging energy substitution and conservation, Brazil has significantly reduced oil imports. Investments in hydro-electric plants and in alcohol production have expanded Brazil's energy resources, and recent natural gas discoveries will add to the diversification strategy. With the present world oil price prospects and the country's resource constraints, two general principles should guide future development of the sector: (a) energy development of domestic fuels should be coordinated, to avoid excess duplication or over-expansion of supply relative to market demand; and (b) economic criteria should be strictly applied to energy investments, and pricing should reflect market forces.

15. Brazil is not a low-cost producer of petroleum. While the current production target of 740,000 bbl/day by 1989 seems to be cost-effective with present oil price projections, the cost of future investments, particularly in the deep-offshore areas of the Campos basin, must be carefully scrutinized and the pricing of petroleum derivatives (notably fuel oil, LPG, and naphtha) should more adequately reflect international prices. Alcohol development is also susceptible to weakening oil prices. Brazil's alcohol program is economically viable in the biggest producing areas of the country, though not in the traditional sugar-producing areas in the Northeast. Therefore, further development should be oriented toward productivity improvements in existing facilities rather than toward building new plants, and alcohol conservation encouraged through increasing its retail price relative to that of gasoline. Finally, in order to insure adequate provision of electricity for expanding business and residential consumption without draining the Government budget, the financial condition of the power sector must be improved, and priority transmission and distribution investments which were delayed because of the recession should be completed.

16. The following sector policies would support production and reduce imports:

(a) Development of a long-term energy plan for coordinated production and consumption of energy resources.

(b) Energy pricing policy, especially for petroleum derivatives, alcohol and electricity, which would better reflect opportunity costs and therefore promote efficient domestic energy production and use.

(c) Financial rehabilitation of the power sector through higher tariffs, improved debt/equity ratios, and other means, and completion of priority investments to improve system reliability.

(d) Emphasis on agricultural and industrial productivity improvements in alcohol production, with strong limitations on expansion of capacity in new or high-cost regions of the country.

D. Financial and Fiscal Reform

17. In the mid-1960s, financial and fiscal reforms played a fundamental role in economic stabilization in laying the basis for a period of extraordinarily rapid economic growth. Two decades later, however, inflation is over 200% a year, real free market interest rates (on the order of 25% to 30%) are higher than the returns that can be earned on investments in real assets, financial markets are fragmented, and the portfolios of many major financial institutions are of doubtful quality. There is a growing consensus in Brazil that reforms similar in scope to those of the 1960s are again required.

18. Monetary and Fiscal Reform. Financial reform, carried out in close coordination with fiscal reform, could play an important role in completing both economic stabilization and the adjustment of the economy to changed international economic conditions. Three major objectives of financial reform would be: (i) more effective monetary and fiscal control; (ii) enhanced stability of the financial system; and (iii) increased efficiency in mobilizing and allocating resources. High real interest rates can be attacked directly through tax reforms and reductions in compulsory lending at below-market rates; they can be addressed indirectly by reducing uncertainty about future financial policies, and by measures resulting in improved monetary control. Financial reform alone cannot bring down real interest rates to sustainable levels. But it can reinforce other measures critical to economic stabilization and structural adjustment.

19. The Government has stated its intention to unify Brazil's federal budgets (those of Treasury, the Monetary Authorities and the state enterprises) and is also proceeding to redefine the roles of the National Treasury, the Central Bank, and the Bank of Brazil. The goal would be to establish a clear separation between the conduct of monetary and fiscal policy and achieve better discipline over public expenditure. The Government has already taken a major step forward by consolidating, within the Federal Government budget, most fiscal expenditures previously financed through the monetary budget, and by limiting any fiscal expenditure by the Central Bank or Bank of Brazil to that contained in the budget. A new Secretariat of the Treasury is being established in the Finance Ministry to administer the overall fiscal budget and to unify thousand of special funds that have been managed independently up to now by government agencies.

Tax Reform

20. The tax system is also badly in need of reform. Some activities are still undertaxed or not taxed at all. Taxation varies significantly across sectors or sources of incomes. There is almost no taxation on property, wealth, and inheritance. Fiscal incentives have proliferated, they not only erode revenues, but also reduce the ability to influence investment and accentuate the lack of equity in the overall tax system. In order to prepare a broader tax reform the Government established a Tax Commission in March 1985. The main objectives of the reform which the Bank supports are increasing state and local government autonomy on taxation, using the tax system to direct savings more to productive investment than to financial transactions, and improving the tax system as a policy instrument for improving the income distribution and for balanced regional development.

21. While the Commission's recommendations will not be fully implemented for several years, some steps appear feasible before then. As part of the fiscal adjustment for 1986, significant changes to the tax system are already being made. They include an increase in the progressiveness of the personal income tax, taxation of all forms of interest income at a uniform rate, and reduction of the lag between the accrual of corporate tax liability and payment of the tax.

22. The following sector policies would not only improve the Government's monetary and fiscal control but would also help mobilize savings and channel them to productive investment, by improving the financial system, reducing intermediation costs, and broadening and rationalizing the tax base:

(a) Budget consolidation:

Budgetary provision for wheat, sugar and agricultural credit subsidies; transfer of decentralized funds to Treasury budget; completion of process of budget consolidation; and redefinition of the functions of the Bank of Brazil.

(b) Monetary policy management:

Transfer to Bank of Brazil or BNDES of the Central Bank's development banking functions; establishment of Central Bank as the sole monetary authority; transfer to the Treasury of responsibility for the Federal public debt; and greater independence for the Central Bank.

(c) Financial system improvements:

Reduction in compulsory lending for certain sectors by commercial banks and in reserve requirements; strengthening and reform of the state and regional banking system; reform of the housing finance system; and new regulations for financial markets and for financial conglomerates.

(d) Tax reform:

Program to reduce tax exemptions and allowances; encouragement of longer-term holding of financial assets through differential tax rates; reduction of the wedge between borrowing and lending rates; and reorganization of tax and transfer system between Federal, State and municipal levels.

E. Public Sector Management

23. Management problems stem from the expansion of the public sector in the 1970s as the Government sought to maintain investment and growth in a difficult external environment, counter inflationary trends for which growing public sector deficits were themselves largely responsible, and meet a variety of competing and sometimes conflicting social objectives. Public expenditures expanded primarily through the monetary budget, which was handled by the Central Bank and used increasingly to channel development and welfare expenditures through subsidized credit programs and other subsidy arrangements. Public sector prices were held down in the attempt to restrain inflation. State enterprises were encouraged to borrow overseas for ambitious investment programs, and to borrow more to support a deteriorating balance of payments.

24. Since 1980, in an environment of recession, rising inflation and severe constraints on both external and domestic borrowing, the Government has made strenuous efforts to bring public expenditures under better control. There has been a substantial reduction in the public sector's operational deficit and borrowing requirements, from an estimated 6.6% of GDP in 1982 to about 3% in 1985. The aim in 1986 is to reduce this deficit to 0.5% of GDP.

25. The Government proposes to strengthen public sector management in several key areas, with Bank finance for:

- the establishment of a National Treasury Secretariat to administer Government funds more effectively,
- strengthening Federal information, planning, policy research, programming, budgeting, evaluation and reporting systems,
- improved programming and screening procedures for public investment projects, and
- the introduction of performance evaluation systems, rehabilitation programs and selective privatization programs for the state enterprise sector.

26. These measures, together with programs also to be supported by the Bank for the development of information systems and financial control, have the potential for greatly improved management of the public sector.

BRAZIL - EXPANDED FIVE-YEAR LENDING PROGRAM

(FY86-90)

FY86	US$ Million	
Electric Power Sector	0.0	
Agricultural Sector II	400.0	
Northeast Rural Development	171.0	
Alcohol Development	175.0	
Agricultural Credit	150.0	
Upper and Middle Sao Francisco Irrigation	56.0	
Salvador Metropolitan	49.0	
Northeast Rural Development	185.0	
Agricultural Extension	155.0	
Santa Catarina Market Towns	24.5	(10)
Northeast Urban Reconstruction (Flood)	100.0	(1,465.5)

FY87		
Public Sector Management	25.0	
Northeast Education Policy	10.0	
Financial Reform I	300.0	
Rural Electrification II	175.0	
Northeast Health - Primary	50.0	
Industrial Skills Vocational Training	100.0	
Urban Transport IV	200.0	
Electric Power Sector II (S)	400.0	
Irrigation Engineering (S)	45.0	
State Highway Sector Maintenance	150.0	
Agricultural Sector III	350.0	(12)
Northeast Rural Development V	200.0	(2,005.0)
Export Development II (R)	200.0	
Alcohol Development II (R)	175.0	
Agricultural Research III (R)	100.0	
Natural Gas (R)	50.0	(5)
Minas Gerais Forestry (R)	20.0	(545.0)

FY88		
Northeast Irrigation	200.0	
Financial Reform II	200.0	
Industrial Restructuring	250.0	
Power Distribution (S)	300.0	
Electric Power Sector II (S)	400.0	
Livestock Disease Control (S)	50.0	
Cerrado Transport	100.0	
Rural Telecommunications	100.0	
FEPASA Railways II	100.0	
Northeast Rural Development VI	100.0	
Northeast Rural Development VII	100.0	(12)
Northeast Education	150.0	(2,050.0)
Rubber Development (R)	60.0	
Ports II (R)	100.0	
Health/Population (R)	40.0	(4)
Urban Sector (R)	200.0	(400.0)

FY89	US$ Million	
Agricultural Sector IV	300.0	
Education Sector (S)	100.0	
Northeast Irrigation (S)	100.0	
Feeder Roads IV (S)	150.0	
Rural Water and Sanitation (S)	100.0	
Industrial Restructuring II (S)	300.0	
Northeast Small and Medium Cities (S)	100.0	
Technology Development (S)	100.0	
Electric Power Sector III	400.0	
Northeast Small Industries	150.0	(11)
Financial Reform III	200.0	(2,000.0)
Export Development III (R)	300.0	

FY90		
Water and Sewerage (S)	150.0	
Rural Electrification III (S)	200.0	
Medium Cities (S)	50.0	
Gas Exploration/Development (S)	150.0	
Agricultural Credit (S)	300.0	
Transport Sector (S)	200.0	
Electric Power Sector IV (S)	300.0	
Grande Carajas (S)	150.0	
Development Banking (S)	200.0	
Oil Palm Development (S)	100.0	(11)
Agricultural Credit (S)	200.0	(2,000.0)

January 16, 1986

Brazil -

✓ – Policies too vague

✓ – No sense of priorities

✓ – No annual action programs.

– Breakdown I, S [illegible] public & private.

– No need for para 33 on Bank staff -

– Sectoral [illegible]

– ~~Ba~~ Current Bank lending program.

– Look at Argentina + Colombia.

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Dec. 23, 1985

BRAZIL - PROSPECTS FOR STABILIZATION AND GROWTH → BB

A. Current Situation

1. During 1983-85, Brazil succeeded in achieving the external adjustment required to reach a reasonable equilibrium in its balance of payments (see Table 1 for details). After three years of GDP decline, the economy grew by about 4.5% in 1984, while the trade surplus reached US$13 billion and a small current account surplus (US$500 million) was also achieved. In 1985, in spite of high (7-8%) GDP growth, the trade surplus has remained at about US$12 billion, the current account deficit is below 1% of GDP, and gross international reserves have remained virtually unchanged during the year, at a level equivalent to about 8 months of imports. The presence of substantial excess capacity has facilitated this year's rapid growth. The large increase in exports achieved in recent years (from US$15.2 billion in 1979 to US$27.0 billion in 1984), and the efficient import substitution taking place in petroleum and some industrial subsectors, have contributed substantially to this economic performance, and should also help Brazil maintain acceptable growth rates in future years. Brazil has thus achieved a unique position among the high-debt countries, in being able to resume economic growth without a deterioration in its balance of payments. Grows much.

2. The external adjustment was not, however, accompanied by a parallel domestic achievement. Inflation remains above 200% annually, and real interest rates are still high, although they have fallen in recent months. Both factors introduce an element of uncertainty into investment planning, at a time when substantial increases in productive investment will soon be needed.

3. Brazil's productive structure has in recent years been demonstrably more efficient and competitive than that of other heavily indebted countries in the LAC region. The speed with which Brazilian industry adapted itself in 1983-84 to the need to increase exports was indeed remarkable, as has been also in recent years the export performance of agriculture. However, the current incentives structure does not ensure the continuing increase in exports required for high growth of output and employment over the medium and long term. The key development issue facing Brazil today is, therefore, whether to continue current policies and maintain a growth rate of about 5% per year, or, alternatively, try to maximize increases in production and employment through structural reforms that may be politically difficult in the short run.

B. Development Alternatives

4. Brazil needs to (a) maintain a GDP growth rate of at least 6.5% per year in order to improve living standards and generate enough employment growth (at least 4% per annum) to hire new entrants into the labor force and reabsorb those affected by the recent recession; and (b) improve its creditworthiness position, by reducing its debt service and debt to export ratios by at least 25% by 1990 (with continued improvement in the 1990s), so that it can resume amortization payments in the early 1990s. All three growth scenarios presented in this section meet the

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Table 1. BRAZIL--HISTORICAL DATA

	1980	1981	1982	1983	1984	1985*
Real GDP Growth Rate Per Annum	7.2	-1.6	0.9	-3.2	4.5	7.0
Debt to Exports Ratio 1/	3.2	3.1	4.1	3.9	3.4	3.7
Interest Payments to Exports Ratio (%) 2/	34.0	40.3	52.1	43.4	37.0	39.9
Total Debt to GDP Ratio (%) 3/	27.9	28.9	31.9	44.3	47.2	47.2
Interest Payments to GDP Ratio (%) 4/	3.0	3.7	4.4	4.9	5.4	5.1
Debt Service Ratio (%) 5/	64.2	69.1	90.7	58.4 6/	72.3	80.5
Terms of Trade (1983=100)	119.8	111.8	106.6	100.0	107.7	113.1
Real Growth Rates of: Imports	-12.3	-5.3	-13.4	-20.7	-0.3	4.4
Exports	23.6	21.6	-10.4	15.3	25.9	-2.3
Current Account Deficit (US$ Billions)	-12.4	-11.0	14.8	-6.1	.5	-1.3

1/ Total debt, including short-term, as a proportion of Exports of Goods and NFS

2/ Total interest payments, including short-term, as a percentage of Exports of Goods and NFS

3/ Total debt, including short-term, as a proportion of GDP

4/ Total interest payments, including short-term, as a percentage of GDP

5/ Total interest payments plus amortization on M&LT debt as a percentage of Exports of Goods and NFS

6/ Includes only amortization actually paid.

* Estimate

creditworthiness target but only the two more rapid growth scenarios attain the GDP and employment objectives.

5. On the basis of its large, generally efficient economic system and its proven capacity to export, Brazil could maintain an annual growth rate of about 5% over the next 5-10 years, without undertaking any major additional policy reform. This "low-growth" scenario assumes, however, that the Government will follow an exchange rate policy of periodic devaluations equivalent to the difference between domestic and international inflation, and that inflation does not increase substantially over its present level, although no major reduction in it would be achieved.

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6. Table 2 shows Bank projections based on the above assumptions. In this alternative, Brazil would need to run a current account as well as a large trade surplus to service its external debt. Exports would grow modestly. With an export growth rate averaging 2.4% in real terms between 1985-90, a moderate increase in non-oil imports would be feasible as long as Brazil continues an active energy substitution program and reduces oil imports in real terms. Creditworthiness indicators would improve substantially. However, although consumption per capita would increase about 3.2% annually, no significant reduction in unemployment and underemployment would occur, and social unrest would be likely to increase substantially. Inflation would be higher and more susceptible to acceleration than if an active stabilization policy were implemented. The risks of an interruption to growth are higher without the effort to adjust. This option, in short, would not be conducive to ensuring long-term, sustained economic and social development. For without an adjustment program, the Bank annual lending program would have to be reduced--from US$1.5 billion to about US$1 billion per year or less--and no "new money" would be likely to be obtained from commercial banks.

7. Table 2 also shows alternative projections which reflect the impact of the adjustment and growth program described below. The "high-growth" option would include, inter alia, export development and trade liberalization, freer commercial policies in agriculture, fiscal and financial reform, and lower public sector deficits. This overall program would stimulate increased investment and GDP and employment growth in a more stable domestic environment. With tighter economic management, it should be expected that reduced public sector demand for credit, lower inflation expectations and increased access to external resources would lower real interest rates and encourage investment. "New money" and increased agricultural and manufactured exports would permit higher imports and better GDP growth. Growth in GDP averaging 8% p.a., which is considered feasible if the external environment is accommodating and the medium-term adjustment program is effectively implemented, would permit major gains in employment and other social directions, and would allow growth in consumption per capita of about 5.2% per year, thereby easing economic and political tensions. Rapid growth would also strengthen the balance of payments and the capacity to service the debt. Traditional creditworthiness indicators, while improving by a third over the decade, are not substantially better than in the "low-growth" option. In this "high-growth" option, the country is incurring more debt to support the structural adjustment process and to raise more quickly the living

GNP per capita (1983) = US$ 1,890

Table 2: BRAZIL - PROJECTIONS OF KEY VARIABLES

	1985	1986	1987	1988	1989	1990	1995
"HIGH GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	8.0	8.0	8.1	8.1	8.1	8.0
GDP per Capita Growth Rate	4.7	5.8	5.8	5.9	6.0	6.0	5.9
Consumption per Capita Growth Rate	6.4	4.9	4.4	5.3	5.1	6.6	5.6
Investment/GDP (%)	18.0	20.0	22.0	23.0	24.0	24.0	24.0
Marginal Savings Rate	0.14	0.44	0.44	0.34	0.36	0.24	0.26
Trade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	12.4	13.3	14.6	16.8	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	5.3	6.5	7.3	7.9	8.2
Exports of GNFS/GDP (%)	12.7	12.1	11.8	11.8	11.8	11.9	11.8
Imports of Goods Real Growth Rate	4.4	21.6	21.9	16.3	14.8	11.9	8.4
Imports of GNFS/GDP (%)	7.8	8.3	8.9	9.3	9.6	10.0	10.0
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.5	109.8	116.0	122.9	130.9	160.0
DOD/GDP (%)	47.2	42.2	38.4	34.9	31.8	29.1	19.5
DOD/X Ratio	3.7	3.5	3.2	3.0	2.7	2.4	1.7
DS/X (%)	80.5	79.5	72.4	63.9	59.0	49.3	29.4
Interest Payments/GDP (%)	5.1	3.9	3.5	3.2	2.9	2.6	1.8
"MODERATE GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	7.1	7.1	7.1	7.1	7.1	7.2
GDP per Capita Growth Rate	4.7	4.9	4.9	4.9	5.0	5.0	5.1
Consumption per Capita Growth Rate	6.4	4.0	4.3	4.3	4.2	5.4	5.1
Investment/GDP (%)	18.0	20.0	21.0	22.0	23.0	23.0	24.0
Marginal Savings Rate	0.14	0.45	0.35	0.35	0.36	0.25	0.25
Trade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	13.1	14.2	15.7	18.1	26.1
Exports of Goods Real Growth Rate	-2.3	2.5	4.0	4.6	5.3	5.9	7.3
Exports of GNFS/GDP (%)	12.7	12.2	11.9	11.7	11.5	11.5	11.4
Imports of Goods Real Growth Rate	4.4	21.5	12.9	11.3	10.7	8.6	7.8
Imports of GNFS/GDP (%)	7.8	8.4	8.6	8.9	7.1	9.2	9.7
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.7	109.1	114.5	120.3	126.8	155.8
DOD/GDP (%)	47.2	42.7	38.8	35.4	32.4	29.5	20.6
DOD/X Ratio	3.7	3.5	3.3	3.0	2.8	2.6	1.8
DS/X (%)	80.5	79.6	73.6	66.0	61.7	52.8	31.9
Interest Payments/GDP (%)	5.1	4.0	3.6	3.3	3.0	2.6	1.9
"LOW GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	5.0	5.0	5.0	5.0	5.0	5.1
GDP per Capita Growth Rate	4.7	2.8	2.8	2.8	2.9	2.9	3.0
Consumption per Capita Growth Rate	6.4	2.5	3.4	3.3	3.5	3.4	3.2
Investment/GDP (%)	18.0	19.0	19.0	19.0	19.0	19.0	19.0
Marginal Savings Rate	0.14	0.44	0.22	0.23	0.21	0.23	0.18
Trade Indicators							
Trade Surplus (US$ billions)	12.1	13.1	14.4	16.0	17.8	19.9	23.3
Exports of Goods Real Growth Rate	-2.3	2.5	2.4	2.4	2.4	2.5	3.3
Exports of GNFS/GDP (%)	12.7	12.4	12.2	12.0	11.8	11.6	10.6
Imports of Goods Real Growth Rate	4.4	12.7	5.3	5.2	5.2	5.2	5.3
Imports of GNFS/GDP (%)	7.8	8.0	8.0	8.0	7.9	7.9	6.2
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	103.0	104.7	105.7	106.3	106.2	100.7
DOD/GDP (%)	47.2	42.8	38.7	34.6	30.8	27.2	16.2
DOD/X Ratio	3.7	3.4	3.2	2.9	2.6	2.3	1.5
DS/X (%)	80.5	79.5	74.0	66.9	62.7	53.4	29.5
Interest Payments/GDP (%)	5.1	4.1	3.7	3.3	3.0	2.5	1.5

Notes :

1. Debt includes public and publicly guaranteed, private non-guaranteed and short term debt
2. Exports and imports include that of goods and non-factor services.

standards of the population. In general terms, however, Brazil's creditworthiness--as reflected in the Government's readiness to adopt needed policy reforms to promote growth, stabilization, and external balance--is significantly improved.

8. The "high-growth" scenario, as indicated above, assumes the timely adoption of the required policy reforms and no increase in protectionism in OECD countries. At this point, the Government finds it inadvisable to proceed quickly with proposed trade liberalization. Although the fundamental importance of export promotion is recognized and the need for tariff reform stressed in the National Development Plan, the Government has indicated that it does not wish to compromise Brazil's negotiating position in forthcoming GATT and other trade talks. Brazil's established industrial efficiency and capacity to compete internationally make trade policy reform a less critical adjustment issue at this point than in other high debt countries, although many anomalies still exist. Why?

9. The most likely growth scenario, in view of the forthcoming trade negotiations, the priorities in the new National Development Plan, and the Government's 1986 economic program (see para. 24), is one which is slightly below the "high-growth" option. In this "moderate-growth" option, the Government would carry out all policy changes specified in the "high-growth" case except for trade liberalization. In its place, the Government would take steps to simplify the import system and further strengthen the drawback mechanism. As in the "high growth" case, it would also maintain the present exchange rate policy, devaluing the cruzeiro in line with domestic inflation and continuing its link to the U.S. dollar. In such an environment, manufactured export growth and net foreign capital inflows would still be substantial, albeit somewhat lower than in the "high-growth" scenario; they would permit a large increase in imports and investment. As in the "high-growth" scenario, this option assumes that export growth will not be made impossible by an increase in protectionism in OECD countries. Table 2 shows the comparisons. GDP would average 7%, rather than 8% per year. Consumption per capita would grow about 4.4% per year and creditworthiness would improve at a satisfactory rate.

C. Proposed Medium-Term Adjustment and Growth Program

This section too vague.

10. The economic policy program proposed in this paper, equivalent to the "moderate-growth" scenario, is aimed at raising GDP growth sufficiently to make up for the drop in employment and living standards encountered in the recent recession and to continue the economic progress begun in the 1970s, while improving creditworthiness in the process. The program would increase the efficiency and competitiveness of Brazilian production in the manufacturing and agricultural sectors; rationalize public investment, promote efficient private investment, and encourage increases in public and private savings; maintain a sound balance-of-payments position; undertake required reforms of the fiscal and financial systems; improve the efficiency of the public sector, including both the General Government and public enterprises; stabilize the domestic economy; increase the efficiency of educational and health services; and raise productivity and income levels in the Northeast Region. The program encourages private investment in the productive sectors, leaving the Government to concentrate more of its resources on infrastructure and social services. The key aspects are summarized in the following paragraphs, and specified in more detail--

including the required timing--in the Policy Matrix shown in Annex I. The current position of the Brazilian Government on the proposed reforms, and the proposed response of the Bank, in particular, and of the external community in general, are described in Sections D and E below.

11. Industry and Trade. Sectoral policies to promote exports and efficient import substitution consist of continuation of the present exchange rate policy of periodic devaluations equal to domestic inflation, some simplification of import regulations, and further improvements to the drawback system. With these policies, Brazilian export growth is expected to be sufficient to generate trade surpluses of US$12-15 billion per year for the rest of the decade and to permit a substantial increase in non-oil imports (see Table 2), when combined with additional foreign borrowing. While this program is being implemented, we would continue to encourage the Brazilians to proceed with the broader package of trade policy reforms envisaged within the "high-growth" scenario and spelled out in Annex II. [illegible]

12. Agriculture. Aiming also at increasing productive efficiency and exports, the proposed program for agriculture would, inter alia, further reduce credit subsidies and finance the remaining ones through the fiscal budget; introduce free trade for key agricultural products, with limited Government interventions under pre-established conditions; phase out wheat subsidies; and start operations of futures markets and bankers acceptances' trading for key agricultural products. The program would be time-phased over five years.

13. Energy. The proposed energy program would promote efficient import substitution and conservation, mainly through appropriate pricing policies. It would also include the Power Sector Investment and Financial Rehabilitation Plan, now being appraised as the framework for the proposed FY87s Power Sector Loan.

14. Investment and Savings. The program in these areas would include the systematic screening and monitoring of the Public Sector Investment Program by the Planning Ministry, with Bank staff assistance; the strengthening and selective privatization of public enterprises; Which? What? appropriate incentives to private investment through sufficient credit availability and by implementing the sectoral reforms referred to in paras. 11-13 above; and savings increases through reductions in the public deficit (see para. 24 below), and credit and tax incentives to private savings. Consequently, the public sector's share in total investment is expected to decline, from an estimated 50% in 1984-85 to 45% by 1990; and with the elimination of the public sector deficit, the public sector's share in total savings is expected to approximate its share in total investment.

15. Balance of Payments. In addition to the exchange rate and sectoral policies referred to above (paras. 11-13), the proposed program would include carefully managed debt rescheduling and new external borrowing, as well as incentives to foreign private investment.

16. Fiscal and Financial Reform. The reforms in this area would be aimed at improving resource allocation and would include, inter alia, the consolidation of all fiscal expenditures in the Federal Budget; the reform

how?

of the Central Bank and the Banco do Brasil functions; the progressive elimination of the prevailing segmentation of credit markets; and tax reforms directed towards increasing savings and improving their utilization for productive investment.

how?

17. Public Sector Management. The program would improve the overall efficiency of the public sector by establishing a Treasury Secretariat in the Finance Ministry, which would have operational control of the unified fiscal budget; strengthening the Planning Ministry's departments dealing with the planning and monitoring of public investment and current expenditures; undertaking operational audits and action plans to improve the efficiency of public enterprises; and improving economic information and accounting control systems.

institutional reform to improve efficiency?

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18. Stabilization. The proposed policies in this area would be directed towards progressively reducing inflation, from about 225% in 1985 to a figure which, if major changes in the indexation system are feasible, could be 20% or less in 1990. The program would include, inter alia, a substantial reduction of the public sector deficit and of the rate of increase of the domestic public debt, to levels consistent with the desired gradual reduction in inflation and with the credit availability required for the financing of private investment; the maintenance, on a continuous basis, of monetary and incomes policies compatible with increased internal stability; and the preparation and implementation of a program for dealing with the price stabilization problems posed by the widespread indexation of the Brazilian economy. If price increases are not reduced substantially, the proposed gradual approach to stabilization would have to be reviewed, and other options considered. Such options would have to include, inter alia, a substantial modification to the indexation system and monetary reform.

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19. Social Development. The program in this area would be aimed at restoring appropriate levels of education and health services, and improving their cost efficiency; and at improving the productivity and income levels of the Northeast population, in both urban and rural areas. The priority to be attached to these areas would be in line with the proposed shift in emphasis, within the public sector, from productive activities to social services, and with the parallel enhancement of the role of the private sector as the main agent for the development of productive activities.

D. The Brazilian Position

20. Many of the key policy directions suggested in this paper have been discussed extensively by Bank staff with the Brazilian authorities, in connection with proposed Bank loans. There is now a remarkable coincidence of views--particularly with the Planning Ministry--in many policy areas. For instance, we have reached agreement on most aspects of the programs proposed for 1986--and on the overall objectives for the longer term--concerning Agriculture, Energy (except fuel prices), Public Sector Investment, Fiscal and Financial Reform, Public Sector Management (including, in particular, mechanisms and procedures for screening and monitoring public investment) and Social Development. There are, however, some policy areas in which no decision has been taken yet by the Government, or in which the adopted decisions do not go far enough. These

include trade policy and fuel prices--on which disagreements may emerge in the near future--and policy issues--referred to in para. 23 below--which we have not yet discussed fully with the Government. Further discussions will also be required concerning stabilization policy (see para. 24 below).

21. The most important remaining long-term issue concerns trade policy. We had reached agreement on the full program included in Annex II with a Working Group formed by the Government to prepare the proposed Export Development II project. At the political level, however, the question has become controversial. The Ministry of Foreign Affairs has indicated that any unilateral decision on trade policy now would undermine Brazil's position in the GATT and other trade talks. The industrial establishment has traditionally been opposed to liberalized trade, although its views are probably changing with the increased importance of exports and better knowledge of anomalies which benefit some manufacturers at the expense of others. Policy reform in this area is likely to be slow; however, as explained above, satisfactory growth and creditworthiness improvements can occur without such a reform.

22. In another major area the Government has now corrected--or has a plan to correct--most of the distortions introduced by the freeze of public sector prices adopted for several months earlier this year. One important exception to this is the price of petroleum derivatives, some of which (fuel oil, naphtha, and LPG) are still below international levels.

23. Other structural issues which have not been discussed yet fully with the Government include the time-phasing of the elimination of credit subsidies (which we and the Government have agreed to review in December 1986); the required incentives for private investment and savings (on which additional ESW would be required, particularly concerning tax policy); and the ways to proceed concerning external debt management and incentives to foreign investment. We do not anticipate major disagreements between the views of the Government and of Bank staff on these issues, with the possible exception of the timing of the elimination of the remaining rural credit subsidies.

24. The Congress has just passed the Government's 1986 Economic Program. This program includes, inter alia, a larger fiscal adjustment than previously expected, envisaging a reduction of the operational fiscal deficit of the public sector from 2.8% of GDP in 1985 to 0.5% in 1986. Both IMF and Bank staff consider that the overall objectives of the program could be accepted by our institutions, although we have still to examine its consistency and viability in detail. Subject to the conclusions of the required further analysis, this program could be considered as a substantial step forward within a gradual stabilization approach. Its successful implementation, particularly concerning the reduction of the fiscal deficit, would also be important in connection with longer-term policies directed toward increasing private investment and savings, which are regarded by the Government as well as the Bank as the key to more sustainable growth in Brazil. The stabilization policies suggested in this paper are basically similar to those included in the Government program.

E. The Role of the World Bank, The IMF and the Commercial Banks

25. World Bank Financing. Increased external support would be essential to the success of the medium-term adjustment program. We propose that the Bank should adopt a graduated-response posture, with an annual lending amount in 1986-90 which would vary between US$1 billion under the "low-growth" option (assuming no further progress in policy reform, exchange rate devaluations equal to the difference between domestic and international inflation, and no substantial change in the rate of inflation) and US$2.0 billion under the "moderate-growth" alternative (a level to be reached if and when Brazil goes forward with the reform package suggested in this paper). These commitment levels would be consistent with average annual gross disbursements of, respectively, US$1.1 and US$1.7 billion from the entire Brazil loan portfolio (see Tables 3A-3C). The proposed lending under the "low-growth" option would make the Bank's relative exposure in Brazil decline to below 10% of our overall portfolio by 1990, while under the "moderate-growth" scenario, Brazil's share in the Bank portfolio would increase to slightly over 11%. The specific lending level for each year would depend upon the degree to which the required reforms are adopted and implemented, and would in practice be determined by the extent to which policy reforms associated with specific loans are put into effect.

26. The Bank's current program for Brazil envisages an annual US$1.5 billion lending level. The program for FY86-87 includes three large quick-disbursing loans, for a total amount of US$1.2 billion. All other operations in the program are more traditional, and slower-disbursing, project and sector loans. Most of the increase required to reach the expanded US$2.0 billion level referred to above would come from additional policy-based operations, including additional agricultural sector loans, sectoral financial rehabilitation loans, and possibly industrial restructuring operations. The additional lending would also include increases in our program for education (particularly vocational training) and health to support the social content of the adjustment program.

27. If the Brazilian Government is also willing to commit itself to a comprehensive program of trade reform, beginning in 1986, in addition to the other policy changes, then Bank lending levels could reach US$2.5 billion per year (the "high-growth" scenario). A series of policy-based loans in support of trade reform would be added to the lending program. These lending magnitudes would increase the Brazilian share of the overall Bank portfolio to 13% by 1990.

Is this the only diff b/w mod growth & high growth

28. IMF and Commercial Bank Assistance. Bank support for the adjustment program would not depend on a stand-by agreement between Brazil and the IMF. The Government, while willing to undertake a substantial stabilization effort, has indicated that it does not intend--probably for domestic political reasons--to reach formal agreement with the Fund. However, it does intend to keep the Fund informed about the features and implementation of its program. If Brazil adopts a viable short- and medium-term economic program, but does not reach an operational agreement with the Fund, we believe that the Bank should still try to assist Brazil with an expanded lending program and with the mobilization of commercial banks' resources. This would probably require, however, an agreement to

have the Fund monitor performance in the fiscal, monetary and balance-of-payments policy areas. It should be noted that cooperation between the staff of the Bank and the Fund concerning Brazil has improved substantially over the last few months, particularly concerning the flow of information and the interchange of technical opinions.

29. After substantial "involuntary lending" in 1983 and 1984, commercial banks have not provided this year any "new money" to Brazil. In view of its overall high level of foreign exchange reserves, the country has not needed new money in 1985. Moreover, as is shown in the low-growth projections, Brazil could grow during the next 5-10 years at an annual rate of about 5% with virtually no "new money" from commercial banks and with a very low level of net inflows from other sources. As indicated above, however, to maintain a growth rate high enough to reduce unemployment and underemployment substantially (by, say, 2% of the labor force per year), Brazil would indeed need net capital inflows from the commercial banks. According to the "moderate-growth" projections presented in this paper, such inflows should reach an average annual level of US$2.6 billion in 1986-90, which would be equivalent to a 3.5% annual increase in their nominal exposure (but to about a 4% reduction of their exposure in real terms). It is also estimated that the "moderate-growth" option would require about US$1.5 billion per year in net inflows from suppliers, official export agencies and the IDB, and about US$1.1 billion per year in foreign direct investment. IDB lending to middle-income countries like Brazil, while constrained by present institutional policies, is assumed to expand substantially. Under the "high-growth" option, additional net commercial bank lending would average almost US$3.0 billion per year for the next five years, and net inflows from other sources (apart from the World Bank), about US$1.7 billion. (See Tables 3A-3C for details.)

30. Independent of "new money," Brazil needs to reschedule the existing debt of commercial banks, probably until the early 1990s. Until very recently, the commercial banks had maintained the position that, if they were to reschedule existing debt or provide "new money", Brazil would first have to agree on a stand-by arrangement with the Fund. During the last few weeks, however, representatives of some large banks have indicated to Bank staff that they would also accept the monitoring by the Fund of agreed fiscal, monetary and balance-of-payments targets, without necessarily requiring a formal stand-by arrangement. The Government has indicated that it would seek a one-year rescheduling agreement with the banks, if multi-year rescheduling is not possible.

31. Monitoring. The proposed monitoring system is described below. We have requested from the Government a general policy statement, laying out the basic elements of its short- and medium-term economic program. Our evaluation of the program would form the core of a report which would be distributed to the Board, as the basis for Bank lending, and by the Government to commercial banks, as the framework for co-financing. The monitoring would then proceed at two levels:

(a) Before submitting a policy loan to the Board, Bank staff would review Brazil's economic performance in terms of its stated objectives and policy actions, to ascertain whether the program is on track. A positive conclusion would be needed in order to submit each policy loan to the Board.

TABLE 3A: FINANCING REQUIREMENTS AND SOURCES (HIGH GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,233)	(2,405)	(3,321)	(3,882)	(4,265)
Direct Foreign Investment (Net)		807	792	1,275	1,457	1,737	1,916
MLT	Gross Disbursements	10,420	15,284	17,621	18,629	20,495	20,588
	Amortization	9,388	11,885	12,359	12,402	13,462	12,340
	Net Disbursements	1,032	3,399	5,262	6,227	7,033	8,248
1) World Bank	Commitments	1,500	2,500	2,500	2,500	2,500	2,500
	Gross Disbursements	800	1,646	2,126	2,216	2,297	2,387
	Amortization	400	418	542	637	931	1,170
	Net Disbursements	400	1,228	1,584	1,579	1,366	1,217
2) Other Multilateral	Commitments	275	800	800	800	800	800
	Gross Disbursements	297	290	366	456	572	662
	Amortization	136	157	173	186	214	260
	Net Disbursements	161	133	193	270	358	402
3) Official Export Credits	Gross Disbursements	888	1,048	1,195	1,066	1,900	2,550
	Amortization	806	686	413	372	1,162	1,316
	Net Disbursements	82	362	782	694	738	1,234
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,545	1,682	1,787	1,871	1,815
	Amortization	1,142	975	882	996	1,071	1,165
	Net Disbursements	423	570	800	791	800	650
6) Commercial Banks	Gross Disbursements	6,797	10,685	12,204	13,086	13,845	13,167
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,145	1,963	2,977	3,858	4,834
Other Capital		(200)	(1,500)	(1,968)	(2,285)	(2,785)	(3,478)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(922)	(1,238)	(1,389)	(1,537)	(1,926)
DOD							
World Bank		4,305	5,533	7,117	8,696	10,062	11,279
Other Multilateral		1,942	2,075	2,268	2,538	2,896	3,298
Official Export Credits		6,256	6,618	7,400	8,094	8,832	10,066
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,485	8,285	9,076	9,876	10,526
Commercial Banks		66,467	67,612	69,575	72,552	76,410	81,244
TOTAL		89,581	92,980	98,242	104,469	111,502	119,750

TABLE 3B: FINANCING REQUIREMENTS AND SOURCES (MODERATE GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,503)	(1,660)	(2,284)	(3,052)	(2,621)
Direct Foreign Investment (Net)		807	794	879	1,063	1,247	1,429
MLT	Gross Disbursements	10,420	15,394	16,769	17,724	19,701	17,981
	Amortization	9,388	11,884	12,359	12,412	13,398	12,211
	Net Disbursements	1,032	3,510	4,410	5,312	6,303	5,770
1) World Bank	Commitments	1,500	2,000	2,000	2,000	2,000	2,000
	Gross Disbursements	800	1,348	1,626	1,716	1,797	1,887
	Amortization	400	418	542	637	889	1,086
	Net Disbursements	400	930	1,084	1,079	908	801
2) Other Multilateral	Commitments	275	275	500	500	500	500
	Gross Disbursements	297	280	315	351	404	446
	Amortization	136	156	173	186	214	241
	Net Disbursements	161	124	142	165	190	205
3) Official Export Credits	Gross Disbursements	888	1,498	1,196	1,159	1,850	1,960
	Amortization	806	686	413	372	1,163	1,316
	Net Disbursements	82	812	783	787	687	644
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,480	1,655	1,788	1,816	1,789
	Amortization	1,142	975	882	1,006	1,048	1,139
	Net Disbursements	423	505	773	782	768	650
6) Commercial Banks	Gross Disbursements	6,797	10,718	11,929	12,692	13,824	11,892
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,178	1,688	2,583	3,837	3,559
Other Capital		(200)	(1,400)	(1,847)	(2,274)	(2,597)	(2,700)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(865)	(856)	(1,128)	(1,335)	(1,383)
DOD							
World Bank		4,305	5,235	6,319	7,398	8,306	9,107
Other Multilateral		1,933	2,057	2,199	2,364	2,554	2,759
Official Export Credits		6,256	7,068	7,851	8,638	9,325	9,969
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,420	8,193	8,975	9,743	10,393
Commercial Banks		66,467	67,645	69,333	71,916	75,753	79,312
TOTAL		89,572	93,082	97,492	102,804	109,107	114,877

TABLE 3C: FINANCING REQUIREMENTS AND SOURCES (LOW GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(83)	539	1,352	2,011	3,265
Direct Foreign Investment (Net)		807	798	887	977	966	1,054
MLT	Gross Disbursements	10,420	13,619	14,099	13,404	13,877	11,960
	Amortization	9,388	11,883	12,359	12,412	13,314	11,971
	Net Disbursements	1,032	1,736	1,740	992	563	(11)
1) World Bank	Commitments	1,500	1,000	1,000	1,000	1,000	1,000
	Gross Disbursements	800	1,028	1,051	1,066	1,062	1,057
	Amortization	400	418	542	637	805	920
	Net Disbursements	400	610	509	429	257	137
2) Other Multilateral	Commitments	275	250	250	250	250	250
	Gross Disbursements	297	273	273	273	264	266
	Amortization	136	155	173	186	214	226
	Net Disbursements	161	118	100	87	50	40
3) Official Export Credits	Gross Disbursements	888	878	856	829	1,400	1,450
	Amortization	806	686	413	372	1,163	1,316
	Net Disbursements	82	192	443	457	237	134
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,357	1,185	1,085	1,134	1,100
	Amortization	1,142	975	882	1,006	1,048	1,080
	Net Disbursements	423	382	303	79	86	20
6) Commercial Banks	Gross Disbursements	6,797	10,013	10,686	10,133	10,007	8,080
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	473	445	24	20	(253)
Other Capital		(200)	(1,400)	(1,647)	(1,986)	(2,182)	(2,930)
IMF (Net)		0	(535)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(516)	(593)	(646)	(792)	(883)
DOD							
World Bank		4,305	4,915	5,424	5,853	6,110	6,247
Other Multilateral		1,970	2,088	2,188	2,275	2,325	2,365
Official Export Credits		6,256	6,448	6,891	7,348	7,585	7,719
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,297	7,600	7,679	7,765	7,785
Commercial Banks		66,467	66,940	67,385	67,409	67,429	67,176
TOTAL		89,609	91,345	93,085	94,077	94,640	94,629

(b) Specific policy reforms would be supported by individual loans, such as those reported in the following table:

Policy Area	Monitoring Instruments
A. Industry and Trade	Export Development Loans* Industrial Restructuring Loans*
B. Agriculture	Agriculture Sector Loans Agriculture Credit Loans
C. Energy	Power Sector Loans Transportation Sector Loans
D. Investment and Savings:	
1. Public Sector Investment and Savings	Public Sector Management Loans Public Sector Review missions Overall Bank economic assessments IMF surveillance
2. Private Sector Investment and Savings	Overall Bank economic assessments IMF surveillance
E. Balance of Payments	Overall Bank economic assessments IMF surveillance
F. Fiscal and Financial Reform	Financial Sector Reform Loans
G. Public Sector Management	Public Sector Management Loans
H. Stabilization	IMF surveillance
I. Social Development	Education Sector Loans Health Sector Loans Northeast Rural Devt. Loans Northeast Small and Medium Scale Industry Loans

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* Under the "high-growth" option only.

32. The overall economic assessment of the program and the periodic program monitoring would be undertaken by economic missions, including public investment and sectoral missions. The work would be done in close coordination with IMF staff if--as is assumed here--the Fund is involved in the surveillance of Brazilian performance, with or without a stand-by arrangement. The monitoring to be performed by the Bank in connection with proposed loans would also be used to recommend cofinancing for specified priority projects. Whenever possible, these loans would be based upon policy actions taken before Board presentation, with further progress being a condition for processing subsequent loans in the sector (and for

maintaining the level of the expanded overall lending program). In some instances, as in the proposed FY86 Agricultural Sector Loan, the loan would be disbursed in two tranches, with policy conditionality attached to both of them.

33. Implications for Bank Staffing. The proposed Bank program under the "moderate-" or "high-growth" scenario would require an increase of about 150 staff weeks per year in economic and sector work, equivalent to 25% of our current ESW program. This would include: (a) about 50 staff weeks for work on industry, trade and financial reform; and (b) about 100 staff weeks for work on several areas which are not linked to specific Bank loans--such as private investment and savings, certain areas of public sector investment activity, public debt management, indexation and tax reform; for monitoring the overall execution of the program and preparing periodic reports on it; and for increased contacts with Fund and commercial bank staff. It should be noted that, given the scope of the proposed program, the increase referred to above is relatively small because (a) it is assumed that the monitoring of fiscal, monetary, and balance-of-payments policies would be undertaken by the Fund; (b) substantial work has already been done by Bank staff concerning key issues related to the agricultural, industrial, financial and power sectors, and to public sector enterprises; and (c) Brazilian working groups are undertaking much of the additional required work on agriculture and trade policy issues, as a result of prior agreements with the Government. The staffing requirements would have to be reestimated to the extent that the Fund is not involved in the monitoring process.

BRAZIL - PROPOSED MEDIUM-TERM ADJUSTMENT AND GROWTH PROGRAM

Moderate-Growth Option

Main Goals: (1) To maintain growth rates in 1986-90 which are high enough to provide employment to new entrants in the labor force, and to a number of currently underemployed workers equivalent to 2% of the labor force per year. Target average growth rate 7% per year.

(2) To improve the country's creditworthiness, consistent with a reduction of the debt to export ratio from 3.7 in 1985 to 2.6 in 1990, and 1.8 in 1995.

(3) To reduce domestic inflation substantially by 1990.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
A. BALANCE OF PAYMENTS								
1. Exchange Rate Policy	Maintain international competitiveness	Devaluation of 30% in 1983; subsequent full adjustment to domestic inflation	+Maintenance of competitive exchange rate policy through periodic adjustments which are at least equal to the difference between domestic and international inflation	*	*	*	*	*
2. Trade Balance	Maintain trade surplus levels consistent with growth and stabilization objectives and with gradual reduction of debt service ratios	Exchange rate policy and other measures required to achieve an annual US$12 billion trade surplus in 1984 and 1985	+Policies on Industry and Trade, Agriculture and Energy (See B, C and D)	*	*	*	*	*
3. Debt Management	Debt rescheduling to reduce adjustment pressures, 1986-90 limited new borrowing in amounts consistent with stability and growth objectives, and with gradual reduction of debt service ratio to sustainable level by around 1990	Annual arrangements for rescheduling principal payment, 1982-85.	+Rescheduling of principal on old commercial debt falling due 1986-90 (multi-year rescheduling would be preferable)	*	*	*	*	*
		Controlled and limited new borrowing, 1982-84. No new commercial borrowing 1985.	+Agreed annual programs of official and commercial borrowing	*	*	*	*	*
4. Direct Investment	Resumption of direct investment inflows to complement domestic investment	-	+Review of foreign investment and technology transfer policies		*			
			+Policy changes as required			*		

+ Denotes policies essential to adjustment program.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
B. INDUSTRY AND TRADE								
1. Exchange Rate Policy	Maintain international competitiveness	-	See A.1					
2. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 13% annually, to permit import expansion while covering debt service	Liberalization of duty drawback system for exporters, extension of drawback system on limited basis to indirect exporters and removal of fiscal export subsidy (credito premio)	+Strengthening of export promotion through improvements in quality control and certification; marketing, design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures		*			
			+Simplification of indirect drawback system		*			
			+Elimination of remaining indirect taxes on exports			*		
3. Export Financing	Rationalize and extend financing arrangements for exports	Reduction of subsidy element in pre-shipment export financing	Strengthening of export credit insurance	*	*			
4. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Elimination of tariff surcharges; reduction in average tariff level and in number of items subject to "suspended imports"; increased flexibility in external financing requirements for imports; liberalization of firms, import programs for annual imports up to US$100,000; increased autonomy to CACEX's field offices; and elimination of foreign credit financing as a criterion for the application of the Law of Similars	+Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making	*	*			
Bank support		(Export Development I, FY84)	ESW on Industry and Trade	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
C. AGRICULTURE								
1. Agricultural Credit	Rationalization of rural credit system	Elimination of negative real interest rates, Center-South (1983) and agreement on reductions in North-Northeast (1985)	+Budgetary provision for costs of interest rate subsidies (equalization costs for Federal and State banks, monetary correction shortfall North-Northeast)	*				
			+Elimination of negative real interest rates in North-Northeast, except special target groups			*		
			+Market interest rates Center-South, except special areas				*	
			Market interest rates in North-Northeast, except special target groups					*
			+Full fiscal provision for remaining subsidies		*	*	*	*
2. Trade and Pricing	Trade liberalization and development of efficient marketing system	-	? +Introduction of free trade policy for 1986-87 crops, within defined price limits	*				
			+Phase-out food price controls and wheat subsidy, implement targeted food assistance programs	*	*	*		
			Reopen access to external futures trading, remove tax on domestic futures trading	*				
			Establish legal/regulatory framework for storage warrants, bankers acceptance matters in bonded agricultural commodities	*				
			+Rationalization of trade regulations for agricultural commodities	*				
			Establish agricultural price data system		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
			+Free trade for key agricultural products, subject to minimum price guarantees, market safeguards and government stock management		*		*	
			Start domestic futures market for major agricultural commodities and bankers acceptance trading		*			
			Integrated data systems for CACEX, Central Bank			*		
			Improved crop forecasting and stock information systems		*	*		
			+Reform of system of agricultural taxation			*	*	*
3. Taxation	Minimize tax disincentives to agricultural export growth	-						
Bank Support		(Agriculture Credit and Export Loan, FY83)	Agriculture Sector II	*				
			Agriculture Credit I	*				
			Agriculture Sector III		*			
			Agriculture Credit II			*		
			Agricultural Credit III					*
			Cofinancing	*	*	*		*
			ESW on Agriculture	*	*	*		
D. ENERGY								
1. Energy Development and Conservation	Cost-effective development of domestic energy resources	Reassessment of energy investment priorities (1985)	Development of a long-term energy efficiency plan	*				
			+Pricing policies promoting efficient domestic energy use	*	*	*	*	*
2. Electric Power	Realistic investment and financial plans and implementation	Formulation and initiation of Investment Program for Financial Plan for 1984-88; real tariff increases	+Financial rehabilitation; balanced resource allocation, improved system reliability, tariffs to be brought into line with long-run marginal costs	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
Bank Support		(Power Transmission, Conservation and Distribution loans, FY85)	Power Transmission		*			
			Power Sector I	*				
			Power Sector II		*			
			Transport Sector I		*			
			Energy Conservation			*		
			Transport Sector II					*
			Cofinancing	*	*			
E. INVESTMENT AND SAVINGS								
1. Public Sector Investment	Program limited, with specified exceptions, to completion of high-priority rehabilitation-recovery programs	Increased supervision of public sector, including state enterprise, investment programs; real reductions in 1983-84.	+Annual Government-monitored program of public sector investment in context of multi-year investment programs (with continuing Bank review and progress reporting)	*	*	*	*	*
			+Channelling of new external funds into key areas of rehabilitation and/or priority new investment	*	*	*	*	*
2. Private Investment	Increase market incentives for private sector investment in new productive assets to support target GDP growth	-	Promotion of investment efficiency through sectoral adjustment policies (see B,C,D)	*	*	*	*	*
			+Encouragement of increased investment through banking and financial reforms (see F.3 and 5) and stabilization measures (H)	*	*	*	*	*
3. Savings	Major increases in savings available for private investment	Reductions achieved in Government spending and deficit financing, 1983-85.	+Stabilization measures further reducing the deficit and the disincentives to save (see H)	*	*	*		
			Preparation of tax measures to promote savings	*				
			Implementation of tax incentives for savings		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing				
				1986	87	88	89	90
F. FISCAL AND FINANCIAL REFORM								
1. Budget Consolidation	Establish basis for improved fiscal management	Creation of Treasury Secretariat to manage budget transactions	+Budgetary provision for wheat, sugar and agricultural credit subsidies	*				
		Inclusion in 1986 budget of most quasi-fiscal items formerly in the "monetary" budget	+Transfer of decentralized funds to Treasury budget	*				
			+Completion of process of budget budget consolidation		*			
2. Monetary Authorities	Strengthen basis for monetary policy formulation and management	-	+Law defining functions of Banco do Brasil	*				
			+Transfer to Banco do Brazil or BNDES of Central Bank's development banking functions		*			
			+Establishment of Banco Central as sole monetary authority		*			
			Transfer to Treasury of responsibility for Federal public debt		*			
			+Greater independence for the Central Bank (legislative or constitutional provision)			*		
3. Banks	Restore the institutional base for growth in savings and private investment	-	+Reduction in compulsory lending for certain sectors by commercial banks, and in reserve requirements	*	*	*		
			Reform of state and regional development banks		*	*	*	
			Strengthening of investment banks		*	*	*	
			Reform of state commercial banks			*	*	
			Legislation and regulations to govern a liberalized, integrated banking and financial system		[illegible]		*	*
								*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	1986	87	88	89	90
4. Housing Finance	Stabilize and support housing investment		+Reform of the housing finance system		*			
5. Financial Markets	Strimulate flow of funds for private investment		New regulations for financial markets, including tax reforms		*	*		
			Establishment of "Brazil Fund" to encourage foreign portfolio investment		*	*		
			New regulations for financial conglomerates			*		
6. Tax Reform	Increased tax revenues in a more efficient and equitable system		Program to reduce tax exemptions and allowances	*	*			
			Tax reform to encourage longer-term holdings of financial assets	*	*			
			Tax measures to reduce wedge between borrowing and lending rates		*			
			+Major tax and transfer reform at Federal, State and municipal levels			*	*	
Bank Support			Financial Sector Reform I	*				
			Financial Sector Reform II		*			
			Financial Sector Reform III			*		
			Financial Sector Reform IV				*	
			Cofinancing	*	*	*	*	
			ESW on the Financial System		*		*	
G. PUBLIC SECTOR MANAGEMENT								
1. Fiscal Administration	Efficient arrangement of Government funds, including debt operations	Establishment of National Treasury Secretariat in the Finance Ministry (See F.1)	+Fully operational control of budget operations, through Treasury and SEPLAN (SOF)	*				
2. Integrated Management System (SEPLAN)	Strengthening of Federal information, planning, policy research, programming budgeting, policy information, evaluation and reporting	-	+Strengthening and expanded operation of:					
			- general and sector planning and project evaluation (IPLAN)	*	*	*	*	*
			- multi-year investment planning--CPPG	*	*	*	*	*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
3. State Enterprise Management	Development of flexibility and efficiency in the state enterprise system, with privatization of some enterprises	SEST supervision of state enterprise operations (since 1980)	+Introduction of system for performance evaluation	*				
			+Development of rehabilitation programs for selected state enterprises	*	*	*		
			+Finance and rehabilitation programs	*	*	*	*	*
			Selective privatization of enterprises directly or via capital markets	*	*	*	*	*
4. Statistical Development	Information systems development: national and regional statistics	-	Initiation of IBGE development program to expand national and regional information base		*			
			Interim development of national account and public finance research (FGV)		*	*		
			Development of integrated national/regional statistical operations			*	*	*
5. Financial Control			Strengthening of audit systems (SECIN &/or Tribunal da Contas)	*	*	*		
Bank Support			Public Sector Management Loan	*				
			Public Sector Management II				*	
			ESW on Public Investment and public enterprises	*	*	*	*	*
H. STABILIZATION 1. Government expenditure	No real increase in current or capitalinvestment outlays, but a shift away from state enterprise activity into priority social programs	Real reduction in state enterprise expenditures; emergency social program introduced 1985	+Reductions in Govt. and state enterprise operating expenditures, including personnel costs; extra provision for maintenance, financial rehabilitation, completion of priority investments; careful evaluation of new investment proposals involving Government or state enterprises	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
2. Taxation	Increase in (recovery of) net tax revenues to 1970s ratios	Measures to restore and increase income tax revenues (increase equivalent to 1.7% of GDP proposed)	+Further short-term adjustments to increase revenue collection and reduce cost of tax exemptions and allowances	*	*	*	*	
			Major reform of tax and incentive systems and mechanisms for revenue sharing			*	*	
3. Other Revenues	Public sector prices, levies to cover cost of services.	Some real increases in 1985	+Public sector prices to increase in real terms; social security and similar charges to be adjusted to cover programs'costs	*	*	*	*	
4. Subsidies	(See F.1)							
5. Public sector deficit	Reduce public sector deficit (broadly defined) to normal financing range	"Operational" deficit cut from 6.8 to estimated 2.8% of GDP, between 1982 and 1985	+Reduction of "operational" fiscal deficit to 1% of GDP	*				
			+Further improvements in fiscal performance, according to targets to be agreed annually, to secure gradual decline in ratio of total public debt to GDP		*	*	*	*
6. Monetary Policy	Expansion consistent with agreed stabilization targets	Short periods of tight monetary restraint, 1981-84.	+Meeting annual monetary targets based upon expected growth and inflation	*	*	*	*	*
7. Incomes policy	Real wage increases linked to productivity growth, to increase employment opportunities	Successful efforts to reduce real wages in 1983-84, some real wage recovery in 1985.	+Public sector wage policy consistent with no increase in real wage bill in 1986-87, and real increases smaller than in the private sector during subsequent years	*	*	*	*	*
8. Indexation	Reduction of the inflation mechanisms implied by the Government indexation system, while avoiding distortions that might be caused by inflation if indexation is eliminated	-	+Preparation of detailed program on how to deal with indexation and related issues	*				
			+Implementation of the program		*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
I. SOCIAL & REGIONAL PRIORITIES								
1. Social Adjustment	Recovery from social costs of economic recession through programs designed to reduce poverty, improve income distribution and promote employment rhgough economic growth	Social sector priority program in nutrition, health, education, housing, water supply, small-scale agriculture and job creation (1985)	Preparation and implementation of plans of expanded, more cost-effective and efficiently delivered health, education and other social services	*	*	*	*	*
2. Regional Development	Increase employment and incomes, and promote sustained growth in the Northeast region	New rural development programs for the Northeast (1985)	Preparation of comprehensive, multi-sectoral Northeast regional development program	*				
			Phased implementation in line with domestic and external reserve availability		*	*	*	*
Bank Support			Education Sector Loan				*	
			Health Sector Loan					*
			NE lending program (rural development, industries, irrigation, education, health)	*	*	*	*	*
			ESW on health and education programs and NE regional development	*				

ANNEX
December 16, 1985

BRAZIL - A PROPOSED COMPREHENSIVE, MEDIUM-TERM PROGRAM FOR TRADE LIBERALIZATION

Area	Policy Objectives	Further Recommended Measures
1. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 15% annually, to permit import expansion while covering debt service	Formulation and initial steps in implementation (see below) of a multi-year program for export expansion and trade policy rationalization Implementation of GATT Code for subsidies
2. Export Financing	Rationalize and extend financing arrangements for exports	Provision of access to financing to all exporters at internationally competitive rates, consistent with GATT Subsidy Code
3. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Specification of import rationalization objectives, identification and consideration of specific measures to reduce anomalies in policies and procedures affecting different categories of producer, with implementation subject to balance-of-payments situation; results of ongoing studies of effective protection; and results of trade negotiations Implementation of GATT codes for Customs Valuation and Anti-Dumping Elimination of most items from the list of "Import Suspension" Liberalization of firms' annual import programs, eliminating discrimination by products and providing automatic approval for firms importing up to a pre-determined value. (Import programs would be used as a tool to control imports only in the event of a balance of payments crisis). Reduction or elimination of most tariff exemptions schemes, and reduction of scope of application of Law of Similars Reduction of tariff levels and dispersion to a nominal average of about 40% range, with perhaps half the items in the 30-40% range, a minimum tariff of 10% and a maximum of 85% (including IOF tax) Gradual phasing-out of non-tariff restrictions, so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and
Bank support		Export Development II Export Development III Industrial Restructuring I Industrial Restructuring II Cofinancing ESW on Industry and Trade

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BRAZIL - PROSPECTS FOR STABILIZATION AND GROWTH

A. Current Situation

1. During 1983-85, Brazil succeeded in achieving the external adjustment required to reach a reasonable equilibrium in its balance of payments (see Table 1 for details). After three years of GDP decline, the economy grew by about 4.5% in 1984, while the trade surplus reached US$13 billion and a small current account surplus (US$500 million) was also achieved. In 1985, in spite of high (7-8%) GDP growth, the trade surplus has remained at about US$12 billion, the current account deficit is below 1% of GDP, and gross international reserves have remained virtually unchanged during the year, at a level equivalent to about 8 months of imports. The presence of substantial excess capacity has facilitated this year's rapid growth. The large increase in exports achieved in recent years (from US$15.2 billion in 1979 to US$27.0 billion in 1984), and the efficient import substitution taking place in petroleum and some industrial subsectors, have contributed substantially to this economic performance, and should also help Brazil maintain acceptable growth rates in future years. Brazil has thus achieved a unique position among the high-debt countries, in being able to resume economic growth without a deterioration in its balance of payments.

2. The external adjustment was not, however, accompanied by a parallel domestic achievement. Inflation remains above 200% annually, and real interest rates are still high, although they have fallen in recent months. Both factors introduce an element of uncertainty into investment planning, at a time when substantial increases in productive investment will soon be needed.

3. Brazil's productive structure has in recent years been demonstrably more efficient and competitive than that of other heavily indebted countries in the LAC region. The speed with which Brazilian industry adapted itself in 1983-84 to the need to increase exports was indeed remarkable, as has been also in recent years the export performance of agriculture. However, the current incentives structure does not ensure the continuing increase in exports required for high growth of output and employment over the medium and long term. The key development issue facing Brazil today is, therefore, whether to continue current policies and maintain a modest growth rate, or, alternatively, try to maximize increases in production and employment through structural reforms that may be politically difficult in the short run.

B. Development Alternatives

4. Brazil needs to (a) maintain a GDP growth rate of at least 6.5% per year in order to improve living standards and generate enough employment growth (at least 4% per annum) to hire new entrants into the labor force and reabsorb those affected by the recent recession; and (b) improve its creditworthiness position, by reducing its debt service and debt to export ratios at least 25% by 1990 (with continued improvement in the 1990s), so that it can resume amortization payments in the early 1990s. All three growth scenarios presented in this section meet the

Table 1. BRAZIL--HISTORICAL DATA

	1980	1981	1982	1983	1984	1985*
Real GDP Growth Rate Per Annum	7.2	-1.6	0.9	-3.2	4.5	7.0
Debt to Exports Ratio 1/	3.2	3.1	4.1	3.9	3.4	3.7
Interest Payments to Exports Ratio (%) 2/	34.0	40.3	52.1	43.4	37.0	39.9
Total Debt to GDP Ratio (%) 3/	27.9	28.9	31.9	44.3	47.2	47.2
Interest Payments to GDP Ratio (%) 4/	3.0	3.7	4.4	4.9	5.4	5.1
Debt Service Ratio (%) 5/	64.2	69.1	90.7	58.4 6/	72.3	80.5
Terms of Trade (1983=100)	119.8	111.8	106.6	100.0	107.7	113.1
Real Growth Rates of: Imports	-12.3	-5.3	-13.4	-20.7	-0.3	4.4
Exports	23.6	21.6	-10.4	15.3	25.9	-2.3
Current Account Deficit (US$ Billions)	-12.4	-11.0	14.8	-6.1	.5	-1.3

1/ Total debt, including short-term, as a proportion of Exports of Goods and NFS

2/ Total interest payments, including short-term, as a percentage of Exports of Goods and NFS

3/ Total debt, including short-term, as a proportion of GDP

4/ Total interest payments, including short-term, as a percentage of GDP

5/ Total interest payments plus amortization on M&LT debt as a percentage of Exports of Goods and NFS

6/ Includes only amortization actually paid.

* Estimate

creditworthiness target but only the two more rapid growth scenarios attain the GDP and employment objectives.

5. On the basis of its large, generally efficient economic system and its proven capacity to export, Brazil could maintain an annual growth rate of about 5% over the next 5-10 years, without undertaking any major additional policy reform. This "low-growth" scenario assumes, however, that the Government will follow an exchange rate policy of periodic devaluations equivalent to the difference between domestic and international inflation, and that inflation does not increase substantially over its present level, although no major reduction in it would be achieved.

6. Table 2 shows Bank projections based on the above assumptions. In this alternative, Brazil would need to run a current account as well as a large trade surplus to service its external debt. Exports would grow modestly. With an export growth rate averaging 2.4% in real terms between 1985-90, a moderate increase in non-oil imports would be feasible as long as Brazil continues an active energy substitution program and reduces oil imports in real terms. Creditworthiness indicators would improve substantially. However, although consumption per capita would increase about 3.2% annually, no significant reduction in unemployment and underemployment would occur, and social unrest would be likely to increase substantially. Inflation would be higher and more susceptible to acceleration than if an active stabilization policy were implemented. The risks of an interruption to growth are higher without the effort to adjust. This option, in short, would not be conducive to ensuring long-term, sustained economic and social development. For without an adjustment program, the Bank annual lending program would have to be reduced--from US$1.5 billion to about US$1 billion per year or less--and no "new money" would be likely to be obtained from commercial banks.

7. Table 2 also shows alternative projections which reflect the impact of the adjustment and growth program described below. The "high-growth" option would include, inter alia, export development and trade liberalization, freer commercial policies in agriculture, fiscal and financial reform, and lower public sector deficits. This overall program would stimulate increased investment and GDP and employment growth in a more stable domestic environment. With tighter economic management, it should be expected that reduced public sector demand for credit, lower inflation expectations and increased access to external resources would lower real interest rates and encourage investment. "New money" and increased agricultural and manufactured exports would permit higher imports and better GDP growth. Growth in GDP averaging 8% p.a., which is considered feasible if the external environment is accommodating and the medium-term adjustment program is effectively implemented, would permit major gains in employment and other social directions, and would allow growth in consumption per capita of about 5.2% per year, thereby easing economic and political tensions. Rapid growth would also strengthen the balance of payments and the capacity to service the debt. Traditional creditworthiness indicators, while improving by a third over the decade, are not substantially better than in the "low-growth" option. In this "high-growth" option, the country is incurring more debt to support the structural adjustment process and to raise more quickly the living

GNP per capita (1983) = US$ 1,890

Table 2: BRAZIL - PROJECTIONS OF KEY VARIABLES

	1985	1986	1987	1988	1989	1990	1995
"HIGH GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	8.0	8.0	8.1	8.1	8.1	8.0
GDP per Capita Growth Rate	4.7	5.8	5.8	5.9	6.0	6.0	5.9
Consumption per Capita Growth Rate	6.4	4.9	4.4	5.3	5.1	6.6	5.8
Investment/GDP (%)	18.0	20.0	22.0	23.0	24.0	24.0	24.0
Marginal Savings Rate	0.14	0.44	0.44	0.34	0.36	0.24	0.26
Trade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	12.4	13.3	14.6	16.8	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	5.3	6.5	7.3	7.9	8.2
Exports of GNFS/GDP (%)	12.7	12.1	11.8	11.8	11.8	11.9	11.8
Imports of Goods Real Growth Rate	4.4	21.6	21.9	16.3	14.8	11.9	8.4
Imports of GNFS/GDP (%)	7.8	8.3	8.9	9.3	9.6	10.0	10.0
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.5	109.8	116.0	122.9	130.9	161.0
DOD/GDP (%)	47.2	42.2	38.4	34.9	31.8	29.1	19.5
DOD/X Ratio	3.7	3.5	3.2	3.0	2.7	2.4	1.7
DS/X (%)	80.5	79.5	72.4	63.9	59.0	49.3	29.4
Interest Payments/GDP (%)	5.1	3.9	3.5	3.2	2.9	2.6	1.8
"MODERATE GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	7.1	7.1	7.1	7.1	7.1	7.2
GDP per Capita Growth Rate	4.7	4.9	4.9	4.9	5.0	5.0	5.1
Consumption per Capita Growth Rate	6.4	4.0	4.3	4.3	4.2	5.4	5.1
Investment/GDP (%)	18.0	20.0	21.0	22.0	23.0	23.0	24.0
Marginal Savings Rate	0.14	0.45	0.35	0.35	0.36	0.25	0.25
Trade Indicators							
Trade Surplus (US$ billions)	12.1	12.3	13.1	14.2	15.7	18.1	28.1
Exports of Goods Real Growth Rate	-2.3	2.5	4.0	4.6	5.3	5.9	7.3
Exports of GNFS/GDP (%)	12.7	12.2	11.9	11.7	11.5	11.5	11.4
Imports of Goods Real Growth Rate	4.4	21.5	12.9	11.3	10.7	8.6	7.8
Imports of GNFS/GDP (%)	7.8	8.4	8.6	8.9	9.1	9.2	9.7
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	104.7	109.1	114.5	120.8	126.8	155.8
DOD/GDP (%)	47.2	42.7	38.8	35.4	32.4	29.5	20.6
DOD/X Ratio	3.7	3.5	3.3	3.0	2.8	2.6	1.8
DS/X (%)	80.5	79.6	73.6	66.0	61.7	52.8	31.9
Interest Payments/GDP (%)	5.1	4.0	3.6	3.3	3.0	2.6	1.9
"LOW GROWTH" OPTION							
National Accounts Indicators							
GDP Growth Rate	7.0	5.0	5.0	5.0	5.0	5.0	5.1
GDP per Capita Growth Rate	4.7	2.8	2.8	2.8	2.9	2.9	3.0
Consumption per Capita Growth Rate	6.4	2.5	3.4	3.3	3.5	3.4	3.2
Investment/GDP (%)	18.0	19.0	19.0	19.0	19.0	19.0	19.0
Marginal Savings Rate	0.14	0.44	0.22	0.23	0.21	0.23	0.18
Trade Indicators							
Trade Surplus (US$ billions)	12.1	13.1	14.4	16.0	17.8	19.9	23.3
Exports of Goods Real Growth Rate	-2.3	2.5	2.4	2.4	2.4	2.5	3.3
Exports of GNFS/GDP (%)	12.7	12.4	12.2	12.0	11.8	11.6	10.6
Imports of Goods Real Growth Rate	4.4	12.7	5.3	5.2	5.2	5.2	5.3
Imports of GNFS/GDP (%)	7.8	8.0	8.0	8.0	7.9	7.9	8.1
Creditworthiness Indicators							
Total Debt Outstanding and Disbursed (US $ billions)	101.1	103.0	104.7	105.7	106.3	106.2	100.7
DOD/GDP (%)	47.2	42.8	38.7	34.6	30.8	27.2	16.2
DOD/X Ratio	3.7	3.4	3.2	2.9	2.6	2.3	1.5
DS/X (%)	80.5	79.5	74.0	66.9	62.7	53.4	29.5
Interest Payments/GDP (%)	5.1	4.1	3.7	3.3	3.0	2.5	1.5

Notes :

1. Debt includes public and publicly guaranteed, private non-guaranteed and short term debt
2. Exports and imports include that of goods and non-factor services.

standards of the population. In general terms, however, Brazil's creditworthiness--as reflected in the Government's readiness to adopt needed policy reforms to promote growth, stabilization, and external balance--is significantly improved.

8. The "high-growth" scenario, as indicated above, assumes the timely adoption of the required policy reforms. The Government, however, finds it inadvisable to proceed quickly with proposed trade liberalization. Although the fundamental importance of export promotion is recognized and the need for tariff reform stressed in the National Development Plan, the Government has indicated that it does not wish to compromise Brazil's negotiating position in forthcoming GATT and other trade talks. Brazil's established industrial efficiency and capacity to compete internationally make trade policy reform a less critical adjustment issue at this point than in other high debt countries, although many anomalies still exist.

9. The most likely growth scenario, in view of the forthcoming trade negotiations, the priorities in the new National Development Plan, and the Government's 1986 economic program (see para. 24), is one which is slightly below the "high-growth" option. In this "moderate-growth" option, the Government would carry out all policy changes specified in the "high-growth" case except for trade liberalization. In its place, the Government would take steps to simplify the import system and further strengthen the drawback mechanism. As in the "high growth" case, it would also maintain the present exchange rate policy, devaluing the cruzeiro in line with domestic inflation and continuing its link to the U.S. dollar. In such an environment, manufactured export growth and net foreign capital inflows would be somewhat lower than in the "high-growth" scenario; however, they would still permit a large increase in imports and investment. Table II shows the comparisons. GDP would average 7%, rather than 8% per year. Consumption per capita would grow about 4.4% per year and creditworthiness would improve at a satisfactory rate.

C. Proposed Medium-Term Adjustment and Growth Program

10. The economic policy program proposed in this paper, equivalent to the "moderate-growth" scenario, is aimed at raising GDP growth sufficiently to make up for the drop in employment and living standards encountered in the recent recession and to continue the economic progress begun in the 1970s, while improving creditworthiness in the process. The program would increase the efficiency and competitiveness of Brazilian production in the manufacturing and agricultural sectors; rationalize public investment, promote efficient private investment, and encourage increases in public and private savings; maintain a sound balance-of-payments position; undertake required reforms of the fiscal and financial systems; improve the efficiency of the public sector, including both the General Government and public enterprises; stabilize the domestic economy; increase the efficiency of educational and health services; and raise productivity and income levels in the Northeast Region. The key aspects are summarized in the following paragraphs, and specified in more detail--including the required timing--in the Policy Matrix shown in Annex I. The current position of the

Brazilian Government on the proposed reforms, and the proposed response of the Bank, in particular, and of the external community in general, are described in Sections D and E below.

11. Industry and Trade. Sectoral policies to promote exports and efficient import substitution consist of continuation of the present exchange rate policy of periodic devaluations equal to domestic inflation, some simplification of import regulations, and further improvements to the drawback system. With these policies, Brazilian export growth is expected to be sufficient to generate trade surpluses of US$12-15 billion per year for the rest of the decade and to permit a substantial increase in non-oil imports (see Table 2), when combined with additional foreign borrowing. While this program is being implemented, we would continue to encourage the Brazilians to proceed with the broader package of trade policy reforms envisaged within the "high-growth" scenario and spelled out in Annex II.

12. Agriculture. Aiming also at increasing productive efficiency and exports, the proposed program for agriculture would, inter alia, further reduce credit subsidies and finance the remaining ones through the fiscal budget; introduce free trade for key agricultural products, with limited Government interventions under pre-established conditions; phase out wheat subsidies; and start operations of futures markets and bankers acceptances' trading for key agricultural products. The program would be time-phased over five years.

13. Energy. The proposed energy program would promote efficient import substitution and conservation, mainly through appropriate pricing policies. It would also include the Power Sector Investment and Financial Rehabilitation Plan, now being appraised as the framework for the proposed FY87s Power Sector Loan.

14. Investment and Savings. The program in these areas would include the systematic screening and monitoring of the Public Sector Investment Program by the Planning Ministry, with Bank staff assistance; the strengthening and selective privatization of public enterprises; appropriate incentives to private investment through sufficient credit availability and by implementing the sectoral reforms referred to in paras. 11-13 above; and savings increases through reductions in the public deficit (see para. 24 below), and credit and tax incentives to private savings. Consequently, the public sector's share in total investment is expected to decline, from an estimated 50% in 1984-85 to 45% by 1990; and with the elimination of the public sector deficit, the public sector's share in total savings is expected to approximate its share in total investment.

15. Balance of Payments. In addition to the exchange rate and sectoral policies referred to above (paras. 11-13), the proposed program would include carefully managed debt rescheduling and new external borrowing, as well as incentives to foreign private investment.

16. Fiscal and Financial Reform. The reforms in this area would be aimed at improving resource allocation and would include, inter alia, the consolidation of all fiscal expenditures in the Federal Budget; the reform

of the Central Bank and the Banco do Brasil functions; the progressive elimination of the prevailing segmentation of credit markets; and tax reforms directed towards increasing savings and improving their utilization for productive investment.

17. Public Sector Management. The program would improve the overall efficiency of the public sector by establishing a Treasury Secretariat in the Finance Ministry, which would have operational control of the unified fiscal budget; strengthening the Planning Ministry's departments dealing with the planning and monitoring of public investment and current expenditures; undertaking operational audits and action plans to improve the efficiency of public enterprises; and improving economic information and accounting control systems.

18. Stabilization. The proposed policies in this area would be directed towards progressively reducing inflation, from about 225% in 1985 to a figure which, if major changes in the indexation system are feasible, could be 20% or less in 1990. The program would include, inter alia, a substantial reduction of the public sector deficit and of the rate of increase of the domestic public debt, to levels consistent with the desired gradual reduction in inflation and with the credit availability required for the financing of private investment; the maintenance, on a continuous basis, of monetary and incomes policies compatible with increased internal stability; and the preparation and implementation of a program for dealing with the price stabilization problems posed by the widespread indexation of the Brazilian economy. The proposed gradual approach to stabilization would have to be reviewed, and other options considered, if price increases are not reduced substantially.

19. Social Development. The program in this area would be aimed at restoring appropriate levels of education and health services, and improving their cost efficiency; and at improving the productivity and income levels of the Northeast population, in both urban and rural areas. The priority to be attached to these areas would be in line with the proposed shift in emphasis, within the public sector, from productive activities to social services, and with the parallel enhancement of the role of the private sector as the main agent for the development of productive activities.

D. The Brazilian Position

20. Many of the key policy directions suggested in this paper have been discussed extensively by Bank staff with the Brazilian authorities, in connection with proposed Bank loans. There is now a remarkable coincidence of views--particularly with the Planning Ministry--in many policy areas. For instance, we have reached agreement on most aspects of the programs proposed for 1986--and on the overall objectives for the longer term--concerning Agriculture, Energy (except fuel prices), Public Sector Investment, Fiscal and Financial Reform, Public Sector Management (including, in particular, mechanisms and procedures for screening and monitoring public investment) and Social Development. There are, however, some policy areas in which no decision has been taken yet by the Government, or in which the adopted decisions do not go far enough. These

include trade policy and fuel prices--on which disagreements may emerge in the near future--and policy issues--referred to in para. 23 below--which we have not yet discussed fully with the Government. Further discussions will also be required concerning stabilization policy (see para. 24 below).

21. The most important remaining long-term issue concerns trade policy. We had reached agreement on the full program included in Annex II with a Working Group formed by the Government to prepare the proposed Export Development II project. At the political level, however, the question has become controversial. The Ministry of Foreign Affairs has indicated that any unilateral decision on trade policy now would undermine Brazil's position in the GATT and other trade talks. The industrial establishment has traditionally been opposed to liberalized trade, although its views are probably changing with the increased importance of exports and better knowledge of anomalies which benefit some manufacturers at the expense of others. Policy reform in this area is likely to be slow; however, as explained above, satisfactory growth and creditworthiness improvements can occur without such a reform.

22. In another major area the Government has now corrected--or has a plan to correct--most of the distortions introduced by the freeze of public sector prices adopted for several months earlier this year. One important exception to this is the price of petroleum derivatives, some of which (fuel oil, naphtha, and LPG) are still below international levels.

23. Other structural issues which have not been discussed yet fully with the Government include the time-phasing of the elimination of credit subsidies (which we and the Government have agreed to review in December 1986); the required incentives for private investment and savings (on which additional ESW would be required, particularly concerning tax policy); and the ways to proceed concerning external debt management and incentives to foreign investment. We do not anticipate major disagreements between the views of the Government and of Bank staff on these issues, with the possible exception of the timing of the elimination of the remaining rural credit subsidies.

24. The Congress has just passed the Government's 1986 Economic Program. This program includes, inter alia, a larger fiscal adjustment than previously expected, envisaging a reduction of the operational fiscal deficit from 2.8% of GDP in 1985 to 0.5% in 1986. Both IMF and Bank staff consider that the overall objectives of the program could be accepted by our institutions, although we have still to examine its consistency and viability in detail. Subject to the conclusions of the required further analysis, this program could be considered as a substantial step forward within a gradual stabilization approach. Its successful implementation, particularly concerning the reduction of the fiscal deficit, would also be important in connection with longer-term policies directed toward increasing private investment and savings, and would also make it easier to consider later on some other stabilization options. The stabilization policies suggested in this paper are basically similar to those included in the Government program.

E. The Role of the World Bank, The IMF and the Commercial Banks

25. World Bank Financing. Increased external support would be essential to the success of the medium-term adjustment program. We propose that the Bank should adopt a graduated-response posture, with an annual lending amount in 1986-90 which would vary between US$1 billion under the "low-growth" option (assuming no further progress in policy reform, exchange rate devaluations equal to the difference between domestic and international inflation, and no substantial change in the rate of inflation) and US$2.0 billion under the "moderate-growth" alternative (a level to be reached if and when Brazil goes forward with the reform package suggested in this paper). These commitment levels would be consistent with average annual gross disbursements of, respectively, US$1.1 and US$1.7 billion from the entire Brazil loan portfolio (see Tables 3A-3C). The proposed lending under the "low-growth" option would make the Bank's relative exposure in Brazil decline to below 10% of our overall portfolio by 1990, while under the "moderate-growth" scenario, Brazil's share in the Bank portfolio would increase to slightly over 11%. The specific lending level for each year would depend upon the degree to which the required reforms are adopted and implemented, and would in practice be determined by the extent to which policy reforms associated with specific loans are put into effect.

26. The Bank's current program for Brazil envisages an annual US$1.5 billion lending level. The program for FY86-87 includes three large quick-disbursing loans, for a total amount of US$1.2 billion. All other operations in the program are more traditional, and slower-disbursing, project and sector loans. Most of the increase required to reach the expanded US$2.0 billion level referred to above would come from additional policy-based operations, including additional agricultural sector loans, sectoral financial rehabilitation loans, and possibly industrial restructuring operations. The additional lending would also include increases in our program for education (particularly vocational training) and health to support the social content of the adjustment program.

27. If the Brazilian Government is also willing to commit itself to a comprehensive program of trade reform, beginning in 1986, in addition to the other policy changes, then Bank lending levels could reach US$2.5 billion per year (the "high-growth" scenario). A series of policy-based loans in support of trade reform would be added to the lending program. These lending magnitudes would increase the Brazilian share of the overall Bank portfolio to 13% by 1990.

28. IMF and Commercial Bank Assistance. Bank support for the adjustment program cannot depend on a stand-by agreement between Brazil and the IMF. The Government, while willing to undertake a substantial stabilization effort, has indicated that it will not need "new money" in 1986 and does not intend--probably for domestic political reasons--to reach formal agreement with the Fund. However, it does intend to keep the Fund

informed about the features and implementation of its program. If Brazil adopts a viable short- and medium-term economic program, but does not reach an operational agreement with the Fund, we believe that the Bank should still try to assist Brazil with an expanded lending program and with the mobilization of commercial banks' resources. This would probably require, however, an agreement to have the Fund monitor performance in the fiscal, monetary and balance-of-payments policy areas. It should be noted that cooperation between the staff of the Bank and the Fund concerning Brazil has improved substantially over the last few months, particularly concerning the flow of information and the interchange of technical opinions.

29. After substantial "involuntary lending" in 1983 and 1984, commercial banks have not provided this year any "new money" to Brazil. In view of its overall high level of foreign exchange reserves, the country has not needed new money in 1985. Moreover, as is shown in the low-growth projections, Brazil could grow during the next 5-10 years at an annual rate of about 5% without any "new money" from commercial banks and with a very low level of net inflows from other sources. As indicated above, however, to maintain a growth rate high enough to reduce unemployment and underemployment substantially (by, say, 2% of the labor force per year), Brazil would indeed need net capital inflows from the commercial banks. According to the "moderate-growth" projections presented in this paper, such inflows should reach an average annual level of US$2.6 billion in 1986-90, which would be equivalent to a 3.5% annual increase in their nominal exposure (but to about a 4% <u>reduction</u> of their exposure in real terms). It is also estimated that the "moderate-growth" option would require about US$1.5 billion per year in net inflows from suppliers, official export agencies and the IDB, and about US$1.1 billion per year in foreign direct investment. Under the "high-growth" option, additional net commercial bank lending would average almost US$3.0 billion per year for the next five years, and net inflows from other sources (apart from the World Bank), about US$1.7 billion. (See Tables 3A-3C for details.)

30. Independent of "new money," Brazil needs to reschedule the existing debt of commercial banks, probably until the early 1990s. Until very recently, the commercial banks had maintained the position that, if they were to reschedule existing debt or provide "new money", Brazil would first have to agree on a stand-by arrangement with the Fund. During the last few weeks, however, representatives of some large banks have indicated to Bank staff that they would also accept the monitoring by the Fund of agreed fiscal, monetary and balance-of-payments targets, without necessarily requiring a formal stand-by arrangement. The Government has indicated that it would seek a one-year rescheduling agreement with the banks, if multi-year rescheduling is not possible.

31. <u>Monitoring Agreement</u>. It would clearly be preferable to have the IMF involved in the surveillance of Brazil performance, with or without a stand-by arrangement. In such a case, the monitoring instruments to be used in connection with the proposed program would be as follows:

TABLE 3A: FINANCING REQUIREMENTS AND SOURCES (HIGH GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,233)	(2,405)	(3,321)	(3,882)	(4,265)
Direct Foreign Investment (Net)		807	792	1,275	1,457	1,737	1,916
MLT	Gross Disbursements	10,420	15,284	17,621	18,629	20,495	20,588
	Amortization	9,388	11,885	12,359	12,402	13,462	12,340
	Net Disbursements	1,032	3,399	5,262	6,227	7,033	8,248
1) World Bank	Commitments	1,500	2,500	2,500	2,500	2,500	2,500
	Gross Disbursements	800	1,646	2,126	2,216	2,297	2,387
	Amortization	400	418	542	637	931	1,170
	Net Disbursements	400	1,228	1,584	1,579	1,366	1,217
2) Other Multilateral	Commitments	275	800	800	800	800	800
	Gross Disbursements	297	290	366	456	572	662
	Amortization	136	157	173	186	214	260
	Net Disbursements	161	133	193	270	358	402
3) Official Export Credits	Gross Disbursements	888	1,048	1,195	1,066	1,900	2,550
	Amortization	806	686	413	372	1,162	1,316
	Net Disbursements	82	362	782	694	738	1,234
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,545	1,682	1,787	1,871	1,815
	Amortization	1,142	975	882	996	1,071	1,165
	Net Disbursements	423	570	800	791	800	650
6) Commercial Banks	Gross Disbursements	6,797	10,685	12,204	13,086	13,845	13,167
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,145	1,963	2,977	3,858	4,834
Other Capital		(200)	(1,500)	(1,968)	(2,285)	(2,785)	(3,478)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(922)	(1,238)	(1,389)	(1,537)	(1,926)
DOD							
World Bank		4,305	5,533	7,117	8,696	10,062	11,279
Other Multilateral		1,942	2,075	2,268	2,538	2,896	3,298
Official Export Credits		6,256	6,618	7,400	8,094	8,832	10,066
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,485	8,285	9,076	9,876	10,526
Commercial Banks		66,467	67,612	69,575	72,552	76,410	81,244
TOTAL		89,581	92,980	98,242	104,469	111,502	119,750

TABLE 3B: FINANCING REQUIREMENTS AND SOURCES (MODERATE GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(1,503)	(1,660)	(2,284)	(3,052)	(2,621)
Direct Foreign Investment (Net)		807	794	879	1,063	1,247	1,429
MLT	Gross Disbursements	10,420	15,394	16,769	17,724	19,701	17,981
	Amortization	9,388	11,884	12,359	12,412	13,398	12,211
	Net Disbursements	1,032	3,510	4,410	5,312	6,303	5,770
1) World Bank	Commitments	1,500	2,000	2,000	2,000	2,000	2,000
	Gross Disbursements	800	1,348	1,626	1,716	1,797	1,887
	Amortization	400	418	542	637	889	1,086
	Net Disbursements	400	930	1,084	1,079	908	801
2) Other Multilateral	Commitments	275	275	500	500	500	500
	Gross Disbursements	297	280	315	351	404	446
	Amortization	136	156	173	186	214	241
	Net Disbursements	161	124	142	165	190	205
3) Official Export Credits	Gross Disbursements	888	1,498	1,196	1,159	1,850	1,960
	Amortization	806	686	413	372	1,163	1,316
	Net Disbursements	82	812	783	787	687	644
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,480	1,655	1,788	1,816	1,789
	Amortization	1,142	975	882	1,006	1,048	1,139
	Net Disbursements	423	505	773	782	768	650
6) Commercial Banks	Gross Disbursements	6,797	10,718	11,929	12,692	13,824	11,892
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	1,178	1,688	2,583	3,837	3,559
Other Capital		(200)	(1,400)	(1,847)	(2,274)	(2,597)	(2,700)
IMF (Net)		0	(536)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(865)	(856)	(1,128)	(1,335)	(1,383)
DOD							
World Bank		4,305	5,235	6,319	7,398	8,306	9,107
Other Multilateral		1,933	2,057	2,199	2,364	2,554	2,759
Official Export Credits		6,256	7,068	7,851	8,638	9,325	9,969
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,420	8,193	8,975	9,743	10,393
Commercial Banks		66,467	67,645	69,333	71,916	75,753	79,312
TOTAL		89,572	93,082	97,492	102,804	109,107	114,877

TABLE 3C: FINANCING REQUIREMENTS AND SOURCES (LOW GROWTH OPTION)
(US$ Millions)

		1985	1986	1987	1988	1989	1990
Current Account		(1,339)	(83)	539	1,352	2,011	3,265
Direct Foreign Investment (Net)		807	798	887	977	966	1,054
MLT	Gross Disbursements	10,420	13,619	14,099	13,404	13,877	11,960
	Amortization	9,388	11,883	12,359	12,412	13,314	11,971
	Net Disbursements	1,032	1,736	1,740	992	563	(11)
1) World Bank	Commitments	1,500	1,000	1,000	1,000	1,000	1,000
	Gross Disbursements	800	1,028	1,051	1,066	1,062	1,057
	Amortization	400	418	542	637	805	920
	Net Disbursements	400	610	509	429	257	137
2) Other Multilateral	Commitments	275	250	250	250	250	250
	Gross Disbursements	297	273	273	273	264	266
	Amortization	136	155	173	186	214	226
	Net Disbursements	161	118	100	87	50	40
3) Official Export Credits	Gross Disbursements	888	878	856	829	1,400	1,450
	Amortization	806	686	413	372	1,163	1,316
	Net Disbursements	82	192	443	457	237	134
4) Other Official Net		(34)	(39)	(60)	(84)	(87)	(89)
5) Supplier's Credits	Gross Disbursements	1,565	1,357	1,185	1,085	1,134	1,100
	Amortization	1,142	975	882	1,006	1,048	1,080
	Net Disbursements	423	382	303	79	86	20
6) Commercial Banks	Gross Disbursements	6,797	10,013	10,686	10,133	10,007	8,080
	Amortization	6,797	9,540	10,241	10,109	9,987	8,333
	Net Disbursements	0	473	445	24	20	(253)
Other Capital		(200)	(1,400)	(1,647)	(1,986)	(2,182)	(2,930)
IMF (Net)		0	(535)	(926)	(689)	(566)	(495)
Change in Reserves		(300)	(516)	(593)	(646)	(792)	(883)
DOD							
World Bank		4,305	4,915	5,424	5,853	6,110	6,247
Other Multilateral		1,970	2,088	2,188	2,275	2,325	2,365
Official Export Credits		6,256	6,448	6,891	7,348	7,585	7,719
Other Official Net		3,696	3,657	3,597	3,513	3,426	3,337
Supplier's Credits		6,915	7,297	7,600	7,679	7,765	7,785
Commercial Banks		66,467	66,940	67,385	67,409	67,429	67,176
TOTAL		89,609	91,345	93,085	94,077	94,640	94,629

Policy Area	Monitoring Instruments
A. Industry and Trade	Export Development Loans* Industrial Restructuring Loans*
B. Agriculture	Agriculture Sector Loans Agriculture Credit Loans
C. Energy	Power Sector Loans Transportation Sector Loans
D. Investment and Savings:	
1. Public Sector Investment and Savings	Public Sector Management Loans Public Sector Review missions IMF surveillance
2. Private Sector Investment and Savings	Bank economic missions IMF surveillance
E. Balance of Payments	Bank economic missions IMF surveillance
F. Fiscal and Financial Reform	Financial Sector Reform Loans
G. Public Sector Management	Public Sector Management Loans
H. Stabilization	IMF surveillance
I. Social Development	Education Sector Loans Health Sector Loans Northeast Rural Devt. Loans Northeast Small and Medium Scale Industry Loans

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* Under the "high-growth" option only.

32. As indicated above, most of the monitoring to be performed by the Bank would be carried out in connection with proposed loans, and we would recommend cofinancing for specified priority projects on this basis. Whenever possible, these loans would be based upon policy actions taken before Board presentation, with further progress being a condition for processing subsequent loans in the sector (and for maintaining the level of the expanded overall lending program). In some instances, as in the proposed FY86 Agricultural Sector Loan, the loan would be disbursed in two tranches, with policy conditionality attached to both of them. In the cases of at least part of the policy decisions in the areas of Investment and Savings and Balance of Payments, the monitoring by Bank staff would not be linked to specific loans; it would be performed, instead, by economic missions, including public investment review missions, which would work in

close coordination with the IMF staff. Such missions would also assess the country's performance in the implementation of its overall economic program; a positive conclusion in this respect would also be a condition for Board presentation of each policy-based loan.

33. Implications for Bank Staffing. The proposed Bank program under the "moderate-" or "high-growth" scenario would require an increase of about 150 staff weeks per year in economic and sector work, equivalent to 25% of our current ESW program. This would include: (a) about 50 staff weeks for work on industry, trade and financial reform; and (b) about 100 staff weeks for work on several areas which are not linked to specific Bank loans -- such as private investment and savings, certain areas of public sector investment activity, public debt management, indexation and tax reform; for monitoring the overall execution of the program and preparing periodic reports on it; and for increased contacts with Fund and commercial bank staff. It should be noted that, given the scope of the proposed program, the increase referred to above is relatively small because (a) it is assumed that the monitoring of fiscal, monetary, and balance-of-payments policies would be undertaken by the Fund; (b) substantial work has already been done by Bank staff concerning key issues related to the agricultural, industrial, financial and power sectors, and to public sector enterprises; and (c) Brazilian working groups are undertaking much of the additional required work on agriculture and trade policy issues, as a result of prior agreements with the Government. The staffing requirements would have to be reestimated to the extent that the Fund is not involved in the monitoring process.

BRAZIL - PROPOSED MEDIUM-TERM ADJUSTMENT AND GROWTH PROGRAM

Moderate-Growth Option

Main Goals: (1) To maintain growth rates in 1986-90 which are high enough to provide employment to new entrants in the labor force, and to a number of currently underemployed workers equivalent to 2% of the labor force per year. Target average growth rate 7% per year.

(2) To improve the country's creditworthiness, consistent with a reduction of the debt to export ratio from 3.7 in 1985 to 2.6 in 1990, and 1.8 in 1995.

(3) To reduce domestic inflation substantially by 1990.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
A. BALANCE OF PAYMENTS								
1. Exchange Rate Policy	Maintain international competitiveness	Devaluation of 30% in 1983; subsequent full adjustment to domestic inflation	+Maintenance of competitive exchange rate policy through periodic adjustments which are at least equal to the difference between domestic and international inflation	*	*	*	*	*
2. Trade Balance	Maintain trade surplus levels consistent with growth and stabilization objectives and with gradual reduction of debt service ratios	Exchange rate policy and other measures required to achieve an annual US$12 billion trade surplus in 1984 and 1985	+Policies on Industry and Trade, Agriculture and Energy (See B, C and D)	*	*	*	*	*
3. Debt Management	Debt rescheduling to reduce adjustment pressures, 1986-90 limited new borrowing in amounts consistent with stability and growth objectives, and with gradual reduction of debt service ratio to sustainable level by around 1990	Annual arrangements for rescheduling principal payment, 1982-85.	+Rescheduling of principal on old commercial debt falling due 1986-90 (multi-year rescheduling would be preferable)	*	*	*	*	*
		Controlled and limited new borrowing, 1982-84. No new commercial borrowing 1985.	+Agreed annual programs of official and commercial borrowing	*	*	*	*	*
4. Direct Investment	Resumption of direct investment inflows to complement domestic investment	-	+Review of foreign investment and technology transfer policies		*			
			+Policy changes as required			*		

+ Denotes policies essential to adjustment program.

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
B. INDUSTRY AND TRADE								
1. Exchange Rate Policy	Maintain international competitiveness	-	See A.1					
2. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 13% annually, to permit import expansion while covering debt service	Liberalization of duty drawback system for exporters, extension of drawback system on limited basis to indirect exporters and removal of fiscal export subsidy (credito premio)	+Strengthening of export promotion through improvements in quality control and certification; marketing, design and packaging; access of small and medium size firms to export promotion services and information; coordination among government agencies and private associations; decentralization and greater automaticity of export procedures		*			
			+Simplification of indirect drawback system		*			
			+Elimination of remaining indirect taxes on exports			*		
3. Export Financing	Rationalize and extend financing arrangements for exports	Reduction of subsidy element in pre-shipment export financing	Strengthening of export credit insurance	*	*			
4. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Elimination of tariff surcharges; reduction in average tariff level and in number of items subject to "suspended imports"; increased flexibility in external financing requirements for imports; liberalization of firms, import programs for annual imports up to US$100,000; increased autonomy to CACEX's field offices; and elimination of foreign credit financing as a criterion for the application of the Law of Similars	+Simplification and increased automaticity in CACEX's import procedures, increasing decentralization of decision-making	*	*			
Bank support		(Export Development I, FY84)	ESW on Industry and Trade	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
C. AGRICULTURE								
1. Agricultural Credit	Rationalization of rural credit system	Elimination of negative real interest rates, Center-South (1983) and agreement on reductions in North-Northeast (1985)	+Budgetary provision for costs of interest rate subsidies (equalization costs for Federal and State banks, monetary correction shortfall North-Northeast)	*				
			+Elimination of negative real interest rates in North-Northeast, except special target groups			*		
			+Market interest rates Center-South, except special areas				*	
			Market interest rates in North-Northeast, except special target groups					*
			+Full fiscal provision for remaining subsidies		*	*	*	*
2. Trade and Pricing	Trade liberalization and development of efficient marketing system	-	+Introduction of free trade policy for 1986-87 crops, within defined price limits	*				
			+Phase-out food price controls and wheat subsidy, implement targeted food assistance programs	*	*	*		
			Reopen access to external futures trading, remove tax on domestic futures trading	*				
			Establish legal/regulatory framework for storage warrants, bankers acceptance matters in bonded agricultural commodities	*				
			+Rationalization of trade regulations for agricultural commodities	*				
			Establish agricultural price data system		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
			+Free trade for key agricultural products, subject to minimum price guarantees, market safeguards and government stock management		*		*	
			Start domestic futures market for major agricultural commodities and bankers acceptance trading		*			
			Integrated data systems for CACEX, Central Bank			*		
			Improved crop forecasting and stock information systems		*	*		
3. Taxation	Minimize tax disincentives to agricultural export growth	-	+Reform of system of agricultural taxation			*	*	*
Bank Support		(Agriculture Credit and Export Loan, FY83)	Agriculture Sector II	*				
			Agriculture Credit I	*				
			Agriculture Sector III		*			
			Agriculture Credit II			*		
			Agricultural Credit III					*
			Cofinancing	*	*	*		*
			ESW on Agriculture	*	*	*		
D. ENERGY								
1. Energy Development and Conservation	Cost-effective development of domestic energy resources	Reassessment of energy investment priorities (1985)	Development of a long-term energy efficiency plan	*				
			+Pricing policies promoting efficient domestic energy use	*	*	*	*	*
2. Electric Power	Realistic investment and financial plans and implementation	Formulation and initiation of Investment Program for Financial Plan for 1984-88; real tariff increases	+Financial rehabilitation; balanced resource allocation, improved system reliability, tariffs to be brought into line with long-run marginal costs	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
Bank Support		(Power Transmission, Conservation and Distribution loans, FY85)	Power Transmission		*			
			Power Sector I	*				
			Power Sector II		*			
			Transport Sector I		*			
			Energy Conservation			*		
			Transport Sector II					*
			Cofinancing	*	*			
E. INVESTMENT AND SAVINGS								
1. Public Sector Investment	Program limited, with specified exceptions, to completion of high-priority rehabilitation-recovery programs	Increased supervision of public sector, including state enterprise, investment programs; real reductions in 1983-84.	+Annual Government-monitored program of public sector investment in context of multi-year investment programs (with continuing Bank review and progress reporting)	*	*	*	*	*
			+Channelling of new external funds into key areas of rehabilitation and/or priority new investment	*	*	*	*	*
2. Private Investment	Increase market incentives for private sector investment in new productive assets to support target GDP growth	-	Promotion of investment efficiency through sectoral adjustment policies (see B,C,D)	*	*	*	*	*
			+Encouragement of increased investment through banking and financial reforms (see F.3 and 5) and stabilization measures (H)	*	*	*	*	*
3. Savings	Major increases in savings available for private investment	Reductions achieved in Government spending and deficit financing, 1983-85.	+Stabilization measures further reducing the deficit and the disincentives to save (see H)	*	*	*		
			Preparation of tax measures to promote savings	*				
			Implementation of tax incentives for savings		*			

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
F. FISCAL AND FINANCIAL REFORM								
1. Budget Consolidation	Establish basis for improved fiscal management	Creation of Treasury Secretariat to manage budget transactions	+Budgetary provision for wheat, sugar and agricultural credit subsidies	*				
		Inclusion in 1986 budget of most quasi-fiscal items formerly in the "monetary" budget	+Transfer of decentralized funds to Treasury budget	*				
			+Completion of process of budget budget consolidation		*			
2. Monetary Authorities	Strengthen basis for monetary policy formulation and management	-	+Law defining functions of Banco do Brasil	*				
			+Transfer to Banco do Brazil or BNDES of Central Bank's development banking functions		*			
			+Establishment of Banco Central as sole monetary authority		*			
			Transfer to Treasury of responsibility for Federal public debt		*			
			+Greater independence for the Central Bank (legislative or constitutional provision)			*		
3. Banks	Restore the institutional base for growth in savings and private investment	-	+Reduction in compulsory lending for certain sectors by commercial banks, and in reserve requirements	*	*	*		
			Reform of state and regional development banks		*	*	*	
			Strengthening of investment banks		*	*	*	
			Reform of state commercial banks			*	*	
			Legislation and regulations to govern a liberalized, integrated banking and financial system				*	*
								*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
4. Housing Finance	Stabilize and support housing investment		+Reform of the housing finance system		*			
5. Financial Markets	Strimulate flow of funds for private investment		New regulations for financial markets, including tax reforms		*	*		
			Establishment of "Brazil Fund" to encourage foreign portfolio investment		*	*		
			New regulations for financial conglomerates			*		
6. Tax Reform	Increased tax revenues in a more efficient and equitable system		Program to reduce tax exemptions and allowances	*	*			
			Tax reform to encourage longer-term holdings of financial assets	*	*			
			Tax measures to reduce wedge between borrowing and lending rates		*			
			+Major tax and transfer reform at Federal, State and municipal levels			*	*	
Bank Support			Financial Sector Reform I	*				
			Financial Sector Reform II		*			
			Financial Sector Reform III			*		
			Financial Sector Reform IV				*	
			Cofinancing	*	*	*	*	
			ESW on the Financial System		*		*	
G. PUBLIC SECTOR MANAGEMENT								
1. Fiscal Administration	Efficient arrangement of Government funds, including debt operations	Establishment of National Treasury Secretariat in the Finance Ministry (See F.1)	+Fully operational control of budget operations, through Treasury and SEPLAN (SOF)	*				
2. Integrated Management System (SEPLAN)	Strengthening of Federal information, planning, policy research, programming budgeting, policy information, evaluation and reporting	-	+Strengthening and expanded operation of:					
			- general and sector planning and project evaluation (IPLAN)	*	*	*	*	*
			- multi-year investment planning--CPPG	*	*	*	*	*

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
3. State Enterprise Management	Development of flexibility and efficiency in the state enterprise system, with privatization of some enterprises	SEST supervision of state enterprise operations (since 1980)	+Introduction of system for performance evaluation	*				
			+Development of rehabilitation programs for selected state enterprises	*	*	*		
			+Finance and rehabilitation programs	*	*	*	*	*
			Selective privatization of enterprises directly or via capital markets	*	*	*	*	*
4. Statistical Development	Information systems development: national and regional statistics	-	Initiation of IBGE development program to expand national and regional information base		*			
			Interim development of national account and public finance research (FGV)		*	*		
			Development of integrated national/regional statistical operations			*	*	*
5. Financial Control			Strengthening of audit systems (SECIN &/or Tribunal da Contas)	*	*	*		
Bank Support			Public Sector Management Loan	*				
			Public Sector Management II				*	
			ESW on Public Investment and public enterprises	*	*	*	*	*
H. STABILIZATION 1. Government expenditure	No real increase in current or capitalinvestment outlays, but a shift away from state enterprise activity into priority social programs	Real reduction in state enterprise expenditures; emergency social program introduced 1985	+Reductions in Govt. and state enterprise operating expenditures, including personnel costs; extra provision for maintenance, financial rehabilitation, completion of priority investments; careful evaluation of new investment proposals involving Government or state enterprises	*	*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
2. Taxation	Increase in (recovery of) net tax revenues to 1970s ratios	Measures to restore and increase income tax revenues (increase equivalent to 1.7% of GDP proposed)	+Further short-term adjustments to increase revenue collection and reduce cost of tax exemptions and allowances	*	*	*	*	
			Major reform of tax and incentive systems and mechanisms for revenue sharing			*	*	
3. Other Revenues	Public sector prices, levies to cover cost of services.	Some real increases in 1985	+Public sector prices to increase in real terms; social security and similar charges to be adjusted to cover programs'costs	*	*	*	*	
4. Subsidies	(See F.1)							
5. Public sector deficit	Reduce public sector deficit (broadly defined) to normal financing range	"Operational" deficit cut from 6.8 to estimated 2.8% of GDP, between 1982 and 1985	+Reduction of "operational" fiscal deficit to 1% of GDP	*				
			+Further improvements in fiscal performance, according to targets to be agreed annually, to secure gradual decline in ratio of total public debt to GDP		*	*	*	*
6. Monetary Policy	Expansion consistent with agreed stabilization targets	Short periods of tight monetary restraint, 1981-84.	+Meeting annual monetary targets based upon expected growth and inflation	*	*	*	*	*
7. Incomes policy	Real wage increases linked to productivity growth, to increase employment opportunities	Successful efforts to reduce real wages in 1983-84, some real wage recovery in 1985.	+Public sector wage policy consistent with no increase in real wage bill in 1986-87, and real increases smaller than in the private sector during subsequent years	*	*	*	*	*
8. Indexation	Reduction of the inflation mechanisms implied by the Government indexation system, while avoiding distortions that might be caused by inflation if indexation is eliminated	-	+Preparation of detailed program on how to deal with indexation and related issues	*				
			+Implementation of the program		*	*		

Area	Policy Objectives	Actions Taken by Government	Further Measures Recommended	Proposed Timing 1986	87	88	89	90
I. SOCIAL & REGIONAL PRIORITIES								
1. Social Adjustment	Recovery from social costs of economic recession through programs designed to reduce poverty, improve income distribution and promote employment rhgough economic growth	Social sector priority program in nutrition, health, education, housing, water supply, small-scale agriculture and job creation (1985)	Preparation and implementation of plans of expanded, more cost-effective and efficiently delivered health, education and other social services	*	*	*	*	*
2. Regional Development	Increase employment and incomes, and promote sustained growth in the Northeast region	New rural development programs for the Northeast (1985)	Preparation of comprehensive, multi-sectoral Northeast regional development program	*				
			Phased implementation in line with domestic and external reserve availability		*	*	*	*
Bank Support			Education Sector Loan				*	
			Health Sector Loan					*
			NE lending program (rural development, industries, irrigation, education, health)	*	*	*	*	*
			ESW on health and education programs and NE regional development	*				

December 16, 198[illegible]

BRAZIL - A PROPOSED COMPREHENSIVE, MEDIUM-TERM PROGRAM FOR TRADE LIBERALIZATION

Area	Policy Objectives	Further Recommended Measures
1. Export Development	Improve industrial productivity and efficiency; nominal growth rate of manufactured exports of 15% annually, to permit import expansion while covering debt service	Formulation and initial steps in implementation (see below) of a multi-year program for export expansion and trade policy rationalization Implementation of GATT Code for subsidies
2. Export Financing	Rationalize and extend financing arrangements for exports	Provision of access to financing to all exporters at internationally competitive rates, consistent with GATT Subsidy Code
3. Import Regime	Increase the market incentives to improve quality and lower costs of domestic production; as a by-product, increase revenues from import trade	Specification of import rationalization objectives, identification and consideration of specific measures to reduce anomalies in policies and procedures affecting different categories of producer, with implementation subject to balance-of-payments situation; results of ongoing studies of effective protection; and results of trade negotiations Implementation of GATT codes for Customs Valuation and Anti-Dumping Elimination of most items from the list of "Import Suspension" Liberalization of firms' annual import programs, eliminating discrimination by products and providing automatic approval for firms importing up to a pre-determined value. (Import programs would be used as a tool to control imports only in the event of a balance of payments crisis). Reduction or elimination of most tariff exemptions schemes, and reduction of scope of application of Law of Similars Reduction of tariff levels and dispersion to a nominal average of about 40% range, with perhaps half the items in the 30-40% range, a minimum tariff of 10% and a maximum of 85% (including IOF tax) Gradual phasing-out of non-tariff restrictions, so that imports will be controlled primarily by the price mechanism, as reflected through the exchange rate and
Bank support		Export Development II Export Development III Industrial Restructuring I Industrial Restructuring II Cofinancing ESW on Industry and Trade

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 30, 1985

TO: See Distribution

FROM: Roberto Gonzalez Cofino, Chief, LC2BR

EXTENSION: 72031

SUBJECT: BRAZIL: Proposed Working Paper on Stabilization, Structural Adjustment, and Growth

1. Atached is an expanded outline for a working paper on stabilization, structural adjustment, and growth in Brazil which we propose to prepare over the coming months to support our policy dialog with the government and as an input to the 1986 CEM. Please send any writen comments you may have to Peter Knight (E928, 72085). A meeting will be held to discuss this proposed work on November 4 at 2:30pm in room E924. The remainder of this memorandum deals with the current situation in Brazil, the problem which this situation poses for Bank operations and policy dialog, and the objectives of the proposed study.

Current Situation

2. With GDP growth for 1985 now estimated at about 7 percent, Brazil is in the second year of recovery from a recession comparable in depth to the Great Depression. The 1981-83 recession was a consequence of stabilization efforts in the face of a severe balance of payments constraint. It reduced domestic absorption, contributing to the generation of the trade surplus necessary to service Brazil's foreign debt. It also had a high cost in lost output and employment. But during this costly stabilization, the prices of capital relative to labor and of tradables relative to non-tradables increased, providing incentives to employ more labor and to use capital more efficiently, as well as to increase the trade surplus, thereby promoting structural adjustment.

3. The balance of payments reflects considerable success on the external front: the 1985 trade surplus is expected to be US$12 billion, current account deficit about US$1.6 billion and gross reserves are over eight months imports of goods and non-factor services. But the impressive external performance has not been accompanied by equal success in domestic stabilization, and this failure threatens the sustainability of the economic recovery. Inflation doubled to 210 percent in 1983 following a 30 percent maxidevaluation against the dollar, and is unlikely to differ much this year from the 224 percent registered in 1984. Wage adjustments are reported to be running above inflation, and major labor unions are now seeking officially recognized quarterly adjustments which could result in

another acceleration of inflation. Despite a package of expenditure cuts and revenue raising measures announced at mid-year, the public sector deficit persists, fed in part by high real interest rates on the some 75 percent of the foreign debt which is now the responsibility of the public sector and even higher rates on an exploding domestic public debt. Extremely high real interest rates in the free segment of the credit market (25% and up for borrowers) coupled with uncertainty about future policies and the presence of substantial unutilized capacity in many sectors of the economy have brought new productive investment, especially private sector investment, to very low levels, though there are now signs that private investment is picking up.

4. Brazil's new Government has now prepared a preliminary version of its first National Development Plan covering the period 1986-89. Among the objectives specified are achieving at least 6 percent annual growth in GDP, maintaining external balance, reducing inflation, restructuring the public sector to better address the high priority now placed on poverty alleviation while holding total public sector expenditures constant in real terms, and providing incentives for the private sector to play the leading role in the growth process. This preliminary version of the plan is not very specific about how all this can be accomplished. Minimizing avoidable conflicts between these objectives within the framework of a coherent economic program remains the greatest challenge facing Brazilian policy makers.

The Problem

5. The Bank's approved lending program for Brazil is intended to support the development and execution by the Government of a medium-term program to restore economic growth while seeking equilibrium in the external accounts and attending to the country's social needs. As stated in the recent CPP, to maintain lending at the $1.5 billion level the Bank expects the Government to give a high priority to domestic stabilization and not adopt an incomes policy inconsistent with the requirements of internal and external stability. The Bank has no evidence at this time that the Government can achieve the objective of domestic stabilization while maintaining GDP growth of at least 6 percent.

6. Unless substantial progress can be achieved in reducing interest rates and inflation, we fear that new productive investment is unlikely to be forthcoming at levels sufficient to maintain growth. Once idle capacity has been used up, inflation could accelerate due to demand pressures. Alternatively, if imports increase to meet excess domestic demand, the Brazilian balance-of-payments situation could rapidly deteriorate. If, however, productive investment starts growing again, and inflation can be reduced substantially, our balance of payments projections suggest that Brazil could grow faster than 6 percent per annum for most of the rest of the decade. This would require, <u>interalia</u>, a rescheduling of Brazil's foreign commercial and bilateral debt and a modest <u>nominal</u> increase (by a percentage lower than international inflation) in the exposure of commercial banks.

Objectives of the Proposed Study

7. The proposed study, to be carried out in consultation with the IMF staff and in cooperation with the Brazilian Government, would recommend an action program to reduce real interest rates and inflation, analyzing in the process several alternative proposals for achieving domestic stabilization with continued structural adjustment and growth. In order to make such recommendations, it will be necessary to seek answers to the following questions:

(a) What has been the relationship between strong adjustment to external constraints and difficulties in domestic stabilization?

(b) How are the foreign and domestic debts of the public sector related, and how do they affect domestic interest rates?

(c) Why are real interest rates in the free segment of the credit market so high? How can they be reduced? It is necessary to reduce inflation to reduce real interest rates? Are high real interest rates the principal factor explaining low investment in productive capacity by the private sector. If so, will they continue to do so once existing capacity is fully utilized?

(d) What is driving Brazilian inflation today? Is it purely inertial, based on backward-looking indexation and expectations formation? What is the role of the public sector deficit? Wage pressures?

(e) Is inflation, even at over 200 percent per year, a problem in a highly indexed economy?

(f) Is it possible to bring inflation down gradually, while maintaining GDP growth of at least 6 percent per annum?

(g) Is the present indexation system hindering stabilization efforts?

If it is found -- as assumed in our recent CPP -- that present inflation rates are detrimental to growth, several options on how they could be reduced will be examined, discussing the advantages and disadvantages of each, the preconditions which would have to met for a successful attack on inflation in Brazil; the trade-off (if any) between stabilization and growth objectives; if sacrifices are necessary, how the loss can be minimized; and institutional changes which could contribute to the fight against inflation and help prevent its resurgence in the future.

8. It should be noted that many of these questions cannot be answered with certainty and will involve making judgements on the basis of the available evidence. This is particularly so in the case where sharp

discontinuities, such as a currency reform or the so-called "heterodox shock", are involved. In any case, the attached expanded outline gives an idea of how the study would be organized and some of its likely findings as well as can be predicted at this time.

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EXPANDED OUTLINE FOR A WORKING PAPER ON STABILIZATION, STRUCTURAL ADJUSTMENT AND GROWTH IN BRAZIL

A. THE PRESENT SITUATION

- Brazil is now in the second year of recovery, following the contraction of 1981-83, with real GDP growth in 1985 now estimated at about 7%, but investment remains depressed and employment is still a major concern.

- Since the maxi-devaluation of February 1983 the prices of capital relative to labor and of traded relative to non-traded goods have increased, providing incentives to employ more labor and use capital more efficiently as well as to increase the trade surplus, thereby promoting structural adjustment.

- The external balance is looking a little better than before, with a remarkable turnaround on the trade account, reconstituted reserves and some prospects of lower interest rates and oil prices.

- Inflation is around 220%, and built into the system through indexation of wages and financial contracts. Wages are adjusted every six months in different months for different groups of workers, based on movements of the National Consumer Price Index (INPC), though there is now strong pressure to move to quarterly adjustment which could result in an acceleration of inflation. The principal of most financial instruments is adjusted on a monthly or quarterly basis in line to the movements of a different index.

- The money base and M1 are very small relative to GDP, under 2% and about 3% of GDP respectively.

- Real interest rates are high (about 25% and up) for a variety of reasons including pervasive uncertainty, pressure from public sector borrowing, doubts on portfolio quality and heavy taxation of the financial system.

- Net public sector debt is large, about 60% of GDP. Of this debt about 58% is external, barely growing, and the liability of public enterprises and the Central Bank. About 42% is internal but growing very rapidly, an estimated 30% in real terms in 1985.

- o Private sector productive investment is beginning to recover, but many firms are holding large amounts of liquid financial assets rather than investing in new capacity.

B. HOW BRAZIL ARRIVED AT ITS PRESENT POSITION

Brazil's current situation reflects both external developments and the policy response to them over the last decade. There is a close linkage between external and internal factors.

B1. External Factors

Brazil has suffered an income loss of several percentage points of GDP since 1977 in the form of (i) deteriorated terms of trade, and (ii) higher real interest rates on external debt.

Compute losses, LIBOR, spread, fees.

More recently, it was forced to cut current deficits sharply as borrowing possibilities dried up. This implied a loss of foreign savings (especially important for the public sector) and required cuts in absorption relative to domestic output.

compute loss of financing from past trends.

B2. Linking External and Internal Factors

Initially Brazil responded to deteriorating terms of trade by encouraging public enterprises and the private sector to borrow abroad. This was done through a variety of policies including increased control of the financial system which tightened credit outside certain subsidized lines. Foreign capital induced in this way mainly entered through resolution 63 (to financial intermediaries) and bill 4131 (to large public and private firm).

Ratios of loans to private sector to total assets of financial institutions, cumulative entry of 63 and 4131 capital

As foreign inflows dried up over 1980-83 and forced an improvement in the nonfactor current account of 4.5% of GDP there were three important responses.

- o First, the public sector turned to the domestic capital markets for financing, in the form of issuing ORTN, LTN, borrowing from the domestic banking system, higher compulsory requirements on deposits, and money creation.

  Resources raised from each source

- o Second, because it was then necessary to transform domestic resources into foreign interest payments a trade surplus was needed: this required a substantial real depreciation of the exchange rate, cuts in real wages and tighter credit policy to depress demand and the domestic economy so that the private sector would run the trade surplus. Investment demand, including that of state enterprises, bore the brunt of the adjustment. Exchange policy since then has involved continuous devaluation against the US dollar at the rate of domestic inflation.

Real exchange rates, wages, unemployment, investment, trade surplus

- Third, because real depreciation raised the real cost of foreign debt it was considered necessary to socialize some of the cost in the Central Bank to avoid bankrupcies. As a result there are now domestic public dollar liabilities which are the counterpart to some of the external debt. Because much of the internal debt carries the option of exchange correction, real depreciation raises the public internal debt burden too.

Amount of exchange risk socialized

B3. <u>Internal Factors</u>

The most longstanding policy factor has been the attempt to borrow the country out of its difficulties following the first oil price rise of 1974. This led to the need to take contractionary actions abruptly, when foreign borrowing options dried up.

However, as the government turned increasingly to the domestic financial markets for funding, the composition of financial instruments shifted, away from money and towards those indexed by monetary or exchange correction. Some sold at discounts depending on real interest rates (ORTN) while some sold at par and bore correction plus fixed interest and benefited from tax concessions (<u>cadernetas</u>: liabilities of the housing system). Switches between these categories introduce the possibility of instability, rather as did switches between cruzeiro and indexed assets in the mid-1970s.

Composition of financial instruments

Government therefore crowded out private borrowers, and high real interest rates encouraged private financial activity at the expense of commodity production.

Data on real interest rates, on loans to the private sector and non-financial public sector by the banking system, and value added by financial intermediaries

The domestic private sector seems to have responded smartly to the rise in real interest rates, and may have moved into a net creditor position by cutting costs. In many cases "financial" profits seem to outweigh "real"profits. Public enterprises were slow to adjust and their financial position has been weakened.

Data on private corporate balance sheets. Compare with SEST data for public enterprises

The domestic household sector was hit by falling real wages and unemployment. It appears to be in a tight spot in terms of mortgage obligations. This implies a shaky housing system, the second locus of financial distress.

Data on unemployment, wages versus correction, delinquencies

The residual source of financing is money creation. The inflation tax peaked relative to GDP in 1979 at 3.3%, and then fell sharply to about 1.5%. However, as it was levied on a shrinking money base,inflation rose and the level of uncertainty over future inflation and relative price variability mounted. There have been two step-jumps in inflation, 1979-80 from 40% to 100% and 1983 from 100% to 200+%. Both followed maxi-devaluations of the exchange rate and a supply shock--a change from annual to quarterly wage adjustments in 1979 and damage to crops by floods and drought in 1983. Conventional tax revenue as a percent of GDP has fallen from a high of 26.5% in 1973 to 24.4% in 1984. The fall is sharper if the tax burden net of transfers and subsidies is used, from 17.0% in 1973 to 6.4% in 1984.

Although it does not yield much revenue, the costs of raising the inflation tax appear to have increased to a very high level. However, both external and internal financing options are limited. Furthermore, the small size of the base shows the extent to which Brazilian institutions have adapted to inflation and suggests that relatively small exogenous or policy shocks can result in large increases in inflation.

C. THE PUBLIC DEFICIT AND THE PUBLIC DEBT

At least four concepts of the deficit are relevant.

- The conventional nominal deficit as measured by the public sector borrowing requirements.

- The "operational" deficit, which excludes monetary and exchange correction on public debt.

- The "operational nonfinancial" deficit. This can be defined as the operational deficit excluding interest charges other than those on external and domestic debt held by the Monetary Authorities.

- The "cash deficit", a more recent concept, is defined as the change in the difference between all assets of the Monetary Authorities and all their liabilities except the monetary base and federal government securities.

There are serious problems in measuring the deficit, especially on a timely basis. The nominal deficit is very large, over 20% of GDP, and because of rising inflation it has tripled as a percent of GDP since 1980. The operational deficit has been brought down from its 1982 high of 6.8% of GDP and is estimated to be about 2% in 1985, roughly the same as in 1984.

The cash deficit includes the cost of servicing the foreign debt held by the Central Bank, other foreign operations of the government, and certain domestic operations by the monetary authorities, but excludes service on the debt of state enterprises and state and local governments to the banking system not covered by transfers from the Treasury or the Monetary Authorities. This measure of the deficit may be on the order of 6.5% of GDP in 1985.

Excluding internal debt held by the Central Bank, the global internal net public debt (including that of the federal, state and local governments in the form of borrowing from the banking system and arrears in payments to suppliers as well as securities) is on the order of 25% GDP in 1985, while the foreign debt of the public sector (net of reserves) is on the order of 35% of GDP. Inputing real interest rates of 20% (net of taxes) on the internal debt and 12% (including spreads and commissions) on the foreign debt gives an interest bill on the order of 9.2% of GDP in 1985. (These are rough estimates, to be checked by the mission.)

Such an estimate would imply that the operational non-financial deficit is negative, i.e. a surplus of about 5.6% of GDP after excluding about 1.6% of GDP of interest on foreign loans serviced by the Central Bank less interest on reserves since service of the net debt held by the Monetary Authorities is not included in the operational deficit. There is considerable debate over what is the proper concept of deficit to use when looking at the impact of the deficit on domestic financial markets. This issue will be discussed and a judgement made on what is the best concept to use for this purpose.

Estimates of these various deficits for 1985 and as many years back as they can be obtained on a consistent basis

In an international context Brazil's debt burden is heavy indeed. For a sample of 12 OECD countries, the interest payments on public debt grew from 2.2% of GDP in 1973 to 5.8% in 1984. But these interest payments are nominal ones, whereas in principle, Brazil's domestic interest rate is calculated in real terms, net of taxes, though in fact the monetary correction index used to correct the principal has not always fully reflected domestic inflation. Furthermore, Brazil is trying to finance its public sector interest costs with limited access to the external capital market and with limited domestic means. The result is that it has further raised interest rates and runs the risk of getting onto an unstable path marked by greater concern over the quality of its liabilities, greater uncertainty, and still higher rates.

D. REVERSING THE PROCESS: TOWARDS DOMESTIC STABILIZATION WITH GROWTH

There appear to be three main macro objectives:

1. renewed and sustainable domestic growth, which probably requires decreasing uncertainty and interest rates;

2. lower inflation; and

3. maintaining the integrity of the domestic and foreign debt.

Note that with the third goal we assume that various concerns discourage the use of any alternative policy forcing those holding public debt to bear large capital losses. For example, the possibility of converting debt to equity in public enterprises on a large scale is assumed away. For a number of reasons, which will be spelled out in the working paper, inflation at over 200% per year is unlikely to be stable -- the tendency is for inflation to accelerate and turn into hyperinflation unless a serious attempt is made to reduce it.

In order the achieve these objectives, the government has a number of instruments -- fiscal, monetary and exchange rate policies, setting wage and monetary correction, limiting public enterprise investment and so on. In addition currency reform has been suggested, to replace the cruzeiro with a new money deriving from the indexed ORTN. A number of institutional changes would help. Perhaps the most important are the unification of Brazil's federal budgets (fiscal, monetary and state enterprises) which is already proceeding, and reordering of the relationships between the National Treasury, the Central Bank, and the Bank of Brazil so as to establish a clear separation between the conduct of monetary and fiscal policy, an objective of the present Government. Giving the Central Bank greater independence from the Government would also help. These institutional changes could help establish better control of public expenditure and could be the starting point for a broader process of reform to improve the overall efficiency of the financial system, increase its stability, and encourage domestic resource mobilization for investment.

Four possible approaches to domestic stabilization will be examined in this section: the gradualist approach which the Government has outlined in the First National Development Plan of the New Republic (IPND/NR), the currency reform approach proposed by Andre Lara Rezende and Persio Arida, the "heretodox shock" approach which is similar to that taken recently in Argentina and involves a wage and price freeze subsequent to a readjustment of all wages to their average real value during the previous adjustment period, and a more traditional approach designed to reduce domestic absorption through tight monetary and fiscal policies. The advantages and disadvantages of each will be assessed and policy recommendations made based on this analysis. (If other promissing approaches are identified by the mission, they will be included in the analysis.)

It is clear that there are no easy solutions and policy recommendations must be made with an appreciation of the range of uncertainty. However, it may be helpful to try and identify the nature of the main problem clearly.

Assume that the above estimates are roughly correct. An inflation tax of 1.5% of GDP ought to be attainable at moderate inflation rates. Thus the main financial problem facing the Brazilian government is how to fund part of its interest charges without placing the markets under greater stress and how to bring down interest rates to enable the slowing of growth of its debt burden; this growth is now the main symptom of an unsustainable fiscal policy.

High domestic rates and low levels of productive investment are probably also tied to inflation-induced uncertainty. Therefore it will be necessary to take steps to slow inflation. The strong inertial component will make this difficult. However, abolishing indexation outright might add to uncertainty and inhibit further holding of public debt. It may also be difficult to effect politically if there is a perception that the result might be to redistribute income from wages. Therefore it is vital that the public deficit is seen to be under control first. It is also crucial to negotiate an incomes policy to avoid a wage explosion.

On the external front constraints might be easing a little. Real interest rates are down by about 2.5%; this corresponds to a gain of about 1.25% of GDP. A slipping dollar bodes stronger commodity prices. Net imports of petroleum and derivatives now account for some 27% of imports (about 1.7% of GDP) so that a 25% price fall could imply a terms of trade gain of another 0.4%. Therefore one way of phrasing the policy question is how best to use a reversal of the previous losses (or at least a great improvement from the previous trend).

It might be argued that any external breathing space be used to strengthen Brazil's external position. But this option does not confront the problem that the economy's performance is constrained by the heavy financing needs of the domestic (and far more costly) public debt. The highest priority now appears to be to ease pressure for money creation and domestic financing.

Therefore a better policy combination appears to be:

1. Relax domestic credit policy somewhat, through reducing compulsory deposit requirements and freeing up funds to the private sector. This would help bring down interest rates and encourage a higher level of activity and employment which in turn would result in any external space being used to reduce the trade surplus.

2. At the same time the government would need to apply tight fiscal policy, involving a combination of tax increasees and cuts in exemptions and spending. Because there is now probably total "crowding out", the reduced fiscal deficit

would not have a deflationary effect if combined with a less tight credit policy. Overall, the reduced need for a trade surplus would permit some reflation of the economy.

3. Confidence might be helped by some reform of the tax system. To further bring down interest rates the financial transactions tax and witholding rate for interest income could be partly replaced by other taxes. This would confer unnecessary capital gains on holders of existing public debt. Therefore it might be desirable to retain taxes on public debt issued before a specified date. The tax reform should also seek to increase equity in accord with the Government's objectives. Phasing out of quantitative restriction on imports, replacing them with non-prohibitive tariffs and reducing prohibitive tariffs could contribute to the fiscal effort and also help slow domestic price incrases. A serious constraint is that major tax changes must be approved by Congress prior to the beginning of the calendar year in which they are to be applied.

4. By holding down its own expenditures except for priority social programs, reducing interest rates, and undertaking an equity-increasing tax reform, the Government should be in a position to negotiate a "social pact" embracing wages, interest, and profits. The objective would be to avoid an inflationary struggle over distributional shares.

5. When a comprehensive measure of the deficit excluding monetary and exchange correction on the outstanding public debt declines to the range of normal financing (1-2% of GDP) it could be time for the currency reform or the heterodox shock and institutional reforms to render the resurgence of inflation less likely.

Except for the currency reform or heterodox shock, the approach suggested here comes close to the gradualist policy which the Government has outlined. If this approach fails, and inflation accelerates sharply, it may become politically feasible to begin rather than end the stabilization process with a shock treatment with or without a currency reform.

QUESTIONS RELATED TO DOMESTIC STABILIZATION IN BRAZIL

(a) What has been the relationship between strong adjustment to external constraints and difficulties in domestic stabilization?

(b) How are the foreign and domestic debts of the public sector related, and how do they affect domestic interest rates?

(c) Why are real interest rates in the free segment of the credit market so high? How can they be reduced? It is necessary to reduce inflation to reduce real interest rates? Are high real interest rates the principal factor explaining low investment in productive capacity by the private sector. If so, will they continue to do so once existing capacity if fully utilized?

(d) What is driving Brazilian inflation today? Is it purely inertial, based on backward-looking indexation and expectations formation? What is the role of the public sector deficit? Wage pressures?

(e) Is inflation, even at over 200 percent per year, a problem in a highly indexed economy?

(f) Is it possible to bring inflation down gradually, while maintaining GDP growth of at least 6 percent per annum?

(g) Is the present indexation system hindering stabilization efforts?

(h) What is the best way to reduce real interest rates and inflation in Brazil?