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Clausen's: Brazil

Vol 1



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OFFICE MEMORANDUM

DATE: October 10, 1986

TO: Memorandum for the Record

FROM: Roberto Gonzalez Cofino, Chief, Brazil Division, LC2

EXTENSION: 72031

SUBJECT: BRAZIL - Mr. Conable's Meeting with the Brazilian Delegation
to the Annual Meetings

1. Mr. Conable met on September 27, 1986, at 9:30 a.m. with Mr. Joao Sayad, Brazil's Planning Minister and Governor in the Bank. Messrs. Fernao Bracher, President of the Central Bank; Luiz Felipe Lampreia, Secretary for International Affairs of the Planning Ministry; Eimar Avillez, Technical Assistant to the Executive Director; and Stern, Knox, Gué and Gonzalez Cofino also attended the meeting.

2. Mr. Conable started the meeting by asking about the Government's intentions concerning the price freeze and the adjustment of power tariffs. Mr. Sayad explained that since the Cruzado Plan was put into effect last January economic growth has been too fast. GDP is growing at an annual rate of 7%, and industrial output at 12%. Total wage income has increased substantially, and there is now excess demand throughout the economy. The Government has tried to reduce demand by establishing compulsory loans affecting consumers of gasoline, cars and international travel, but additional actions are likely to be required. In Mr. Sayad's view, an inflationary mentality still prevails in Brazil; if the price freeze were to be terminated now, both prices and wages would increase substantially, and the current stabilization effort would end in a costly failure.

3. Messrs. Conable and Stern asked about what measures the Government was considering for dealing with the situation, and about the likely timetable for their adoption. Mr. Sayad said that the Government will evaluate the situation later this year, and that the likely sequence of actions concerning the price freeze would be as follows: (a) correction of relative prices without abandoning the price freeze; this might include increases in prices of wheat, milk and gasoline, and in power tariffs; (b) reduction of excess demand; (c) unfreezing of agricultural prices; (d) unfreezing of prices in other competitive sectors; and (e) definition of rules to be followed concerning prices in non-competitive sectors. This strategy would have to include, as an essential component, a social agreement on wage levels, with a view to avoiding inflationary wage increases. Mr. Stern pointed out that if the price freeze remained in place for a long period, new substantial distortions would be likely to emerge. Mr. Sayad acknowledged this risk, adding, however, that it is not going to be feasible, politically, to move very fast in implementing the strategy referred to above. He also indicated that, while the Government intended to increase power tariffs, this could not be mentioned now, because it would make it impossible to avoid general increases in other prices, and in wages.

October 10, 1986

4. Mr. Stern said that compliance by Brazil of the conditions of the large FY86 Power Sector and Credit and Marketing Reform loans was being closely watched. A failure in such compliance would damage the prospects for implementing the FY87-88 lending program. Mr. Conable pointed out that the credibility of Brazil and of the Bank would suffer if the conditions were not complied with; this would pose difficulties for other loans, not only to Brazil but, also, to other member countries. Mr. Sayad assured Messrs. Conable and Stern that the Brazilian Government shared their concern. Both loans supported programs that were very important for his country, and the Government intended to implement those programs fully. Mr. Sayad pointed out that the power sector program was particularly important, not only because of its impact on the power sector but, also, because it was the first step in a high-priority Government program for reforming the enterprises owned by the public sector.

cc: Mr. Conable's Office
Messrs. Stern
Knox
Gué, LC2
Quijano, Mirza, LAC

RGonzalezCofino:nev

ANNUAL MEETING BRIEF

Push for Brazil
to sign MIGA

Name of Country: BRAZIL

Date: September 5, 1986

Meeting with: Mr. Joao Sayad, Minister of Planning, and
Mr. Fernao Bracher, President of the Central Bank

Population: 134.4m Estimated Growth Rate 2.3%

GNP per capita: \$1,630 (1985)

	(\$m)		(\$m)
Total Commitments to date:	13,084.6	FY86: Commitments:	1,620.0
of which:		Disbursements:	716.3
Bank (154)	13,084.6	Amortization:	496.6
IDA (0)	0.		
Total Undisbursed:	3,626.5		
Lending Program FY87-88:	3,894.0		

<u>Summary Data</u>	Average 1983-85	1986	
GDP growth	3.2	7.0	Aid Group Meeting: n.a.
Export growth	10.7	-0.5	Last Meeting: n.a.
Import growth	-9.4	25.7	IMF Status as of: 9/86:
Current Account Deficit % GDP	-0.009	.094	Article IV Consultation
Gross Debt Service Ratio	71.9	73.0	underway
Annual Inflation Rate	223.3	46.1	

Background: After a recession in 1981-83, Brazil has resumed its remarkable economic expansion with an 8.3% real increase in GDP being registered in 1985; a 7% increase is expected this year. An external adjustment program has brought about trade surpluses of \$12-13 billion per year, more than enough to service the interest on Brazil's \$100 billion external debt. 1986 has seen a substantial internal adjustment, with inflation being brought down from 14% per month in February to about 1% per month since then. This "Cruzado Plan" has brought the Government of Jose Sarney unprecedented popular support. Such support, however, has declined somewhat in recent months, mainly as the result of the scarcity of some food items. The Government has adopted recently some demand management measures, to reduce the overheating of the economy. A critical decision still to be made is when and how the current price freeze will be terminated or modified.

Issues likely to be raised by delegation:

1. The size and composition of the FY87-88 lending program.
2. Bank assistance in cofinancing and in helping Brazil reenter international capital markets.

Issues to be raised by Bank Management:

1. Prospects for an agreement with the Bank on a monitorable, medium-term economic program.
2. Compliance with conditions of the FY86 Credit and Marketing Reform and Power Sector Loans.

Attachments:

FIVE YEAR LENDING PROGRAM: FY86-90 (FY86 actual)

Biographical Information

Present Economic Situation

1. Seven months after the adoption of the Cruzado Plan, the immediate challenge for the Government is to move away from the price freeze adopted last February, without causing inflation to reignite. The Brazilian economy is growing rapidly--real GDP growth of about 7% is expected this year--and reported inflation has been running at about 1% per month. However, the price freeze is becoming more difficult to enforce, and some food items (mainly beef and milk) and consumer durables are becoming scarce. These difficulties are likely to increase--and some new economic distortions to emerge--if the price freeze is not relaxed soon. To prevent the economy from overheating, the Government has allowed interest rates to rise, placed restrictions on consumer credit, and imposed taxes and compulsory loans on selected automobile- and travel-related expenditures. Skepticism has arisen about the Government's ability to hold to its fiscal deficit target of 2.5% during this election year. Finally, investment, while increasing, does not seem to be rising rapidly enough to sustain economic growth at about 7% per year, the Government's medium-term goal.

2. In the international area, Brazil is moving toward more economic cooperation with Argentina and Uruguay. Agreements were signed this summer, including a series of bilateral trade protocols with Argentina. The Government is now preparing for the negotiations in late 1986 or early 1987 of a multi-year rescheduling agreement with commercial banks. The IMF has just been to Brazil for Article IV consultations, its first mission in over eighteen months. At the same time, Finance Minister Funaro has announced the possibility of putting a ceiling on Brazil's debt service payments--as a negotiating position with Brazil's creditors--if no new money is forthcoming in 1987.

Issues Likely to be Raised by Delegation

3. The Size and Composition of the FY87-88 Lending Program. The Delegation is likely to confirm the Government's interest about the operations included in our FY87-88 lending program, including, in particular, the proposed loans for the power sector, irrigation, rural development in the Northeast region, urban transport, industrial technology, financial reform and export development. We suggest that you tell them that the Bank is working on all these projects and is willing to finance them, provided that the Government adopts a medium-term economic policy program acceptable to the Bank (see para. 5 below), and also takes the required project-related decisions. If this is done on a timely basis, Bank lending to Brazil in FY87-88 could reach up to US\$2 billion per year. Our lending level, however, could also remain well below the FY86 level (US\$1.6 billion) if no agreement is reached on the medium-term program, or if the Government delays the adoption of project-related decisions. One possible cause of delays is the current price freeze, which could make it necessary to postpone the release of the second tranches of the FY86 Power Sector and Credit and Marketing Reform loans (see para. 7 below) and the processing of FY87 operations for Power and Agriculture.

4. Bank Assistance in Cofinancing and in Helping Brazil Reenter International Capital Markets. The delegation is also likely to ask for Bank assistance in obtaining cofinancing (US\$700 million) for the power sector project approved in June 1986, and for helping Brazil to re-enter the international capital markets in other ways. You may wish to confirm to them that the Bank is most willing to help in this respect, but the success of the cofinancing operation will depend upon several factors, including:

- (a) the normalization of Brazil's relations with the Paris Club;
- (b) the medium-term strategy that Brazil will adopt vis-a-vis the commercial banks, including the country's position concerning a possible multi-year rescheduling agreement; and
- (c) the timing of the agreement between Brazil and the Bank on a medium-term economic policy framework, which should have been finalized before a formal approach is made to potential cofinancing sources (see para. 5 below).

Issues to be Raised by Bank Management

5. The Prospects for an Agreement with the Bank on a Monitorable, Medium-Term Economic Program. Although discussions between Bank staff and the country's authorities on the Government's economic program began early in 1986, the adoption of the Cruzado Plan in late February made it necessary to modify the Government program and to redesign our approach. Discussions resumed in August and will continue, at the technical level, during the Annual Meetings week. Such a program, which should be monitorable, should complement and strengthen the short-run stabilization as well as lead to sustainable long-run development. The Cruzado Plan, although quite effective in terms of short-term stabilization, has also implied a setback--hopefully temporary--in the required deregulation of the Brazilian economy. The price freeze adopted last February was an unavoidable feature of the stabilization program. But if maintained beyond a short transition period, it is likely to become an obstacle to long-term efficient economic development. Consequently, the medium-term program should include, inter alia: (a) the phasing out of the price freeze; (b) reforms of the financial sector, where the operating inefficiencies and weak balance sheets of much of the sector, exposed by the cessation of inflation, could have severe consequences on investment and on long-run recovery; (c) progress towards trade liberalization; (d) the continued execution of our agreed program of investment program reviews; and (e) the initiation of an ordered program of reform of state enterprises, including the privatization of a number of these entities.

6. We suggest that you confirm to the delegation that an early agreement on a medium-term economic policy framework is an essential pre-requisite for the Bank being able to: (a) maintain, or increase, its own lending to Brazil; and (b) help the country reenter international capital markets. This is even more important in view of the absence of an active IMF role in this country. You may wish to add that, in order to avoid substantial slippages in our lending program and in possible cofinancing operations, final agreement on this program should be reached before the end of 1986.

7. Compliance with the Conditionality of the FY86 Power Sector and Credit and Marketing Reform Loans. The conditions for the release of the second tranches of these loans (respectively, US\$250 million and US\$200 million) include, inter alia:

- (a) the liberalization of commerce in key agricultural products, and the continuation of substantially positive and market-determined real interest rates for rural credit; and
- (b) the achievement of specific rate of return targets in the power sector, which is likely to imply tariff increases in early 1987.

Compliance with these conditions, and the related release of the second tranches of these two loans, might be delayed beyond the target dates (around next December), if the price freeze is not relaxed soon. We suggest that you confirm to the Delegation the importance of a timely compliance, not only for releasing the second tranches, but also for allowing us to process on schedule several FY87-88 follow-up operations.

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: BRAZIL
OPERATIONS PROGRAM: FY86-90
AS OF END JULY 1986

SECTOR			FY86	FY87	FY88	FY89	FY90	FY86_90	
AGRICULTURE	PA131-CREDIT & MKTG.REFORM	L	500.0	.0	.0	.0	.0	500.0	
	PA149-UP&MDLE SAO FRMCO IR	L	57.0	.0	.0	.0	.0	57.0	
	PA159-AGR EXTENSION II-A	L	155.0	.0	.0	.0	.0	155.0	
	PA208-IRRIG ENGINEERING-A	L	48.0	.0	.0	.0	.0	48.0	
	PA219-NE R/D V-PERNAMBUCO-	L	92.0	.0	.0	.0	.0	92.0	
	PA138-NE RURL DEVT BAHIA-C	L	.0	171.0	.0	.0	.0	171.0	
	PA148-AGR CREDIT-C	L	.0	300.0	.0	.0	.0	300.0	
	PA156-NE R/D IV-PIAUI-C	L	.0	78.0	.0	.0	.0	78.0	
	PA207-NE R/D VI-CEARA-C	L	.0	122.0	.0	.0	.0	122.0	
	PA220-NE R/D VII-MARANHAO-	L	.0	88.0	.0	.0	.0	88.0	
	PA229-NE IRR II-ITAPARICA-	L	.0	125.0	.0	.0	.0	125.0	
	PA212-NE R/D VIII ALAGOAS-	L	.0	.0	60.0	.0	.0	60.0	
	PA213-NE R/D IX-PAR'BA/MIN	L	.0	.0	135.0	.0	.0	135.0	
	PA179-LVSTK DISEASE CONT-B	S	.0	.0	50.0	.0	.0	50.0	
	PA206-AGRICULTURAL CREDIT	L	.0	.0	.0	300.0	.0	300.0	
	PA157-NE IRRIGATION-C	S	.0	.0	.0	70.0	.0	70.0	
	*SUB-TOTAL AGRICULTURE			852.0	884.0	245.0	370.0	.0	2351.0
	EDUC + PHN	PA152-NE BASIC HLTH SERV-A	L	59.5	.0	.0	.0	.0	59.5
		PA218-IND SKILLS VOC TRG-B	L	.0	100.0	.0	.0	.0	100.0
		PA225-NE ENDEMIC DISEASE C	L	.0	.0	75.0	.0	.0	75.0
PA151-EDUCATION SECTOR		L	.0	.0	.0	150.0	.0	150.0	
PA190-II NE BASIC HLTH SRV		L	.0	.0	.0	115.0	.0	115.0	
PA226-NW BRAZ MALARIA CTRL		S	.0	.0	.0	150.0	.0	150.0	
*SUB-TOTAL EDUC + PHN			59.5	100.0	75.0	415.0	.0	649.5	
ENERGY + POWER	PA205-ELEC POWER SEC I-A	L	500.0	.0	.0	.0	.0	500.0	
	PA137-ELEC PWR SEC (COFIN)	M	.0	.0	.0	.0	.0	.0	
	PA143-RURAL ELECTR II-B	L	.0	225.0	.0	.0	.0	225.0	
	PA211-ELEC PWR SCTR II-C	L	.0	300.0	.0	.0	.0	300.0	
	PA191-PWR SCTR III-C	L	.0	.0	350.0	.0	.0	350.0	
	PA161-RURAL ELECTRIFICATIO	S	.0	.0	.0	.0	200.0	200.0	
*SUB-TOTAL ENERGY + POWER			500.0	525.0	350.0	.0	200.0	1575.0	
INDUSTRY + IDF	PA228-IND RESTRUC TA-C	M	.0	15.0	.0	.0	.0	15.0	
	PA170-IND RESTR II-D	L	.0	.0	350.0	.0	.0	350.0	
	PA186-NE SMLL & MED IND-C	L	.0	.0	200.0	.0	.0	200.0	
	PA189-IND TECH DEVT-B	L	.0	.0	100.0	.0	.0	100.0	
	PA142-FINAN. REFORM I-C	S	.0	.0	300.0	.0	.0	300.0	
	PA202-RURAL TELECOM-C	S	.0	.0	.0	280.0	.0	280.0	
	PA188-GRANDE CARAJAS DEVT	S	.0	.0	.0	.0	250.0	250.0	
	PA195-DEVT BANKING IV	S	.0	.0	.0	.0	200.0	200.0	
	PA196-NW SMALL & MED INDUS	S	.0	.0	.0	.0	200.0	200.0	
	PA217-IND RESTR III	S	.0	.0	.0	.0	400.0	400.0	
*SUB-TOTAL INDUSTRY + IDF			.0	15.0	950.0	280.0	1050.0	2295.0	
INFRASTRUCTURE	PA154-SALVADOR METRO DEVT-	L	55.0	.0	.0	.0	.0	55.0	
	PA185-STA CATARINA TOWNS-A	L	24.5	.0	.0	.0	.0	24.5	
	PA204-NE URBN RECON (FL'D)	L	100.0	.0	.0	.0	.0	100.0	
	PA153-URBN TRANSPRT IV-A	L	.0	200.0	.0	.0	.0	200.0	
	PA197-SAO PAULO HWY MGMT-B	L	.0	200.0	.0	.0	.0	200.0	
	PA194-WTR & SEWRGE SEC-B	L	.0	.0	250.0	.0	.0	250.0	
	PA203-FEPASA RAILWYS-B	S	.0	.0	100.0	.0	.0	100.0	
	PA165-FEEDER ROADS IV-D	L	.0	.0	.0	250.0	.0	250.0	
	PA166-NE RURAL WTR&SANIT-B	L	.0	.0	.0	100.0	.0	100.0	
	PA184-CERRADO TRANSPORT-D	L	.0	.0	.0	100.0	.0	100.0	
	PA163-PORTS II-C	S	.0	.0	.0	50.0	.0	50.0	
	PA155-WATER & SEWERAGE SEC	S	.0	.0	.0	.0	200.0	200.0	
	PA171-MEDIUM CITIES URBAN-	S	.0	.0	.0	.0	50.0	50.0	
	PA192-TRANSPORT SECTOR	S	.0	.0	.0	.0	275.0	275.0	
	PA222-METROPOLITAN DEV-B	S	.0	.0	.0	.0	100.0	100.0	
PA223-NORTHEAST CITIES-B	S	.0	.0	.0	.0	150.0	150.0		
*SUB-TOTAL INFRASTRUCTURE			179.5	400.0	350.0	500.0	775.0	2204.5	
NON-PROJECT	PA181-PUB SCTR MGMT-A	L	29.0	.0	.0	.0	.0	29.0	
	PA183-FINANC REFORM II-D	L	.0	.0	.0	400.0	.0	400.0	

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: BRAZIL
OPERATIONS PROGRAM: FY86-90
AS OF END JULY 1986

SECTOR		FY86	FY87	FY88	FY89	FY90	FY86_90
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	*SUB-TOTAL NON-PROJECT	29.0	.0	.0	400.0	.0	429.0
	<u>*TOTAL BRAZIL</u>	<u>1620.0</u>	<u>1924.0</u>	<u>1970.0</u>	<u>1965.0</u>	<u>2025.0</u>	<u>9504.0</u>
RESERVE	PA147-AGR SECTOR III-C R	.0	250.0	.0	.0	.0	250.0
	PA201-NATURAL GAS-C R	.0	250.0	.0	.0	.0	250.0
	PA224-LOW INCOME WS & SEW- R	.0	50.0	.0	.0	.0	50.0
	PA139-RUBBER DEVT-D R	.0	.0	60.0	.0	.0	60.0
	PA140-EXPT DEVT II-D R	.0	.0	300.0	.0	.0	300.0
	PA193-NE MEDIUM CITIES-B R	.0	.0	200.0	.0	.0	200.0
	PA209-MINAS GERAIS FRSTRY- R	.0	.0	20.0	.0	.0	20.0
	PA214-NE EDUCATION-C R	.0	.0	150.0	.0	.0	150.0
	PA227-IND POLLUTN CNTRL-C R	.0	.0	50.0	.0	.0	50.0
	PA150-EXP DEVT III-D R	.0	.0	.0	300.0	.0	300.0
	PA231-2ND FEDERAL HWY SCTR R	.0	.0	.0	300.0	.0	300.0
	PA215-EXPT DEVT IV-C R	.0	.0	.0	.0	300.0	300.0

LAC REGION, OFFICE OF THE PROGRAM COORDINATOR
08/12/86
MMC:SELM8A

JOAO SAYAD
Minister of Planning

Joao Sayad, 40, has a PhD in economics from Yale University and was professor of economics at the University of Sao Paulo from 1968 to 1983. Prior to his appointment as Minister of Planning, he was Secretary of Finance for the State of Sao Paulo. As Minister of Planning, Mr. Sayad is Brazil's Governor in the Bank. Mr. Sayad was instrumental in the February 1986 economic reform and the preparation of the Plano de Metas, which seeks to define the longer-term Brazilian development strategy.

FERNAO BRACHER
President of the Central Bank

Mr. Fernao Bracher, 51, was appointed President of the Central Bank of Brazil in August 1985, taking over from Mr. Antonio Carlos Lemgruber at the same time as Mr. Dilson Funaro succeeded Mr. Dornelles as Minister of Finance. Mr. Bracher is an experienced Sao Paulo banker, without close political affiliations but respected in PMDB (the ruling party) circles. He was a director of Banco da Bahia from 1961 to 1973 and joined the directorate of BRADESCO (Brazil's largest private sector bank) when the former was taken over by BRADESCO. From 1974 to 1979 he was Director of the External Area of Banco Central, and on return to BRADESCO became executive vice-president for its security operations and, in 1981, international operations. His education (in law) was received at the University of Sao Paulo and the University of Freiburg in West Germany.

OFFICE MEMORANDUM

DATE: September 15, 1986

TO: Memorandum for the Record

FROM: Roberto Gonzalez Cofino, Chief, Brazil Division, LC2

EXTENSION: 72031

SUBJECT: BRAZIL - Mr. Conable's Meeting with Brazil's President, Jose Sarney

1. Mr. Conable met on September 10, 1986, at 4:50 p.m., with President Jose Sarney, in the Hotel Willard, Washington, D. C. Brazil's Planning Minister, Mr. Joao Sayad; the Brazilian Ambassador to the U.S., Mr. Sergio Correa da Costa; the technical assistant to the Bank's Executive Director representing Brazil, Mr. Eimar Avillez; and Messrs. Knox and Gonzalez Cofino also attended the meeting.

2. President Sarney started the meeting by thanking the Bank for its financial and technical assistance to his Government. Mr. Conable said that Brazil is one of the Bank's main borrowers and that the Bank expects to continue a close association with this country. He referred then to the Cruzado Plan, hoping that its implementation will continue to be satisfactory.

3. President Sarney made then a detailed statement related to the Cruzado Plan, indicating that it had been under careful preparation for several months, and that it had been preceded by important fiscal and banking reforms. He said that in adopting the Plan, the Government had taken into account the experience of Israel and Argentina under their respective stabilization programs. The Plan was being implemented carefully by the Government. There had been some supply problems--mainly scarcities of beef and milk--caused by a sharp increase in domestic demand. Such problems were being resolved by the Government. On the whole, Mr. Sarney considered that the Plan has been highly successful, referring to the reduction of inflation to an average monthly rate of 0.9% in March-August; the continuing high rate of economic growth; the reduction of unemployment to 2.8% of the labor force; and the substantial increase achieved since last February in real wages.

4. Mr. Sarney stated also that the two key economic challenges facing Brazil were the need to increase investment, and the large size of the foreign debt and of debt service payments. Such payments amounted now to 5% of GDP, a magnitude that was constraining Brazil's development, and reducing its import capacity. His Government would continue renegotiating its debt with commercial banks, and would try also to find solutions, at the political level, to the problems posed by unfavorable trade trends. The President added that all the recent increases in Brazil's exports were being used for servicing its external debt, and not for increasing imports to the level required for dealing with the country's economic and social problems.

September 15, 1986

5. Mr. Conable asked whether there were any problems affecting the implementation of the Bank's program for Brazil. Mr. Sarney and Minister Sayad said that there were no major problems. Mr. Sayad added that the Government hoped that the existing obstacles to cofinancing operations would be overcome soon by the joint action of Brazil and the Bank. He also said that the Government would like to see an increase in the number of Brazilian staff members in the Bank. Mr. Conable replied that he would welcome suggestions of names of qualified Brazilians for this purpose.

6. Mr. Conable said that, while Brazil's economic program seemed to be on the right track, there was a need to relax the price freeze to avoid distortions in the country's economy. He also asked for the Government's views concerning the possibility of increasing power tariffs. President Sarney said that the Cruzado Plan in general, and the price freeze in particular, had been necessary to change expectations determined by many years of inflation. Minister Sayad indicated that, while the price freeze might be modified, price controls would continue to be necessary. He added that the tariff issue would be considered later.

7. Minister Sayad said that Brazil would support the increase of the Bank's capital, and that it would participate in such an increase.

8. The meeting ended with President Sarney thanking again Mr. Conable for his visit, and for the support being provided by the Bank to Brazil.

cc: ~~Mr.~~ Conable's Office
Messrs. Stern, EXC
Knox, LAC
Gue, LC2 (o/r)
Quijano, Mirza (LAC)
Voyadzis, LC2

RGonzalezCofino:nev

OFFICE MEMORANDUM

DATE: September 9, 1986

TO: Mr. Barber B. Conable
(through Mr. Ernest Stern) *ES*

FROM: A. David Knox *AK*

EXTENSION: 75901

SUBJECT: BRAZIL - Your September 10 Meeting with President Jose Sarney

I would like to add the following paragraph to my September 3 briefing memorandum.

6. The Government of Brazil is now preparing a comprehensive National Environmental Program. We have just been informed by the Planning Ministry that President Sarney will announce later this month the main objectives of the Program. The authorities have also indicated that they would welcome the technical and financial support of the Bank for this purpose. I suggest that you: (a) ask President Sarney for his views on these matters; (b) underscore the importance that you attach to environmental issues; and (c) tell the President that the Bank would be prepared to support his Government efforts in this area.

RGonzalezCofino:nev

OFFICE MEMORANDUM

DATE: September 3, 1986

TO: Mr. Barber B. Conable

(through Mr. Ernest Stern) *ES* - see note, p. 2

FROM: A. David Knox *AM*

EXTENSION: 75901

SUBJECT: BRAZIL - Visit of President Jose Sarney

1. You will meet with Mr. Jose Sarney, President of Brazil, on Wednesday, September 10, 1986, at 4:50 p.m. The meeting, a short courtesy visit, will take place in the Presidential Suite of the Willard Hotel. President Sarney will be accompanied by Joao Sayad, Minister of Planning, and two officials from the Ministry of Foreign Affairs. (The President's and Minister's biographies are included in Attachment 2.) An economic update of the Government's stabilization program and the issues likely to be raised during your meeting are given below.

Economic Background

2. Since the recession in 1981-83 Brazil has begun to grow rapidly again, with an 8.3% real increase in GDP registered in 1985 and only slightly less expected this year. Its external adjustment program has resulted in trade surpluses of US\$12-13 billion a year, more than enough to service the interest on its US\$100 billion external debt. 1986 has seen substantial internal adjustment through the Cruzado Plan, with inflation being brought down from 14% per month in February to about 1% per month since then. This relative price stability has brought the Government of President Sarney unprecedented popularity. In recent months, however, popular support has declined somewhat, owing mainly to the scarcity of some food items.

3. The challenge for the Government now is to move away from the extensive controls which were needed to stop inflation quickly, without causing inflation to reignite and growth to falter. The price freeze is becoming more difficult to enforce. Capacity constraints are evident at the present high level of consumer demand, and there is skepticism arising about the Government's ability to hold to its fiscal deficit target of 2.5% of GDP in this election year. Recent measures to prevent the economy overheating include the imposition of taxes and compulsory loans on selective automobile and travel expenditures. Although distortions are emerging and doubts are growing, the Government seems determined to maintain the freeze, including the fixed exchange rate, at least to February 1987. If the freeze is maintained for much longer, it is likely to become an obstacle for achieving long-term efficient growth.

Issues to be Discussed

4. President Sarney may inquire about the level and type of assistance which the Government can expect from the World Bank. Bank lending to Brazil in FY86 was US\$1.62 billion. You may wish to indicate that future lending could be maintained at FY86 levels, and perhaps

reach as much as US\$2 billion per year provided that the Government completes a macro-economic framework for sustained growth and price stability, and timely and appropriate decisions are taken by the Government on project-related issues. (The proposed lending program for FY87-90 is given in Attachment 1.) The Bank's ability to help the Government with possible co-financing also depends on the availability of an acceptable medium-term economic program.

5. A macro-economic issue of particular concern to the Bank is the need for a Government strategy to gradually remove price controls. The present price freeze, while an essential component of the Cruzado Plan to break inflationary expectations, is clouding the prospects for new investment. The timely disbursement of two large Bank loans approved at the end of FY86 also is dependent on flexible prices. Prolonging the current price freeze would preclude the freeing of the market for soybeans, soybean products, rice, cotton, and maize, a key feature of the Credit and Marketing Reform Loan, and would prevent the raising of electric power tariffs, an important part of the Power Sector Rehabilitation Loan.

Attachments

LYap/RGCofino:bm/cg-p/mhc

Essentially you should tell
the President that

- a) prolonged price controls do not work
- b) they are unnecessary if accompanied by appropriate fiscal and monetary policies
- c) While the Bank is prepared to lend \$2 billion per year, we will not be in a position to take such a lending package to the Board if the two large loans of last year are not made effective because of failure to act on prices and tariffs - action promised before the end of November.

ES
9/4

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: BRAZIL
OPERATIONS PROGRAM: FY86-90
AS OF END JULY 1986

SECTOR			FY86	FY87	FY88	FY89	FY90	FY86_90	
AGRICULTURE	PA131-CREDIT & MKTG.REFORM	L	500.0	.0	.0	.0	.0	500.0	
	PA149-UP&MULE SAO FRNCO IR	L	57.0	.0	.0	.0	.0	57.0	
	PA159-AGR EXTENSION II-A	L	155.0	.0	.0	.0	.0	155.0	
	PA208-IRRIG ENGINEERING-A	L	48.0	.0	.0	.0	.0	48.0	
	PA219-NE R/D V-PERNAMBUCO-	L	92.0	.0	.0	.0	.0	92.0	
	PA138-NE RURL DEVT BAHIA-C	L	.0	171.0	.0	.0	.0	171.0	
	PA148-AGR CREDIT-C	L	.0	300.0	.0	.0	.0	300.0	
	PA156-NE R/D IV-PIAUI-C	L	.0	78.0	.0	.0	.0	78.0	
	PA207-NE R/D VI-CEARA-C	L	.0	122.0	.0	.0	.0	122.0	
	PA220-NE R/D VII-MARANHAO-	L	.0	88.0	.0	.0	.0	88.0	
	PA229-NE IRR II-ITAPARICA-	L	.0	125.0	.0	.0	.0	125.0	
	PA212-NE R/D VIII ALAGOAS-	L	.0	.0	60.0	.0	.0	60.0	
	PA213-NE R/D IX-PAR'BA/MIN	L	.0	.0	135.0	.0	.0	135.0	
	PA179-LVSTK DISEASE CONT-B	S	.0	.0	50.0	.0	.0	50.0	
	PA206-AGRICULTURAL CREDIT	L	.0	.0	.0	300.0	.0	300.0	
	PA157-NE IRRIGATION-C	S	.0	.0	.0	70.0	.0	70.0	
	*SUB-TOTAL AGRICULTURE			852.0	884.0	245.0	370.0	.0	2351.0
	EDUC + PHN	PA152-NE BASIC HLTH SERV-A	L	59.5	.0	.0	.0	.0	59.5
		PA218-IND SKILLS VOC TRG-B	L	.0	100.0	.0	.0	.0	100.0
		PA225-NE ENDEMIC DISEASE C	L	.0	.0	75.0	.0	.0	75.0
PA151-EDUCATION SECTOR		L	.0	.0	.0	150.0	.0	150.0	
PA190-II NE BASIC HLTH SRV		L	.0	.0	.0	115.0	.0	115.0	
PA226-NW BRAZ MALARIA CTRL		S	.0	.0	.0	150.0	.0	150.0	
*SUB-TOTAL EDUC + PHN			59.5	100.0	75.0	415.0	.0	649.5	
ENERGY + POWER	PA205-ELEC POWER SEC I-A	L	500.0	.0	.0	.0	.0	500.0	
	PA137-ELEC PWR SEC (COFIN)	M	.0	.0	.0	.0	.0	.0	
	PA143-RURAL ELECTR II-B	L	.0	225.0	.0	.0	.0	225.0	
	PA211-ELEC PWR SCTR II-C	L	.0	300.0	.0	.0	.0	300.0	
	PA191-PWR SCTR III-C	L	.0	.0	350.0	.0	.0	350.0	
	PA161-RURAL ELECTRIFICATIO	S	.0	.0	.0	.0	200.0	200.0	
*SUB-TOTAL ENERGY + POWER			500.0	525.0	350.0	.0	200.0	1575.0	
INDUSTRY + IDF	PA228-IND RESTRUC TA-C	M	.0	15.0	.0	.0	.0	15.0	
	PA170-IND RESTR I1-D	L	.0	.0	350.0	.0	.0	350.0	
	PA186-NE SMLL & MED IND-C	L	.0	.0	200.0	.0	.0	200.0	
	PA189-IND TECH DEVT-B	L	.0	.0	100.0	.0	.0	100.0	
	PA142-FINAN. REFORM I-C	S	.0	.0	300.0	.0	.0	300.0	
	PA202-RURAL TELECOM-C	S	.0	.0	.0	280.0	.0	280.0	
	PA188-GRANDE CARAJAS DEVT	S	.0	.0	.0	.0	250.0	250.0	
	PA195-DEVT BANKING IV	S	.0	.0	.0	.0	200.0	200.0	
	PA196-NW SMALL & MED INDUS	S	.0	.0	.0	.0	200.0	200.0	
	PA217-IND RESTR III	S	.0	.0	.0	.0	400.0	400.0	
	*SUB-TOTAL INDUSTRY + IDF			.0	15.0	950.0	280.0	1050.0	2295.0
INFRASTRUCTURE	PA154-SALVADOR METRO DEVT-	L	55.0	.0	.0	.0	.0	55.0	
	PA185-STA CATARINA TOWNS-A	L	24.5	.0	.0	.0	.0	24.5	
	PA204-NE URBN RECON (FL'D)	L	100.0	.0	.0	.0	.0	100.0	
	PA153-URBN TRNSPRT IV-A	L	.0	200.0	.0	.0	.0	200.0	
	PA197-SAO PAULO HWY MGMT-B	L	.0	200.0	.0	.0	.0	200.0	
	PA194-WTR & SEWRGE SEC-B	L	.0	.0	250.0	.0	.0	250.0	
	PA203-FEPASA RAILWYS-B	S	.0	.0	100.0	.0	.0	100.0	
	PA165-FEEDER ROADS IV-D	L	.0	.0	.0	250.0	.0	250.0	
	PA166-NE RURAL WTR&SANIT-B	L	.0	.0	.0	100.0	.0	100.0	
	PA184-CERRADO TRANSPORT-D	L	.0	.0	.0	100.0	.0	100.0	
	PA163-PORTS II-C	S	.0	.0	.0	50.0	.0	50.0	
	PA155-WATER & SEWERAGE SEC	S	.0	.0	.0	.0	200.0	200.0	
	PA171-MEDIUM CITIES URBAN-	S	.0	.0	.0	.0	50.0	50.0	
	PA192-TRANSPORT SECTOR	S	.0	.0	.0	.0	275.0	275.0	
	PA222-METROPOLITAN DEV-B	S	.0	.0	.0	.0	100.0	100.0	
	PA223-NORTHEAST CITIES-B	S	.0	.0	.0	.0	150.0	150.0	
*SUB-TOTAL INFRASTRUCTURE			179.5	400.0	350.0	500.0	775.0	2204.5	
NON-PROJECT	PA181-PUB SCTR MGMT-A	L	29.0	.0	.0	.0	.0	29.0	
	PA183-FINANC REFORM II-D	L	.0	.0	.0	400.0	.0	400.0	

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: BRAZIL
OPERATIONS PROGRAM: FY86-90
AS OF END JULY 1986

SECTOR		FY86	FY87	FY88	FY89	FY90	FY86_90
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	*SUB-TOTAL NON-PROJECT	29.0	.0	.0	400.0	.0	429.0
	<u>*TOTAL BRAZIL</u>	<u>1620.0</u>	<u>1924.0</u>	<u>1970.0</u>	<u>1965.0</u>	<u>2025.0</u>	<u>9504.0</u>
RESERVE	PA147-AGR SECTOR III-C R	.0	250.0	.0	.0	.0	250.0
	PA201-NATURAL GAS-C R	.0	250.0	.0	.0	.0	250.0
	PA224-LOW INCOME WS & SEW- R	.0	50.0	.0	.0	.0	50.0
	PA139-RUBBER DEVT-D R	.0	.0	60.0	.0	.0	60.0
	PA140-EXPRT DEVT II-D R	.0	.0	300.0	.0	.0	300.0
	PA193-NE MEDIUM CITIES-B R	.0	.0	200.0	.0	.0	200.0
	PA209-MINAS GERAIS FRSTRY- R	.0	.0	20.0	.0	.0	20.0
	PA214-NE EDUCATION-C R	.0	.0	150.0	.0	.0	150.0
	PA227-IND POLLUTN CNTRL-C R	.0	.0	50.0	.0	.0	50.0
	PA150-EXP DEVT III-D R	.0	.0	.0	300.0	.0	300.0
	PA231-2ND FEDERAL HWY SCTR R	.0	.0	.0	300.0	.0	300.0
	PA215-EXPRT DEVT IV-C R	.0	.0	.0	.0	300.0	300.0

LAC REGION, OFFICE OF THE PROGRAM COORDINATOR
08/12/86
MMC:SELM8A

JOSE SARNEY

President, Federative Republic of Brazil

Jose Sarney is Brazil's first civilian president in 21 years. Originally vice-president, he became president following the death of President-elect Tancredo Neves in April 1985. He has enjoyed substantial popular support since the adoption of the Cruzado Plan in February 1986 to cut back inflation.

Originally part of the Social Democratic Party (PDS), as Senator from the state of Maranhao and then as president of the party, President Sarney is now a member of the Brazilian Democratic Movement Party (PMDB). He is also a major landowner, a published poet, and a member of the Brazilian Academy of Letters.

JOAO SAYAD

Minister of Planning

Joao Sayad, 40, has a PhD in economics from Yale University and was professor of economics at the University of Sao Paulo from 1968 to 1983. Prior to his appointment as Minister of Planning, he was Secretary of Finance for the State of Sao Paulo. As Minister of Planning, Mr. Sayad is Brazil's Governor in the Bank. Mr. Sayad was instrumental in the February 1986 economic reform and the preparation of the Plano de Metas, which seeks to define the longer-term Brazilian development strategy.

OFFICE MEMORANDUM

DATE: July 31, 1986

TO: Memorandum for the Record

FROM: Roberto Gonzalez Cofino, Chief, Brazil Division, LC2

EXTENSION: 72031

SUBJECT: BRAZIL - Mr. Conable's Meeting with the President of Brazil's Central Bank, Mr. Fernao Bracher

1. Mr. Conable met with Mr. Fernao Bracher on July 28, 1986, at 10:30 a.m. The meeting was also attended by Messrs. Antonio Seixas (Director of External Debt in the Central Bank); Jose Artur D. Medeiros (Minister-Counselor in the Brazilian Embassy); Eimar Avillez (Technical Assistant to the Bank's Executive Director representing Brazil); and Vibert, Sam and Gonzalez Cofino.
2. Mr. Conable started the meeting by welcoming Mr. Bracher, and by asking for his views on Brazil's current situation and on Bank assistance to his country. Mr. Bracher described the fiscal measures adopted last week by the Government, which are expected to yield about 1.5%-2.0% of GDP in additional revenues and "compulsory loans". This should make it possible, in his view, to reduce the fiscal deficit substantially; finance additional public and private investments; and reduce monetary expansion. Moreover, inflation is being kept below 1% per month; economic growth remains strong; and the trade surplus is still among the four largest in the world.
3. In Mr. Bracher's view, the main problem faced by Brazil is the large amount of medium-term debt contracted in the late 1970s and early 1980s to finance large investment projects which required long execution periods. When the commercial banks stopped its voluntary lending in 1982, it became necessary for Brazil to reschedule its debt payments. Now the Government would like to explore actively the possibility of having again normal access to the international capital markets. For that purpose, Mr. Bracher thought that Brazil would need the support of the Bank through cofinancing arrangements with commercial banks.
4. Mr. Conable referred to the requirements that would have to be met for making it possible to use the Bank's cofinancing instruments, including the availability of an appropriate economic policy framework, a clear view of the likelihood and implications of future debt reschedulings, and the normalization of Brazil's relations with the Paris Club and the IMF. At Mr. Conable's request, Mr. Gonzalez Cofino described these requirements in more detail, including, in particular, the characteristics of the economic policy framework that would provide the basis for approaching the commercial banks. Concerning the IMF, he referred to the need to clarify as soon as possible when the pending Article 4 Consultations would be undertaken.

July 31, 1986

5. Mr. Bracher said that the Government is willing to discuss with the Bank the required economic policy framework; that they would welcome the Article 4 Consultations with the Fund in the near future; and that the only reason why the relations with the Paris Club are not fully normal yet is the insistence of the creditors in a formal IMF arrangement--a requirement that Brazil will not be willing to meet in the foreseeable future. He also thought, however, that the current Brazilian economic program should be acceptable to the Fund, to the bilateral creditors, and to the commercial banks. He repeated his request for Bank assistance in mobilizing resources from commercial banks, and asked also for Mr. Conable's personal help vis-a-vis the international financial community.

6. Mr. Conable confirmed the Bank's willingness to assist Brazil in these matters, provided that the country's economic performance and policies continue to provide an adequate basis for doing so. It was agreed that Mr. Bracher and his advisors would continue these discussions with the Bank's Cofinancing Task Force on Brazil.

cc: Messrs. Stern (o/r)
Knox (o/r)
Gué, LC2 (o/r)
Steckhan, LC1
Vibert, VPCAU
Sam, EXC
Quijano, LAC
Toft, LEG
Rajasingham, FPAMA
Dolenc, LAC

RGonzalezCofino:nev

OFFICE MEMORANDUM

DATE: July 25, 1986

TO: Mr. Barber B. Conable

(through Mr. Willi A. Wapenhans, Acting Senior Vice President, Operations)

FROM: Suitbertus M. L. van der Meer, Acting Regional Vice President, LAC

EXTENSION: 75906

SUBJECT: BRAZIL - Visit of Central Bank President, Mr. Fernao Bracher

1. On Monday, July 28, 1986, you will meet with Mr. Fernao Bracher (see Attachment 1 for biodata). Mr. Bracher will probably be accompanied by Messrs. Sergio Correa de Costa, Brazil's Ambassador to the United States; and Antonio Seixas, Director of External Debt in the Central Bank. Messrs. Vibert and Gonzalez Cofino will attend from the Bank. The following paragraphs provide information on developments which have taken place since you met Minister Sayad on July 15; and identify the issues likely to be discussed during your meeting with Mr. Bracher.

Recent Developments

2. The Government announced last night some important policy decisions, including, inter alia:

- (a) a substantial increase in the tax on the yield of short-term financial assets (with maturities of up to 2 months) and a reduction in the tax on the yield of longer-term paper;
- (b) a 25% tax on international air travel, and on foreign exchange sold to tourists going abroad;
- (c) increases in the prices of gasoline and alcohol (25%); new cars (30%); and used cars (10% to 20%). The price increases were described yesterday by President Sarney as "compulsory loans" from consumers, who will be given 3-year Government bonds for amounts equivalent to the extra cost of their purchases of these items;
- (d) establishment of a National Development Fund, which would collect most of the additional resources referred to above, and would lend them to private and public enterprises, to finance productive investments; and
- (e) an increase of 10% in taxi fares.

3. We have not received yet all the information required to evaluate these measures fully, but it seems clear that they will reduce the fiscal deficit substantially, while also helping finance additional productive investments. Moreover, these decisions constitute the first modification of the price freeze introduced last February.

4. Another important development: the Government and the foreign commercial banks will sign today the agreement negotiated last March for the rescheduling of the debt repayments which were due in 1985.

Issues

5. Mr. Bracher is likely to tell you that Brazil is now ready to approach the commercial banks to obtain cofinancing linked to the recently approved Power Sector Loan, and that they would like to have the support of the Bank for this purpose. As we did in the occasion of Mr. Sayad's visit, we suggest that you confirm to Mr. Bracher that the Bank is most willing to help in this respect, but that the form and timing of our assistance will depend upon several factors, including:

- (a) the normalization of Brazil's relations with the Paris Club;
- (b) the medium-term strategy that Brazil will adopt vis-a-vis the commercial banks, including the country's position concerning a possible multi-year rescheduling agreement; and
- (c) the timing of the agreement between Brazil and the Bank on a medium-term economic policy framework. (The Government has accepted the advisability of reaching such agreement, but further discussions with them in this respect have been postponed pending the completion by the Government of the updating of its economic program; we plan to continue these discussions in Brasilia later this summer).

As to (a) and (b), we also believe that improving relations with the IMF, possibly by carrying out the usual Article 4 Consultations, would help with both the Paris Club and the banks.

6. We suggest that you also ask Mr. Bracher for his views on:

- (a) the policy decisions adopted yesterday (see para. 2 above); and
- (b) the possibility of the approval in the near future of some other important measures (such as the administrative reform mentioned by Mr. Sayad during his July 15 meeting with you).

Attachment

cc: Messrs. Stern (o/r)
Knox (o/r)
Gue, LC2 (o/r)
Vibert, VPCAU
Sam, EXC

RGonzalezCofino:nev

ATTACHMENT

FERNAO BRACHER

Mr. Fernao Bracher, 51, was appointed President of the Central Bank of Brazil in August 1985, taking over from Mr. Antonio Carlos Lemgruber at the same time as Mr. Dilson Funaro succeeded Mr. Dornelles as Minister of Finance. Mr. Bracher is an experienced Sao Paulo banker, without close political affiliations but respected in PMDB (the ruling party) circles. He was a director of Banco da Bahia from 1961 to 1973 and joined the directorate of BRADESCO (Brazil's largest private sector bank) when the former was taken over by BRADESCO. From 1974 to 1979 he was Director of the External Area of Banco Central, and on return to BRADESCO became executive vice-president for its security operations and, in 1981, international operations. His education (in law) was received at the University of Sao Paulo and the University of Freiburg in West Germany.

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OFFICE MEMORANDUM

DATE: July 17, 1986

TO: Memorandum for the Record

FROM: Roberto Gonzalez Cofino, Chief, Brazil Division, LC2

EXTENSION: 72031

SUBJECT: BRAZIL - Mr. Conable's Meeting with Brazil's Planning Minister
Mr. Joao Sayad

1. Mr. Conable met with Minister Sayad on July 15, 1986 at 3:00 p.m. The meeting was also attended by Messrs. Ivo Pereira (Planning Ministry); Luiz Felipe Lampreia (Planning Ministry); Eimar Avillez (Technical Assistant to the Bank Executive Director representing Brazil); and Stern, Knox, Stanton, Sam and Gonzalez Cofino.
2. After discussing briefly the signing, earlier the same day, of five Bank loans for Brazil, Mr. Conable asked for Mr. Sayad's views on how the Bank should help his country in the future. Mr. Sayad said that, in addition to further Bank loans, his Government wished to have the support of the Bank for obtaining cofinancing from commercial banks. Brazil attached the highest priority to this possibility and intended to have a small group of Government officials come to Washington in the near future to work with Bank staff in designing a strategy on how to proceed for mobilizing commercial banks' resources. Mr. Conable said that the Bank welcomed Brazil's interest in using the Bank's cofinancing instruments, and that we would be willing to consider ways to help in this respect.
3. Mr. Sayad indicated that he had also discussed the possibility of utilizing the World Bank cofinancing instruments with Messrs. Volcker (Federal Reserve), Whitehead (U.S. State Department), and Darman (U.S. Treasury). These U.S. officials had indicated that the possible multi-year rescheduling of Brazil's foreign debt, and the Paris Club situation, were issues that had to be dealt with in connection with the mobilization of new money from commercial banks. Mr. Sayad added that, in his Government's view, the Paris Club creditors had accepted Brazil's decision to pay 15% of its arrears and to pay in full all future interest.
4. Mr. Stern asked what economic measures were being considered as a follow-up to the "Cruzado Plan". Mr. Sayad said that the adoption of the "Cruzado Plan" had been accompanied by a substantial expansion of domestic demand, which now has to be slowed down. He added that the price freeze had posed no major problems up to now. Beef was the only item in short supply, and this was due to other causes. The price freeze would be phased out gradually in the future. The Government, however, did not intend to announce in advance how and when it would do so, because this would cause immediate disruptions in the market. Messrs. Conable and Stern said that it would be advisable not to maintain the price freeze for too long a period.

July 17, 1986

5. Mr. Sayad then referred to other policy actions that are likely to be adopted in the near future. They included: (a) the creation, by late July, of long-term financial instruments, with fluctuating interest rates; (b) the adoption of a comprehensive Public Sector Administrative Reform Program, which would comprise the rehabilitation of state enterprises and the reform of the Government Administration; (c) the partial privatization of some public enterprises (although the Government would retain control of, inter alia, power, steel and oil enterprises); (d) changes in fiscal incentives; and (e) the approval of a 5-year plan that would include, inter alia, targets for agricultural and industrial policy, and for investments in power, transportation, water and sewerage, and steel. In answering Mr. Conable's questions, Mr. Sayad clarified that the Government did not intend to start new steel investments but, rather, to complete projects being built, and to rehabilitate financially the steel state enterprises.

6. Concerning public finances, Mr. Sayad said that the overall deficit of the Federal State Enterprises would be zero this year, although there would be a Government equity investment of about \$1 billion in the Power Sector companies. The efforts to reduce the Federal Government deficit were, however, constrained by the fact that interest payments were now equivalent to 50% of tax revenues. The Government was nevertheless committed to reduce such deficit.

7. Mr. Conable gave Mr. Sayad a letter on MIGA, indicating that it would be very good if Brazil could find it possible to join MIGA in the immediate future. Mr. Sayad said that his Government would give careful consideration to the possibility of doing so.

8. Mr. Sayad invited Mr. Conable to visit Brazil in the near future. Mr. Conable said that he would do so, at a date to be fixed later.

9. Finally, Mr. Sayad said that his Government considered as very important the support being provided to Brazil by the Bank. Mr. Conable assured him of the Bank's intention to continue providing such support.

cc: Messrs. Stern
Knox
Gué, LC2 (o/r)
van der Meer, LCP
Stanton, EXC
Sam, EXC
Quijano, LAC

RGonzalezCofino:nev

OFFICE MEMORANDUM

DATE: July 10, 1986

TO: Mr. Barber B. Conable
(through Mr. Ernest Stern) *es*

FROM: A. David Knox *AK*

EXTENSION: 75901

SUBJECT: BRAZIL - Visit of Planning Minister Joao Sayad

1. On Tuesday, July 15, 1986, at 3:00 p.m., you will meet with Mr. Joao Sayad (see Attachment 1 for biodata). Mr. Sayad will be accompanied by Mr. Sergio Correa da Costa, Brazil's Ambassador to the United States, and Mr. Luiz Felipe Lampreia, head of the Secretariat of International Affairs of the Planning Ministry. The following paragraphs provide some background on the country's political and economic situation, and on its relations with the Bank; and identify the issues likely to be discussed during your meeting with Mr. Sayad.

Political Background

2. Following 21 years of military rule, a civilian president, Mr. Tancredo Neves, was elected in January 1985. This completed the transition, started two years earlier, to a democratic regime, re-establishing the authority of elected Federal and State representatives throughout Brazil. Mr. Neves, however, became ill and unable to take office, and died in April 1985. Vice President Jose Sarney then became President. He spent his first months in office consolidating his power, and considering several policy options for dealing with inflation and with other serious economic issues. Popular support for the Sarney Government increased substantially after the adoption, in early 1986, of the economic reforms referred to below.

Economic Background

3. Brazil achieved remarkable economic growth rates in the 1967-80 period, averaging 11% per year in 1967-73 and 7% per year in 1974-80. After 1974, however, growth was accompanied by the introduction of substantial distortions in the economic structure--increasing credit and fiscal subsidies, rising import barriers, artificially low domestic agricultural prices, inefficient and rapid growth of state enterprises, accelerating inflation--and by heavy borrowing from foreign commercial banks. By 1980, inflation had reached 110% per year and foreign debt about US\$70 billion. By 1984, inflation had exceeded 200% and foreign debt US\$100 billion.

4. While the distortions referred to above were serious, and had to be corrected, the economic growth achieved in the 1960s and 1970s had been healthier than in most Latin American countries. The realistic exchange rate which prevailed during most of those years, and the large size of the domestic market, facilitated the emergence of a relatively efficient production structure, in industry and agriculture. After 1983, when the

Government adopted a substantial adjustment program, supported by the Fund and the Bank, the economy's response was quick and far-reaching. The country's foreign trade account (which had been negative until 1980 and showed a surplus of only US\$900 million in 1982) has registered surpluses of US\$12-13 billion per year since 1984. After the 1981-83 recession, the economy started to recover, growing about 4.5% in 1984 and 8% in 1985. But, in spite of some degree of fiscal and monetary restraint, inflation remained over the 200% level, owing mainly to the widespread indexation of wages and prices. And some important structural adjustment measures were still needed to ensure long-term growth.

5. In January and February of 1986, the Government adopted two very important reforms: (a) the termination of a long-used scheme which had allowed the main official financial institutions (the Central Bank and the Bank of Brazil) to become virtually unrestricted sources of fiscal deficit financing; and (b) the "Cruzado Plan", which eliminated indexation, established temporary price and wage controls, created a new monetary unit (the "cruzado") and included several other measures directed towards controlling the fiscal deficit and reforming the country's financial system. Later on, in May and June, the Government decided (with the support of Bank loans) to reduce agricultural credit subsidies substantially; liberalize trade of agricultural products (in late 1986 or early 1987); and adopt a comprehensive public sector reform which includes, inter alia, a program for the rehabilitation and privatization of state enterprises.

6. The initial results of the "Cruzado Plan" have been positive: inflation has come down from a monthly rate of about 15% until February to less than 1%, on the average, for the March-May period, while economic growth has continued, apparently at an annual rate of about 6-7%. Over the longer term, the success of the Plan will depend, inter alia, on the ability of the Government to control the fiscal deficit; on the relaxation of the temporary price controls, without undue delays and without causing a renewed acceleration of inflation; and on the growth of private investment, particularly in industry and agriculture.

Bank Relations with Brazil

7. Bank lending to Brazil, which had averaged less than US\$1 billion per year until FY83, increased to about US\$1.5 billion annually in FY84-85, and to over US\$1.6 billion in FY86. During the last four years, the Bank, and to a much lesser extent the Inter-American Development Bank, have become the only sources of new "voluntary" long-term external financing available to Brazil. This increased assistance has been based upon a comprehensive economic policy dialogue, which has become particularly intensive since the new Government took office in 1985.

8. The Bank lending program for the FY87-90 period is expected to remain in the US\$1.5-2.0 billion range. The possibility of reaching the US\$2.0 billion per year level--envisaged in the current program shown in Attachment 2--would depend upon continuing progress by the Government in the implementation of the ongoing economic program and in the adoption of additional structural reforms. The most important next step in this

respect is likely to be an additional reform of the country's financial system, which would be supported by a FY88 Bank loan. (This loan could be advanced to FY87 if the Government adopts soon the required decisions.) Other possible policy reform areas, which could also be supported by Bank loans, include trade policy reform and additional measures in the agricultural policy area and in the reform and privatization of state enterprises.

9. The Government has also indicated its desire to have the Bank play a leading role in helping Brazil regain a normal access to international capital markets. The Bank has answered that it is willing to do so, provided that the issues referred to in para. 11 below are effectively dealt with.

Issues to be Discussed with Mr. Sayad

10. Mr. Sayad is likely to confirm his Government's interest about the operations included in our FY87-88 lending program, including, in particular, the proposed loans for the power sector, irrigation, rural development in the Northeast region, urban transport, industrial technology, financial reform and export development. I suggest that you tell him that the Bank is working on all these projects and is willing to finance them, provided that the Government adopts the required decisions. Such decisions would be particularly important for two possible policy-based loans: (a) the financial reform loan where decisions would be needed concerning, inter alia, the increase in efficiency of the Bank of Brazil, the creation of long-term financial instruments, and the further reduction of the segmentation of credit markets; and (b) the possible export development loan, which would have to be based on a liberalization of Brazil's foreign trade policy.

11. Mr. Sayad is also likely to ask for Bank assistance in obtaining cofinancing for the power sector project approved last month, and for helping Brazil to re-enter the international capital markets in other ways. I suggest that you confirm to him that the Bank is most willing to help in this respect, but that the form and timing of our assistance will depend upon several factors, including:

- (a) the normalization of Brazil's relations with the Paris Club;
- (b) the medium-term strategy that Brazil will adopt vis-a-vis the commercial banks, including the country's position concerning a possible multi-year rescheduling agreement; and
- (c) the timing of the agreement between Brazil and the Bank on a medium-term economic policy framework. (The Government has accepted the advisability of reaching such agreement, but further discussions with them in this respect have been postponed pending the completion by the Government of the updating of its economic program; we plan to continue these discussions in Brasilia later this summer).

don't say that, it's unnecessary.
ES

The basic point is - we cannot help Brazil go to the market as long as they have not decided against a further rescheduling. As long as that loans no one will sign up for new lending in 1986, only to have it rescheduled in 1987.

ES

July 10, 1986

As to (a) and (b), we believe that improving relations with the IMF, possibly by carrying out the usual Article 4 Consultations, would help with ~~both the Paris Club, and the banks.~~

12. I suggest that you ask Mr. Sayad for his views on the issues referred to in the prior paragraph. In doing so, you may add that some of them are also important in connection with the consideration by our Board of future large loans for Brazil. For instance, several Executive Directors indicated last month that they would not support in the future such large loans unless satisfactory overall agreement is reached between Brazil and the Paris Club. Likewise, the Board presentation of future policy-based loans would require prior agreement on the medium-term economic policy framework referred to above.

Attachments

cc: Mr. Gué, LC2

RGonzalezCofino:nev

JOAO SAYAD

Joao Sayad, 40, has a PhD in economics from Yale University and was professor of economics at the University of Sao Paulo from 1968 to 1983. At that time he left to become Secretary of Finance for the State of Sao Paulo under Governor Franco Montoro. In March 1985 he was appointed Minister of Planning by President Elect Tancredo Neves. As Minister of Planning, Mr. Sayad is Brazil's Governor in the Bank. Mr. Sayad was instrumental in the preparation of the 1986-90 National Development Plan as well as the February 1986 economic reform.

BRAZIL - LENDING PROGRAM: FY86-90
(As of End-June 1986)

PROJECT	(in US\$ millions)					FY86-90 TOTAL
	FY86 ACTUAL	FY87	PROJECTED		FY90	
<u>AGRICULTURE</u>						
Credit & Marketing Reform	500.0					500.0
Northeast Irrigation - Sao Francisco	57.0					57.0
Agricultural Extension II	155.0					155.0
Irrigation Engineering	48.0					48.0
Northeast Rural Development (Pernambuco)	92.0					92.0
Northeast Rural Development (Bahia)		171.0				171.0
Agricultural Credit		300.0				300.0
Northeast Rural Development (Piaui)		78.0				78.0
Northeast Rural Development (Ceara)		122.0				122.0
Northeast Rural Development (Maranhao)		89.0				89.0
Northeast Irrigation - Itaparica		125.0				125.0
Northeast Rural Development (Alagoas)			60.0			60.0
Northeast Rural Dev't. (Minas Gerais/Paraiba)			140.0			140.0
Livestock Disease Control (S)			50.0			50.0
Agricultural Credit				300.0		300.0
Northeast Irrigation (S)				70.0		70.0
SUB-TOTAL	852.0	885.0	250.0	370.0	0	2,357.0
<u>EDUCATION & POPULATION, HEALTH & NUTRITION</u>						
Northeast Basic Health Services	59.5					59.5
Industrial Skills Vocational Training		100.0				100.0
Northeast Endemic Disease Control			75.0			75.0
Education Sector				150.0		150.0
Second Northeast Basic Health Services				115.0		115.0
Northwest Malaria Control (S)				150.0		150.0
SUB-TOTAL	59.5	100.0	75.0	415.0	0	649.5
<u>ENERGY & POWER</u>						
Electric Power Sector I	500.0					500.0
Electric Power Sector (Cofinancing)		0				0
Rural Electrification II		225.0				225.0
Electric Power Sector II		300.0				300.0
Power Sector III			350.0			350.0
Rural Electrification III (S)					200.0	200.0
SUB-TOTAL	500.0	525.0	350.0	0	200.0	1,575.0
<u>TECHNICAL ASSISTANCE</u>						
Public Sector Management	29.0					29.0
Industrial Restructuring I		15.0				15.0
SUB-TOTAL	29.0	15.0				44.0

BRAZIL - LENDING PROGRAM: FY86-90
(As of End-June 1986)

PROJECT	(in US\$ millions)					FY86-90 TOTAL
	FY86 ACTUAL	FY87	FY88 PROJECTED	FY89	FY90	
<u>INDUSTRY AND FINANCIAL REFORM</u>						
Industrial Restructuring II			350.0			350.0
Northeast Small & Medium Industry			200.0			200.0
Industrial Technical Development			100.0			100.0
Financial Reform I (S)			300.0			300.0
Financial Reform II				400.0		400.0
Rural Telecommunications (S)				280.0		280.0
Grande Carajas Development (S)					250.0	250.0
Development Banking IV (S)					200.0	200.0
Northwest Small & Medium Industry (S)					200.0	200.0
Industrial Restructuring III (S)					400.0	400.0
SUB-TOTAL	0.	0.	950.0	680.0	1,050.0	2,680.0
<u>INFRASTRUCTURE</u>						
Salvador Metropolitan Development	55.0					55.0
Santa Catarina Towns	24.5					24.5
Northeast Urban Reconstruction	100.0					100.0
Urban Transport		250.0				250.0
Sao Paulo State Highway		200.0				200.0
Water and Sewerage Sector			250.0			250.0
FEPASA Railways			100.0			100.0
Feeder Roads IV				250.0		250.0
Northeast Rural Water and Sanitation				100.0		100.0
Cerrado Transport				100.0		100.0
Ports II (S)				50.0		50.0
Water and Sewerage Sector (S)					200.0	200.0
Medium Cities (S)					50.0	50.0
Transport Sector (S)					275.0	275.0
Metropolitan Development (S)					100.0	100.0
Northeast Cities (S)					150.0	150.0
SUB-TOTAL	179.5	450.0	350.0	500.0	775.0	2,254.5
TOTAL	1,620.0	1,975.0	1,975.0	1,965.0	2,025.0	9,560.0

(S) means standby project, or a project which can be advanced to a preceding year.

Note: The lending program above excludes reserve projects which are currently under preparation, and which could be included in the lending program to replace projects that are dropped. Reserve projects include a second export development loan; a third agricultural sector loan; loans for natural gas, forestry and water supply; loans for education and urban development in the Northeast; and a loan for industrial pollution control.

July 9, 1986