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The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
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McNamara Papers

Travel

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BRAZIL

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LATIN AMERICA - GENERAL

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BRAZIL

10/22/68 President Arthur da Costa e Silva
(Rio)

10/23/68 Luncheon hosted by Finance Minister Netto - list attached
(Rio)

" Mario Andreatza, Minister of Transport
Col. Ajace, Deputy Minister
Mr. Rezende, head of the Federal Highways Department
Col. Arujo, head of GEIPOT (Government vgtncy supervising the
Transport Survey)

" Jayme Magrassi Sa, President of BNDE

" Jose Costa Calvancanti, Minister of Mines and Energy
Mario Bhering, head of Electrobras
John Cotrim, President of Furnas

" Dr. Octavio Rodriguez Lima, leading gynecologist

10/23/68 Nilo de Soufa Coelho, Governor of Parnambuco State
(Recife)

10/24/68 Euler Bentes, Head of SUDENE
(Recife)

10/24/68 Luiz Viana, Governor of the State of Bahia
(Bahia) Angelo Sa, Industrial Secretary of the State

10/25/68 Lelio Toledo Piza, President, State Bank of Sao Paulo
(Sao Paulo) Gastao Vidigal, President of the Banco Mercantil, Sao Paulo
Walter Lorch, President of a trucking firm, Sao Paulo

" Abreu Sodre, Governor, State of Sao Paulo
Luis Arrobas Martins, State Secretary of Finance
Herbert Levy, Secretary of Agriculture
Eduardo R. Yassuda, Secretary of Public Works
Firmino Rocha de Freitas, Secretary of Transport
Lucas Nogueira Gareez, President of CESP (largest power company in
the State)

" Rubens vaz da Costa, President, BNB (Bank of the Northeast)

" Roberto Campos, former Minister of Planning

" Julio Mesquita, Editor of Estado de Sao Paulo

10/26/68 Delfim Netto, Finance Minister
(Rio) Ernane Galveas, President, Central Bank
Paulo Lyra, President of the Banco do Brasil
Vilar de Queiroz, principal assistant of the Minister

" Helio Beltrao, Minister of Planning
Mr. Velloso, Deputy Minister of Planning

10/26/68 Roberto Marinho, Editor of O Globo
(Rio)

" Augusto de Azevedo Antunes, industrialist

" Candido Mendes de Almeida, lawyer and political scientist; visiting
 lecturer at Harvard, Columbia and other universities

" Mario Simonson, Vargas Foundation

" Luiz Ganzaga do Nascimento Silva, former Minister of Housing

" Nascimento Brito, Journal do Brasil

*original + 127 in
out of book*
~~Mr. McNamara - for your early consideration, please.~~

RBS 10/14

Proposed Schedule for Mr. McNamara's Trip to Brazil
(October 14, 1968 edition)

Tues. Oct. 22 Arrive Rio on AR 130. ^(20.30) Proceed to Copacabana Palace for private dinner and rest.

Wed. Oct. 23 10:00 Call on Minister of Interior, Albuquerque Lima.
11:00 Call on Minister of Transport, Mario Andreazza.
12:00 Call on President of BNDE, Magrassi Sa.
13:15 Lunch hosted by Minister of Finance for various Cabinet members and heads of agencies which are past or prospective IBRD borrowers.
After lunch presumably return to hotel for brief rest and checking out.
16:00 Call on President with subsequent loan signing *and release?* followed by ~~brief press conference.~~ *statement to press*
17:30 Leave Presidential Palace for Galeao Airport.
18:45-21:15 Presidential plane for Recife (111 Jet).
Dinner on plane.
Night at Grande Hotel.

Thurs. Oct. 24 07:00 Check out of hotel.
07:30 Call on Euler Bentes, Head of SUDENE.
09:15 Visit Port of Recife for 30 minutes and drive straight to airport.
10:30-12:40 SUDENE plane to Petrolina.
12:50-16:30 Visit to Sao Francisco Irrigation project (Juazeiro) and lunch hosted by Governor of State of Pernambuco, Nilho Coelho.
16:35-18:15 SUDENE plane to Salvador.
19:00 Check into Plaza Hotel.
20:00 Call on Governor of Bahia, Luiz Viana.
Dinner in private. Night at Plaza Hotel.

Fri. Oct. 25 8:00-9:00 Receive at hotel, Rubens Vaz da Costa, President of Banco do Nordeste. Then check out of hotel.

9:15-12:00 Visit Industrial Park of Aratu.

12:30-14:30 Jet lll to Sao Paulo. Lunch on plane.

15:30-16:00 Call on Governor of State of Sao Paulo, Abreu Sodre.

16:45 Arrive Hotel Jaragua.

17:30-18:30 Receive Julio Mesquita (Editor of Estado de Sao Paulo) for tea. 1/ 2/

19:00-20:00 Cocktails for Messrs. Klabin, Vidigal, Lorch and Toledo Piza.

20:30 Private dinner hosted by Mr. McNamara at hotel for Roberto Campos. Night at Hotel Jaragua.

Sat. Oct. 26 08:00 Check out of hotel.

08:45-09:45 Presidential plane (jet) to Rio (Galeao). (Earlier takeoff doubtful owing to normally prevailing morning fog.) *(Delfim Neto)*

^{11:00}
11:00-~~12:30~~ Joint Meeting at Ministerio da Fazenda with Minister of Finance *(Delfim Neto)* and Minister of Planning (Helio Beltrao). *(meeting with)*

^{14:00-14:30}
13:00 Lunch with these two Ministers and President of Central Bank (Galveas).

15:15 Check into Copacabana Palace Hotel.

16:00-20:40 Receiving intellectuals and thought leaders as follows:

16:00-16:30 Mario Simonson 1/, Vargas Foundation

16:40-17:10 Jose Sette Camara 1/, Director of Journal do Brasil

17:20-17:50 Luiz Ganzaga do Nascimento Silva 1/

18:00-18:30 Dr. Octavio Rodriguez Lima (tentative) 1/

18:40-19:10 Prof. Candido Mendes Almeida (Braz. Society for Instruction) 1/

^{19:20-19:40}
19:20-19:40 Augusto Antunes

^{19:50-20:10}
~~19:50-20:10~~ Octavio Bulhoes

^{20:20-20:40}
~~20:20-20:40~~ Roberto Marinho (Editor of O Globo) 2/

1/ Assuming that he will prefer seeing Mr. McNamara at the hotel rather than his office.

2/ Interpreter to be present.

Tues. Oct. 22 20:30 Arrive Rio on AR 130. Proceed to Copacabana Palace for private dinner and rest.

Wed. Oct. 23 9:30-10:30 *check out Plaza* Call on Minister of Interior, Albuquerque Lima. *President of Banco Costa Cardenero. Phering. Pres of Sudec. Estrem. - L...*

11:00-11:45 Call on Minister of Transport, Mario Andreatza.

12:00-12:45 Call on President of BNDE, Magrassi Sa.

13:15-14:45 Lunch hosted by Minister of Finance for various Cabinet members and heads of agencies which are past or prospective IBRD borrowers. *+ some of them*

15:45 *own Plaza* After lunch presumably return to hotel for brief rest and checking out.

16:00-16:30 Call on President with subsequent loan signing and release of statement to press.

16:30-17:30

17:30-18:30 Leave Presidential Palace for Galeao Airport.

18:45-21:15 Presidential plane for Recife (111 Jet). Dinner on plane.

21:30 *20:50* Night at Grande Hotel.

Thurs. Oct. 24 07:00-07:30 Check out of hotel.

07:30-9:00 Call on Euler Bentes, Head of SUDENE. *Pres of Sudec Prog + prospective IBRD project*

09:15-10:00 Visit Port of Recife for 30 minutes and drive straight to airport.

10:30-12:40 SUDENE plane to Petrolina.

12:50-16:30 *13:50* Visit to Sao Francisco Irrigation project (Juazeiro) and lunch hosted by Governor of State of Pernambuco, Nilho Coelho. *14:00-16:30*

16:35-18:15 SUDENE plane to Salvador.

19:00 Check into Plaza Hotel. *Place*

20:00-20:30 *20:30* Call on Governor of Bahia, Luiz Viana. *Dinner with gov. Plaza*

20:30 Dinner in private. Night at Plaza Hotel.

Fri. Oct. 25 8:00-9:00 Receive at hotel, Rubens Vaz da Costa, President of Banco do Nordeste. *(very knowledgeable about N.E. fluent English)* Then check out of hotel.

9:15 *check out* Visit Industrial Park of Aratu.

9:15-12:00

12:30-14:30 Jet 111 to Sao Paulo. Lunch on plane.

15:30-16:00 Call on Governor of State of Sao Paulo, Abreu Sodre.

16:45 Arrive Hotel Jaragua.

17:30-18:30 *Call on* Receive Julio Mesquita (Editor of Estado de Sao Paulo) for tea. *1/ 2/* *Interpreter present*

19:00-20:00 Cocktails for Messrs. Klabin, Vidigal, Lorch and Toledo Piza. *trans-entire*

20:30 Private dinner hosted by Mr. McNamara at hotel for Roberto Campos. Night at Hotel Jaragua. *names do Estado*

1/ Assuming that he will prefer seeing Mr. McNamara at the hotel rather than his office.
 2/ Interpreter to be present.

Sat. Oct. 26

08:00³ Check out of hotel.
 9:30-10:00
 08:45-09:45 Presidential plane (jet) to Rio (Galeao). (Earlier takeoff doubtful owing to normally prevailing morning fog.)
 10:00-10:50
 11:00-12:00 Meeting at Ministerio da Fazenda with Minister of Finance (Delfim Neto).
 11:45-12:45
 12:00-12:30 Meeting with Minister of Planning (Helio Beltrao).
 13:00-14:00 Lunch with these two Ministers and President of Central Bank (Galveas).
 14:30
 15:15 Check into Copacabana Palace Hotel.
 16:00-21:10 Receiving intellectuals and thought leaders as follows:
 16:00-16:30 Mario Simonson 1/, Vargas Foundation
 16:40-17:10 ~~Jose Sette Camara 1/, Director of Journal do Brasil~~ *Nascimento de 170, Journal do Brasil*
 17:20-17:50 Luiz Ganzaga do Nascimento Silva 1/ *free lunch*
 18:00-18:30 Dr. Octavio Rodriguez Lima (tentative) 1/ *government*
 18:40-19:10 Prof. Candido Mendès Almeida (Braz. Society *ad sci.* for Instruction) 1/
 19:20-19:45 Augusto Antunes *interpreter*
 20:00-20:30 Octavio Bulhoes *Mr*
 20:40-21:10 Roberto Marinho (Editor of O Globo) 2/ *interpreter*
 21:15 Check out of hotel.
 23:00 Leave Rio (Galeao) - Varig 854.

Sun. Oct. 27

08:00 Arrive New York (Kennedy) and proceed to Washington.

- 1/ Assuming that he will prefer seeing Mr. McNamara at the hotel rather than his office.
- 2/ Interpreter to be present.

21:15 Check out of hotel.

23:00 Leave Rio (Galeao) - Varig 854.

Sun. Oct. 27 08:00 Arrive New York (Kennedy) and proceed to Washington.

DESLOCAMENTO AEREO - RECIFE/PETROLINA

Avião Turbo Hélice do BNH - Dia 24.10.68

- Decolagem
- Recife/Petrolina, às 10:30 hs.
Os passageiros deverão estar no Aeroporto às 10:15 hs.
 - Mr. Mc Namara
Presidente do Banco Mundial
 - Governador Nilo Coelho
 - Dr. Apolônio Sales
Presidente da CHESF
 - General Euler Bentes Monteiro
Superintendente da SUDENE
 - Dr. Jader (DRN)
 - Mr. Alter
Chefe do Departamento do Hemisfério Ocidental

Avião FP-MW da SUDENE

- Decolagem
- Recife/Petrolina, às 10:15 hs.
Os passageiros deverão estar no Aeroporto às 10:00 hs.
 - Mr. Wiese
Chefe da Divisão do Brasil
 - Mr. Clark
Chefe do Departamento de Informações
 - Mr. Steckham
Assistente Pessoal de Mr. Mc Namara
 - Sr. Ary Pinto
Ministério da Fazenda
 - Dr. Marcus Vinicius
(da Presidência da República)
 - Dr. Pioger (da ONU)

Avião FP-PCX da SUDENE

- Decolagem Recife/Petrolina - às 10:15 hs. Os passageiros deverão estar no Aeroporto às 10:00 hs.
- Sr. Rafael Valentino (MINTER)
- Sr. Milton Ferreira (MINIPLAN)
- Sr. Alberto Alves (MINIFAZ)

2 funcionários da Guarda Pessoal de Mr. Mc Namara

DESLOCAMENTO ANEC - PETROLINA/SALVADOR

Avião Turbo Hélice do BNH - Dia 24.10.68

Decolagem

- Petrolina/Salvador, às 16:35 hs.

Os passageiros deverão estar no Aeroporto às 16:20 hs.

- Mr. Mc Namara

- Mr. Alter

- Gen. Euler Bentes Monteiro

- Ary Pinto

- Marcus Vinicius

Avião PP-FMV da SUDENE

Decolagem

- Petrolina/Salvador, às 16:20 hs.

Os passageiros deverão estar no Aeroporto às 16:00 hs.

- Mr. Wiese

- Mr. Steckham

- Milton Ferreira

- Alberto Alves

- Rafael Valentino

2 funcionários da Guarda Pessoal de Mr. Mc Namara

LUNCH HOSTED BY MR. DELFIM NETO, MINISTER OF FINANCE
FOR MR. ROBERT MCNAMARA, ON WEDNESDAY OCTOBER 23RD
AT 13:15 - AT THE YATE CLUB OF RIO DE JANEIRO

Helio Beltrão	Minister of Planning
José Magalhães Pinto	Foreign Trade Minister
Mario David Andreazza	Transport Minister
Afonso Albuquerque Lima	Interior Minister
José Costa Cavalcanti	Mines and Energy Minister
Francisco Negrão de Lima	Governor of Guanabara State
Roberto de Abreu Godré	Governor of São Paulo State
Israel Pinheiro	Governor of Minas Gerais State
Ivo Silveira	Governor of Santa Catarina State
Ernani Galvêas	President of Central Bank of Brazil
Nestor Yost	President of Bank of Brazil
Ary Burger	Director of Central Bank of Brazil
Paulo Pereira Lira	Director of Central Bank of Brazil
Jayme Magrassi de Sá	B.N.D.E. President
João Paulo dos Reis Veloso	General Secretary - Ministry of Planning
Mario Bhering	President of ELETROBRAS
Lucas Garcez	President of CESP
John Cotrim	President of FURNAS
João Camilo Pena	President of CEMIG
Cicero Sales	President of COCAP

Marcus Vinicius de Moraes	Special Assistant to the President
José Maria Vilar de Queiroz	Advisor to the Finance Minister
Elizeu Rezende	Director of D.N.E.R.
Sergio Bath	Secretary to Foreign Affairs - Planning Ministry
Rodrigo Ajace Moreira Barbosa	General Secretary - Transport Ministry
Ary Pinto	Advisor to the Finance Minister
José Flavio Pecora	Advisor to the Finance Minister
Gustavo Silveira	Press Officer - Finance Ministry
Oscar Victor Peterson	President of ALCOMINAS
Mario Trindade	President of Banco Nacional de Ha- bitação
Luis Clovis de Oliveira	President D.N.P.V.N. (Departa - mento Nacional de Portos e Vias Navegáveis)
Ambassador Jorge Alvares Maciel	Assistant Secretary to the Ministry of Foreign Affairs
Milton Ferreira	Chief of Cabinet - Ministry of Planning
Isaac Lopes de Castro	Advisor to the Planning Minister
Rafael Aauto Costa	Press Officer - Planning Ministry
Antonio Adolfo Manta	President Rêde Ferroviária Federal

COCKTAIL PARTY OFFERED BY MR. LUIS VIANA FILHO
GOVERNOR OF THE STATE OF BAHIA, FOR MR. ROBERT
MCNAMARA, ON THURSDAY OCTOBER 24, 20:30 - AT
THE PALACIO DA ACLAMAÇÃO, SALVADOR .

Boris Tabacof	Secretary of Finance, State of Bahia
Angelo C. de Sá	Secretary of Industry and Trade, State of Bahia
Luis Prsco Viana	Secretary of Information, State of Bahia
Hilton J. M. Rodrigues	Chief of Governor's executive office (Casa Civil)
Helio R. de Brito	Private Secretary of the Governor
Lelivaldo Brito	President of the State Bank
Victor Gradim	Member of ^{1/} Reconcavo Development Comission ^s , former President of the Development Bank <u>1/</u> Reconcavo: Salvador and surrounding area.

B

Mr. Gunter Wiese

October 11, 1968

Enrique Lerdau

BRAZIL: Sao Paulo Water Supply

I was visited today by Mr. Athayde Rosa and Mr. Eros Roberto Grau; respectively Financial Director and Lawyer of Companhia Metropolitana de Aguas de Sao Paulo (COMASP). They are in Washington on occasion of next week's signature of an IDB loan of US\$16.5 million to COMASP.

They explained that COMASP is a mixed enterprise (majority shareholder is the Government of the state of Sao Paulo and minority shareholders are the participating municipalities and some private individuals) created some six months ago to assume responsibility for the provision of water to the metropolitan region. In the first instance they will take over the sizeable supply expansion program, but in the course of the next three years are also to take charge of water distribution. They will thus completely displace the state's Departamento de Aguas e Esgotos (DAE) which is scheduled to disappear. COMASP will have much greater freedom to alter water rates than DAE, and expects to earn a reasonable rate of return on investment.

They stated that in view of the size of their program COMASP was considering approaching the Bank for a loan, and would like to have some indication of how they would be received. I explained to them that the Bank's present lending intentions excluded this project - on which some discussions had taken place with the Governor of Sao Paulo in 1967 - and that this decision was based on several considerations among which an important one was that the city of Sao Paulo should be better able to finance its own infrastructure than any other part of the country. Moreover, the state of Sao Paulo already figured rather heavily in the distribution of prospective Bank's loans to Brazil.

Mr. Rosa, who is an employee of CESP on loan to COMASP and is thus acquainted with the Bank, replied that while he understood the Bank's position, he would urge that it be reconsidered. He argued that neither the state nor the municipalities could possibly finance a project of this size out of their own resources, even though he agreed that municipalities were better off now than they have ever been in the past. He made the point that the state was trying very hard to persuade the 38 municipalities in the Sao Paulo metropolitan area to use their new resources for projects of this kind and release resources on the state level. However, the state had no legal powers to compel them to do so. He added that it might well be that the contribution of World Bank resources to the project, if made conditional on reasonable participation by these municipalities, could have a catalytic effect in bringing the latter around.

They said that they would inform the Secretary of State for public works, Eng. Eduardo Riomey Yassuda - who will be in Washington next week to sign the IDB loan - of the Bank's thinking and that he might want to have some further discussions. I therefore made a tentative appointment for him to see Mr. Wiese at 10 a.m. on October 18.

Recommendation

Since the arguments presented by the COMASP officials tie in very closely with one of the main conclusions of the economic report - that it is most important to tie down the greatly augmented municipal resources for priority investments and that the separation of powers between different levels of government made this extremely difficult - I suggest that the Bank reconsider its decision regarding this project if on further investigation it appears that Bank participation might have the effect described by the officials. I would suggest that the Secretary be asked to provide substantial additional information on the financial situation of the municipalities and on the contribution they would make. It seems to me that the rationale underlying the Bank's decision not to participate in the project implies that the decision could be reconsidered if either of two circumstances exist:

- (a) that the state and the municipalities are already making the maximum effort that can reasonably be expected to finance their investments from their own resources (and that no appreciable and demonstrable low priority investments are being made) or
- (b) that the Bank's participation would really play the strategic role in mobilizing additional municipal resources that was suggested by the COMASP officials.

ELerdau: tg

From: Gunter Wiese
To: Mr. Gerald Alter

Can we discuss this?

Enrique Lerdau

BRAZIL: Loan Request for Water Supply Projects by BNH

1. The papers accompanying the letter of October 2 from the President of the National Housing Bank to Mr. McNamara - in which a US\$25 million loan is requested - contain some material on the BNH's program. The following note summarizes and analyzes this information. For comments on the institutional arrangements envisaged by BNH, reference is also made to the memorandum to Mr. Alter from Messrs. Wiese and Shibusawa.
2. When formulating its program, the BNH, through its water and sewerage sub-agency FISANE (the degree of autonomy from BNH is not quite clear but seems very limited) expected to devote NCr. 302 million (US \$82 million)^{1/} to sanitation programs in the 1968-70 period, and expected thereby to support a package of projects costing NCr. 713 million (US \$194 million) during the same period. It is stated, however, that "... these amounts have already been increased substantially".
3. The BNH would thereby devote only a small share of its resources to sanitation - 5.5 percent - while the bulk of its application of funds would be for housing. It is important to note that the BNH obtains most of its own resources from the unemployment compensation fund (FGTS) - financed by an 8 percent payrolls tax - which imposes on the BNH liabilities subject to monetary correction. To remain solvent it therefore must invest in assets also subject to such correction, and its housing as well as its sanitation loans are based on this principle. For the same reason its reserves are mostly invested in readjustable Treasury obligations. The degree to which the BNH helps to finance the Federal Treasury thus depends on the size of its program and on the resources it is able to obtain.
4. FISANE is the original lender while the individual municipalities will be the ultimate borrowers. Between them lies a system of intermediaries whose role is not totally clear. The financial intermediaries seem to be mainly state development banks; the promotional agents seem to be mainly regional organizations and may be a device to fit SUDENE into the program. The contributions to total project cost are said to be distributed as follows:

^{1/} The exchange rate used by BNH in its presentation is 3.675 cruzeiros per US dollar.

State Governments	18.75%
Regional Organizations	18.75%
Municipalities	25.00%
BNH (FISANE)	<u>37.50%</u>
	100.00%

It should be noted, however, that the BNH participation in total project cost implied in the figures of para. 2 above, is 42.3 percent. The discrepancy is not explained.

5. The three year program covers 310 municipalities. The number of immediate beneficiaries is given as 14.3 million, but it is not certain that this figure is meaningful. (See below, para. 6). In order to obtain a clearer picture of the main contents of the program, a tabulation of the main characteristics of the municipalities included in the program which have present populations of more than 50,000 is attached. It shows 31 such municipalities, 16 of them with populations over 100,000.

6. Total project cost of the 31 municipalities is NCr. 266 million (US\$72 million) and of the 16 largest ones NCr. 166 million (US\$45 million). The range of percentages presently supplied with potable water is 0-94 percent; on average it is just under one half ^(50%) and does not differ greatly between the 15 smaller municipalities and the 16 largest ones. How meaningful these figures are depends on whether uniform criteria were used in the definitions: the fact that in Sao Paulo all but two municipalities show round numbers (no decimals) makes one wonder. The number of immediate beneficiaries in the 31 municipalities is 0.9 million in the 15 smaller municipalities and 2.8 million in the 16 larger ones. The figures are open to question because it seems at least possible that in some cases the figures include and in others they exclude the population presently served. This suspicion is aroused by the fact that in some cases - e.g. the three municipalities in Mato Grosso, as well as Duque de Caxias, Florianopolis and several others - the number of those presently served plus the "immediate beneficiaries" would greatly exceed the present population.

7. Only one municipality among the 31 is located in the Northeast (Campina Grande in Paraiba); two are in the Amazon region (Manaus and Belém); five are in the Far Western states of Goiás and Mato Grosso; twelve are in the Center-East (Minas Gerais and Rio de Janeiro) and the remainder are in the Far South (Santa Catarina) and Sao Paulo. It should be noted that the country's largest cities - Sao Paulo, Rio de Janeiro, Recife, Belo Horizonte, Salvador and Porto Alegre - are not included, although some of the municipalities involved in the COMASP project - serving the Sao Paulo metropolitan region - are listed in the BNH program. (See my memo to Mr. Wiese of October 11.)

8. The material supplied by the BNH does ~~not~~ give any indication of the amount or type of project information available to, or required by the BNH. Indeed, it is conceivable under the emphasis on decentralization that seems implied in the material, that the BNH's role is seen as that of a pure financial intermediary. If so, it is not clear at what level the project evaluation function rests and what the basic standards for it are to be.

9. It thus appears that many questions will confront the forthcoming project identification mission. Outstanding among them are the selection of the "card core" of FISANE program which would be suitable for IBRD financing, what is a proper supervision structure for the municipal projects, what is a proper financial participation by the different levels of government in the light of the recent constitutional reforms, and what arrangements will have to be made regarding proper water and sewerage charges.

Attachment

cc. Messrs. Wiese
Shibusawa
Morse

ELerdau: tg

Project	Type of Project ^{a/}	Total Cost (Ncr. 000)		Present Population		Population Presently Served	% Presently Served		Number of Immediate Beneficiaries		Number of Ultimate Beneficiaries	
		Pop. 50-100,000	Pop. over 100,000	50,000-100,000	Over 100,000		50,000-100,000	Over 100,000	50,000-100,000	Over 100,000	50,000-100,000	Over 100,000
<u>Amazonas</u>			<u>15,800</u>		<u>232,000</u>	<u>168,000</u>		<u>72.4</u>		<u>221,000</u>		<u>464,000</u>
Manaus	N&E		15,800		232,000	168,000		72.4		221,000		464,000
<u>Goiás</u>		<u>2,400</u>	<u>31,688</u>	<u>80,000</u>	<u>342,000</u>	<u>71,190</u>	<u>25.0</u>	<u>15.0</u>	<u>72,000</u>	<u>307,800</u>	<u>80,000</u>	<u>750,000</u>
Anapolis	E	2,400	31,688	80,000	342,000	71,190	25.0	15.0	72,000	307,800	80,000	750,000
Goiana	E					51,190						
<u>Matto Grosso</u>		<u>14,500</u>	<u>5,500</u>	<u>131,034</u>	<u>100,416</u>	<u>107,660</u>	<u>52.2</u>	<u>39.0</u>	<u>140,530</u>	<u>109,412</u>	<u>441,000</u>	<u>245,000</u>
Campo Grande	E		5,500		100,416	39,225		39.0		109,412		245,000
Corumba e Ladario	E	6,500		64,000		36,485	57.0		64,530		210,000	
Quiba	E	8,000		67,034		31,950	47.7		76,000		231,000	
<u>Minas Gerais</u>		<u>24,220</u>	<u>10,140</u>	<u>266,900</u>	<u>282,300</u>	<u>299,500</u>	<u>27.0</u>	<u>80.6</u>	<u>128,470</u>	<u>16,750</u>	<u>515,000</u>	<u>386,800</u>
Sontagem	N	12,000		70,000		3,000	4.3		49,870		166,100	
Divinopolis	N	7,900		70,300		6,500	9.2		46,200		183,200	
Uberlandia	N		3,540		119,000	72,500		60.9		16,750		138,000
Juiz de Fora	I&E		6,600		163,300	155,000		94.9		-		248,800
Montes Claros	N	4,120		66,000		34,660	52.5		14,800		99,700	
Barbacena	I	2,200		66,600		27,840	45.9		17,600		66,000	
<u>Para</u>			<u>22,940</u>		<u>525,409</u>	<u>189,624</u>		<u>36.1</u>		<u>472,868</u>		<u>1,100,000</u>
Belem	E		22,940		525,409	189,624		36.1		472,868		1,100,000
<u>Paraiba</u>		<u>11,000</u>		<u>135,000</u>	<u>135,000</u>	<u>80,000</u>	<u>59.3</u>		<u>40,000</u>		<u>100,000</u>	
Campina Grande	E		11,000		135,000	80,000		59.3		40,000		100,000
<u>Rio de Janeiro</u>		<u>54,370</u>		<u>1,709,414</u>	<u>821,042</u>		<u>48.0</u>		<u>1,367,780</u>		<u>2,940,000</u>	
Barra Mansa	N	1,200		107,287		-			85,829		150,000	
Duque de Caxias	E	6,000		297,346		236,721	79.6		237,876		500,000	
Nilopolis	N	4,000		165,879		-			132,703		260,000	
Niteroi & Sao Goncalvo	E	22,170		729,974		584,321	80.0		583,980		1,300,000	
Nora Iguescu	N	13,000		231,428		-			185,142		400,000	
Sao Joao de Meriti	N	8,000		177,500		-			142,250		330,000	
<u>Santa Catarina</u>		<u>4,800</u>	<u>6,400</u>	<u>56,000</u>	<u>140,000</u>	<u>106,000</u>	<u>28.6</u>	<u>64.3</u>	<u>50,400</u>	<u>126,000</u>	<u>120,000</u>	<u>300,000</u>
Florianopolis	E&I		6,400		140,000	90,000		64.3		126,000		300,000
Lages	E&I	4,800		56,000		16,000	28.6		50,400		120,000	
<u>Sao Paulo</u>		<u>54,493</u>	<u>8,000</u>	<u>558,000</u>	<u>345,000</u>	<u>617,600</u>	<u>66.8</u>	<u>71.8</u>	<u>441,700</u>	<u>319,300</u>	<u>1,300,000</u>	<u>950,000</u>
Campinas	E&I		8,000		240,000	161,000		67.1		230,000		600,000
Rogi das Cruzes	E&I	9,000		84,000		50,400	60.0		63,000		170,000	
Sao Carlos	E&I	8,000		64,500		48,300	74.9		54,800		120,000	
Sao Jose dos Campos	E&I	6,720		72,000		43,200	60.0		54,000		200,000	
Araraquara	E&I	5,888		74,500		59,600	80.0		63,400		190,000	
Jundiai	E&I	5,000			105,000	84,000		80.0		89,300		350,000
Sao Jose do Rio Preto	E&I	7,800		85,000		68,000	80.0		72,200		250,000	
Sao Vicente	E&I	9,585		90,000		45,000	50.0		72,000		200,000	
Taubate	E&I	2,500		83,000		58,100	70.0		62,300		170,000	
<u>TOTAL</u>		<u>100,413</u>	<u>165,838</u>	<u>1,091,934</u>	<u>1,811,539</u>	<u>2,416,616</u>	<u>46.3</u>	<u>50.2</u>	<u>283,130</u>	<u>2,940,910</u>	<u>2,456,000</u>	<u>7,235,600</u>
		50,000 - 100,000				505,035						
		Over 100,000				1,911,581						

a/ N = New system
E = Extension
I = Improvement

Mr. Gerald Alter

October 11, 1968

Gunter K. Wiese

BRAZIL: Status of Loans under Preparation - Industrial Credit
(other than for the Northeast)

I am referring to my memo to you of October 8 informing you about the status of preparation of our loans which are to be signed in 1969/70. I am writing this separate memo to give you background on another loan which may be ready for signing after the end of that fiscal year.

I am referring to the loan of \$50 million which in the five-year program is listed for 1971/72 under Private Finance Companies. At the time this annual classification was given to that loan by me, certain changes in the Bank's policy were still under discussion and made it difficult for me to more than guess at the likely timing of the loan. I now think that it would be possible to bring such a loan to signing no later than two years from now.

You will recall that one of the conditions for our becoming a lender for industrial credit in Brazil was that the Government undertake to eliminate negative interest rates from any credit programs which the Bank would help finance. When you and I visited Brazil a month ago, the Government undertook to send us a cable to that effect. I am expecting to receive this cable within the next few days. On the basis of that expectation, we are beginning to schedule a mission to initiate the preparation of the loan. Its timing will be early next year, given the fact that we have to coordinate it with the mission scheduled to visit the BNB in February of next year. It seems impossible to find adequate staff for a mission to go before the end of the year, and the Brazilian institutions involved have asked us not to come in January because of their heavy involvement during that month in the annual closing and re-budgeting of their accounts.

Terms of Reference for the Mission

We are now beginning to think about the terms of reference for the mission. A first question concerning us is whether this should be a loan through a Government agency to be passed on to certain financial intermediaries. This has been our standard pattern in the past and also seems to be the preference of the Central Bank. The latter also suggested that we channel such a loan through the BNDE. If we were to do this, we would have to decide whether we want to use the loan to strengthen only the private finance companies, or whether we also wish to make the state-owned development banks participate.

An additional question is whether we would want to use the BNDE (or any other Government intermediary) simply as a post office, or whether we want to give it substantial freedom in the selection and intensity of supervision of the next stratum of banking intermediaries. These are difficult questions, given the fact that the Brazilian banking structure is complex. The less ramified our channel would be, the easier it would be to supervise it (both for us and for the BNDE), but the more political scars is any selection likely to leave.

For this reason we are also exploring alternatives. One such alternative might be to make a straight loan to the Central Bank, to be added to the country's foreign exchange reserves and to have the counterparts channelled through the banking system as additional industrial credit without necessarily being separated from the other credit programs already underway (e.g., FINAME and FIPEME). Our loan would, of course, have to be long term, but we could have flexibility on the conditions we would attach regarding the term of relending the counterparts. We could therefore have a "rollover" arrangement. Under such an arrangement, all (or almost all) banking institutions would be eligible to receive World Bank funds, provided they relend for periods above an agreed minimum and provided they completely eliminate any lending by them on subsidized terms. Such a loan would be an industrial sector loan. In order to make it justifiable, the Bank may wish to consider whether before making the loan there should also be an agreement on a more rational system in Brazil for protective duties on industrial equipment imports. In summary, a loan of this type would mean that the Bank would deliberately attach greater importance to: (a) the elimination of subsidized credit on a country-wide scale; (b) an injection of medium-term funds into the industrial credit picture, also on a country-wide scale; and (c) the reform of the industrial protective system--than to concentrated strengthening of a few private institutions. I am, however, doubtful whether we would be able to achieve all three objectives with \$50 million. I believe that we would probably have to increase the amount to \$100 million.

Another alternative might be some kind of hybrid solution between the two foregoing alternatives. In any event, it would be essential that our funds be useable for Cruzeiro financing if they are to be disbursed quickly. Under the second alternative, we could, however, establish a link between our disbursements and the overall industrial imports into the country during a given period.

We are fully aware that the last two alternatives are far-reaching departures from the established practice and require major policy decisions by the Bank. Even the first alternative would differ from the past practice of avoiding loans for private development companies through a publicly-owned channel with more than post office functions. In these circumstances, I would appreciate as much guidance from you as possible. Could we discuss this some time after our return from Brazil? It might be preferable to wait until then because we may have the opportunity during the trip to hear some views expressed on this by persons outside the Department and the Bank.

cc: Messrs. Husain, Diamond/Garcia Rayneri/Carnemark/Ballesteros

GKwiese:mr

C

for the next five years it is difficult to envisage, with total Bank lending of \$1 billion for Brazil, more than \$200 million of lending for the Northeast, if we adhere to the major lending objectives listed above. Even achieving the \$200 million level will require the identification and successful preparation of many projects in difficult sectors such as agriculture.

*A poor man
as Argentina
is not stated
in terms
fundamental
to Brazil's
growth*

Attachment

cc: Mr. Knapp
Mr. Friedman
Mr. Baum
Mr. Evans
Mr. Wiese

THE NORTHEAST

*
85 12 270

I. Introduction

1. According to the official estimates, per capita income in the Northeast is about one-half of the national average of about \$175. One aspect of Brazil's long-term growth has been the decline of the proportion of the population living in the area. While in 1872 this proportion seems to have been almost 47 percent, in 1967 it was less than 30 percent. Largely as a result of migration into the South-Central area, population in the Northeast in the past two decades had continued to grow more slowly than in the rest of the country. On the other hand, output has grown somewhat more rapidly. Consequently, per capita income during the last 20 years has risen appreciably faster than in the richer parts of Brazil, even though a large gap remains.

2. One reason for this relatively favorable course of events in the last two decades was that periodic droughts which traditionally have afflicted the Northeast have not occurred since 1958 when agricultural losses of some US\$200 million were suffered. In the last few years, other reasons may have been that development planning for the region has become more effective and that a large transfer of resources from the more developed parts of Brazil to the Northeast through the fiscal system is taking place.

low growth
note growth
2x substitution

II. Present Development Plans for the Northeast

3. The plight of the Northeast came forcibly to the fore usually as a consequence of a major drought, of which there were six since the beginning of this century. Until the 1950's, federal programs to aid the Northeast were largely concentrated on design and construction of hydraulic works in an attempt to temper or eliminate the ravages of droughts on agricultural output and income of the region.

4. In the early 1950's, national income accounts were prepared in Brazil for the first time. The regional breakdown of the accounts gave numerical evidence of the large gap in per capita income between the Northeast and the rest of the country. Coincidentally with the availability of this information, federal programs in the Northeast shifted their emphasis from the prevention of income declines following droughts to more comprehensive regional development planning designed to close the income gap between the Northeast and the rest of the country. This shift in emphasis found institutional expression first in the creation of the Bank of the Northeast in 1952 and, more importantly, of the Superintendency for the Development of the Northeast (SUDENE) in 1959.

9/19 To Mr. Miller
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5. SUDENE was entrusted with the responsibility for working out and executing policies for overall development of the region. Development of industry and agriculture received primary attention in the successive three-year guiding plans executed by SUDENE since 1961. A fourth plan, covering the period 1969-73, has just been released after approval by the Congress. Details on its composition and order of priorities are not presently available; it is reported, however, to incorporate increasing investments in the fields of housing, sanitation and education in addition to infrastructure, industrial and agricultural projects.

III. The Fiscal Transfers

6. Until 1966 federal tax resources were channelled to the Northeast through (a) earmarking certain national taxes or specified proportions of them for use largely by SUDENE and the Bank of the Northeast; (b) revenue sharing between states and the Federal Government of some other federal taxes (the petroleum, electricity and mineral taxes); (c) permitting federal corporate income taxpayers to discharge 50% of their tax liabilities by investing in the Northeast in projects approved by SUDENE ("Article 34/18").

7. The Constitution of 1967 abolished all earmarking of federal budgetary revenues for specific expenditures, with the exception of the petroleum tax (IUCL) and the electric power tax (IUEE). At the same time, it reduced the share of the states and municipalities in the IUCL from 60 percent to 40 percent. These changes were more than offset, however, by the other major innovation of the new Constitution, the creation of the Participation Fund, whereby states and municipalities receive - in equal parts - 20 percent of the federal income and consumption taxes.

8. The formulas by which the IUCL, the IUEE and the Participation Fund are distributed among states have in common a strong redistributive element since [the poorer states receive a far greater share of the total distributed than the proportion of the respective taxes generated by them.] Thus, of the likely total collection of IUCL, IUEE and federal income and consumption taxes in 1968, less than 10 percent would originate in the Northeast, but over 35 percent of the totals likely to be distributed would go to the Northeastern states. In contrast, the states of Guanabara and Sao Paulo, with 23 percent of the population and about four times the Northeastern per capita income, will probably generate over 65 percent of these taxes, while receiving probably under 16 percent of the totals distributed.

9. The other major tax incentive provided by the Federal Government to stimulate private investment, Article 34/18, has grown rapidly in recent years and has accounted for a modest industrial boom in the Northeast at a time when the bulk of Brazil's industry - located in Sao Paulo - was undergoing repeated crises. Although for some years Article 34/18 funds accumulated in the Bank of the Northeast (BNB) at a faster rate than they could be utilized, the recent step-up in project approvals by SUDENE has already resulted in a rapid acceleration in disbursements.

10. The importance of the various federal transfers described above can be gauged from the fact that of the total of approximately US\$500 million of likely 1968 tax revenues available to the Northeast from all sources, almost 50 percent would probably originate outside the region.

11. A complete picture of the Federal Government's fiscal relations with the Northeast cannot be obtained without a geographic breakdown of direct federal expenditures. This, unfortunately, is not available. However, some indication of the order of magnitudes involved can be derived from the 1968-70 public investment budget of the entire federal sector. Of the roughly 45 percent of the federal investments (exclusive of capital transfers to local governments) which can be classified by their geographic location, almost one-third is to be located in the Northeast. On the other hand, in 1968 much less than 10 percent of the Federal Government's total current budgetary revenues are likely to originate in the Northeast.

IV. Project Financing by Foreign Agencies

12. While hardly any foreign funds went to the Northeast in the forties and fifties, since the early sixties USAID and IDB have made special efforts to develop and finance projects in the region. AID maintains a large resident mission of more than 50 persons in the Northeast, geared to technical assistance and project financing. By the end of 1967, AID had made more than \$400 million of project loans in Brazil, of which about \$75 million was specifically for projects in the Northeast. Of the IDB's Brazil portfolio of \$385 million, loans totalling about \$130 million were made for specific projects in the Northeast. In addition, funds from these agencies came to the Northeast through certain industrial and agricultural credit projects covering the entire country.

Limiting Factors

13. AID's project lending in the Northeast has concentrated on road construction, electric power and industry. The bulk of IDB's lending has been for electric power; water supply and sewerage; and industry. Both AID and IDB have faced severe limitations in the extent of their lending in the Northeast and in the selection of sectors and projects for financing. These limitations are described below. In addition, the prospective reduction in AID's overall resources renders unlikely any expansion in its lending activities in the Northeast. There may even be a reduction. The projects being actively prepared by AID for lending in 1968 do not include any in the Northeast. As regards the IDB, about \$35 million of its projected lending of \$100 million in Brazil this year would be for a road project in the Northeast. As far as we know, the IDB currently does not intend to expand its lending activities in the Northeast.

(a) Management and Organization

14. The major problem in project financing in agriculture, education and transportation (as distinct from power and industry) in the whole of Brazil is a relatively lower efficiency of institutions in formulating and executing projects. This has generally been more acute in the Northeast. Project financing in these sectors in the Northeast has to be accompanied by substantial technical assistance in the organization and management of project institutions.

(b) Availability of Projects in Relation to Resources

15. The large transfer of federal funds created a situation in certain sectors in which projects were not available for all the amounts that the foreign agencies wished to lend in this region. [In sectors such as education and agriculture, considerable assistance in project preparation has to precede foreign lending.]

(c) Limitations of Agency Practices

16. Apart from the above-mentioned factors, AID has been restricted by the limitations on the extent of local cost financing it could undertake. More than half of the total amount of AID's lending for Northeastern projects was for projects where the loans were used directly for imports.

17. The above limitations also indicate the measures which the external agencies need to adopt if, through their project lending, they expect to make a significant contribution to the development of this region. (1) First, project lending has to be preceded by substantial assistance in project preparation, in many cases with a long lead time. (2) Second, the agencies need to be flexible in their attitudes about the types of institutions they are prepared to work with. For example, exclusion of government-owned institutions as channels for industrial finance would automatically exclude the agencies from contribution to industrial expansion. (3) Third, sectors such as agriculture and transport where the need for institution building is the greatest are also the areas where the foreign exchange component of projects is relatively low. Consequently, external financing agencies have to be prepared to do a substantial amount of local cost financing.

V. Proposed Bank Lending in the Northeast

18. [Since the beginning of the current phase of lending in Brazil, the Bank has not financed a project in the Northeast.] In our concern to support the Government's program for economic reform, our main criterion for the selection of projects has been ready availability. Hence the concentration on power projects in the Center-South region. Moreover, the project preparation activities we have promoted outside the electric energy field are only now beginning to bear fruit.

19. The Bank has been associated with an active program of project preparation in the Northeast as a part of the Brazil Transport Survey. (1) A substantial part of the Second Highway Construction Loan will be for highways in the Northeast.

20. (2) In industrial finance we have recently had discussions with the Government Bank of the Northeast (BNB) on the possibility of a Bank loan to finance the foreign exchange requirements of BNB's industrial financing program. An initial problem is that BNB's funds are lent to private industry at negative real interest rates, since the nominal interest rates are

substantially lower than the rate of inflation. Such a policy weakens rational allocation of funds on the basis of the economic and financial feasibility of projects. We therefore propose to insist that the World Bank funds and the associated local resources be lent to private industry at realistic positive interest rates. As part of our investigation of the industrial finance project we shall also look into the general economic justification of the industrial development currently underway.

21. We have also discussed with SUDENE possible irrigation and water supply projects and shall pursue them actively. At our initiative FAO will explore the possibility of a fisheries project and other agricultural projects in the Northeast.

22. Our current five-year lending program of \$1.0 billion envisages lending of about \$200 million for projects in the Northeast. Achieving this will require a major increase in our present project preparation efforts and would be consistent with the priorities and objectives of our lending program. The following table shows the project composition of our current program of roughly \$200 million for the Northeast:

	(US\$ million)					
	<u>68/69</u>	<u>69/70</u>	<u>70/71</u>	<u>71/72</u>	<u>72/73</u>	<u>Total</u>
Highways	-	20 ✓		25	25	70
Recife Port	-	5 ✓				5
Bank of Northeast	-	25 ✓				25
Agricultural Credit			20 ✓		25	45
Irrigation			7 ✓			7
Fisheries			8 ✓			8
Water Supply/Sewerage			25 ✓	15		40
Education					10	10
	<u>-</u>	<u>50</u>	<u>60</u>	<u>40</u>	<u>60</u>	<u>210</u>

1/ Projects listed as unidentified at the time of the tabulation of the 5-year lending program.

August 15, 1968

Marto Ballesteros

BRAZIL - SUDENE's Fourth Guiding Plan, 1969-1973

Background

1. The Superintendency for the Development of the Northeast (SUDENE) started in 1960 to prepare plurianual investment plans. The first three were three-year programs; the fourth covers a five-year period, 1969-1973.
2. The programs consist of a series of projects in different sectors, varying in degree of precision and detail. Financing for these projects is expected from four main sources:
 - (1) three regional agencies - financed mainly through the Federal budget - (SUDENE, the Sao Francisco Valley Authority (SUVALE), and the Department of Works against Droughts (DNOCS)), dependencies of the Ministry of the Interior,
 - (2) other Federal Government agencies including development banks,
 - (3) State Governments, and
 - (4) external sources.

Resources from other than the regional agencies are given only as "estimates" or "indicative figures"; the plans themselves are not binding, but "guiding plans." Moreover, the fourth plan explicitly states that contributions from Federal Government sources, including the regional agencies, are subject to the necessary revisions to make them compatible with the plurianual and annual Federal budgets. Consequently, the entire fourth plan has from the start a markedly "indicative" character.

3. No evaluation of the execution of the first three guiding plans has been made in Brazil. SUDENE acknowledges that shortfalls were large and widespread, owing to budgetary difficulties and problems of project preparation and execution; there is insufficient information, however, to make a complete evaluation.
4. Some figures are available on SUDENE's actual and estimated expenditures during the period of the third plan (1966-68). The figures indicate total expenditures of NCr.366 million or 44 percent of the NCr.830 million contemplated in the plan (1967 prices). The proportion of SUDENE to total expenditures in that plan was 26 percent. Shortfalls appear to have occurred in all expenditure sectors, although differences in classification make accurate comparisons difficult.

The Fourth Guiding Plan, 1969-1973

5. The Fourth Guiding Plan contemplates expenditures of NCr.6,190 million (about US\$1.8 billion) during the five-year period 1969-73. SUDENE's contribution is estimated at NCr.1,370 million (US\$375 million), or 22 percent of the total. The plan targets envisage annual investment expenditures by SUDENE of roughly twice the actual spending rate during the preceding plan.

6. The Plan does not specify a target of overall rate of growth of income during the period. There is only a reference to the goal of achieving "an average annual rate of growth of the secondary sector of 9 percent, which will constitute a significant step forward in the establishment of a dynamic center of manufacturing production in the Northeast."

7. The following are listed as "some of the more tangible goals" of the Plan:

- a. An increase of the generating capacity of the Paulo Afonso hydro station of 660 MW.
- b. Construction of 3,650 Kms. of roads and paving of 3,430 Kms.
- c. Provision of water and sewerage facilities for 6 million persons.
- d. Modernization of part of the agricultural sector by:
(i) irrigation of approximately 100,000 hectares, (ii) improvement in sugarcane cultivation and sugar production, and (iii) improvement of the marketing system through better financing facilities and the construction of storage centers.
- e. Execution of a social program aimed at improving health, education and housing conditions.

8. The proposed sectoral distribution of total and SUDENE expenditures is as follows:

	<u>SUDENE</u> (NCr. million at 1968 prices)	<u>TOTAL</u>	<u>SUDENE</u> (Percentages)	<u>TOTAL</u>
Power	270	1,250	19.7	18.1
Transportation	190	1,160	13.8	16.7
Water and sanitation	150	660	11.0	9.5
Natural resources	120	210	8.7	3.1
Human resources	165	1,830	12.2	26.5
Agriculture	240	1,100	17.5	16.0
Industry	60	60	4.4	0.9
Special programs	55	190	4.0	2.7
Administration	120	450	8.7	6.5
Total	<u><u>1,370</u></u>	<u><u>6,910</u></u>	<u><u>100.0</u></u>	<u><u>100.0</u></u>

Source: SUDENE, IV Plan Director

9. In the previous program only SUDENE's contribution was broken down by sectors. A valid comparison between the sectoral emphases of the two programs can therefore not be made, as the SUDENE financed proportion seems to vary substantially between sectors. The fourth plan appears, however, to give greater stress to expenditures for human resource development (i.e. health, education and housing, mostly financed by other federal ministries, state governments and BNH) and for agriculture.

10. Traditionally, the efficiency of institutions in charge of project formulation and execution has been relatively lower in the fields of education and agriculture than in other sectors. If this continues to be the case, the planned stepping up of investments in these fields is unlikely to be achieved.

11. The proposed projects in the different sectors are generally not presented with sufficient precision to permit a judgement as to their quality, stage of preparation and readiness for execution. Nor is the financing aspect treated in sufficient detail, consisting in many cases of "indicative" amounts to be contributed by different agencies.

12. The Plan envisages an amount of external financing of NCr.600 million (US\$164 million), i.e. less than 9 percent of total planned investment. External financing forecasts are heavily concentrated in the sectors of power, transportation and water/sanitation. The estimate of external financing for the power sector alone is NCr.324 million, but the plan does not distinguish between committed and future loans or mention possible sources of financing. The Plan is more explicit regarding external resources for the transportation and water/sanitation sectors which are expected from the Inter-American Development Bank under loans already signed or under consideration.

The Sudene Plan and Bank Lending

13. The Bank's current five-year program envisages lending of about \$200 million for projects in the Northeast, an amount in excess of total external financing foreseen in the SUDENE Plan for approximately the same period. This fact, however, is not necessarily a cause for concern - as indicated earlier, the financing side of the SUDENE plan consists to a large extent of "indicative" amounts to be contributed by Federal and State agencies over which SUDENE has little if any ascendancy. Moreover, part of the Bank's planned Northeastern loans will finance agencies (e.g. DNER and BNH) for part of their Northeastern projects, i.e. will replace non-SUDENE resources in the SUDENE financing plan. Furthermore, no matter what the effective limiting factor of the overall volume of the SUDENE plan may have been - financial constraints, or limited capacity for project preparation or execution - the possibility exists that a higher overall level of investment may be achieved in the course of a few years by virtue of more active participation by the Bank in development projects in the Northeast. Finally, the project content of the Bank's five year program for the Northeast is still highly tentative and in the process of being firmed up by extensive sector and project work.

MBallesteros/s

Enrique Lerdau

BRAZIL: Industrialization Policy in the Northeast and Bank Lending

1. In the paper on the Northeast that was prepared for Mr. McNamara on August 15, it was stated that "As part of our investigation of the industrial finance project, we shall also look in to the general economic justification of the industrial development currently underway". Since the proposed investigation is meant to provide guidance to the Bank in formulating its general approach to a loan for industrial credit in the Northeast, it is important that there be some prior agreement on what the relevant questions are which the mission (scheduled to go in January 1969) should try to answer. While industrial credit as such is no novelty for the Bank, the peculiarities of a regional program supported by fiscal resources do present some unusual complexities, which warrant a discussion of what the right conceptual framework is for a Bank operation.

2. We must start from the premise that much of the recent industrialization of the Northeast would not have taken place without the fiscal and financial incentives offered by the Federal and state governments. This cannot be proved rigorously, but both casual empiricism - discussions with Brazilian officials, industrialists and bankers - and a priori reasoning support this view. The incentives by main types, are:

- (a) federal income tax exemptions as investment incentives (Article 34/18); ✓
- (b) negative real interest rates on industrial loans by the Bank of the Northeast (BNB), a federally controlled development bank; ✓
- (c) industrial infrastructure provided by state governments (such as the industrial park of Aratu, in Bahia). ✓
- (d) additional tax advantages to firms established under Article 34/18.

It is my impression that (a) is by far the most important one, followed, perhaps, by (c).

3. If one accepts that such incentives constitute subsidies paid by the community at large, questions on economic justification can be grouped into questions regarding the transfer of resources to make the investment itself and questions regarding the possibility of future subsidy needs deriving from the particular structure of the investments.

In both groups, of course, the overriding criterion will have to be whether the policy pursued presents a viable long term development strategy for Brazil as a whole.

4. Little need be said about the general question of whether resources should be channelled from the more prosperous to the less developed parts of a country. This is a national decision not very different from that of foreign assistance programs at the international level. (The objections sometimes raised in Sao Paulo to this policy also have their international counterpart). If instead of granting tax exemptions the federal government spent the same amounts on public works in the Northeast, the question would not even be asked. There is, of course, a general fiscal question regarding federal revenue and expenditure levels, but this could only be linked to the Northeast question if all other revenues and expenditures are taken as given. In the present context it is thus not directly relevant.

5. Once the present system is recognized for what it is: an attempt to use public resources to develop a backward area, the main question is one of efficiency. There are known to be high yield public sector investment projects in the area - some roads for instance seem to show very high rates of return - but it may well be doubted that on average the efficiency of resource utilization of the public sector is as great as that of the private sector. Thus the scheme by which entrepreneurs interested in profits are the users of the public investment funds cannot, a priori, be presumed to lead to a less productive - i.e. developmental - use of capital than if the public sector had determined their use directly. In view of the quality of many state governments - and some federal institutions - in the Northeast, I would rather expect the opposite to be the case.

6. There is, however, one important distinction between public works and private use of public resources. If a road is built it imposes approximately the same future gross burden on the community (maintenance expenditures) when its rate of return is low as when it is high. If, on the other hand, an industrial enterprise is built up, the future burden on the community may be great if the firm is unable to operate efficiently. The protection (or direct subsidy) needed will be a long term drain on community resources. Moreover, its incidence may well be counterproductive: the beneficiaries may be Northeastern labor, but if the firm produces for the local market and needs protection against imports from the rest of the country (or world) the consumers bearing the burden will also be residents of the region.

7. It would thus seem important to obtain a clear picture of the profitability of the enterprises already developed under the system and of the criteria used for determining how the authorities respond to applications under Article 34/18. It seems that each project is subjected to two appraisals: the first one on economic grounds by SUDENE and the second, on financial and creditworthiness grounds, by BNB (since beneficiaries also become BNB borrowers).

8. It would seem important, in this connection, to make an assessment of the sensitivity of the profits figures to different interest rates. While far from conclusive, this analysis should give reasonably good answers to two questions regarding the efficiency of the present system:

- (a) has the BNB's practice of granting loans at negative real interest rates for financing fixed assets led to unnecessary subsidies to investors who, being beneficiaries of Article 34/18, needed no further inducement to invest? If so, it may have mis-allocated scarce public resources;
- (b) has BNB's practice of granting working capital loans at negative real interest rates resulted in investments that would show current losses without this subsidy?

9. Regarding the economic evaluation criteria used by SUDENE, it would be important to know whether employment is given such a large weight that projects are approved which are justified only if the opportunity cost of labor is counted as zero, but which need permanent subsidies when they have to pay the going wage rate. If so, this practice would raise difficult problems for Bank participation, since it would mean that the Bank would have to lend for enterprises which require permanent subsidies in order to be financially viable.

10. Besides employment, other questions regarding the development impact of BNB's industrial projects are the degree to which they depend on inputs produced in the region, the degree to which they depend on the protective effects of the inefficient railroad and coastal shipping services (and their vulnerability to competition once domestic transport costs come down), and the degree to which profits are reinvested in the region (important since most of the ownership is vested in the Center-South). Not all of these may be directly relevant to the Bank's lending conditions, but they do all seem to have a bearing on our approach to the project, inasmuch as they are the basic ingredients for determining benefits and costs.

cc. Messrs. Carnemark/Ballesteros

Elerdau: tg

Mr. Gerald Alter (through Mr. Wiese)

October 15, 1968

M. Ballesteros and E. Lerdau

BRAZIL: Agricultural Policy in the Northeast

Background

1. Agriculture contributes approximately 45 percent of Northeast GDP. Food crops account for roughly one-third of farm output, raw materials for 40 percent and livestock products for the remainder. Agricultural production has been growing at an average annual rate of 7 percent over the last few years, growth being relatively higher in livestock and food crops.

2. Moving from east to west, the Northeast consists of four main regions: a humid area (zona de mata) parallelling the coast, a transition zone (agreste), a semi-arid area (sertao), and finally the tropical rain forest region. Farm activity varies accordingly between these areas. The leading crop in the humid area is sugar-cane, grown in large plantations. Food crops predominate in the transition area, where farms are usually small. Cotton and livestock are the leading activities in the semi-arid region, where farms again tend to be large.

3. The inability of Northeast agriculture to provide an abundant supply of foodstuffs has long been considered the principal obstacle to sustained development of the region. Proposals to overcome this problem have largely taken three directions:

- a. Irrigation. Over the past sixty years, a substantial number of dams have been built in the Northeast in response to the droughts that periodically afflict the region. But since, to a large extent, these were treated as work relief projects in times of drought, no provision was made for effective use of the dammed-up waters; the irrigation potential of the reservoirs is estimated at 700-800,000 hectares, but only 10,000 hectares are in fact irrigated.
- b. Colonization. New lands could be opened up in the Western tropical rain forests region.
- c. Better utilization of the humid area lands. Sugar-cane is grown without the use of modern techniques, resulting in relatively poor yields; using modern methods the same amount of sugar-cane could be produced in half the land area now devoted to this crop. This would free substantial amounts of land for the cultivation of food crops.

4. Proposals to follow all three courses were first made explicitly by SUDENE in 1960 and incorporated into its Guiding Plans, but little headway has been made thus far. The explanation appears to lie mainly in failure to reconcile conflicting interests and pressures. In the latest Plan (IV Plan Director, 1969-73) emphasis is placed on expanding production in the semi-arid region via irrigation and adoption of improved production and marketing techniques, and on colonization of new lands.

Policy Questions

5. The key issue for both the Government and external lenders - what should be the basic strategy toward the sector - has thus not received much systematic treatment. The questions that need answering are of two types:

- a. [Which are the most promising projects and programs on which public funds] can be expended in the Northeast with a reasonable expectation of yielding an adequate economic rate of return, and what are the policies which will have to be followed to reap the benefits of these expenditures? and
- b. What - if any - is the degree of subsidy involved in spending public resources on Northeastern agricultural development, rather than in other parts of the country?

6. Several things seem clear: (1) Questions falling under the first heading are much easier to answer than those in the second group. (2) To be able to act intelligently immediately, external lenders need only to have good answers to the first group of questions. (3) For a rational long-term action program the Government as well as external lenders must be in a position to answer the second group of questions. External lenders are justified in helping with the financing of projects as long as they are confident that these will yield a rate of return in excess of a previously chosen minimum, even if they don't know whether better alternatives exist. Where precisely this minimum should be established - whether at 6 percent or at 9 percent, for example - is an important, but not a vital, issue. This implies that it need not be established first that outside the Northeast there are no other agricultural projects with higher rates of return. But this short-term approach cannot be used permanently as the basis for decision-making in the public sector. Doing so might mean agreeing to long-term slowdowns in the national growth rate for the purpose of letting the most backward area catch up, without ever knowing the degree of this slowdown and without consciously deciding whether this price should be paid.

7. On the basis of the above, we suggest that the immediate questions to be answered - and on which the forthcoming FAO/Bank mission

to the Northeast should primarily focus - are those falling into the first group. They will involve judgments as to the relative merits of new irrigation dam construction versus the utilization - through the construction of canals, etc. - of the dams constructed in the past; the possible returns on sugar-cane modernization and using the freed land for other crops, the possibility of labor intensive citrus fruit growing, the use of supervised credit schemes in selected areas and - very particularly - the issue of whether in the more backward areas cheap (not subsidized) crop credit, rather than long-term credit for fixed investments, might be the most productive use of public and foreign funds. In the course of finding answers to these questions - including rough quantification of the alternatives involved - judgments on existing institutions will have to be made. These include not only the existing credit mechanisms but also the extension services of state and federal governments. Moreover, judgments on the productive capacity of particular areas may well have to be very tentative. If the necessary soil studies do not exist, even experienced agronomists cannot be expected to come up with reliable answers. Such judgments should nevertheless suffice to give us a reasonable idea of what particular agricultural projects in the Northeast the Bank ought to give priority to for the time being. In the process, policy issues concerning water charges, interest rates, support prices, provision of technical services, etc. - will undoubtedly emerge, and should be identified as early as possible so as to become part of our dialogue with the Government.

8. At the same time - and largely outside the framework of the forthcoming mission - we should consider with the Government what type of action should be initiated now so that in a maximum of two years we can become more confident that we know something about the second group of questions. The model here may well be what was done in the transport and power sectors. If the Bank were willing to provide financial and technical help in using consultants on a massive scale, we see no reason why over time a similar flow of projects should not emerge in agriculture from all parts of the country. Only when that situation is reached, will the cost of particular projects in terms of the alternatives foregone become a meaningful practical issue. And only then will we be able to know what the Government's policy toward the Northeast means in terms of the overall development of Brazilian agriculture. In this context also the issue of employment - e.g., labor intensive crop projects versus livestock projects with high returns but little labor use - will become susceptible to conscious and rational decisions.

cc: Messrs. Wiese
Ballesteros
Shibusawa
Lerdau

(This memo has not been cleared by the Projects Department.)

MBallesteros/ELerdau:mr

October 9, 1968

Note on Recife Port

The Port of Recife is the third largest in Brazil after Santos and Rio de Janeiro. For the Northeast it is not only important from the point of view of international trade, but also from the point of view of the substantial coastal shipping with the more prosperous South. It is run by the Recife Port Authority, an autonomous entity of the State of Pernambuco, under a concession of the Federal Government.

Annual tonnage handled presently is about 1.6 million tons. Oil ranks highest among the commodities handled (38%), followed by sugar (31%), food stuffs (17%) and general cargo (12%).

The Port was studied as a part of the first phase of the Transport Survey. The Survey's findings include a forecast of traffic, which is expected to increase by about 50% by 1976. The Survey found that existing physical facilities and organization were inadequate to cope with this increase in traffic and recommended specific measures to remedy the situation.

The Government's 3-Year Plan of Action, communicated to the Bank in connection with the highway loan, includes a program for the reorganization of ports. The Ports, including Recife, are to be set up as corporations with representation not only by municipal and state interests, but also by business and industrial interests. For the reform of accounting and tariffs, the Government proposes to engage consultants to implement the program, including the introduction of commercial accounting as a basis for tariff determination.

The investment program for the Port of Recife, emerging from the Transport Survey, envisages total investment by 1976 of about \$40 million. While a substantial part of this program would be financed from the Port Improvement Tax levied on all cargo passing through Brazilian ports, external financing to the tune of about \$10 million would be required. The project for external financing could include construction and improvement of quays, storage facilities and acquisition of equipment for the handling of goods. A Bank mission will be in Brazil in October/November to discuss, among other things, a Bank loan for the improvement of the Ports of Rio de Janeiro, Santos and Recife.

The Governor of Bahia may raise the question of Bank financing of a steel plant in Bahia, USIBA, and of a telephone company, TEBASA. On these, two recent memos written in the Bank are attached.

C O P Y

OFFICE MEMORANDUM

TO: Mr. Gunter K. Wiese

DATE: August 29, 1968

FROM: M. A. Saeed

SUBJECT: BRAZIL - USIBA Steel Plant Proposal

The USIBA steel plant is planned for a location near Salvador (Bahia), to produce flat products. At the time Booz, Allen, Hamilton conducted the Steel Survey the estimated cost was \$47.8 million to produce 80,000 tons of tin plate and 58,000 tons of sheet products annually. The proposal, however, was undergoing extensive modification at the time of the Steel Survey and, consequently, it would now be necessary to collect up-to-date data.

The Steel Survey's conclusion was strongly against building new plants for flat products. The Survey showed that, as far as the flat products were concerned, it would be far more economical to round out and expand the facilities of the existing large plants (COSIPA, USIMINAS and CSN) than to build new ones. The estimated cost for rounding out the plant capacity was about \$135-\$196 per ton of ingot, and \$257 for expansion. The USIBA plant proposal has a preliminary cost estimate of \$347 per ton.

It is unlikely that the USIBA project would be suitable for Bank financing. However, since the project has been modified since the Steel Study, and estimates for the latest proposal are not available, you may wish to ask IFC to look into the project.

MASaeed:sh

Files

September 27, 1968

Curt Carnemark

BRAZIL - Tebasa

On September 25 Messrs. Eitel Rizzoni, Julio A. M. Coutinho, Gordon H. Sharpe of Page Communications and Messrs. Geraldo Dannemann and Vicente Nogueira Filho of Tebasa visited the Bank to inquire about Bank financing for Tebasa's immediate expansion program. They met Messrs. Wiese and Carnemark.

Tebasa - Telefones da Bahia S.A. is a privately owned telephone company serving the State of Bahia. It was founded in 1959 and started operations in 1962. The company's concession on all telecommunication in the State was recently validated by the Federal Government for a period of 60 years.

Tebasa's present capacity of 20,000 lines is becoming fully utilized and Page Communications has assisted in preparing an expansion program for the next three years. It will double present line capacity and interconnect by means of microwave 50 cities in the State. The total cost of the program is estimated at US\$60 million of which some US\$25 million would be in foreign exchange. The program would be financed as follows:

<u>Equity</u>	<u>US\$Million</u>	<u>Debt</u>	<u>US\$Million</u>
State of Bahia	6	Long-term debt to be obtained	39
Advances for new users	7		
34/18	<u>8</u>		
	21		

Existing assets amount to some US\$5 million, almost entirely backed by equity. The debt/equity ratio including existing equity would be 60:40. The debt/equity ratio in respect of new investments would be approximately 2 to 1. After the construction is finished, another US\$7 million payments by users would gradually increase equity and thus decrease the debt/equity ratio.

Mr. Wiese pointed out that the Bank so far had not been asked by the Brazilian Government to provide finance for the telecommunications sector and that the Bank's current lending program did not include telecommunications. Inclusion of the sector in the Bank's program would have to be preceded by a discussion between the Government and the Bank on the opportunity cost and justification of such a step. If the Bank subsequently were to initiate consideration of telecommunication projects, it would probably require, inter alia, some type of master plan for that sector similar to the ones already existing for the power and transport sectors.

Mr. Rizzoni stated that Contel had worked out a "code of telecommunications" which could be considered more as a policy plan than a master plan of investment priorities.

Mr. Dannemann said that he understood fully the Bank's position and that he would inquire in Rio whether the Government would consider requesting Bank assistance in the telecommunications sector. He envisaged, however, that considerable time might pass before the Government would reach any decision and that therefore he would probably have to turn to other lenders, realizing the urgency of this expansion program.

C. Carnemark:hvp

cc: Mr. Hittmair (Projects)
Mr. Wiese (ah)

October 9, 1968

Note on Highway BR-324

The Governor of Bahia may raise the question of Bank financing of Highway BR-324.

The project comprises the construction of two additional lanes on the last 32 kms. of Highway BR-324 leading into Salvador and connecting it to the north-south trunk routes. The total cost would be about \$10 million. Traffic counts show very high average density on this stretch - as much as 8,000 vehicles per day in certain parts - and, prima facie, the project has a high economic priority. Its feasibility has been studied as a part of the second phase of the Transport Survey. Although the detailed report is still awaited, indications are that the highway would be suitable for inclusion in the second Bank highway project.

A Bank mission, which will visit Brazil in October-November, will discuss with the State and Federal Governments the steps, including detailed engineering, necessary to bring this and other highways in the second project to appraisal for a Bank loan. A problem already identified is the alignment of the highway in the vicinity of the Aratu Industrial Park and the access to the highway of traffic originating in the Park. This will be among the questions to be discussed by the Bank mission with the Federal and State Governments.

Mr. Gerald Alter

July 1, 1968

Gunter K. Wiese

BRAZIL - Possible Bank Loan to BNB

During our reconnaissance tour of the Northeast, Mr. Shibusawa and I spent June 17 in Fortaleza for discussions with the Bank of the Northeast (BNB). We met with Dr. Rubens Vaz da Costa, President of the bank, and Messrs. Nilson Holanda and Walter Queiro, Director and Deputy Director, respectively, of the Industrial Investment Credit Department (called GARIM). We also met with the head of the division appraising industrial projects, Mr. Murilo Peddigeo.

Mr. da Costa explained that BNB's present pipeline of applications for long-term industrial credit consisted of over 70 projects with a total cost of approximately \$200 million. In the case of the average projects, 50% of the total cost would be financed by equity contributions under Law 34/18 and another 25% would be equity raised by the sponsors outside of 34/18. The remaining 25% of project cost would be covered by long-term credits by the BNB. Such loans would be on 8 to 10-year terms and at about 14% interest without monetary correction, except in cases where loans would be convertible into foreign exchange to pay for imported equipment. In the latter case, both amortization and interest payments would be fully adjusted in case of exchange rate devaluations.

The \$200 million industrial program to be financed in part by the BNB would probably require imports of equipment valued at about \$20 million. Almost all of these imports would have to come from Europe or Japan. For this reason BNB could not hope to obtain financing for these imports from the AID or the IDB. To be sure, some of the equipment could be financed by suppliers credits but, given the fact that more than 70 projects were involved, individual consignments would be small and the terms and interest rates therefore were expected to be quite unfavorable. Some of this equipment could probably be procured in Southern Brazil at substantially higher prices and significantly lower quality. In these circumstances, BNB would like the Bank to consider lending some \$20 million to BNB to cover the cost of imports required for the \$200 million industrial program referred to above.

I explained to Mr. da Costa that in order to enable the Bank to seriously consider such a loan, the Bank would probably have to be satisfied on four counts:

- (1) That it would not be possible to finance the equipment in question through a private intermediary;
- (2) That the BNB's industrial project appraisal and supervision machinery was demonstrably good;
- (3) That the industrial program which the IBRD loan would help to finance would, by and large, consist of financially sound projects with reasonably good economic justification; and

- (4) That the IBRD loan would not help finance a program which would be partly financed by domestic credit granted at negative interest rates, as presently envisaged.

As regards the first point, I believe that a case can be made that the BNB is the only reasonable channel through which external lending agencies could help finance the development of medium-scale industries in Brazil's northeast. The private finance companies of Brazil generally do not operate in the northeast, quite apart from the fact that they are not yet really in the long-term lending business.

As regards point 2, I spent almost an entire afternoon reviewing samples of internal appraisal reports prepared by CARIM. I have the impression that the quality of their work, at first glance, would justify allocating staff time of the World Bank group to further probe into BNB's internal decision-making processes.

As to the third question, I have indeed misgivings. Looking over BNB's present long-term industrial portfolio, I concluded that perhaps only $\frac{1}{4}$ or $\frac{1}{3}$ of their operations has been linked to plants with obvious economic justification and consists of such obvious opportunities to substitute imports from the south of Brazil with relatively high transportation costs as breweries, soft drinks, vegetable and fruit canning and low quality textiles based on regionally grown cotton. Another 25% of their portfolio seemed clearly questionable even in the eyes of BNB's present management, since it includes relatively esoteric electrical and chemical plants not based on regionally available raw material. The remaining roughly $\frac{1}{2}$ of their present portfolio and their proposed investments consist of projects which I felt unable to judge even intuitively. In terms of their economic merits I deem it necessary for a Bank Group team to spend considerable time probing into the economics and financial prospects of projects in this category before some reasonably reliable conclusions on the quality of this portfolio section could emerge.

As regards the fourth point, I would be averse to recommending to the Bank to proceed with the consideration of BNB's loan request unless the proposed cruzeiro loans by the BNB of roughly \$30 million were to be made at positive interest rates, i.e., with full monetary correction. Without such correction it would appear that the subsidy elements in the financing of the program would be excessive, given the fact that the financing of 50% of the program under 34/18 already consists of capital which cannot afford to be demanding in terms of dividend expectations for fear of reverting to the Federal Treasury. The BNB officials conceded that without 34/18 most of the past and proposed industrial projects in the northeast would not have materialized or, respectively, would not go forward. Unquestionably, basic industrial investment conditions in the northeast are less favorable than in the south for well-known reasons. Moreover, existing legislation pertaining to the revaluation of assets in Brazil's highly inflationary environment permit enough leeway to the individual firm to show paper profits even though in real terms annual results may be negative and result in equity erosion in real terms. When I enquired about the prospects for changing BNB's present industrial lending policies and introducing monetary correction into their cruzeiro loans

(perhaps coupled with a reduction in the nominal interest rate) I was told that the political obstacles confronting such a change were indeed formidable. The best one could hope for was to raise the present nominal rate of 1½% to perhaps 20%, but even that would take considerable political maneuvering.

Recommendation

In these circumstances I recommend against our sending an exploratory IFC mission to Fortaleza without our first reaching an understanding with the Federal Government on a change in the long-term industrial lending policy of the BNB to the effect of introducing monetary correction into their cruzeiro loans. Discussions on this subject could be held by you on the occasion of your forthcoming visit to Brazil in September. In the event that the Federal authorities at that time were to appear willing to make the aforementioned change in order to pave the way for a World Bank loan to BNB, we should immediately request IFC's Development Finance Companies Department to send a reconnaissance mission to Fortaleza for about two to three weeks.

Please indicate to me, at your earliest convenience, whether you concur with the above recommendation.

cc: Messrs. Diamond
R. Garcia/Patterson (IFC)
Sassoon
Shibusawa/Carnemark (o/r)

GWiese/vs

LENDING PROGRAM

Annex 1

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

FIVE-YEAR FORECAST

B R A Z I L
(\$ Million)

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

1970/71 185 200

Mr. Gerald Alter

October 8, 1968

Gunter K. Wiess

BRAZIL: Status of preparation for Loans
to be signed in fiscal 1969/70

In accordance with your request, this is to inform you on the status of those loans in the five-year lending program which are to be signed in 1969/70:

1. \$50 Million to FURNAS for Marimbondo Hydro

The project already has a timetable which provides for Board approval in December 1969. Preparations by the borrower for appraisal in April 1969 are proceeding on schedule.

2. \$5 Million for Santos Port Storage

A timetable already exists providing for appraisal in December 1969 and Board approval in late July 1969. Recent developments indicate that the project is likely subject to substantial slippage. BNDE has performed poorly in terms of guiding the project preparation despite substantial assistance on our part. A feasibility study has been prepared by US consultants, which is of poor quality. On top of this, the Government so far has been unable to make a decision on the location of the silo inside the port area. There are two alternatives with major differences in terms of the implications for the cost benefit analysis of the project and in terms of the time necessary to complete the project. We have offered BNDE to send a Bank mission in early November which would try to fill in the gaps in the feasibility study. This was before we learned that the question of the location of the silo continues to be at issue between various Government agencies. We have now concluded that such a mission would be fruitless so long as the site of the silo is undetermined. In these circumstances, I have asked Mr. Husain to review the situation of the project with BNDE later this month and to return with a recommendation as to the proper course of action for the Bank to take. I am beginning to wonder whether, in the circumstances, it might not be most appropriate to eliminate the project from the five-year plan for the time being. It is likely to be subject to substantial slippage for reasons already outlined and also because several Government agencies in Brazil are disagreeing on who should be the borrower of a Bank loan. Moreover, successful completion of project preparations will require substantial manpower input by the Bank, which I do not deem justified, given the small size of the Bank loan in relation to our other activities in Brazil and the half-hearted attitude on the part of the BNDE. You may recall that in its present form the project is a small residual of a larger one we set out to prepare three years ago. In any event, I shall approach you with a more formal recommendation of the project after Mr. Husain's return.

October 8, 1968

3. \$50 Million for Roads

A Bank mission will visit Brazil during the second half of this month to complete the identification of the project and prepare a timetable of the steps preceding Board presentation. The monthly timetable will be started after its return. Present prospects are for expeditious processing of the loan.

4. \$30 Million for Ports

A Bank mission will visit Brazil late this month and early November to complete the identification of the project and prepare a timetable for Bank action. Until the return of that mission, our judgment on the timing elements affecting the proposed loan must remain tentative.

5. \$25 Million for the Bank of the Northeast

A Bank/IFC mission is scheduled to visit Fortaleza in February of next year. Prospects are good that a firm timetable can be developed after its return, which would envisage the signing of the loan before mid-1970.

6. \$30 Million for Hanna/Antunes Iron Ore Export Project

Various discussions preparatory for appraisal are proceeding actively. The sponsors are presently visiting Europe to sign up potential purchasers of the ore. We are discussing with the sponsors next week the terms of reference for a feasibility study on the project which would take four months. All steps necessary for appraisal should be completed by the middle of next year so that presentation to the Executive Directors would be possible before mid-1970.

cc: Messrs. Guinness
King
Garcia-Rayneri
Brenner
Husain ✓

GKWiese:mr



ECONOMIC COMMITTEE

DECLASSIFIED

APR 01 2013

WBG ARCHIVES

EC/M/68 - 35

August 8, 1968

What makes a rich country so poor - edu? health? agri - efficiency? Indus - better use of growth? Disparity? Govt? need of poor? gov. structure? role of the political system?

Conclusions and Recommendations on the Economy of Brazil

I. Introduction

1. The Committee met on July 29, 1968^{1/} to consider the Economic Policy Memorandum on Brazil prepared by the Western Hemisphere Department (EC/O/68 - 70/1, dated July 12, 1968) attached herewith.

II. Five-Year Development Strategy

2. The Western Hemisphere Department representative said that the purpose of the lending program, recommended in the Memorandum, which geared the amounts of lending to the levels of economic performance achieved, was to harmonize project lending to general economic performance and avoid all or nothing alternatives. It was recognized that in the medium term the most that could be hoped for was a modest improvement in performance, but, by holding up the prospect of a substantial lending program linked as it was to specific criteria, the Bank's influence in securing better performance might be greater than hitherto.]

3. The threshold criteria of realistic exchange rate and pricing policies for any Bank lending to Brazil assumed no sharp deterioration in overall management, such as a complete breakdown of the stabilization effort. It was emphasized that the other additional criteria for the second level of lending, although applicable only to particular sectors, also had general

1/ Members of the Economic Committee present: Messrs. Kamarck (Deputy Chairman), Avramovic, Hansen, Larsen, Lipkowitz, van der Mel, Thompson, Weiner.

Also present: Messrs. Chaufournier, Holsen, Husain, Lerdaun, Wiese, Yang and Miss Villafuerte.

IMF: Messrs. Beza, Daremblum, Restrepo.

D I S T R I B U T I O N

Committee:

- The Economic Adviser to the President, Chairman
- Director, Economics Department
- Director, Special Economic Studies
- Director, EDI
- Special Adviser to the President (Mr. Rist)
- Senior Adviser, Economics Department
- Economic Advisers, Area and Projects Departments

Copies For Information:

- President
- President's Council
- Directors, Area Departments
- Secretary
- Treasurer
- Director, Information Department
- Director, European Office
- Secretary, Loan Committee
- Executive Vice President (IFC)

economic significance. [Some 40 percent of the lending program was in transport, and would thus be tied to sectoral issues, like the railroad deficit, which were also of major economic consequence.]

III. Creditworthiness

4. It was stated that a realistic exchange rate policy was a necessary but not sufficient condition for creditworthiness and that, bearing in mind previous debt rescheduling in 1962 and 1964 and the possible trend in the debt service ratio, satisfactory debt management also ought to be given particular emphasis. The Western Hemisphere Department agreed, noting that this was implied in its evaluation and recommendations. The forecasts of the debt service ratio referred to total and not just public debt and were based on assumptions which had only to vary slightly to make a considerable difference to the ratio.

5. In this connection, the IMF representatives noted that the Brazilian government had improved its debt management in the last few years, and the Fund did not regard it as an immediate problem. They had made comparatively little use of the Fund's credit facilities, preferring to remain within the gold or first credit tranche.

6. No IDA operations were in prospect. The Brazilian authorities however, were likely to be responsive to such a prospect and therefore there would be certain advantages in being able to say that in principle IDA assistance had not been excluded, even though there would be other reviews of Brazil before it could materialize.

IV. Conclusions and Recommendations

7. The Committee agreed that:

- (a) the proposed five-year lending program and associated performance criteria represented a reasonable basis for planning future operations and that, subject to the findings of future periodic reviews, Brazil be considered creditworthy and eligible for:
 - (i) minimum Bank annual lending of US\$50 million, provided no major setbacks occurred in price and exchange rate policies; ✓
 - (ii) another US\$100 million per year as long as, in addition to (i) above, the relevant sectoral performance criteria were met; ✓
 - (iii) another US\$50-100 million per year, if, in addition to the relevant sectoral criteria, general economic performance improved substantially; ✓
- (b) Brazil be considered eligible for IDA credits on a hard blend basis provided that the minimum criteria for general economic performance and sectoral performance were met; ✓

- (c) on economic grounds, local cost financing sufficient to allow 40-45 percent of the total cost of projects financed by official agencies was warranted; and that ✓
- (d) the potential for securing an improvement in economic performance justified exploratory talks with the Government on a Consultative Group or similar arrangement. ✓

N. J. Brady
Acting Secretary

Attachment: Economic Policy Memorandum on Brazil from the Western Hemisphere Department (EC/O/68-70/1, dated July 12, 1968).

Secretary's Department

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EC/O/68 - 70/1

July 12, 1968

ECONOMIC COMMITTEE

Economic Policy Memorandum from
the Western Hemisphere Department

BRAZIL

I. Introduction

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

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

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

- (a) Success in restraining current expenditures of the Federal Government (improvement needed);
- (b) Success in eliminating the deficits of the railroads (improvement needed);
- (c) Success in controlling state government expenditures and in transferring expenditure functions from the federal to the local governments (improvement needed);

- (d) Economic pricing policies by public enterprises, especially steel (improvement needed) and electric power (continuation of present practice needed);
- (e) Maintenance of realistic exchange rates, i.e., frequent adjustments until inflation is eliminated (improvement needed);
- (f) Farmgate coffee prices which do not make the production of surpluses profitable (continuation of present practice needed);
- (g) Debt management policies preventing the re-emergence of excessive short-term debts (recent deterioration possible but not yet clearly established);
- (h) Financial and economic planning which effectively coordinate the intention of the spending agencies with resource availabilities and subordinates them to national priorities (improvement needed);
- (i) Channelling of medium and long-term credit to private industry and agriculture at positive, but not excessive, interest rates (improvement needed);
- (j) Stability in policy regarding property rights and treatment of foreign and domestic investments (continuation of present practice needed);
- (k) Non-inflationary wage policies (continuation of present practice needed)."

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

II. Statement of Policy Issues

4. I consider that the principal issues facing the Committee are:
- (a) The adequacy of Brazil's performance in the light of the previously agreed criteria.
 - (b) The relative weights and the interpretation of some of these criteria.

- (c) The appropriate Bank lending posture under varying performance assumptions.
- (d) Terms for Bank lending and IDA eligibility.

III. Discussion of Policy Issues

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

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

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

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

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

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

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

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

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

IV. Sectoral Criteria

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

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

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

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

V. General Economic Management

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

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

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

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

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

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

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

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

VI. Recommendations

20. I recommend that:

- (a) Brazil be considered creditworthy for minimum Bank annual lending of US\$50 million, provided no major setbacks occur in price and exchange rate policies;
- (b) Brazil be considered creditworthy for another US\$100 million per year as long as, in addition to (a) above, the aforementioned sectoral performance criteria are met;
- (c) Brazil be considered creditworthy for another US\$50-100 million per year, approximately, if general economic performance improves substantially;
- (d) It be agreed that Brazil be considered eligible for IDA credits on a hard blend basis, provided that the criteria under (b) above are met;
- (e) It be agreed that, on economic grounds, local cost financing sufficient to allow external financing to cover 40-45 percent of the total cost of projects financed by official agencies is warranted;
- (f) Exploratory talks be initiated with the Government regarding its attitude to a Consultative Group or similar mechanism.

Gerald Alter
Director

Attachments:

Annex 1: Five-Year Forecast

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

SUMMARY AND CONCLUSIONS OF BRAZILIAN ECONOMIC REPORT, DATED 9/27/68,
BASED ON MARCH/APRIL 1968 MISSION

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

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

3. Net foreign reserves fell by about US\$100 million in 1967 but this trend was reversed after the 18.5 percent devaluation at the end of the year, when several hundred million dollars in short term funds entered the country. The 1967 results were partly the result of lower coffee prices and of production and marketing difficulties with selected agricultural products, but a contributing element was the 11.1 percent rise in imports (c.i.f.) which followed an increase of 36 percent in 1966. Although import growth in excess of the GDP growth rate is quite consistent with efforts to reduce price inflation, increases of this magnitude could not but cause concern to the authorities, especially as during the first half of 1968 a further growth of 22 percent over the corresponding period of 1967 took place. Exports of manufactures continued to rise at an encouraging pace in 1967, but more than half of the US\$47 million increase was in steel and steel products, which were exported below cost during the domestic recession of early 1967. In the first half of 1968 no further growth in manufactured exports occurred. In spite of the Government's policy to maintain realistic exchange rates, the average rate rose less than domestic prices during 1965-67. At the same time the practice of fairly substantial annual or semi-annual devaluations encouraged periodic speculative capital movements which interfered with domestic monetary policy as well as with orderly balance of payments management. It was in the light of this experience that the Government announced, in August of 1968, that not only was it devaluing the currency by a further 14.5 percent but that in the future smaller and more frequent rate adjustments were envisaged. This new policy should go a long way towards safeguarding the international competitiveness of the economy until inflation is brought under control.

4. The full exploitation of Brazil's large potential for non-coffee exports will be a key condition for sustained economic growth. To achieve this, the exchange rate policy must not only offset domestic cost increases but will have to be fully coordinated with other policies affecting the profitability of these exports. At the present unusually high prices cotton is very profitable; if the price should, in a year or two, decline by 10-15 percent, over one fourth of Brazil's production might have yielded losses at the exchange rate that prevailed until August 1968. Even more important is that the relative profitability of coffee not be allowed to rise so much as to reverse the shift in land use that took place in recent years. The policy variables here are the Government's coffee policy as well as the exchange rate. Between 1963/64 and 1965/66 the policies by which the effective prices for coffee exporters and producers were determined resulted in a clear shift of profitability in favor of other crops; since then some reversal has taken place although coffee, at a yield of 10 bags per hectare, is still less profitable than rice, beans or groundnuts. On the other hand profits in the rather promising soybeans and corn production are already made precarious by the present price relations; if further substantial concessions are made to the coffee sector the gains of recent years can easily be lost. (For details, see Vol. II, Annex B). The danger then would be two-fold: (a) non-traditional exports would stagnate and (b) the inflationary impact of the accumulation of unsaleable coffee stocks would undermine the stabilization program. The Government is fully aware of this danger; what remains to be seen is the extent to which the various agencies involved in making the relevant decisions, are able to coordinate their viewpoints.

5. One of the enduring obstacles to stabilization as well as development continues to be the excessive claim of the public sector on resources. For 1968 it is estimated that domestically financed government expenditures may account for almost 31 percent of GNP - 28.8 percent through taxes and 1.8 percent through borrowing - and the prospects are for further increases in this ratio. Under the influence of transitional difficulties in 1967 the state governments in 1968 raised the effective rate on the value added tax (ICM) by 16.5 percent; it is to be hoped that this measure can be reversed and state expenditures be prevented from rising correspondingly. For the Federal Government the dilemma is accentuated by the fact that the 1967 Constitution - left by its predecessor - forces it to transfer large additional resources to the states and municipalities, without giving it much influence over the manner in which these funds are spent. It will be one of the main challenges for the Government to devise ways by which either important federal expenditure functions can be shifted to the local governments that are receiving the additional revenues or the distribution of tax revenues between levels of government is altered. This task will be made even more difficult by virtue of the fact that the present system has one important positive feature which should not be sacrificed: it results in substantial shifts of tax revenues from the richer parts of the country to the less developed Northeast. However, it also results in large - and probably excessive - transfers to the almost uninhabited Amazon region; it is to be doubted that this allocation of resources conforms to a sound strategy for the long-term development of Brazil.

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

7. Even with such a policy, present federal investments intentions are probably excessive. There can be no doubt about the usefulness of a large part of them: the needs in power, transport, steel and petroleum, for instance, cannot be disputed. But given the growing share of public resources that is being channelled to the states and that therefore - for the present - must be assumed to be spent without regard to nationally determined priorities, the maintenance of the spending levels planned by the federal agencies would mean depriving the private sector of the

possibility to expand its own investments. Even with the cutbacks suggested by the mission, private investment could probably grow no faster than GDP, and only this if by 1970 about 25 percent of the increase in tax revenues saved is re-lent to the private sector. //

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

9. During the next few years, substantial increases in Brazil's external financial requirements can be expected. The new Government has resisted pressures to reverse the liberalization of import policies, including sizable tariff reductions, initiated by its predecessor, and - if a reasonable growth rate for the economy is to be maintained until inflation is fully controlled - it will be logical to aim for imports to rise faster than GNP. Moreover, a modest improvement in the net foreign

reserve position is also aimed for. Thus, in spite of quite favorable export prospects, net capital inflow requirements may rise from about US \$350 million in 1967 to some US\$550 million by 1970, with gross capital inflows being almost twice as high. Given the volume of loans already committed but undisbursed and the large number of projects suitable for external financing, these requirements should not present insurmountable difficulties, provided reasonable amounts of local currency financing or non-project loans continue to be provided by official lenders. The direct foreign exchange component of the new projects likely to be committed during 1968-70 is about 32 percent of their total costs; if official lenders, on average, finance 40-45 percent of project costs, no balance of payments difficulties should emerge, as long as project financing proceeds without undue delays and as long as adequate exchange rate policies are followed. From 10.6 percent in 1967, net capital inflows would finance 14.0 percent of gross domestic capital formation by 1970, which still would leave Brazil with one of the highest proportions of domestically financed investments among the developing countries. The projection implies, further, that the share of investment in GDP would rise from 14.7 percent in 1967 to 17.3 percent by 1970.

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

Introduction

1. In October 1967 a ~~new~~ Economic Report was issued (WH-173a) which was the work of a mission that had returned from Brazil in March 1967. During March and April of 1968 another mission visited Brazil where, in the meantime, a new Government had taken office; its draft report is expected in July. The following note is therefore partly based on the 1967 Report, modified in some respects by the findings of the 1968 mission but bringing to bear only incompletely the mission's new quantitative material. It is therefore likely that when this material has been processed, analyzed and incorporated into a new Economic Report, some forecasts and projections will differ ~~from~~ those presented here.

Present Position

2. During the fifties and early sixties, the economy grew at a precipitous pace which proved unsustainable since it resulted in accelerating inflation as well as levels indebtedness which made repeated rescheduling operations necessary. At the same time, attempts to repress the results of the inflationary pressures without attacking the causes, led to a complex system of price controls, subsidies, multiple exchange rates, import controls and other ad hoc measures interfering with the allocation of resources. Indeed, the system became so complicated and internally inconsistent that its ultimate incidence could not be fully traced by the authorities themselves, but some of its most counter-productive results stood out: agricultural production - non-coffee - was discouraged by price controls; public utilities were decapitalized by lagging rate adjustments; industries were protected to a degree where the inefficient flourished with the efficient; no long-term capital market could develop because of inflationary expectations; industrial expansion was largely financed by credit, much of it short term and at negative real interest rates, non-traditional exports stagnated because of overvalued exchange rates.

3. In part these policies were associated with the populist character of successive governments. There was a direct political line from President Vargas to Kubitschek and Goulart. The other presidents between 1955 and 1964 - especially Dutra and Quadros - were backed by the conservative opposition to the populists but were unable, in the main, to reverse the latter's policies. In the economic field these policies were expansionist and - until 1962 - greatly stimulated economic activity and growth, but also led to vastly inflated public sector payrolls and to periodic inflationary private sector wage increases by decree.

4. At the time of the military coup of March 1964 the system was beginning to break down. Private investment had fallen in real terms as the Government's policies regarding private property had become increasingly erratic, output was stagnating and the annual rate of inflation exceeded 100 percent as the Treasury's cash deficit was about 5 percent of GNP. Foreign trade arrears and swap liabilities had mounted to levels representing 50 percent of the annual import bill, and the long-term debt service burden was of the order of 29 percent of annual exports.

5. The new Government set itself as prime goals to correct the imbalances that had been accumulating in the economy, to combat inflation and to restore Brazil's external credit standing. Given the magnitude of the task, a policy of gradualism was opted for and the US Government, the IMF and the Bank agreed to support such a policy. In March 1968 a new, elected Government took office and undertook to pursue the same aims, albeit with a greater emphasis on renewed growth.

6. The success of the program, to date, has been far from complete, but considerable progress has been achieved. Most price controls and subsidies have been abolished, the exchange rate has been unified and brought to more realistic levels, public utility rates have been set at more economic levels, the Treasury deficit has been reduced to around 2 percent of GNP and - aided by large food crops - the rate of price increase has been slowed to some 22 percent (wholesale, excluding coffee) in 1967. Coffee prices were set at levels intended to discourage the production of surpluses which in the past had been a major cause of inflation. Moreover, private and public sector wage increases have been forced to lag behind price rises thus removing wages from among the factors causing additional inflation. Swaps and commercial arrears have been eliminated and by rescheduling the external debt in 1964 - which has been serviced punctually since then - Brazil's debt profile was improved.

7. The greatest lack of success was in the failure of the Government to obtain a proper control of its own current expenditures. In spite of stringent wage policies, current expenditures continued to rise in real terms; the actual level of employment is only known to the authorities very approximately. Thus the reductions in the deficit that were achieved came exclusively from raising revenues, making Brazil one of the three most heavily taxed underdeveloped countries in the world (estimated at 29 percent in 1968). This is a serious problem at the Central Government level; it is aggravated by Brazil's federal structure which gives the states and municipalities jointly almost as large a role in public expenditures as that of the Federal Government. Under 1967 Constitution, the latter has to distribute to the local governments specified proportions of its main revenues - the income tax, the federal consumption tax and the sole tax on fuels - and has at the same time only very limited influence on the way these transfers are spent. Not only does this greatly limit the possibilities for adequate financial planning, but it also means that the developmental use of public sector resources is dependent on a large number of decision units not under the control of the Central Government. The efficiency of these local governments varies greatly; while in some cases it probably exceeds that of the Federal Government, in others it is quite unsatisfactory.

8. In both the State and the Federal Governments the capabilities of the spending agencies vary greatly from sector to sector and have themselves been a major determinant - as well as a consequence - of the allocation of public investment funds. In highway construction and electric power impressive levels of efficiency have been reached; the main Government-controlled

industrial firms - large steel enterprises, the country's largest iron ore mining and exporting concern and the petroleum monopoly - while in some cases beset by serious problems, are nevertheless at least potentially sound concern with real technical expertise. On the other hand, the railroads and the coastal shipping services have not developed similar levels of competence; according to Government pronouncements it is now intended to improve them by drastic measures. In the railroads these will have to include organizational, administrative and financial (with a warning) changes, but what is also essential is to ensure the independence of the military to build money-losing lines for strategic reasons.

9. The proved capabilities of agencies in other sectors are generally lower although, at the state level, important exceptions exist. Thus the multiple federal agencies charged with responsibility in agriculture are generally less impressive than the Secretaria de Agricultura (State Ministry) of Sao Paulo. Federal investments in agriculture have been small and ineffective; the main public measures to stimulate output has been to channel more crop credit to agriculture; support prices have also been set but generally at levels - coffee excepted - well below market prices.

10. Brazil still has vast unexploited resources of arable land, minerals and hydroelectric power sites. In spite of a population growth of about 3 percent, demographic pressures, in the aggregate, will therefore not be an important national problem for many decades. Internal population shifts, on the other hand, constitute a real source of pressure on resources; the urban population rises very much faster than that of the rural areas, and urban facilities, such as urban transport, water and sewerage systems, are being put under considerable strains. Between 1950 and 1960 the Rio and Sao Paulo metropolitan areas grew at an annual rate of 5.1 and 6.2 percent respectively; together they account for some 12 percent of Brazil's population. Medium sized cities like Curitiba and Belem grew as fast or in the case of Belo Horizonte (population 1 million) even faster (over 9 percent per year).

11. Partly in response to this pressure, a relatively new institution, the National Housing Bank, has in the last two years developed an ambitious program of channelling public resources to the private sector for housing and to municipalities for water supply. The executing ability of this agency - which is entering a relatively neglected sector - seems to be high; indeed it will be one of the Government's problems to avoid levels of expenditure in this sector that are inconsistent with overall financial stabilization. The same problem does not exist in education; [by and large the quality of educational expenditures at present is very low and before spending substantially larger amounts, major structural changes are called for. In this sector the fragmentation of responsibilities between federal and local government units is a serious obstacle to efficiency.]

Policies

12. Government action in certain key areas will provide in the next few years clues as to the general thrust of economic management. They all

relate simultaneously to stabilization, resource allocation and development. Particular attention should be paid to the following:

- (a) Success in restraining current expenditures of the Federal Government (improvement needed);
- (b) Success in eliminating the deficits of the railroads (improvement needed);
- (c) Success in controlling state government expenditures and in transferring expenditure functions from the Federal to the local governments (improvement needed)
- (d) Economic pricing policies by public enterprises, especially steel (improvement needed) and electric power (continuation of present practice needed);
- (e) Maintenance of realistic exchange rates, i.e. frequent adjustments until inflation is eliminated (improvement needed);
- (f) Farmgate coffee prices which do not make the production of surpluses profitable (continuation of present practice needed);
- (g) Debt management policies preventing the re-emergence of excessive short-term debts (recent deterioration possible but not yet clearly established).
- (h) Financial and economic planning which effectively coordinates the intention of the spending agencies with resource availabilities and subordinates them to national priorities (improvement needed);
- (i) Channelling of medium- and long-term credit to private industry and agriculture at positive, but not excessive, interest rates (improvement needed);
- (j) Stability in policy regarding property rights and treatment of foreign and domestic investments (continuation of present practice needed);
- (k) Non-inflationary wage policies (continuation of present practice needed).

Five Year Program and Projections

13. The past and projected level of public investments - which includes long-term credit programs for industry and housing - are only rough orders of magnitude. They imply an average annual increase of 7.8 percent between

1966 and 1970, if Bank recommendations are accepted. From 1970 onwards, it would be reasonable to aim for 7.0 to 7.5 percent at the most, so as to accommodate the private sector's expansion needs. The sectoral distribution as well as the absolute levels are still subject to review, both within the spending agencies and the Bank. The present planning horizon in Brazil only goes beyond 1970 in some sectors - electric power and transport - and even the 1968-1970 plans are highly tentative.

Capital Inflow and External Debt

14. Gross capital inflows are projected to be around US\$4.5 billion^{1/} during 1968-73. This estimate includes some US\$ 400 million of amortizations of debts which it is expected will be rolled over from year to year by the IMF. In view of the relatively low foreign exchange component of many of the main investment projects, some local currency financing or program lending will be required. The estimates refer to what may be termed justifiable gross capital inflows; they are roughly consistent - subject to more detailed calculations presently underway - with GDP growth rates of 5-6 percent, domestic marginal savings coefficients of around 25 percent and with debt service ratios which are not likely to be below 30 percent by 1980. The policy conditions underlying these assumptions are a very restrained growth of current expenditures of all levels of government, exchange rate policies permitting the exploitation of the large growth potential of non-traditional exports and monetary, fiscal and pricing policies consistent with continued deceleration of demand inflation. In the absence of such policies, the level of capital imports could turn out to be very much larger; virtually no limit can be placed on potential unjustifiable capital imports. In the most extreme case these could take the form of renewed buildups of commercial arrears; in a slightly less dramatic form large increases in service obligations for medium-term suppliers credits and other short- to medium-term debts could be the consequence of substantial deviations from the policy assumptions made here. It should be noted that the terms of borrowing in the next five years will have a significant bearing on the size of the gross inflows required by 1973. In this sense the availability of capital on World Bank Group terms during the next few years will play a role in determining the total required by 1973. Moreover, since even under favorable assumptions about Brazil's savings effort - implying a negligible resource gap by 1980 - interest charges will rise enough to keep the debt service ratio at the indicated high levels, there will be reason to blend Bank loans with IDA credits or other funds obtained on concessionary terms.

15. During the next five years approximately one half of the projected gross capital inflows are likely to be required to amortize present and expected new debts. As in the past, the proportion of gross fixed capital formation that is financed by the resulting net capital inflows from abroad would, under these projections, remain below 15 percent. This places Brazil near the top of the list of underdeveloped countries when ranked by the degree of domestic financing of aggregate investment, especially when in this ranking account is taken of differences in per capita income.

^{1/} These figures replace those used in the earlier 5 year projection.

BRAZIL

BANK/IDA STRATEGY

A. Conclusion on Country Relevant for Bank/IDA

1. Policies

The above discussion of the economic prospects of Brazil identifies five policy areas which should have a major bearing on our future lending to Brazil. These are:

(a) Continued progress in the control of inflation: we should attach special importance to the stabilization and ultimate reduction (in real terms) of the Federal Government's current expenditure. Moreover, with the substantial increase in the taxation receipts of the State Governments, we should support a gradual transfer of some current as well as capital expenditure functions from the Federal Government to the States.

(b) Continued progress in establishing and maintaining a flexible price mechanism: the control of inflation is to be a gradual process and in the meantime the maintenance of a rational pattern of resource allocation and the provision of funds for new investments require a minimum interference with the mechanism of relative prices. In this respect we shall give special attention to the periodic adjustments of public utility prices.

(c) Progress in developing a healthy balance of payments: we consider a continued growth of exports, and the maintenance of an exchange rate which will ensure this, as an important determinant of Brazil's creditworthiness. We would also expect that physical controls do not re-emerge as an instrument of the balance of payments policy. In order that Brazil's creditworthiness is not adversely affected by a serious external liquidity problem, we would attach importance to the prevention of an excessive accumulation of short-term debts.

(d) Maintenance of a coffee policy to prevent the re-emergence of sizable surpluses: the coffee policy of the last three years has been a key element in the control of inflation and a gradual reduction of the very large surpluses. This policy needs to be continued.

(e) Improvement in planning, project preparation and project execution in the less developed sectors and regions of the country: in the discussion below we indicate the emphasis we propose to attach to the less developed sectors and regions in the economy. Our efforts would need to be complimented by the Brazilians' own.

2. Priorities

We conceive our future lending in Brazil as a combination of:

(a) A minimum amount of about \$50 million per year expected to materialize without much uncertainty as an instrument for maintaining a dialogue with the Government on major objectives of economic policy as outlined above: our basic criteria for projects in this category would be availability and readiness. Such is the case with projects in the power sector, and possibly some industrial projects.

(b) Additional project lending increasing under optimum conditions to about \$250 million annually by the early seventies. In order that the sector and project objectives we seek through our lending in this category also contribute to the achievement of the general economic policy objectives, we would deliberately identify and prepare projects in sectors particularly relevant from this point of view.

Since the deficits of transportation entities are a major contribution to the Federal budget deficit, we propose that in the next five years the Bank place major emphasis on the transportation sector in Brazil. The Bank has been associated with the program of studies and project preparation in this sector since 1965. The first phase of a transport survey partly financed by the Bank and covering the railways, the major ports and the highways in the Southern States has been completed. A second phase of the survey covering highways in the remaining States is in progress. A blueprint for the transport sector's reform outlined in the transport survey is being used by the Government to prepare a 3-year Plan of Action. The Bank is negotiating in conjunction with the proposed \$26 million loan for a highway project a memorandum incorporating the specifics of the Government's future transportation policy including a time schedule for the adoption of certain key first steps, such as the merger of the numerous separate railway systems, the closing of uneconomic lines, etc. There is likely to be a continuing flow of bankable projects in highways, ports and possibly railways over the next five years and we propose to link our lending for these projects to performance on the Government's proposed transportation policy undertakings.

Through our proposed lending in agriculture we hope to make a contribution to the establishment and strengthening of channels for the flow of investment funds to the sector. Moreover, we hope to reinforce the Government's efforts to strengthen incentives for production expansion by freeing the prices of agricultural products and improving their marketing and to develop new exports.

Through our proposed lending for industrial credit we expect to provide the much needed foreign exchange for industrial expansion in the Northeast (there are, for the time being, ample domestic funds owing to the substantial tax incentives) and to the strengthening of the newly emerging private finance companies in the more developed part of the country.

The proposed iron ore project would make a direct contribution to exports and hence to the improvement of Brazil's balance of payments. Through our lending for a steel project we hope to induce price flexibility and efficiency in a key industry controlled by the Government.

(c) Insofar as consistent with our objective under (a) above, we would seek to avoid attaching our funds to projects for which suitable bilateral financing could be available unless our presence would improve significantly the terms and amounts of such bilateral financing. These are usually projects with relatively high equipment component and in sectors with highly developed institutions, such as electric power. Thus, in contrast to the recent past when practically all our lending was for power projects, in the next five years less than one-fifth of our total lending would be for power projects. Had suitable projects in other sectors been available to ensure a minimum transfer of funds to Brazil with reasonable certainty, we would have attempted to reduce further our proposed lending in the sector.

(d) Despite the considerably greater effort required to formulate and implement projects in the less developed parts of the country, particularly the Northeast, we shall emphasize the development of these areas. Thus, the Northeast would be given priority in our program for the identification and preparation of transportation and agriculture projects.

(e) In recent years we have coordinated our approach to major economic policy issues with other lenders, particularly IMF and USAID. Despite the relatively modest amount of our recent lending in Brazil this has permitted us some marginal influence on the design of the Government's economic policy and on the position of the other two agencies. Our proposed lending could be more productive if approached within the framework of a Consultative Group, provided that the bilateral and multilateral lenders would be prepared to discuss and generally make commitments on the extent and terms of their support for Brazil's development effort and provided that Brazil would be prepared to formulate periodically programs which could be the basis for convening the Consultative Group. So far the Government has evinced only sporadic interest in this. However, in future discussions with the Government we shall explore the Government's attitude towards a Consultative Group. If a Consultative Group were to be convened, the Bank would have to consider assistance to the Government in the preparation of programs and projects which would be the basis for discussions within the Group.

3. Lending Terms

Brazil may need larger net and gross capital inflows in the late seventies than in the next five years. To prevent an excessive buildup of interest on loans contracted in the late sixties and early seventies, the Government would have to pay serious attention to the terms of borrowing. The Bank/IDA should contribute to preventing the emergence of a debt problem by a moderate flow of IDA funds for projects in Brazil. Between now and the mid-seventies, Brazil would be able to avoid a major liquidity squeeze if it continues to follow policies for the management of balance of payments as outlined above. Extended grace periods on country grounds are not recommended, at least not for the time being; nor are extended maturities recommended if IDA funds would be available in amounts indicated in the lending program.

B. Five-Year Lending Program (see attached table)

Brazil's gross capital requirements during 1968/69-1972/73 are expected to be of the order of about \$4.5 billion. Of this it is proposed that the Bank/IDA contribution be \$900 million to \$1 billion (as compared with \$700 million shown in an earlier projection). This would be consistent with the likely flow of resources from other agencies and with our desire to respond appropriately if the Government's policy in the key areas of economic policy emerges as indicated above.

In conformity with the lending strategy we propose, the lending program comprises transportation, 41 percent of the total, agriculture, 13 percent, electric power, 18 percent, industry, 15 percent, and another 13 percent for education, sanitation and unidentified projects.

The projects included in the program vary in readiness. On the one hand the power projects and the earlier projects in transportation appear relatively close to implementation. On the other, a number of projects in the later years of projection are ideas. A major assumption of these projections is that the Bank and Brazil would be prepared to devote substantial manpower resources to the preparation of projects. This is critical since we are deliberately attempting to expand our lending in sectors such as transportation, agriculture and education where the capabilities of institutions to formulate and implement projects are relatively less developed. We are also assuming that our own project evaluation and processing procedures would be speeded up. If these assumptions are not realized, the Bank/IDA lending in sectors like transportation and agriculture would be considerably less than we envisage.

The deliberate policy of restricting Bank lending in sectors such as power, which would be particularly suitable for financing from bilateral sources, implies that the equipment component and hence the foreign exchange component of future projects would be relatively

low. The foreign exchange component of projects in agriculture, transportation, education, sanitation and private finance companies is not likely to exceed 25 percent and, in many cases, may be less. However, consistent with our desire to make a significant contribution in these areas and to contribute towards meeting Brazil's overall capital requirements (as distinct from foreign exchange content of projects suitable for external financing) we should be prepared for local currency financing in reasonable amounts outside the power sector. For planning purposes, we have assumed that the Bank would be prepared to finance 40 percent of the cost of projects or the foreign exchange component, whichever is larger. This is consistent with the cost sharing formula recommended by the Economic Mission last year and endorsed by the Loan Committee.

In respect of industrial finance companies, we have assumed for purposes of this forecast that there will be changes in present policies which would permit us to lend to a Government-owned institution, Banco do Nordeste do Brasil (BNB), for industrial financing in the Northeast and to use Bank funds for local procurement in case of the proposed loan to private industrial finance companies in the more developed parts of Brazil. The Banco do Nordeste has a surplus of domestic resources but is short of foreign exchange. Given the large amounts of funds available for industrial investment in the Northeast which must - under the system of federal income tax exemptions - be channeled through the BNB, private finance companies do not operate on a significant scale in the Northeast. During our initial investigation of the project we would also examine the economic implications of the diversion of investible funds for the development of industry in the Northeast. In South-Central area, however, there are several rapidly growing private development finance companies. In order to assist and strengthen them we would have to permit the use of Bank funds for local purchases since a substantial proportion of the capital goods requirements of the medium scale industry of this region is manufactured locally.

C. Alternative Lending

If projects in transport and agriculture can be prepared in greater volume and with greater speed than we envisage, we would recommend reduction in our projected lending for electric power and steel.

The extent and area of reduction in our lending in case of poor performance would depend upon where the performance is weak. In general, we would link restrictions on lending because of poor overall economic performance to the minimum lending program (power, and certain industrial projects). Barring a complete collapse of economic management, such as in the early sixties, our lending in transport and agriculture would be linked mainly to sector conditions that are of importance for general economic performance as well. The maximum lending level in the

program would be associated with satisfactory general economic as well as sectoral performance. Since the bulk of our lending would be in sectors where good performance has an important bearing on general economic management, our assumption is that the two will go together.

D. Other Activities and Issues

Lending on the scale proposed would require considerably greater project preparation effort than at present. Since in transport and agriculture there would be a continuing need for technicians to work with local personnel, it might be more productive if done from a resident office in Brazil. We see project preparation as being the focus of a future resident mission. Secondly, if a Consultative Group were to be established for Brazil, we would probably have to assist the Government in formulating annual programs and projects for presentation to the Group. This might again be done by an office in Brazil.

Attachment (1).

Western Hemisphere Department
June 14, 1968

FIVE-YEAR FORECAST

B R A Z I L

(\$ Million)

	1968/69		1969/70		1970/71		1971/72		1972/73		Total					
	Bank	IDA Total	Bank	IDA Total	Bank	IDA Total	Bank	IDA Total	Bank	IDA Total	Bank	IDA Total				
<u>POWER</u>																
Volta Grande (Cemig)	25	25														
Porto Colombia (Furnas)	25	25														
Sao Francisco			25	25												
Marimbondo (Furnas)					50 ^{1/}	50 ^{1/}										
CAEEB Distribution							50	50								
											380	25	405			
<u>TRANSPORT</u>																
Highways I	25	25														
Highways II			50	50												
Sao Paulo Beltway					50	50										
Ports (Rio, Santos, Recife)			30	30												
2 Addtl Transport Projects I							75	25	100							
3 Addtl Transport Projects II									150	150						
											85	45	130			
<u>AGRICULTURE</u>																
Santos Port Storage			5	5												
Agricultural Credit I					30	20	50									
Agricultural Credit II									50	25	75					
											150		150			
<u>INDUSTRY AND MINING</u>																
Iron Ore Export (Hanna/Antunes)			25	25												
Steel (Cosipa)									50	50						
Banco de Nordeste-Ind. Credit			25	25												
Private Finance Companies							50	50								
											40		40			
<u>EDUCATION</u>																
Education I					15	15										
Education II									25	25						
											25		25			
<u>SANITATION</u>																
Small City Water Supply							25	25								
											50		50			
<u>UNIDENTIFIED</u>					50 ^{1/}	50 ^{1/}										
TOTAL	75	75	160	160	180	35	215	175	50	225	250	50	300	840	135	975

^{1/} Bank Loan assumed on a 50:50 joint financing basis. If a Loan for the unidentified project listed in the same year does not materialize, we may consider lending \$100 million for Marimbondo without joint financing.

5 - YEAR ECONOMIC DEVELOPMENT PROGRAM

		Actual Data					Projected Data /k						Period Growth Rates		
		1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1962-66	1969-73
Population - growth rate	%	4.2/a											3.0	2.8	
birth rate	per 1000														
Price Change - c.o.l. index	%	52.6	72.4	87.6	61.8	46.6	29.7								
exchange rate (Cr\$ per US\$)	/c	475.0	620.0	1,850.0	2,220.0	2,220.0	2,715.0								
GNP at Factor Cost; 1964 prices - Total	\$ mil.	16,453	16,766	17,370	18,204	18,932	19,708	20,693	21,873	23,032	24,437	25,903	27,457	3.6	5.9
per capita/d.	\$	223	220	221	225	228	230	234	240	246	254	262	270	0.6	3.0
GDP - at current market prices, Total	\$ mil.	11,575	15,469	1,0198	13,872	19,986	19,600	20,580	21,753	22,906	24,303	25,761	27,307	3.6	5.8
real growth rate	%	5.2	1.9	3.6	4.8	4.0	4.1	5.0	5.7	5.3	6.1	6.0	6.0		
Production Growth (real rates) - agriculture	%	2.7	-2.7	-2.1	17.5	-2.0	4.7	4.2	5.0	5.0				3.8/a	
food per cap.	%	-0.1	-0.2	2.4	7.9									3.3/a	
manufacturing/f	%	7.2	2.7	2.6	-4.7	11.8	3.0	7.0	7.5	7.5				2.7/g	
GDP by Branch - agriculture	%	31.1	27.3	29.2	29.2	28.4									
mining	%														
manufacturing/h	%	24.9	27.5	28.1	25.5	27.9									
construction	%														
transport & communication	%														
public admin. & defense	%	11.4	13.0	13.4											
other branches	%	32.6	32.2	29.3											
Resource Gap	% of GDP	1.9	0.6	-1.2	-3.0	-1.1	0.2	0.4	0.5	1.0	0.9	0.8	0.7		
National Saving - private	% of GDP			13.4	7.3	6.8	6.7	5.3	4.1	3.0					
public	% of GDP			3.6	6.6	7.4	6.5	10.3	11.0	11.9					
Total	% of GDP	15.2	16.2	17.0	13.9	14.2	13.2	15.6	15.1	14.9	15.3	15.5	15.6		
Marginal Saving Rate														.14	.13
Consumption - private	% of GDP	68.2	66.8	66.9	71.1	70.8									
public	% of GDP	15.5	16.3	15.4	13.7	13.8									
Total	% of GDP	83.7	83.1	82.3	84.8	84.6	85.4	83.4	83.3	83.7	83.6	83.5	83.5		
Exports of Goods and Services	\$ mil.	1,325	1,525	1,556	1,732	1,865	1,795	1,968	2,120	2,227	2,343	2,459	2,575	8.9	5.0
Imports of Goods and Services	\$ mil.	1,587	1,567	1,328	1,276	1,614	1,871	2,004	2,115	2,233	2,344	2,455	2,565	0.5	4.9
Net Goods and Services	\$ mil.	-262	-42	228	456	251	-76	-36	5	-6	-1	4	10		
Interest on Public Debt, Gross: Outflow (-)	\$ mil.														
Other Investment Income, Net: Outflow (-)	\$ mil.														
Net investment income: Outflow (-)	\$ mil.	-199	-144	-189	-258	-278	-218	-307	-319	-327	-335	-342	-350		
CURRENT SURPLUS(+) DEFICIT(-)	\$ mil.	-461	-186	39	198	-27	-294	-343	-314	-333	-336	-338	-340		
Long Term Private Capital, Net inflow	\$ mil.	126	43	56	108	155		22	22	22	22	22	22		
Long Term Public Capital, Gross inflow	\$ mil.	303	352	294	394	196		621	592	583	600	616	632		
less: amortization	\$ mil.	122	223	178	170	212		300	300	272	285	300	314		
Net long term pub. cap. inflow	\$ mil.	215	158	157	253	16	321	321	292	311	314	316	318		
Other Capital Inflow, Net (incl. errors, etc.)	\$ mil.	-106	-72	-177	39										
NET BALANCE	\$ mil.	-244	-52	47	618										
DFP Drawings(+) Repayments(-)	\$ mil.	-18	5	-28	20	-39	-33								
Foreign Exch. Reserves, Inc.(+) Dec.(-)	\$ mil.	-179	-75	36	253	-96	-205								
Foreign Exch. Reserves, Gross - govt. entities	\$ mil.	291	216	252	505	409	204	204	204	204	204	204	204		
comm. banks	\$ mil.														
Total	\$ mil.	291	216	252	505	409	204								
Foreign Exchange Reserves, Net - Total	\$ mil.														
External Debt	\$ mil.				3,111.4	3,321.4	3,555.5								
Debt Service Ratio	%	28.4	25.9	23.2	26.3	27.4									
Net Factor Payments to Abroad	% of GDP	1.1	0.7	0.7	1.3	1.2	1.4	1.4	1.6	1.4	1.5	1.5	1.5		
Central Government - Current revenue	\$ mil.				1,905	2,618	2,871	3,613	3,915	4,207	4,464	4,732	5,016		
Current expenditure	\$ mil.			1,121	1,236	1,592	1,936	2,263	2,291	2,352	2,422	2,494	2,568		
Saving	\$ mil.				669	1,126	935	1,350	1,624	1,855	2,042	2,238	2,448		
Capital revenue	\$ mil.														
Capital expenditure	\$ mil.	494	655	406	760	1,183									
Budget Surplus(+) Deficit(-)	\$ mil.														
Military expenditure	% of GDP	2.3	2.5	3.6	2.9	3.1									
Education - expenditure (general government)	% of GDP	2.6	2.4	2.1	2.7	2.2									
school enrol., primary & second.	%	55	58	63	60	64									
literacy rate, adult	%	61/n													
Tax Revenue (general government)	% of GDP	21.7	22.5	24.3	25.3	26.3	24.2	29.2	30.0	30.6					
Public Saving (% of public fixed investment)	%			43.9	72.5	71.2	79.3	92.8	100.9	105.3					
Gross Investment - private fixed	% of GDP	16.3/a	16.5/a	6.1	0.6	2.4	5.1	5.3	5.3	5.0	16.7/a	16.8/a	16.9/a		
public fixed	% of GDP			8.2	9.1	10.4	8.2	11.1	10.9	11.3					
increase in stocks	% of GDP	1.9	1.0	2.2	1.5	1.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0		
Total	% of GDP	18.2	17.5	16.5	12.2	14.3	14.8	17.4	17.2	16.3	17.7	17.8	17.9		
Finance of Investment - National saving	%	83.5	92.6	103.0	113.9	99.3	89.2	89.7	87.8	91.4	86.4	87.1	87.2		
Foreign capital	%														
private	%	8.8	1.1	-15.1	-31.7	0.3									
public	%	7.7	6.3	12.1	17.8	0.4									
Total	%	16.5	7.4	-3.0	-13.9	0.7	10.8	10.3	12.2	8.6	13.6	12.9	12.8		
Public Investment by Purpose - agriculture	%			9.3	8.9	10.9	9.2	9.8	10.5	11.0	11.6				
industry	%			19.7	16.9	16.0	17.4	16.0	16.1	16.4	15.4				
power	%			17.8	18.6	17.3	21.5	21.8	20.6	20.4	20.2				
housing	%				0.7	3.0	4.4	4.3	4.7	5.1	5.5				
transportation	%			28.6	31.7	28.8	27.8	27.9	28.1	26.6	26.4				
telecommun.	%			0.4	0.3	0.4	2.1	2.2	1.7	1.5	1.2				
education	%			4.5	4.8	3.4	3.5	3.8	4.2	4.7	5.3				
health	%			0.1	0.2	0.4	0.4	0.5	0.6	0.6	0.7				
other	%														

/a Average for 1959-61. /b Sao Paulo only. /c Free rate; end of year. /d Provisional estimate which may be subject to considerable downward adjustment as a result of a special study now under way. /e 1962-65. /f Data from 1965 relate to value added by manufacturing. /g 1962-64. /h Net Domestic Product at current factor cost. /i Includes mining, construction and utilities. /j Includes loans undistributed. /k Provisional; new balance of payment projections are under preparation by the Area Department. /l Includes non-budgetary funds. /m 1960, population of 10 years old and over. /n Total fixed investment. /o Includes water supply. /p Includes petroleum.

BRAZIL

Briefing Paper for

Mr. McNamara

A. Economic Diagnosis

1. Brazil has a population of 87 million and a per capita income of somewhat less than \$200. It has the resource endowment, market size and human potential to become a major industrial nation in a generation. Its political system is still evolving; the present supremacy of the military may well erode in a few years as a new generation of civilian politicians, untainted by past corruption and intrigues, emerges. The medium-term growth prospects are still dominated by the legacy of the fast but unbalanced growth of the fifties which was accompanied by inflation and growing distortions in the allocation of resources. The industrial base is relatively broad and includes Latin America's most advanced capital goods industries. But it also includes many inefficient establishments and is based on a precarious financial structure. A vigorous commercial agricultural sector exists, but overall land resources are still very underutilized. Regional differences of degree of development and living standards are excessive. Given time, foreign assistance and a market-oriented economic policy, these obstacles can be overcome. Gross external capital inflows of some US\$600 million per year - more than half of which is needed for debt amortization - should be compatible with average annual growth rates of GDP of 5-6 percent and with a declining debt service ratio in the next few years; once the inheritance of distortions and inflation has been overcome, growth and capital requirements could well become substantially greater.
2. The huge investment requirements of the public sector originate in part in the past neglect of certain sectors, in part in the large changes in the size and distribution of the population - which have put urban facilities under great strain - and in part from the growth potential of the economy itself. Thus the large and mostly efficient Federal and State enterprises in steel, petroleum refining and electric power all have major and economically justifiable expansion programs, to which have to be added the more usual requirements for infrastructure expansion - such as roads and ports - or modernization - such as railroads.
3. The Bank resumed its relations with Brazil, which had been suspended in the late fifties, after the 1964 military coup which overthrew the Goulart Government. The Government of Field Marshal Castelo Branco, succeeded in 1967 by Field Marshal Costa e Silva, opted for a policy of gradualism in reducing inflation which in early 1964 had reached an annual rate of over 100%. The Bank, the IMF and the US Government endorsed this approach as the most appropriate one for Brazil and have supported it through project assistance, standby agreements and program and project loans, respectively. Success has not been uniform in all fields, but overall prospects are nevertheless much better than in 1964. The rate of inflation has declined to about 25% as the fiscal deficits - until 1967 -

were reduced in real terms; the wage-price spiral has been broken; price controls were largely abolished; public utility rates were raised to economic levels; the exchange rate was unified and made more realistic; the external debt was renegotiated and has been serviced punctually, and the climate for investments - foreign and domestic - improved.

4. Substantial problems remain and it is to be expected that even if no slippage from present monetary and fiscal targets occurs, it will take several more years until reasonable price stability is achieved. The fiscal deficit is not yet under control (it actually increased in 1967); one of the largest contributing elements is the operating deficit of the railroads and major changes in rate making, organization and labor policy are still required. The balancing of the Federal budget is also constrained by the already high tax burden - about 30% of GDP - which makes expenditure control mandatory. The excessive Federal bureaucracy is one politically sensitive issue; another is the fiscal autonomy of the states and municipalities which account for over 40 per cent of public expenditures. Moreover, large parafiscal subsidies are still given to some state enterprises through exchange subventions for foreign debt service. Another potential source of further inflation is the coffee sector; the original price policy designed to make the production of surpluses unprofitable was partly reversed in 1967 under the pressure of producers' interests. Opposition to the present wage policy is also growing markedly as real wages continue to decline.

5. The great potential for exports other than coffee will not be realized unless the exchange rate is maintained at realistic levels. Until inflation is brought under control this will require more frequent and/or more substantial adjustments than have been made in recent years. Another area in which structural improvements are vital is the provision of long term credit at reasonable - but not subsidized - interest rates to industry and agriculture. This is needed both to finance the expansion of productive capacity and to reduce the vulnerability of existing industry which has had to rely excessively on short term debt.

B. Strategy of Bank Lending

6. Loans to Brazil totalling \$292 million were made between January 1949 and October 1958. Lending was interrupted during the subsequent six years because of the Bank's concern about Brazil's economic performance. Shortly before the ouster of the Goulart regime in April 1964, we agreed to consider lending \$79 million for two power projects in order to offset until early 1971 Brazilian amortization payments on past Bank loans. But these loans were not signed until early 1965 and were, therefore, made in support of the economic program of the new Government. We supported this program further by lending in 1966 an additional \$150 million for the power sector. We selected this sector for our early attention in Brazil because we felt that our familiarity with this sector (arising from previous loans as well as from our role as executing agency of a UNDP study of power in Central Brazil) would permit us to make a substantial contribution to the transfer

of external resources in support of the overall program at an early date. Moreover, we saw the possibility, apart from direct financial support, of contributing through rate covenants in the Bank loans to the general acceptance of flexible power rates, a policy which was essential in an overall gradualist program for tackling inflation. While confining our actual lending to the power field in the early stages of our new relationship with Brazil, we encouraged the Brazilian Government to embark on a broad program of project preparation, in some cases with the financial assistance of the Bank, in order to lay the basis for the diversification of our lending and to demonstrate to the Brazilian authorities that we were prepared to expand the scale of our lending if they continued to implement their stabilization program.

7. While the volume of our lending has been rather modest in the Brazilian context, the fact that we have coordinated our approach with other lenders, particularly the IMF and USAID, has permitted us to mold to some extent the design of the Government's economic policy and to influence the implementation process. If we are to continue to exert an influence on general economic policy, we must be able to offer the prospect of a reasonable volume of loans, at least US\$100 million a year, materializing without too great uncertainty. On the other hand, if we are to use our loans as instruments to influence governmental policy in the particular sector where the loan is being made, we must be willing to withhold our lending until policy understandings are reached in that particular sector. We are attempting to reconcile these potentially conflicting objectives by selecting sectors for some of our lending where policy understandings on that particular sector can contribute greatly to a solution of the overall economic problem and where the willingness of the Government to adopt appropriate sectoral policies is more than symbolic of the Government's willingness to tackle critical issues. Thus, in 1967 we made a loan of US\$40 million for a livestock development project, a condition for which was that the Government remove inhibiting controls on the marketing and export of meat. We regard expanding meat exports as one of the keys to long-term export growth. In making this particular loan, we also helped increase the supply of long-term lending funds in an environment of continuing, albeit reduced, inflation. This was accomplished by a provision for adjusting farmers' payments to the prices of their product which raised the real rate of interest to the lender. We are continuing to work with the Brazilian authorities in designing other projects in the agricultural field suitable for Bank financing so as to reinforce the move in Brazil toward a rationalization of agricultural policies.

8. The second area where we are making an effort to reinforce constructive policy changes is in transport. In this approach we are aided by the program of studies and project preparation initiated in 1965. The first phase of a transport survey partly financed by the Bank and covering the railways, the major ports and the highways in the Southern States has been completed. A second phase of the survey

covering highways in the remaining states is in progress. Bank lending for transportation is to induce a reduction of the Federal Government's budgetary deficit, the railway deficit alone being equivalent to over one-third of the deficit. A blueprint for the transport sector's reform outlined in the transport survey is being used by the Government to prepare a three-year Plan of Action. The Bank is negotiating, in conjunction with a proposed US\$30 million loan for a highway project, a memorandum incorporating the specifics of the Government's future transportation policy, including a time schedule for the adoption of certain key first steps, e.g., a merger of the numerous separate railway systems, the closing of uneconomic lines, etc. There is likely to be a continuing flow of bankable projects in highways, ports and possibly railways, over the course of the next three years and we propose to link our lending for these projects to performance on the Action Plan.

9. While we shall thus be relating part of our lending to the solution of key problems in problem sectors, it is fortunate that simultaneously we can give support to good performance in sectors where policy problems have recently not been acute. We are thus able to contribute to the financing of high priority investment and offer the prospect of a fairly certain flow of Bank lending so long as overall economic policies continue to be implemented. Thus, early in 1968 we signed a loan of US\$22 million for an aluminum plant to be built by Alcominas, a joint enterprise of ALCOA, Hanna and Brazilian minority shareholders. The Government and the Bank viewed this venture as an expression of confidence by foreign investors in Brazil's economic effort. No major governmental policies were modified directly as a result of the loan itself. In this same context we may view the Bank's continuing, but proportionately reduced, involvement in the power sector. We have informed the Brazilian Government that we would hope to gradually phase out our lending for power projects, but that we are willing in 1968 to continue our financing in this area. Governmental policies in this field are rational and being satisfactorily implemented. The power companies themselves have every expectation that these policies will continue and thus can count on Bank loans of US\$50 million in this sector during 1968 so long as the Bank is satisfied with the trend of their overall economic policies. This strengthens our hand in discussing these policies with the Government. In particular, jointly with the International Monetary Fund and the U.S. Government, we have been pressing upon the Brazilian authorities certain actions to improve their budgetary situation and more frequent adjustments in the exchange rate. Our efforts seem to be meeting with success.

10. Taking into account the uncertainties surrounding Brazil's economic program, reflected in two major reverses on the stabilization front in the last few years, we have been reluctant to commit ourselves to a lending program which would greatly exceed US\$100 million a year. ✓

This decision, which was never formally communicated to the Brazilian authorities, also reflected, of course, the stringent resource problem with which the Bank has been confronted. Even though we encouraged and helped finance a project preparation effort in the steel sector, we informed the Brazilian Government that we thought they could obtain adequate financing for steel manufacturing from other sources, indicating that we would be prepared to reconsider our decision if they failed to obtain such financing after making serious efforts. We also informed the Brazilian Government that we would not be prepared to assist in the financing of a major subway project in the city of Sao Paulo. While this decision was based partly on the doubts held by the President's Council as to the propriety of Bank financing of urban subways, it was heavily conditioned by the feeling that we were already sufficiently engaged in the preparation of other projects, given the limitations on the extent of our prospective involvement in Brazil.) X

11. Key issues in our lending to Brazil have been the extent to which the Bank is prepared to finance local currency expenditures and whether the Bank is willing to finance local procurement when Brazilian manufacturers win bids in international competition and with a limited margin of preference. Our economic analysis of Brazil's external capital requirements, taking into account the project content of Brazil's investment program, and the foreign exchange limits in its projects, has led us to conclude that some financing of local currency expenditures is justified, particularly for transportation and agricultural projects where the foreign exchange component is particularly small. In power we are prepared to finance during 1968 only the foreign exchange component, including the foreign exchange component of domestic procurement, whenever Brazilian suppliers win orders in international competitive bidding.

12. The possibility of forming a Consultative Group of capital exporting countries was considered in the Bank. It was decided that the Bank's initiative in this regard would not be justified until Brazil's prospects were clearer.

C. Lending in 1968 and Prospects for the Future

13. Bank lending to Brazil in 1968 (including the Alcominas Loan) is likely to be about \$100 million. The following table lists projects under preparation which are likely to be ready for commitment by the end of the year.

	Total Cost	Direct Foreign Exchange Component	Likely Bank Loan US\$ million	Present Status	Likely Commitment Date
Highways	72	22	30	Negotiations scheduled for April/May	June 1968
FURNAS & CEMIG Power Projects	120	40-50	48-50	Appraisal mission scheduled for April/May	November 1968

The following is a brief description of these projects and of the major issues foreseen.

Highways

14. The proposed Bank loan would be for selected highways in the central and southern regions of Brazil. Feasibility studies for these highways were included in the first phase of the Brazil transport survey. All these highways are located in areas with high traffic density and their completion would contribute to the improved flow of agricultural and industrial products. We have already informed the Government that we wish to negotiate with the loan a statement of transportation policies in highways, railways and ports. Performance in respect of these would determine the extent and timing of our future lending in the transportation sector.

FURNAS and CEMIG Power Projects

15. The FURNAS and CEMIG power companies are efficient previous borrowers of the Bank. It is proposed to make two loans of about \$25 million to each company for hydroelectric projects. The Bank loans would cover the direct and the indirect foreign exchange costs of the project. An economic performance condition for the loans would be an improvement in Brazil's balance of payments management through the adoption of a more flexible exchange rate policy.

16. For lending in 1969 and 1970 we are preparing projects in

ports, highways, agricultural storage, iron ore exports and education. This pipeline should permit lending to Brazil of at least \$100 million annually in these years. Increasing our lending beyond this level in 1970 would be possible but would necessitate our broadening our present project preparation effort.

17. The attached table summarizes the Bank's past loans to Brazil as of February 29, 1968.

Att.

Western Hemisphere Department
April 2, 1968

Bank Loans to Brazil as of February 29, 1968:

<u>Loan No.</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount less Cancellations</u> (US\$ million)	<u>Undisbursed</u>
		Loans fully disbursed		267.0	
403	1965	Central Eletrica de Furnas - Estreito I	Power	57.0	44.7
404	1965	Centrais Eletricas de Sao Paulo - Xavantes	Power	22.5	18.7
442	1966	Centrais Eletricas de Minas Gerais	Power	49.0	46.8
474	1966	Central Eletrica de Furnas - Estreito II	Power	39.0	39.0
475	1966	Cia. Brasileira de Energia Eletrica	Power	6.2	6.2
476	1966	Cia. Forca e Luz do Parana	Power	8.1	8.1
477	1966	Cia. Paulista de Forca e Luz	Power	41.0	40.9
478	1966	Cia. Forca e Luz de Minas Gerais	Power	6.3	6.3
516	1967	Brazil	Livestock	40.0	40.0
526	1968	Cia. Minera de Alumino - Alcominas	Industry*	22.0	22.0
		Total (less cancellations)		558.1	
		of which has been repaid to Bank and others:		<u>125.5</u>	
		Total now outstanding		432.6	
		Amount sold	9.7		
		of which has been repaid:	<u>6.6</u>	<u>3.1</u>	
		Total now held by Bank		<u>429.5</u>	
		Total undisbursed			<u>272.7</u>

*Not yet effective.



Brazil

1. Efficiency of industry in real terms -

Average tariff protection: 50-60% on value added for machinery

2. Financing of industry has been a problem for export
because of financing their short-term funds & lack of
need to convert short-term debt to long-term -
need to have positive interest rates

both of the only & the making long-term loans operated on
negative interest rates & were forced to ration capital -
they gave priority to public & penalized private -

Cost of capital varies from 10% of Brazil reg ant to
costs at reasonable pos. rates in non-bkly mkt
with high pos. rates (bills sold to private sector at 12
per mkt & went at 4% gov. m.)

3. Industrial sector (power, construction, inf.) 30% today vs 33% '60

4. 1st wave of industrialization: import substitution

5. Food imports: ^{1st} consumer troubles for middle & upper class

180 m 1977 -

140 m then

300 m 2002

Marto Ballesteros

MINUTES OF MEETINGS OF BANK MISSION WITH THE MINISTER OF FINANCE
AND THE PRESIDENT OF THE CENTRAL BANK OF BRAZIL

1. The Mission, composed of Messrs. Alter, Wiese, Lerdau, Ballesteros and Holsen, met with Finance Minister Delfim Netto and Central Bank President Ernane Galveas and their advisors^{1/} on the mornings of Thursday and Friday, September 12 and 13, 1968. The meetings convened at 9 a.m. and lasted till noon; the Minister left before they concluded.
2. Mr. Alter proposed that there first be an exchange of views on the salient points of the economic report. This would give focus to the second part of the discussion - possible future Bank lending - since it seemed important to him that the Bank's activities be so designed that they help the Government resolve some of the key problems identified in the report, provided there was agreement on the diagnosis.
3. Mr. Alter stated that the adoption of a new exchange rate policy seemed a very promising step and inquired whether the new policy would conflict with the attempts to reduce interest rates. Mr. Netto replied that interest rates are determined by the market. At present, they are 32-34 percent (the rate now available to savers in the acceptance market). With the new policy, the rate of exchange will move 6 or 7 times a year, the magnitude of the change depending on domestic price increases and inflation in the outside world. For 1968 the overall devaluation is expected to be about 18 percent. Consequently, at present levels of interest rates at home and abroad, the domestic rates are sufficient to discourage speculation and make it attractive to invest locally rather than abroad.
4. Mr. Alter suggested a discussion of the analysis in the report of factors that would affect the stabilization performance in 1968-70. The weak points noted in the report appeared confirmed by developments in recent months; he referred particularly to the problems of Bank of Brazil credit expansion, placement of Government bonds with the Housing Bank and the Bank of the Northeast, and Federal expenditure control. He inquired whether there was common recognition of these weak points and what the Government's present thinking was about how to deal with them.

The Monetary Situation

5. Messrs. Netto and Galveas expressed regret that they had been unable to read the report in detail. Regarding the monetary picture, Mr. Netto declared that the first monetary budget, which projected only a 23 percent increase in credit, was not very objective. Control over

^{1/} Messrs. Vilar de Queiroz, Luis Carvalho and Celso Pastore from the Ministry of Finance and Messrs. Pereira Lira and Matta Machado from the Central Bank.

monetary policy was not possible where large inflows and outflows of capital took place. These flows had reached volumes of \$40-60 million per month, and the main reason for the devaluation had been to stem these large speculative capital inflows and outflows. Take a foreign firm that brings in \$5 million: when they think that there is going to be devaluation they go to the market and get \$5 million in cruzeiros to remit the equivalent foreign exchange. This takes credit away from other firms, resulting in a credit squeeze for them. The main evil of capital flows is that they cause a discriminatory diversion of credit, and that the beneficiaries of inflows are mostly large foreign firms.

6. To Mr. Alter's question whether the credit expansion figures reflected a real expansion or a response of banks to attempt to control the interest rate, Mr. Netto replied that part of the increase was clearly an arithmetical creation resulting from counting as means of payment a number of things that are not. It was also pointed out (Mr. Pereira Lira) that part of the cash squeeze on firms had resulted from much higher collections of indirect taxes, up 110 percent during the first semester. Firms could no longer delay payment because of the adoption of monetary correction and heavy penalties.

7. Mr. Alter inquired whether the Government felt that now that full capacity utilisation had been achieved the situation was delicate and had to be carefully balanced. Mr. Netto agreed; he remarked that the Bank of Brazil credit expansion had been deliberate and authorized by him; for the rest of the year the rate of credit expansion would be reduced. Furthermore, the level of compulsory reserves, which had been lowered in mid-year from 30 to 27 percent, was to return to its original level of 30 percent by the end of the year. Mr. Pereira Lira added that with the new exchange system no violent capital inflows and outflows were expected in the future.

8. Mr. Alter said that it was difficult to understand why the monetary authorities were straightjacketed by inflows of foreign exchange in achieving a reduction of secondary credit expansion. Mr. Galveas replied that the source of expansion comes initially from capital inflows that go to certain large firms; credit to other firms cannot be greatly reduced without seriously hurting them. After April/May a wave of speculation caused a substantial capital outflow, which resulted again in a redistribution of credit, forcing the Central Bank to deliberately expand credit during this second phase. The new exchange system was expected to stabilize capital movements.

9. Messrs. Alter and Lerdau pointed out that the sensitivity of firms to short-term capital derived from their capital structure, and inquired whether any thought was being given in the Central Bank to measures that would alleviate that sensitivity. Mr. Galveas replied that this was being done in certain areas such as agriculture. Mr. Pereira Lira said that part of the problem derived from taxation of illusory profits

and that recent measures (Decree Law 62) would allow firms to readjust their capital, thereby taxing only real profits and allowing them to improve their capital structure if they reinvested the resulting higher after-tax nominal profits.

The Fiscal Situation

10. Turning to the fiscal situation, Mr. Alter indicated that one of the major dangers pointed out in the report was the structural problem arising out of the reallocation of revenues to local governments without a corresponding transfer of functions. There was a real danger that the Federal Government's fiscal situation would become increasingly difficult to manage. He then inquired whether this diagnosis was proper and, if so, what measures were contemplated to correct it, and whether a course of action had been outlined to bring some expenditures under control.

11. Messrs. Galveas and Pereira Lira agreed that the diagnosis was correct. The problem had been eased somewhat by the success in persuading the States to increase the rate of the value added tax to 17 instead of 18 percent. Mr. Netto was in consultation with the States about ways of handling the problem. It was true that some states, like Minas Gerais, had experienced difficulties with the new tax system, but this was due to problems arising from the structure of production, with heavy concentration on certain primary products (cattle, iron ore) that were undergoing a period of crisis. The problems here were specific and did not have policy implications.

12. Regarding the possibility of getting local units to undertake certain functions, considerable attention was being given to the problem although no official policy existed as yet. The Government might try to delay transfer of part of the Participation Fund or suggest projects for use of the capital part of the Participation Fund. Regarding the areas where local units might participate, there was agreement that the sector selection pointed out in the report (transportation, education, sewerage and water supply) made sense.

13. Mr. Alter pointed out that, while realizing that all areas of attacking the problem presented difficulties, we were pressing for the Government's thinking on areas where possibility of rapid success was greatest. He mentioned that there was a dilemma which he wished to discuss further, centering on whether external lending to local units might worsen the imbalance noted above. Units might be placed in a position to blackmail the Federal Government with regard to the provision of the local contribution for the projects. The Brazilian officials agreed with the seriousness of the problem, and some (Mr. Pereira Lira) indicated that matching of funds appeared to be the key to the solution.

14. Mr. Alter brought to the meeting's attention the conclusion in the report about further pronounced declines in private savings by 1970 following the projected increase in the tax burden. The issue of the impact of taxation on savings in Brazil was briefly discussed. Mr. Alter pointed out that even though the exact magnitudes might not be right, the analysis in the report did illustrate an important problem and raise a prima facie case for external financial agencies to channel funds to the private sector.

15. Mr. Alter inquired into the problem of Federal current expenditures, whether the situation was under control, and whether the need for an effective administrative mechanism rather than just ideas was recognized. Mr. Pereira Lira replied that these questions might more adequately be raised with the Ministry of Planning. Mr. Alter then raised the issue of railway deficits. The measures outlined in the Ministry of Transport letter did not provide confidence that the deficits would be significantly reduced. The Bank had hoped that the Ministry would be prepared to reorganize the management of the railways, but no proposal to that effect had been forthcoming. Also omitted from the letter was mention of additional studies on closing of uneconomic lines. We had also expected the Ministry of Transport to formulate its targets in terms of a specific deficit figure; instead they talked about an improvement in the operating ratio. He felt that for the financial authorities the concrete figure should be more relevant, and asked whether they had abandoned hope of achieving a reduction of the deficit. The Brazilian officials replied that they were aware of the problem, and that it required further study on their part.

16. Mr. Alter inquired about the housing program. The Housing Bank was not buying significant amounts of government bonds. What were the plans for 1969? Mr. Galveas replied that reduced receipts by the Housing Bank from Cr.1.4 to 1.2 billion made it difficult for them to buy more bonds. Also the Housing Bank had had to provide additional assistance to savings institutions to compensate for the shift of Federal deposits from them to the Bank of Brazil. The Housing Bank had now Cr.377 million worth of bonds and there was an agreement that they would reach Cr.450 million (including monetary correction) by the end of the year.

17. Mr. Alter asked whether the housing program was one of the areas where changes could be made, or was this program something that the financial authorities had to accept. Mr. Lerdau asked specifically whether it was possible to reduce the Housing Bank applications for 1969 to the level indicated in the draft economic report. Mr. Galveas replied that the 1969 program was now under discussion.

18. Mr. Lerdau referred to another section in the report where it was recommended that transfers to the Highway Department be limited to collections from the gasoline tax and letting the States build some roads included in the Federal program and asked whether this were possible. Brazilian officials replied that this matter should be discussed with the Budget Department in the Ministry of Planning. The level of transfers foreseen for 1969 are higher than the expected proceeds of the gasoline tax, and do not, moreover, include the full Brazilian contributions to externally financed projects. Mr. Alter pointed out that this was one of the issues where more cohesion within

Government agencies was needed, and that we needed an understanding on what the respective ceilings are in each field we are operating; otherwise our own lending policy might turn out to be inconsistent with Government policies. He also expressed concern about our inability to identify the responsible authority within the Government for problems of this nature.

19. Mr. Alter brought up the issue of real interest rates and possibility of introducing indexing of loans to take into account uncertainty about price changes. If the report were correct in diagnosing the problem of capital structure of firms arising from heavy short-term indebtedness, the need for medium and long-term loans was clear. It was difficult to see how this could be done without indexing. The capital market law allowed commercial and investment banks to apply monetary correction to loans of more than one year. Mr. Alter asked what the Brazilian officials thought about the possibility of indexing loans.

20. Mr. Pereira Lira replied that on short-term loans industrialists were reluctant to accept open monetary correction, preferring a high fixed charge instead. There was no experience on how they might react to indexed medium and long-term loans. He felt that they might be persuaded to accept open monetary correction on medium-term loans, and that the policy should be tried. The choice of the appropriate index was a difficult problem, which did not exist in the case of agricultural loans where a special index existed.

21. Mr. Alter opened the second meeting by saying that the previous session had demonstrated a general agreement on the identification of problems but relatively little clarity on proposed steps to meet them. He suggested that today's meeting start with a discussion of the balance of payments of the report, after which he would talk about the proposed Bank lending program.

Balance of Payments

22. Mr. Pereira Lira explained that the Central Bank was now preparing balance of payments projections. Preliminary estimates for 1969 yielded a somewhat larger resource gap than the Bank estimate (\$217 vs \$118 million). Over the longer term, they were arriving at the same general conclusions: the major problem derived from high interest payments which resulted in high debt service ratios. They were in agreement about the need to exercise care on the terms of additional debt to be contracted. One problem was how to deal with offers of short and medium term financial credits; although no debt policy had yet been formulated, the Central Bank was pressing ahead with the debt study in order to arrive at such policy.

23. Mr. Alter asked whether the expansion in private investment during the past year had been accompanied by a marked growth in supplier credits; Mr. Lerdau inquired further whether an instrument for the control of supplier credits existed. Mr. Pereira Lira replied that the largest growth had been in financial, not supplier credits. A mechanism for control of supplier credits existed, since the Central Bank required registration of all loans.

What was needed was to decide upon a set of rules; these would be determined after a review of the full debt picture is completed. Once the rules were adopted, enforcement in a Central Bank registration would not present any problems.

Bank Lending Strategy

24. Mr. Alter explained the work that was being done in the Bank to formulate a lending strategy, emphasizing our interest in working more closely with Brazil and increasing the volume of lending. We took as our starting point our knowledge of particular sectors (power, roads), but would like to have a fairly diversified lending program which focussed in varying degrees on giving support to policy actions that Brazil takes to solve certain economic problems which are key to Brazil's development. The staff's proposed program was worked out in a realistic atmosphere: we did not believe that inflation could be eliminated right away, but we could live with it as long as it did not get out of hand and exchange and price policies were adequate. The overall volume of lending would be conditioned in part on our assessment of how the Government was dealing with these problems; no miracles were expected, but we would want to see evidence of progress. We were also selecting sectors where we would lend if, and only if, government policies in those sectors were moving in the right direction.

25. The total volume of Bank lending might reach \$1 billion over the next five years. So long as there was no breakdown in the stabilization effort, and provided certain sectoral criteria were met, loans for about \$150 million a year would be possible. If by mid-1970 there were evidence of real progress on stabilization and other key development problems, we would move to a level of about \$250 million a year. Throughout the period we would be working with the Brazilians on a whole range of new projects. Considerable work had gone into the preparation of the lending program, but it had not yet received final approval by the Bank's management. Mr. Alter was authorized to discuss it with the Brazilian authorities, but it should be understood that it was not a final program, and its contents should be maintained confidential.

26. The program contemplated new commitments of \$75 million in 1968-69, \$185 million in 1969-70, \$215 million in 1970-71, \$225 million in 1971-72, and \$300 million in 1972-73. Although these were rough orders of magnitude, there were fairly clear ideas on project content, particularly in the early years. Detailed discussion on projects would have to be held with the operating agencies; at this point he wanted to explain and get the Brazilian officials' reaction to the overall design and sectoral composition of the program.

27. Over the five-year period, the sectoral distribution of the program was as follows: power, \$200 million; transport, \$400 million; agriculture, \$150 million; industry and mining, \$150 million. In the power sector, the

key sectoral condition would be maintenance of present policies ensuring adequate rates of return to power companies. In answer to a question he said that this did not imply necessarily maintenance of present rate structures. In transport, an outline of government policies had already been formulated in the Ministry of Transport letter. Although the Bank was not completely satisfied and there were areas, particularly with respect to the railway deficit, where we hope that the Government will reconsider its approach, we are sufficiently encouraged to initiate the process of project preparation to support the \$400 million volume of lending. In agriculture we would look particularly to a continuation of present coffee policies. We were very interested in entering the industrial and mining field, where a major problem appeared to be the necessity to supplement private savings. We would like some part of this lending to be channelled to medium size firms through financial intermediaries. The key policy problem in this sector was interest rates.

28. In addition to those fields, we are thinking of follow up on education (\$40 million) and sewerage and water supply (\$50 million). We would expect here to reach an understanding on how we could give support to a policy of transferring a large part of the financial burden to states and municipalities. This also applied to loans in the transportation sector. Mr. Alter stated that he had some questions of his own about this part of the program. Thus, entering the education field, for example, might have the effect of reducing the financial involvement of local governments which would seem inconsistent with the overall fiscal objectives.

29. Mr. Alter said that those present seemed to be in broad agreement on the question of sectoral policies, and that the question was what had to be done to carry out the suggested program. He invited comments from the Brazilian officials.

30. Mr. Netto said that irrigation and storage were two of the most critical points in the agricultural sector and that he was confident that Brazil could come up with a number of good irrigation projects, which he considered to be of high priority. Mr. Alter said that some of our people who had taken a look at the irrigation potential had some doubts and felt that credit programs might have higher yields. Mr. Netto replied that Brazil had carried out a credit program this year in wheat which had produced a substantial increase in cultivated acreage, but partial drought had prevented a corresponding increase in output. Irrigation and storage were necessary to insure a stable supply of agricultural products; this is a critical element if a stabilization program is to succeed in 5-6 years. It was impossible to have agricultural programs in the NE without irrigation. He asked what the Bank's reaction was to integrated valley development programs.

31. Mr. Alter replied that we were interested in finding projects in Brazil that offered promise and where work had already been done that suggested relatively high yields. Integrated programs usually took a long time to be developed. Mr. Netto said that there was a San Francisco Valley development program, the irrigation part of which could be started. Mr. Alter stated that the success of large scale irrigation projects depended on many factors, e.g., the availability of well prepared settlers, and that integrated valley development schemes therefore had long project preparation periods, often up to 5-6 years. Mr. Wiese explained that an agricultural project identification mission was scheduled to visit the NE about November 20, and mentioned that there appeared to be some discussion about the quality of the soil in areas that topographically are most suitable for irrigation. Mr. Alter mentioned that there was some controversy in the Bank about lending for projects in the NE instead of other areas, but we were prepared to initiate the kind of investigation that would allow us to take a position on this issue. Regarding irrigation projects in particular, we were willing to keep an open mind and would wait for the report of the agricultural mission.

32. Mr. Queiroz asked what Bank policy would be on local cost financing. Mr. Alter replied that the issue had been discussed at a recent Board meeting and the prospects were reasonably good that some local costs would be financed in sectors where the foreign exchange component of projects was low. In the case of Brazil the decision could also be related to success in getting local government entities to finance a share of the cost.

33. Mr. Queiroz noted that the government wanted to move fast in the agricultural sector and expressed concern that no agricultural loans were envisaged in the lending program until mid-1970. Mr. Wiese explained that there were several reasons for this: the selection of the right channel for the loans; the selection of an appropriate indexing system - there was one now in the livestock loan and some months experience is necessary to evaluate how well it worked; the fact that it took time to develop projects and to establish technical supervisory offices, and that it took approximately 9 months from the time the project was ready until the loan was signed. Mr. Queiroz said that in view of the interest of the government in these projects, speedier action might be expected on both institutional and project preparation aspects, and offered to have the Secretary General of Interior come and discuss both aspects with the mission. Mr. Alter replied that we had already responded to the Minister's request by scheduling the November mission and that the proper course for us now was to wait for its report. Nothing would be gained by our having discussions now with the Ministry of Interior. He repeated that the loan schedule itself in the lending program was not rigid and that the Bank was prepared to move as fast as possible.

34. Mr. Alter turned the discussion to the issue of industrial credits. In certain circumstances we could now operate through government owned development banks, although the policy had not yet been applied. He believed that we could make a case for lending through a government bank in the NE - the critical problem here was that measures be taken to offer credit at positive interest rates. He posed the question whether it was at all

conceivable that the Brazilian Government would encourage the Bank of the Northeast to obtain external funds and use indexing in its loans, including those not financed from abroad. Mr. Galveas replied that he thought it would be possible. Mr. Alter pointed out that the Brazilian Government subsidized industrial investment in the NE (through tax incentives and negative real interest rates) as a matter of policy. Positive real interest rates should apply to all funds loaned. In reply to a question, he stated that the Bank did not look upon equity funds provided under Article 34/18 as loan money subject to correction. Mr. Galveas said that the Government's policy regarding the real level of interest rates in industry and agriculture was now under review and that he believed that there would be a willingness to increase the rates. With the new exchange rate policy, it might be possible to apply exchange rate correction. The Brazilian officials expressed a strong preference that any Bank loans for industrial credit outside the NE be channelled through the National Development Bank.

35. Mr. Alter asked whether the interpretation to be drawn from these meetings was that there was substantial agreement on the policy issues presented. In particular, he would like some specific indication from the Finance Minister that the Government had a serious intent to reconsider its interest rate policy. Mr. Vilar de Queiroz, on behalf of the Minister of Finance, accepted the suggestion made by the Bank mission that the Minister before the end of September cable the Bank formally expressing such intent on the part of the Government. There seemed to be agreement that the activity programs presented was a suitable one to initiate, expanding and modifying it as we went along. Mr. Alter thought that we could proceed along the lines of the program presented and that the Brazilian Government could start preparing projects in these areas with the assistance of the Bank. If the Government would designate someone at a high level in the Ministry of Finance or Planning, we would make sure that any modifications in the program that we thought of along the way would be discussed with him and not only with the operating agencies, as a means to achieve effective coordination. Mr. Galveas expressed agreement.

cc: Mr. Diamond (IFC)
Mr. Paterson (IFC)
Mr. Baum (Projects)
Mr. Evans (Projects)
Mr. Weiner (WH)
✓ Mr. E. Lerdau (WH)
Mr. J. Holsen (Economics)

OFFICE MEMORANDUM

TO: Mr. Neil J. Paterson
 FROM: Chauncey F. Dewey
 SUBJECT: BRAZIL -- Briefing Paper

DATE: October 14, 1968

Investment commitments to Brazilian companies (all industrial) total to date slightly in excess of \$33 million, the largest amount committed within any one country by IFC. The first commitment made by IFC anywhere was to a Brazilian company, Siemens do Brasil Companhia de Electricidade, in June 1957. The latest operation was the second investment in Papel e Celulose Catarinense, S.A. approved in September of this year. No investments within Brazil were approved between July 1959 (Champion Celulose, S.A.) and December 1965 (Acos Villares, S.A.) because of internal economic conditions.

Of the nine commitments to date, four have been repaid, sold or cancelled and no longer are held by IFC. The total value of the investments held by IFC at June 30, 1968 (excluding the second Catarinense operation approved in September) was \$20,629,907. The approved investments financed projects in the following areas: three for pulp and paper, one for electrical equipment, one for cement, one for motor vehicles, one for automotive parts, one for steel fabricating and one for fertilizer. Although by value the largest area of investment has been pulp and paper, the largest single investment (\$10.6 million) was in fertilizer (Ultrafertil S.A. - Industria e Comercio de Fertilizantes).

To date, with the exception of D.L.R. Plasticos do Brasil, S.A. (\$450,000 initial investment; \$200,000 principal amount outstanding; manufacturer of automotive parts), all IFC investments have been or are being carried out satisfactorily and may be considered successful operations. The plant of D.L.R. Plasticos is closed and legal action has been instituted by the Company's creditors to recover their claim; for its claim IFC has a mortgage on the Company's assets.

All of IFC's investments to date have been made in companies located in Brazil's industrialized south, principally in the Sao Paulo area. Of the projects under review this trend continues (although discussions with the Northeast Development Bank have been and are taking place concerning projects in that area); however, one of the new projects (cement) is located north of Rio de Janeiro and the other (iron ore) is in Minas Gerais. Of the present and past commitments, five have been to subsidiaries or affiliates (less than 50% ownership) of non-Brazilian corporations -- four U.S.A., one German. The balance are Brazilian owned and managed, although certain foreign licenses may be employed. Of the projects under active consideration, three concern subsidiaries or affiliates of U.S. companies and one is for a purely Brazilian venture including participations by a Brazilian Government agency.

In addition to the IFC projects, in cooperation with IBRD IFC completed the review leading to the IBRD loan (\$22 million) to Companhia Mineira de Alumínio -- Alcominas (aluminium). IFC and IBRD at present jointly are actively considering the iron ore project of Mineracoes Brasileiras Reunidas S.A. (proposed IBRD group financing: \$30/35 million loan from IBRD; \$20 million subordinated investment from IFC).

A brief description of IFC's existing operations in Brazil and projects under active consideration, as well as of the Alcominas project, is attached (Exhibit I).

Attachment

cc: Mr. Koch

PRESENT OPERATIONAL INVESTMENTS

1. ACOS VILLARES S.A.

IFC committed \$5.0 million to this Company in December 1965. The commitment was for \$4.0 million in debt and approximately \$1.0 million in equity. The full amount of the commitment has been disbursed. IFC at present holds approximately 9.5% of the Company's shares and loan repayments commence in November 1968.

Acos Villares is located in an industrial suburb of Sao Paulo and produces high-quality tool, stainless and other special steel products. The project financed by IFC (to be completed in December 1968 after a slight delay) is to enable the Company to increase its output of tool steel and rolling mill rolls. The Company's primary market is the local automotive industry. The majority shareholder is the Villares family, a well-known Brazilian industrial group, which also owns Industrias Villares, an elevator and diesel engine manufacturer.

The Company's sales were about \$18/20 million per year in the last two years; the Company's net profits have not been as good as expected, but this situation is reflected in the entire Brazilian steel industry, the greater part of which is Government owned. As an anti-inflationary measure, the Brazilian Government has not allowed the steel industry to increase its prices to fully offset the effects of cost increases. The Company's results, however, have been improving since April 1968.

2. CHAMPION CELULOSE S.A.

IFC committed \$4.0 million to the Company in 1959. This commitment consisted of a \$4.0 million loan with rights to acquire at no cost approximately 10% of the Company's stock depending on sufficient profits. Additional interest payments beyond a basic 7% rate were also tied to profits. Although IFC has received little deferred interest on this investment, it has acquired the full amount of the stock to which it had rights under the Investment Agreement.

Champion Celulose operates a 75,000 metric ton short fiber pulp and paper mill located at Mogi Guacu in the State of Sao Paulo. The Company is presently doing well, but the results of the Company in dollar terms have been effected by the use of price-level accounting by the Company. A dispute over the application of this accounting practice, which affected IFC's rights to stock and the amount of deferrable interest, arose between IFC and the Company. As IFC now has rights to all the stock due it under the Investment Agreement, the dispute now concerns only the deferrable interest payments and this matter should be resolved shortly.

Only \$1.2 million of the original loan is still outstanding and the full principal amount is to be repaid by December 1969. Eighty per cent of the IFC investment has been sold to participants.

3. D.L.R. PLASTICOS DO BRASIL S.A.

IFC committed \$450,000 in the form of a loan in April 1958. The Company failed to honor their June 1, 1968 maturity (\$200,000 total principal amount is outstanding) and IFC has initiated court action (a mortgage on the Company's assets has been obtained) to recover its claim. The Company produced automotive parts, mostly brake linings under license with Bendix. The main sponsor and President of the Company was Dr. Vincente Ribeiro, also a principal shareholder of Dominium S.A. (a large, diversified Brazilian industrial company specializing in soluble coffee which presently is in receivership). Because of adverse market developments and poor management, D.L.R. Plasticos ceased operations and its plant was closed in mid-1966. Throughout 1966 and 1967 maturities were repaid through advances to the Company from Dominium S.A. As Dominium is no longer able to service D.L.R. Plasticos' debts, IFC has taken the action indicated above.

4. PAPEL E CELULOSE CATARINENSE S.A.

IFC committed approximately \$6.0 million to this Company in 1966. This commitment consisted of a loan and contingent loan totalling \$2.9 million and an equity and contingent equity investment totalling \$3.1 million. In the original financing, other financing sources were ADELA, Inter-American Development Bank, and Banco Nacional de Desenvolvimento Economico (BNDE). In September 1968 IFC approved a \$1.1 million supplementary investment in the Company in the form of convertible debentures. BNDE is providing additional financing and ADELA is again participating in the IFC commitment. Other participants in the IFC commitments are the Bank of America, First Pennsylvania Overseas Development Corporation and Banque Nationale de Paris.

Papel e Celulose Catarinense at present is constructing, in the State of Santa Catarina, a 57,000 metric ton per year integrated kraft pulp and paper mill which will be in operation in 1969. The Company is controlled by the Klabin Group which is one of the largest industrial groups in Brazil and one of the largest manufacturers of pulp and paper in Latin America. The head of this group is Mr. Israel Klabin. Associated with the Klabin Group in this project is the Monteiro Aranha Group. The Brazilian shareholders have fully supported this project financially.

5. ULTRAFERTIL S.A.

IFC committed approximately \$10.6 million to the project in October 1966. This commitment was for a loan of approximately \$7.6 million, an equity investment of \$2.5 million and an overrun commitment of up to \$0.5 million.

The project when completed in late 1969 will represent the largest chemical fertilizer complex in Brazil with an annual capacity of approximately 500,000 short tons of simple and complex fertilizers. Estimated

total cost of the project, including working capital, is estimated at approximately \$69.8 million. In mid-1967 the Company commenced an intensive market seeding program of imported fertilizer under which it is expected to sell 120/150,000 short tons of fertilizers in 1968. The principal shareholders of the Company are Phillips Petroleum with 60.1% of the equity and the Brazilian group of Mr. Pery Igel (Company's President) with 30.1% of the equity. Participating in the IFC investment are First Pennsylvania Overseas Finance Corporation and Bank of California.

6. COMPANHIA MINEIRA DE ALUMINIO -- ALCOMINAS

In addition to the investments of IFC, IFC continues operational work on the IBRD loan for \$22 million made in January 1968 to Companhia Mineira de Alumínio (Alcominas).

This Company is located in Pocos de Caldas, State of Minas Gerais, and will produce 25,000 tons per annum of primary aluminum ingot. The project cost is estimated at \$55 million and the IBRD loan was primarily for the foreign exchange component. The majority shareholders are Alcoa (50%) and the Hanna Mining Company (23%); the balance of the equity is held by various Brazilian interests including the development banks of the State of Minas Gerais and private Brazilians such as Walther Moreira Salles. Expected sales are \$18.5 million annually and the project is expected to be complete by mid-1970. The IBRD loan became effective in August 1968 and approximately \$1.5 million has been disbursed.

PROJECTS UNDER ACTIVE CONSIDERATION

1. LONE STAR CEMENT CORPORATION

The Lone Star Cement Corporation (U.S.) has asked IFC to consider a \$6 million investment in a new plant to be constructed by its existing cement company located near Rio de Janeiro. The project would be a new plant with 440,000 metric tons per annum capacity to be located some 120 miles from Rio. The project cost estimate is presently about \$18 million. The company and IFC's objective is to bring in Brazilian participation in a previously 100% foreign-owned company. To this end, IFC will propose a \$2.4 million common share offering to be held during the construction period and underwritten by IFC and possibly a local investment bank. The product name of the existing company is well known in Brazil and in addition Lone Star controls another Brazilian producer whose shares are already traded and whose stock market reputation is good and, consequently, prospects for placing a portion of this issue in Brazil are promising. This would be IFC's first underwriting in Brazil and one of the largest in that country. The Brazilian Light and Power Company Limited, a Canadian utilities company with substantial funds as a result of compensation for a nationalization of its Brazilian interests, has indicated an intention to participate in the IFC investment.

2. PETROQUIMICA UNIAO S.A.

The project involves the construction and operation of a naphtha cracker and catalytic reformer to produce at full capacity approximately 700,000 tons of basic raw material and intermediate products such as ethylene, propylene, benzene, butadiene, toluene, xylenes and aromatic oils for use in the Brazilian petrochemical industry. The project is under active study and IFC has been requested to provide approximately \$2.5 million in equity and \$5 million in loan.

The total cost of the project, which will be located near Sao Paulo, is estimated at \$60 million. The project is being sponsored by a Brazilian oil refinery (Refineira Uniao), two major Brazilian industrial and financial groups (Moreira Salles and Pery Igel's Ultra Group) and by a subsidiary (Petroquisa) of the state-owned oil company (Petrobras). This would be the first time Petrobras (through its subsidiary Petroquisa) would take a minority position in a private venture.

The project is highly important to the Brazilian petrochemical industry and will result in substantial additional investment in new and economically sized plants to use Petroquimica's products. The sponsors are now making a final selection for the source of the long-term suppliers' credits, which will be a major part of the project's

financing, among U.S., French, and English financing proposals. Action by IFC depends on the speed with which the sponsor's progress, but it is hoped that the project can be taken to the IFC Board of Directors in November 1968.

3. MBR IRON ORE PROJECT

This project has requested both IBRD and IFC consideration and IBRD has indicated its willingness to consider \$30-35 million loan and IFC to consider up to \$20 million of investment. The project would include the mining and sale of 5-6 million TPA of high-grade crushed iron ore. The project would include facilities for mining and a port, but proposes to use the existing facilities of the Central railroad for transporting the ores. New investments would total \$140 million of which \$105 million will be made by the mining company and \$35 million by the Central railroad. The project has a number of outstanding characteristics which include an important foreign exchange earning potential, a relatively lower investment cost due to the existing railroad facilities, extensive reserves of very high-grade ore, and knowledgeable sponsors. The financing plan would depend upon satisfactory long-term purchase contracts being signed, presently expected to be with the Japanese. The project appears to be about mid-way in its development and about one year away from IBRD Board consideration.

CLOSED INVESTMENTS

BRAZIL

In addition to the existing investments, IFC made in the past the following commitments (these investments are closed as of to date).

June 1957 (This was the first IFC commitment.) Loan commitment of \$2,000,000 (7% interest) in Siemens do Brasil Companhia de Eletricidade (Electrical Equipment). \$1,000,000 was cancelled in early 1959. Of the \$1,000,000 disbursed, \$140,000 was repaid in September 1962 and \$860,000 was sold to Siemens e Halske AG Germany in August 1962.

Jan. 1958 Loan commitment of \$1,200,000 (7% interest) in Olinkraft S.A. Celulose e Papel (Pulp and Paper). \$243,000 was cancelled and \$957,000 was sold to Olin Mathieson Chemical Corporation in June 13, 1961.

June 1958 Loan commitment of \$2,450,000 (6% interest) in Wyllis-Overland do Brasil S.A. Industria e Comercio (Motor Vehicles). The last installment was repaid on January 1, 1966. (no participants)

Dec. 1958 Loan commitment of \$1,200,000 (7% interest) in Companhia Mineira de Cimento Portland, S.A. (Cement). This investment was sold to Establisments Cimbra in April 1961.

G

I. Railways

(a) Consolidation of the Railway System

4A. The Government proposes to consolidate the present federal and state railroad networks, embracing 22 railroads, into a single system with four regional superintendencies. This unification is being studied by a commission made up of representatives of the Federal Government and State of Sao Paulo, whose recommendations on the legal, administrative and financial aspects of the merger will be submitted during the third quarter of 1968.

4B. The regional organization recommended by the consultants, however, is already being introduced into the federal railroads and will be reviewed when the above merger is put into effect. It is planned to establish three regional superintendencies early in 1969 (northeast, center and south), coinciding with the geo-economic regions of the country and grouping the operational units located there. The regional superintendents will be selected during the third quarter of 1968, and will take an active part in organizing the regional offices. The new organization will be introduced gradually, so as not to interfere with the continuity of railroad operations. It should be completed by 1970.

(b) Organization of the New National Railway System

5. The federal railroad system is an autonomous mixed-economy enterprise administered by a Board of Directors, composed of a Chairman and Directors, with the assistance of a Consultative Council. The Board of Directors is responsible for the operation of the railroads and their auxiliary services, including the construction of new lines. The Chairman, implementing the resolutions of the Board, is responsible for the day-to-day management of the enterprise, giving an account of his actions to the Minister of Transport, who represents the Federal Government at the General Meeting of Stockholders. Any ministerial agency connected with the railroads will act as a staff agency of the Ministry of Transport and will have no direct supervisory authority over the railroads.

To facilitate the merger, the setting up of the regional systems and the performance of the new activities undertaken, the statutes of RFFSA will be amended to confer greater flexibility on the management. A draft of the statutes has already been prepared and is to be submitted to the General Meeting of Stockholders during the third quarter of 1968.

6. During the second half of 1968, the Federal Railroad System will engage a specialized consulting firm to render technical advice to its staff and, jointly with the staff, to study the reorganization of its services and the implementation of any measures that are considered necessary. In the course of 1969, operating, statistical and cost-accounting criteria, standards and procedures, as well as tariff-setting and commercial policies, will be analyzed and reformulated.

(c) Personnel

7A. The railways will conduct a survey of their personnel to determine actual needs and draw up a program to correct existing distortions. At the same time, they will consider a wage policy that will enable them to recruit and retain personnel with the necessary skill and experience.

The federal railroad system has defined its rational personnel establishment at 131,000 employees on the company's payroll, based on its existing organization and operating methods. This number was reached in 1968 and represents a reduction of 23,000 employees since 1963. Further reshuffling will take place throughout 1969, and redundant staff will have to be pensioned off, dismissed, transferred, or placed at the disposal of the Government. It is hoped that by 1970 RFFSA's payroll will have been cut back to 120,000 employees, representing fewer than 5 men per km of line, which is a perfectly reasonable index.

7B. A working party has been set up by RFFSA to consider revision of the legislation governing the staff of the enterprise. Its findings are to be submitted during the final quarter of 1968.

(d) Accounting

8. The system of accounting will be studied by the above-mentioned consultants and the staff of the railways with a view to updating the schedule of accounts and introducing modern cost accounting in the railways. One basic purpose of the accounting reform will be to provide a rational basis for the reform of the tariff structure.

An auditing office already established within the federal system is advising the accounting services of the various operating units and laying the bases for a mechanized cost accounting system. On these foundations, with the assistance of the technical consultants recommended, it is hoped that by the first half of 1969 the accounts will have been completely reorganized and the new system introduced in the regional superintendencies.

(e) Operations

9. Simultaneously with the merger and reorganization of the present operating units, the railways will revise their operating methods in order to improve the efficiency of railway operations.

Uneconomic stations are gradually being closed down. In the federal system, 202 stations have already been closed or downgraded to simple halts, and a program is being drawn up to eliminate a further 214 stations by December 1969. The cancellation of some trains has been facilitated by improved timetable scheduling and better composition. In addition, during the first half of 1969, an entirely new operating system will be introduced to meet the needs of the regional structure, in collaboration with the technical consultants to be engaged. This system will affect train formation, communications and leave systems, reorganization of workshops, supply and maintenance depots, yards and facilities.

(f) Tariff Policy

10. Beginning in January 1969, the tariff policy will be oriented by competition in the transport market, with any charges resulting from unprofitable operations being allocated to the sectors concerned. The formulation of the new tariff system - which shows the cost of transportation for each specific, regional category of traffic and represents an aggressive policy aimed at winning a larger share of the market - should be completed by the third quarter of 1969, through the joint efforts of the technical consultants and RFFSA's railroad team.

(g) Uneconomic Lines

11. The program for closing uneconomic lines, in pursuance of Decree No.58992 of August 4, 1966, is well underway.

The railroads have already suspended traffic on 75% of the 6,160 km included in the basic program, which is scheduled for completion by 1970. At the request of the railroads, the Standing Committee that is following up the execution of the program has already expanded it to 7,300 km. This revised program is to be completed - and the alternative highways constructed - by 1972.

12. New lines, the planning and/or construction of which is already in hand, will be dealt with as recommended in the Survey Report unless the considerations referred to in Paragraph 13 below are applicable. Construction of those new lines which the Survey Report has identified as uneconomic will be stopped immediately. In cases recommended to be re-studied by the railways, further planning and construction will be stopped as soon as possible and, in any event, not later than the middle of 1969, if the study indicates that the new line would be uneconomic.

13. Wherever the maintenance or construction of uneconomic facilities, including railway lines, is found by the Federal Government to be justified on grounds other than economic, and the Federal Government deems it necessary that these facilities be maintained or constructed, the railways will be reimbursed for construction expenses and net operating losses out of the federal budget, and the expenses will not be charged to the railroads. However, the Federal Government will make an effort to restrict such exceptions to the absolute minimum consistent with national security and social conditions.

14. The investment program for 1968/70, as approved by Law No.5450 of June 5, 1968, will be reviewed periodically, at the intervals laid down in the law, in conformity with the instructions contained in the Strategic Development Plan for 1968/70.

(h) Deficit

15. The main purpose of the above policy is to assure the railroads of a completely viable financial system that will make them increasingly independent of subsidies from the Federal Government.

140 million in '67

how much

The true size of the railroad deficit in RFFSA is now being quantified through the introduction of accounts standardization, by which it is sought to define the charges arising out of government demands, such as low rates for carrying certain goods, provision of free services, maintenance of unprofitable sections, trains and services, granting of fare privileges to former staff, in addition to the discriminatory taxes on rail freight rates, the amounts of which will be recorded in the accounts as notional receipts. Quite apart from this new truth in accounting, the steady reduction of the deficit ought to produce an operating factor of 2.0 in 1968, which will be the best performance index attained by RFFSA since 1959.

II. Highways

16. The objective of the Government's highway policy is to create a roads infrastructure which will be efficiently integrated with, and complementary to, other means of transportation. This involves the development of rational investment programs based on sound economic criteria and the creation of efficient national and state organizations to share, in the most efficient manner possible, the responsibilities for planning, constructing and maintaining the national roads system. The Government's directives in this respect hold that road users must pay the cost of the road services offered.

Accordingly, the following measures will be taken in the course of the next three years:

(a) Delegation of Construction and Maintenance Functions to State Highway Departments

17. A study of the organization of the Federal Highways Department is already underway and will be completed by the end of 1968. On the basis of this study, the Government will formulate in early 1969 a program for the reorganization of the Federal Highways Department, with particular emphasis on its planning, regulatory and supervisory functions.

The study will also attempt to coordinate the work of the State Highway Department with the program to be adopted, so as to enable them to take over from the DNER the duties of construction, paving, maintenance and policing of federal highways.

The transfer of these responsibilities to the State Governments will be effected gradually, as regional conditions, the capacity of the highways agency, and the nature of specific projects permit.

In effecting this delegation, the Federal Government will ensure that the states implement the recommendations of the Survey Report regarding the organization of their highway departments.

(b) User Charges

18. The Government is studying the possibilities of reforming the present system of user charges so that there will be a broad correspondence between the use of highways by particular classes of vehicles and the economic costs of constructing, maintaining and administering the National Roads System. Toward the end of 1968 the Ministry will submit its final proposals to that effect to the country's financial authorities, with a view to analyzing the probable repercussions on Brazil's economic and financial policy. The Government's conclusions will be reported to the World Bank.

(c) Investment Program

19. The Government intends to base its investment program on the highway construction priorities recommended in the Survey Report, with due regard for the national economic situation. Moreover, it intends to maintain, within the Ministry of Transport, a continuous planning process to update the Master Plan on the basis of current and subsequent detailed studies on the technical and economic feasibility of proposed highways, seeking at all times to make the investments that will yield the best return.

III. Ports

20. The Government's policy on ports is to decentralize the administration by setting up autonomous and financially viable entities responsible for their operation, to adopt specific measures for introducing an accounting system, and to set port charges on the basis of the cost of the service rendered at a reasonable level of efficiency. To achieve these objectives, the Government intends to take the following measures:

(a) Decentralization of Port Administration

21. The Federal Government will have to take the necessary legislative and administrative steps to set up corporations in the above ports. In the first half of 1969 inventories of the assets of the principal ports will be conducted, after which the corporations will be set up. The states and municipalities in which the ports are located, as well as business and industrial interests, may participate in these corporations.

(b) Accounting, Tariffs and Port Operations

22. It is proposed to introduce a modern, commercial accounting system in the ports of Rio de Janeiro, Santos and Recife. By December 1968 qualified consultants will be retained to work on the existing plan to introduce such a system in the ports. This work should be completed during the first half of 1969, so that the system can be introduced during the second half of the year.