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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/74

10:00 a.m., May 9, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
J. de Groote	
B. de Maulde	X. Blandin
	M. Teijeiro
R. D. Erb	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	
G. Laske	G. Grosche
G. Lovato	N. Coumbis
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	M. Camara, Temporary
	S. E. Conrado, Temporary
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

European Department: J. J. Hauvonen. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; M. Guitian, S. Kanesa-Thasan, J. P. Lipsky, R. L. Sheehy, C. M. Watson. External Relations Department: H. P. G. Handy. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; N. M. Kaibni, T. K. Morrison. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. S. Cutler. Western Hemsiphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. A. Buyse, A. M. Jul, T. M. Reichmann. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: C. J. Batliwalla, S. El-Khouri, H.-S. Lee, W. Moerke, J.-C. Obame, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, R. L. Bernardo, J. Bulloch, M. B. Chatah, Chen J., L. E. J. M. Coene, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, Wang C. Y., M. A. Weitz.

1. REPORT BY MANAGING DIRECTOR

The Chairman said that he had participated in the first session of the May 7-9 conference on international debt problems in New York City organized by the Chairman of the Federal Reserve Bank of New York. The participants in the conference had included representatives of central banks, commercial banks, economic institutes for international affairs, and the World Bank.

The session in which he had participated, the Chairman continued, had featured a presentation by Mr. Stern, a Vice President of the World Bank, on the Bank's policies concerning structural adjustment loans, in which Mr. Stern had mentioned the need for close collaboration between the Fund and the World Bank. A Governor of the Central Bank of Turkey had then described that country's adjustment experience and the lessons to be learned from it. He himself had spoken on the role of the Fund in adjustment and financing. A brief discussion had followed, and at lunch Mr. Rhodes, the Chairman of the commercial banks' Advisory Committee for the three main Latin American debtor countries, had talked about the results of the adjustment programs in those countries, the role of the Advisory Committee, and the progress made during the previous year in dealing with debt problems in general. At the afternoon session, Mr. Preston, the President of Morgan Bank, had spoken on the role of commercial banks in handling debt problems, and Mr. Fred Bergsten, of the Institute of International Economics had addressed the group on the global aspects of the debt problem.

His own presentation, the Chairman said, had centered on the medium-term outlook for debt--based on the latest World Economic Outlook--and on the role of the Fund and other financial institutions in handling debt problems. He had described the main assumptions on which the medium-term outlook for debt was based, and he had indicated that the problem was manageable and should be alleviated during the remaining years of the decade. He had stressed the importance of the assumptions and had noted that they should be seen as challenges to policy, rather than as forecasts. In commenting on the role of the Fund and other financial institutions, he had underscored the need for strong and convincing adjustment programs to restore balance of payments viability in the medium run, and for an economic and financial environment that would enable adjustment efforts to take off. In particular, he had referred to the need for a sustained noninflationary recovery in the industrial countries through a proper mix of policies conducive to lower real interest rates, and for an open trading system; an increase in nondebtgenerating flows to developing countries from official institutions and direct investors; and a realistic approach to debt problems by the commercial banks, which would have to play a fundamental role in managing the flows of capital to developing countries. He had felt strongly encouraged by previous Executive Board discussions to stress that.

Commercial banks should take a forward-looking approach to debt rescheduling arrangements for countries whose adjustment performance had been positive; under that approach, rescheduling arrangements should be on a multiyear basis, the Chairman went on. Spontaneous voluntary lending could be restored if steps were taken to reschedule the debt of countries that faced an amortization "hump" in about 1986 that would be difficult to finance even if their present strong adjustment efforts were maintained. Support for such an approach seemed to be gaining ground; the commercial bankers at the conference in New York had reacted positively, and he would not be surprised if they were already moving in that direction. He would reiterate the need for multiyear rescheduling in his address to the Annual International Monetary Conference of the American Bankers' Association, to be held in Philadelphia on June 4, 1984.

The discussion at the session in which he had participated had not been conclusive, the Chairman explained. Mention had been made of the possibility of placing a cap on interest rates, but there had been no structured discussion or proposals on that matter. Indeed, there had been no hint of any support for an interest rate cap. Some questions had been posed on the possibility of instituting a system of fixed installment payments for borrowing countries, similar to residential mortgage arrangements, but that idea, too, had received little or no support. The possibility of public guarantees had been mentioned, but the representatives from the central banks had not supported it. In passing, he noted that there had been a marked contrast between the rather vague discussion of the interest rate cap ideas at the conference, and the subsequent fairly explicit press reports on the discussion.

There had been some discussion on the merits of capitalization of existing debt versus the provision of new money, the Chairman said. Some speakers had stressed the need to keep all the banks concerned involved in arrangements providing new money; the capitalization method might assist smaller banks or regional banks that were perhaps less interested in packages providing new money; then the larger money center banks capitalization could facilitate the working of the syndications in which such banks often participated. However, the organizers of those syndications at the conference had not been attracted to the capitalization method; they had felt that it could undermine the cohesion of the syndications and adversely effect relations between lenders and borrowers. The conference participants had seemed to feel that there were more disadvantages than advantages to the capitalization method. Mr. Rhodes had commented that it was important to offer the many banks involved in financing packages a diversity of instruments, including some trade-oriented credits to help to maintain their tie with borrowing countries.

The Executive Directors took note of the Chairman's statement.

2. BRAZIL - 1984 ARTICLE IV CONSULTATION, REVIEW UNDER EXTENDED ARRANGEMENT, AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1984 Article IV consultation and the review under the extended arrangement with Brazil (EBS/84/84, 4/11/84; and Sup. 1, 5/7/84), the letter of intent from the Brazilian authorities and a technical memorandum of understanding pertaining to the second year of the extended arrangement (EBS/84/61, 3/19/84), together with a request from Brazil for a purchase under the compensatory financing facility (EBS/84/86, 4/11/84; and Sup. 1, 5/4/84). They also had before them a report on recent economic developments in Brazil (SM/84/87, 4/25/84).

Mr. Kafka made the following statement:

I. 1983

My Brazilian authorities are in broad agreement with the staff's analysis of developments during 1983. The analysis does not diverge much from that considered by the Executive Board on November 22, 1983. There were then, and are now, some relatively minor analytical differences between the staff and ourselves.

I have, therefore, only a few points regarding 1983.

Corrective price adjustments--including, of course, the real depreciation of the cruzeiro--along with poor crops, in our opinion, contributed much more decisively to the financial problems encountered in 1983 than the staff suggests. This applies to both the first half and the second half of the year.

We also believe that the decline in imports owes much less to restrictions than the staff suggests. The decline in petroleum imports and in the consumption of petroleum derivatives entirely reflects changes in relative prices (the maxidevaluation plus the reduction in implicit subsidies), the growth of domestic production, and substitution by alcohol. The decline in non-oil imports also essentially reflects, it seems to us, changes in relative prices and the reduced level of activity.

Without repeating the staff's analysis, I would like to bring together the basic structural changes made in our economy in 1983.

The relative price structure was completely overhauled. The real devaluation of our currency since February 1983 is one element. Even more radical changes have taken place with respect to other prices, as the staff notes.

The far-reaching overhaul of the wage legislation, including both a change in the indexing system and provision for return to free negotiations, is a further item.

Expenditure control and increased taxes have brought about a reduction by nearly two thirds, from 6.7 percent to 2.6 percent of GDP, in the operational public sector deficit. While the adjustment in the short run necessarily fell heavily on investment expenditures, controllable current expenditures--i.e., everything except debt payments--have also been reduced in real terms to a considerable extent.

A complete turnaround has taken place in monetary policy. Interest rate subsidies were greatly reduced during 1983, and negative real interest rates have been eliminated, with minor exceptions. The changes in interest policy affected in particular agriculture and export finance; it is noteworthy that the area planted to crops has increased by 9.9 percent; and exports are booming. Moreover, a cleanup has taken place in the open market, which will make the conduct of monetary policy much easier and steadier this year than last. There was a sharp, indeed an exceptionally sharp, reduction in the expansion of the monetary base, the money supply, and credit in real terms in 1983, however calculated.

In the external sector, I wish to stress not only the remarkable turnaround in the trade balance and in the current account, but also the heavy burden that is implied by the violent swing from a nonfactor current deficit of almost $3 billion to a nonfactor current surplus of over $4 billion--almost 3 percent of GDP--a burden that is unavoidable to some extent but that should be minimized by sustainable means.

II. 1984

With the success achieved in improving the balance of payments, inflation is now the most urgent problem that we face. All measures adopted are designed to bring about a reduction in inflation this year. On the other hand, we believe that the staff takes far too pessimistic a view on the recovery that is likely in 1984 and, particularly, in subsequent years. In the first quarter, there has already been a modest recovery in output, compared to the deep recession of 1983. We would indeed consider our adjustment program a failure if progress against inflation were not linked to recovery from the frightening decline in real GNP per capita, which we estimate at 12 percent since end of 1980. Our expectations on growth are more favorable than the staff's, based on the following considerations:

First, we believe that on the supply side there are no obstacles to returning to the 1982 average level of output and, possibly, going beyond it. We base these expectations--in addition to the presence of widespread idle capacity--on the projected increase by 22 percent of non-oil imports in dollar terms, only 5 percent below the 1982 increase, and on the staff expectations that import prices of non-oil LDCs will exceed 1982 prices by only 3 percent. This suggests that a relatively minor increase in import substitution--many projects of this kind are coming on stream--should be sufficient to make up for, or better, the real volume of importables of that earlier year.

Second, we assume that a considerable stimulus to demand will come from exports, which in the first four months of 1984 exceeded those of last year by 20 percent. These expectations are based on the hope that there will be no violent intensification of protectionist tendencies in industrial countries and that our trade, in particular with Latin America, will be able at least to recover from last year's heavy decline; in 1983, our exports to Latin America fell by 28 percent from 1982, while our overall exports rose 8.5 percent. Regarding domestic demand, we assume no further decline in real wages or employment and some gradual recovery of the latter.

I would now like to add some comments on the manner in which the program affects various sectors of the economy.

In fiscal policy, our expectation is that the modest recovery in output which seems to have taken place during the first quarter will, if extended, lead to a considerably higher level of tax collections than that foreseen in the budget. At the same time, our feeling is that the monitoring of expenditures, including that affecting specifically the state enterprises and "autarquias" and that affecting the so-called monetary budget, is now functioning satisfactorily; control over the use of credit by state and municiple governments has been and is continuing to be tightened. This suggests a continued achievement of targets regarding the operational public sector borrowing requirement (PSBR) and the overall PSBR as long as inflation behaves as it is expected to. One matter that greatly concerns us is that we are having difficulty providing the counterpart funds to loans for projects being financed by the multilateral development finance institutions, particularly the World Bank. This is a concern despite the tremendous and imaginative efforts that have been and are being made by the World Bank to assist us in our endeavors.

In monetary policy, the program will be tight, unless prices react soon in the manner in which they should react considering the decline in real liquidity. The staff mentions the cuts that will have to ensue in the monetary authorities' credit to agriculture and export, but one must consider that, with the change in interest policy, the elimination of part of the credit that sailed under those descriptions but did not necessarily benefit those sectors, should take place without damage to them. Furthermore, also as a result of the new interest rate policy, private financial institutions' credit to these sectors can be expected to expand, particularly in the financing of manufactured exports.

Important developments are under way in this respect with the assistance of the World Bank. The whole area of monetary policy will be easier to handle as a result of the reforms already undertaken in 1983 and the movement now under way toward incorporating all expenditures paid by the Central Bank under the so-called monetary budget into the fiscal budget. We therefore expect that, in the not too distant future, the Central Bank will be able to concentrate on more classical and more manageable functions, while the Bank of Brazil will be able to compete with other banks for the public's resources and to make full use of its extensive network of branches in the interior of the country to assist the economy.

In price and incomes policy, I agree with the staff that the major corrective prive adjustments are past, which should make inflation easier to deal with in the rest of 1984 than in 1983 or the beginning of this year. Price increases in April continued the decline registered since February in the monthly rate of inflation. Another favorable sign is the low premium--about 8 percent--to which the parallel market exchange rate has fallen. Crops are, on the whole, better this year than last and, where they are not, we have more scope for imports, progress may be affected temporarily by factors not directly controllable deriving from natural conditions. Above all, ingrained inflationary expectations will have to be reversed before anti-inflationary policies have their full effects. I should like to add that, in an economy with important oligopolistic elements but without the ample exchange reserves that would permit us to open up our markets to the world without fear of sudden exchange rate spurts that would greatly prejudice our fight against inflation, we cannot for the time being dispense with continued price surveillance and, in some cases, control.

As to the balance of payments and foreign trade, the disbursement of the foreign loans that should have become available toward the end of last year has permitted us not only to comply with the performance criteria dependent on that disbursement, but also to remove important emergency controls, thereby accelerating the processing of imports as well as other payments. This should substantially benefit production. Of the new financing expected for this year, $2.5 billion reflects bilateral official export credits; we expect that, like ourselves, our friends will take all actions necessary to achieve these disbursement goals. The first quarter results on the trade surplus were beyond our expectations, and the trend is expected to keep up, although undoubtedly during the year there will be fluctuations. The growth of exports, as already mentioned, has been extraordinarily encouraging. In the first quarter, its contributions to the improvement in the trade surplus over that of the same period of 1983 was nearly two thirds.

III. Medium-term Prospects

Our main questions regarding the staff paper refer to the medium-term prospects. We believe that a much better growth outcome is likely than that foreseen in Table 12, always assuming that there is no substantial intensification of protectionist tendencies among industrial countries. The burden of these restrictions at the time of writing is detailed in Appendix VIII to the staff paper; their extent and continued intensification are truly frightening.

Let me state the reasons for our otherwise favorable growth expectations. The first year of the medium term will still be able to benefit from the high level of idle capacity. Furthermore, like the staff, we expect a recovery in the domestic savings ratio. The staff's projections imply that, for the period 1985 to the end of the decade, domestic savings will average some 22 percent of GDP. This ratio--while much higher than recently--corresponds to the 1969-78 average; perhaps more significant, the savings ratio assumed by the staff is only 1 percentage point above the relatively depressed 1974-78 average (though higher than for the most recent period, which, however, included three recession or growth recession years). The new interest rate policy will certainly promote savings. If we have to run an average annual resource surplus (or negative resource gap) of about $10 billion in the medium term--also in line with staff projections--this would mean a domestic investment ratio of about 19 percent of GDP on average, on the basis of the staff's growth assumptions. The challenge of Brazil's resource base, combined with the entrepreneurial mentality that has always prevailed in both our private and public sectors, suggests that all opportunities for investment will be used. The maintenance of competitiveness and recovery should assure the necessary real demand. The investment ratio mentioned, combined with the staff's growth projections, would imply a capital/output ratio of 5; this is far above even the relatively high ratio that prevailed between the first and second oil shocks, which was 3.6; during the five preceding years, the ratio had been 2.3. In the subsequent five years, the ratio was much higher, but, since they include three recession, or growth recession years, these years are hardly characteristic. If we accept the 1974-78 ratio, the potential growth rate for the period 1985-90 is more likely to exceed 5 percent than to be 4 percent.

The potential growth rate could in fact quite reasonably turn out to be even higher. Solutions may--and certainly should--be found to alleviate in the general interest the transfer burden resting on the debtor countries. And there is another consideration. The staff's projections of current account surpluses for the later years of the decade reflect a realistic potential. But one must hope that, apart from a more favorable attitude regarding effective interest payments, developing countries may be able in those latter years to receive voluntary equity and capital inflows on a moderate scale enabling them to increase their international net reserves by such inflows, rather than be forced to do so by current account surpluses, i.e., by exporting capital to other countries, including much wealthier ones.

An adequate supply of imports to make the higher potential growth rate feasible will be facilitated by the same factors I just mentioned. In addition, the flow of exports could grow faster than is foreseen by the staff. Even by the end of the decade, Brazil will still be a relatively small supplier of manufactures to the world--even if it is not inhibited from exporting them by increased protectionism--so that it should be able to increase its market share. And Brazil is likely greatly to increase its exports of grains and ore. The staff's projections of annual export growth at about 10 percent in dollar terms reflect a volume growth of only 5.3 percent, less than four fifths of the world economic outlook projection for major exporters of manufactures and about half Brazil's volume growth in 1978-83, not a particularly buoyant period of world trade. Altogether, therefore, one can expect a per capita GDP growth rate 1-2 percentage points higher than that foreseen by the staff.

I would not like to close without restating our deep-felt thanks for the help we have received since the start of the debt crisis through the quite extraordinary efforts expended in our behalf by the Managing Director, unstinting assistance from the Deputy Managing Director, and the indefatigable efforts of the staff.

Mr. Erb remarked that he broadly agreed with the staff analysis and would focus his comments on the medium-term outlook.

The continued high rate of inflation was the most worrying feature of recent economic developments in Brazil, Mr. Erb considered. Further progress in reducing the public sector borrowing requirement and the surplus on the operational budget, and additional significant reductions in the growth rates of money and credit, would be needed to reduce the rate of inflation.

Commenting on the longer-term outlook for the economy, Mr. Erb said that the staff had noted that the extended arrangement was meant to achieve a fundamental change, namely, a reduction in the country's reliance on foreign borrowed resources and an increase in its reliance on domestic savings and improvements in economic efficiency. It was against the need for that change that present policies and the recent performance should be measured.

The price signals had to be correct, and the restrictive mechanisms should be reduced and eliminated, Mr. Erb continued. As a result of the maxidevaluation of February 1983 and the present policy of depreciating the exchange rate in line with domestic inflation, there was reason to feel confident that the price of foreign exchange would remain realistic. However, the exchange rate still reflected the existence of a large number of trade and payments restrictions and other economic distortions.

The reductions in 1983 in interest rate subsidies for credit to agriculture, exports, and small business were steps in the right direction, but even if those rates were positive, it was not clear whether they fully covered the cost of money to lenders, Mr. Erb went on. Apparently, substantial amounts of credit to those sectors had been provided at subsidized rates, which continued to apply to those loans; near-market rates were being charged only on fresh credit.

As for wages, Mr. Erb said, the reduction in 1983 in the average degree of indexation to past inflation to about 86 percent, the lower wage rates permissible for enterprises whose viability was threatened, and the provision for the gradual establishment of free wage negotiations beginning in mid-1985 were positive developments. He wondered whether the recent debate in Brazil on the broad issue of wage indexation was likely to lead to a more fundamental change in indexation, and whether there been any more recent developments with respect to the establishment of free wage negotiations.

In administered prices, Mr. Erb commented, the recent termination of the subsidies petroleum products, the planned end to wheat price subsidies by mid-1984, and the 5 percent increase in real terms of steel prices and electricity rates, would help to increase economic efficiency. However, it was not clear to him how Brazil's steel and electricity charges stood in relation to world prices. He shared the staff's concern about the recent substitution of the old price surveillance system by a new system of prior approvals for some prices. Although the new system was relatively limited in coverage and was designed to deal with oligopolistic situations, it would contribute to inflation by undermining economic efficiency. As the economic recovery progressed, every opportunity should be taken to eliminate remaining controls.

Commenting on the exchange and trade system, Mr. Erb said that he was particularly pleased that the arrears and the central system of foreign exchange allocation had been eliminated. However, there was still an array of multiple currency practices and other restrictive measures. Although some progress had been made in dismantling those arrangements, the authorities would have to devote much more attention to them in the coming period. As the economy was opened to market forces and the exchange rate was maintained at a level decreasingly dependent on restrictive measures, the remaining restrictions would become anachronistic. The authorities and the staff should be urged to continue monitoring those measures closely and to view them not as technical derogations from Brazil's formal obligations to the Fund, but rather as impediments to efficient resource allocation that should be eliminated as soon as possible.

It was apparent, Mr. Erb continued, that Brazil could not count on the Fund as a permanent source of financing, that the scale of foreign commercial bank lending would have to be smaller in the future than it had been in the early 1980s, and that multilateral development banks had limited resources with which to help Brazil; therefore, a return to higher domestic savings and investment rates was clearly needed. The expansion of trade and direct investment offered good opportunities for restoring both adequate rates of economic growth and a sustainable balance of payments position. Protection against Brazilian exports must be resisted. In 1983, imports by the United States from Brazil had in fact grown by 17 percent, or three times the overall U.S. import growth rate. The view that countervailing action against foreign subsidies constituted a protectionist practice was unacceptable; Brazil should eliminate the subsidies and other measures that induced countervailing and antidumping actions.

That Brazil had yet to take essential steps to make the economy more attractive to foreign private direct investment was a cause for concern, Mr. Erb considered. Apparently there had been only some $700 million in such investment in 1983, and, according to the medium-term outlook, it was not expected to increase very much through 1989. With a more mature investment strategy, Brazil could conceivably attract as much as $3-5 billion a year in foreign investment inflows once the real rate of economic growth had recovered to about 4 percent. The time was ripe to address the issue of direct investment. Failure to do so could perpetuate Brazil's dependency on capital inflows from private foreign banks and increase the country's vulnerability to volatile capital flows at a time when stable capital investments were needed. Creation of a more favorable investment climate in Brazil--including equal treatment of foreign and domestic investors, the elimination of market reserve arrangements and of export and other performance requirements, and the introduction of more adequate patent protection for imported technology--would go some distance toward improving Brazil's growth and balance of payments outlook.

In commenting on short-term capital flows, Mr. Erb noted, Mr. Kafka had stated that Brazil was having difficulty in providing the counterpart funds to loans for projects being financed by the multilateral development finance institutions, and in particular the World Bank. A staff comment on the problem would be helpful.

The proposed purchase under the compensatory financing facility was acceptable, Mr. Erb said. However, it was anomalous that a country with an overall increase of 12 percent in the value of its exports was able to demonstrate an export shortfall. More important, given the effective appreciation of the exchange rate in the early 1980s, there was some question about the degree to which the shortfall had been caused by factors beyond the control of the authorities.

Mr. Teijeiro considered that the recent developments in the Brazilian economy had been satisfactory, and that the authorities were to be commended for their courage and resolution in implementing the adjustment program. The considerable improvements in the fiscal and external areas were particularly commendable. A moderate recovery in output had been evident in the first quarter of 1984, and the strong recovery in exports could lead the way to more significant improvements in economic activity in coming months. The operational account of the public sector had already moved from a deficit equivalent to 6.8 percent of GDP in 1982 to a surplus of 0.3 percent in 1984, and the trade surplus had increased from less than $1 billion in 1982 to $9.1 billion in 1984.

In his remaining comments, he would take a forward-looking approach, raising issues that had an important bearing on improving the results already achieved, Mr. Teijeiro noted. First and foremost, there was the issue of the interest rate on foreign debt; like Mr. Kafka, he hoped that, in the general interest of members, ways would be found to alleviate the transfer burden on the debtor countries. The second problem was the rate of inflation, which had unavoidably accelerated since the beginning of the program as the result of both adjustments in relative prices and the continued indexation. Under their appropriately pragmatic approach to the implementation of the first part of the program, the authorities had wisely given priority to reducing the rate of inflation, thereby contributing to improving the prospects for economic growth in the medium term.

However, Mr. Teijeiro went on, he doubted whether the present macroeconomic policies could reduce the rate of inflation. Adjusting the position of the nonfinancial public sector had been a necessary condition for restoring stabilization, as the authorities had had to check the expansionary effect of fiscal policy on the monetary base. The staff had reported that as a result of developments in the nonfinancial public sector, the monetary base would contract by Cr$4 trillion, thereby providing room for an important accumulation of reserves without increasing the monetary base or M-1 by more than 50 percent. But while control of domestic monetary expansion had clearly been fully regained, it probably was not sufficient to reduce the rate of inflation, given the continued existence of a system of generalized indexation. The kind of drastic tightening of domestic credit provided for under the program could result in developments other than, or in addition to, the desired reduction in the rate of inflation; they could include a further improvement in the balance of payments--as the domestic squeeze on liquidity would encourage capital inflows or discourage capital outflows--or a decline in output.

In the light of the generalized and retroactive indexation and the entrenched inflationary expectations, Mr. Teijeiro continued, inflation might be the last of the various factors to be affected by the renewed control of domestic monetary expansion; therefore, inflation would probably remain at the present high rate. If the demand for M-1 increased by more than 50 percent, the additional liquidity needed might be available through an improvement in the balance of payments. In fact, that had apparently been the outcome in the first quarter of 1984, when the spread between the parallel and official exchange rates had narrowed dramatically, and the performance of the balance of payments in general, and of the trade account, private capital inflows, and the services account, in particular, had greatly improved. As a result, the increase in net international reserves had easily exceeded the performance criterion target. Recent developments clearly suggested that, under the present system of generalized and retroactive indexation, controlling domestic sources of monetary expansion was an ineffective means of reducing the rate of inflation, and was instead a powerful way of improving the balance of payments. Hence, it would not be surprising to find during the next review that the rate of inflation had not been reduced significantly, that the balance of payments had performed better than expected, and that the annual rate of increase in M-1 had kept rising.

It could be argued, Mr. Teijeiro went on, that, given the uncertainties about the outlook for the economy, private capital inflows would not exceed the projected volume. However, there was reason for optimism, as merely reversing the previous capital outflows would be sufficient. The staff could usefully comment on whether the improvement in the external accounts, including the growth in exports in the first quarter of 1984, had been due to some extent to a reduction in overinvoicing and underinvoicing.

Since reliance on domestic control of the monetary base alone to reduce the rate of inflation probably would not be effective and could have a serious adverse effect on output, Mr. Teijeiro said, the counter-inflation effort should be based on a coordinated set of economic instruments designed to de-index the exchange rate, incomes, and public sector pricing policies; and the authorities could consider fixing those variables in advance, consistent with a prospective decline in inflation. Coordination would be essential to the success of such a strategy, because it would help to prevent important changes in relative prices. Particular attention should be paid to the system of wage indexation; present arrangements would promote an automatic increase in real wages if inflation were reduced significantly. Should an overhaul of the indexation policy not be politically feasible in the short run, the present rate of inflation would probably continue. In any event, an effort should be made to consolidate the achievements in the fiscal and monetary sectors, thereby establishing the foundation for a dramatic attack on inflation when the proper political conditions prevailed. Given the renewed control of the monetary base, the adjustment that had been made in the operational deficit seemed sufficient to be compatible with a drastic reduction in the rate of inflation.

The elimination of the exchange restrictions, multiple currency practices, and payments arrears was commendable, Mr. Teijeiro considered, and the decision to submit by mid-1984 legislation providing protection to domestic activity through tariffs, rather than through quantitative restrictions, was welcome. Those initiatives were timely, as improvement in the external accounts had provided room to reduce the restrictions on imports. The import liberalization would help to maintain and even improve the present competitive position without reliance on subsidies, which could promote protectionist reactions in foreign markets; it should also help both to reduce uncertainties, thereby encouraging investment in sectors that had relied heavily on imported materials, and to reduce the inflationary pressures in the economy.

He warmly supported the proposed decisions, Mr. Teijeiro concluded. Brazil had played its part in restoring external balance, and he hoped that the evolution of the external environment would not undermine the Government's success.

Mr. Ismael noted that the authorities had implemented needed adjustment policies and had met the program targets and performance criteria for end-March 1984 with ample room to spare; in particular, they had made substantial progress in adjusting prices and in eliminating subsidies. Nevertheless, inflation, inflationary expectations, and the external debt were still cause for serious concern, as they could prove to be stumbling blocks in the way of full adjustment.

Controlling inflation should certainly receive top priority under the 1984 program, Mr. Ismael said. That inflation had begun to abate somewhat in the first four months of 1984 was encouraging, but for the 12 months ending April 1984 the rate of inflation had been significantly higher than in the previous 12 months; there was some doubt whether the implicit inflation target of 100 percent for the rest of 1984 was still within reach. Mr. Kafka had usefully noted that the record rate of inflation was a reflection mainly of the maxidevaluation of 1983, the elimination of a large number of subsidies, and the poor harvest, but the staff had also cited the lack of steadiness in monetary policy.

The economic situation in Brazil had changed somewhat in recent months, Mr. Ismael continued, particularly in the external sector, where the increase in imports had eased supply constraints. Nevertheless, as inflationary expectations had persisted, and the rate of inflation over the previous year as a whole had accelerated, inflation would certainly continue to be a cause for concern. The 1984 program appropriately sought to retain policy flexibility in recognition of the complex nature of the inflation in Brazil, which had lasted for some two decades. The standard remedy of fiscal austerity and tight credit had not helped to reduce the rate of inflation in 1983, despite wage moderation, price controls on some key commodities, and a substantial decline in M-1.

The main response to inflation in Brazil had been the maintenance of the system of indexation, Mr. Ismael noted. The present difficult debt situation suggested that that response was no longer adequate. The indexation fueled inflation; moreover, while high rates of inflation persisted, indexation would be difficult to eliminate. The vicious circle would have to be broken, and the first step in that direction was the recent decision to phase out wage indexation by 1988, an important departure from past policy, although it was to be implemented more slowly than seemed desirable. Progress had been made in other areas, but many parts of the indexation system in all sectors of the economy had been kept intact. More decisive and direct steps would be needed to supplement the austerity measures and credit restraint under the program. Price controls would not be helpful; indeed, they were difficult to administer and in any event would only add to the distortions while providing no guarantee that inflationary pressures would not emerge from the effort at deregulation. Further price liberalization was clearly preferable.

Monetary restraint probably was not the best way to tackle inflation caused by indexation and cost-push pressures, Mr. Ismael continued. Credit restraint might be helpful, but, in the circumstances, it could prove too high a price to pay for controlling inflation, and the authorities should consider introducing direct measures instead.

The authorities had made considerable progress in the trade sector, Mr. Ismael remarked. The record surpluses recorded in 1983 and in the previous several months were encouraging. The $9 billion trade surplus target for 1984 would be within reach if the present performance could be continued; in that event, new borrowing to finance interest payments could probably be avoided. All countries, particularly Brazil's major trading partners, should avoid any intensification of protectionism and reduce existing trade barriers. Exports must expand vigorously in order to avoid a recurrence of crises.

Brazil's debt problem was admittedly a cause for concern, Mr. Ismael continued. The recent export performance had been excellent, but debt servicing had pre-empted most of the country's resources and would probably continue to do so through the rest of the 1980s. There was no certainty that the current account position would become sustainable even by 1989, when debt servicing was expected to continue to absorb a major share of export reciepts: the share was already 85 percent.

Export performance in the coming period would depend on a variety of factors, Mr. Ismael remarked. The most important ones were the strength and durability of the global economic recovery, and the extent of protection. Another significant factor was the level of interest rates.

The difficulties that had occurred in the external sector, despite the excellent trade performance, underscored the need for more durable solutions to Brazil's debt problem, Mr. Ismael remarked. It was obvious that, given the large debt and debt service burden, Brazil could not be expected to solve its debt problem solely through improving its export performance. The efforts to restore domestic balance and to bring the overall economy back on track were of course welcome, but a direct attack on the external debt itself was essential; in that connection, equally important roles should be played by Brazil's creditors, official institutions, and other interested parties. Without their cooperation, there was little more that the authorities and the Fund could do to alleviate Brazil's debt burden. In the absence of a boom similar to the recovery from the 1975 recession, the prospects for Brazil in the coming period probably would be less favorable than the staff had suggested.

He had no difficulty in supporting the proposed purchase under the compensatory financing facility, Mr. Ismael said. The staff had clearly shown that Brazil was eligible to use the facility. The proposed decisions were acceptable.

Mr. Lovato commented that, during the first year of the extended arrangement, Brazil had had to make sizable adjustments in the face of an unfavorable economic climate internationally and adverse weather at home. In the coming year, conditions for adjustment should be less unfavorable, and the cumulative effect of previously adopted measures should enable the county to make considerable progress. The recent collaboration between Brazil and the Fund had been crucial and should be maintained; the proposed tight schedule of program monitoring was warranted.

Inflation was clearly the main problem to be dealt with in the second year of the extended arrangement, Mr. Lovato said. Most of the inflationary effects of the price liberalization effort of earlier months had already been felt, and recent price data were encouraging, but prices--including real interest rates--had been increased only recently and could be expected to affect domestic prices in the near future. In addition, the continued indexation of wages to past inflation would undoubtedly slow the continued process of price liberalization. Considerable progress had admittedly been made in moderating wages, and the authorities should be urged to maintain their effort at gradually liberalizing the wage system, but the goal of reducing the rate of inflation to 100-130 percent by the end of 1984 implied an average monthly rate of inflation of 3.9-5.7 percent for the rest of 1984. The goal was an ambitious one that could be achieved only in the most favorable circumstances.

There was a close relationship between progress on the inflation front and fiscal adjustment, Mr. Lovato continued. There had been considerable improvement in the fiscal position in 1983, including a noticeable reduction in the operational deficit. The monetary correction could be seen as roughly reflecting the public sector's real capital gain due to inflation. The public sector operational deficit was a measure of the real deficit, and the rate of increase in the real public debt apparently had been substantially reduced in 1983, thereby making an important contribution to monetary stability. The difficulty in adjusting the financial position of state enterprises, which accounted for most of the operational deficit, underscored the need to use the quantitative criterion on the nonfinancial public sector borrowing requirement to monitor closely the evolution of the public enterprise sector.

On monetary policy, Mr. Lovato said that the re-establishment of positive real interest rates should stimulate savings and improve their allocation. Given the recent fluctuations in monetary velocity, it was difficult to judge the appropriateness of the target for the monetary base. The degree of restrictiveness of the target would depend to a great extent on some crucial factors, particularly inflationary expectations affecting money demand. If those expectations weakened and the rate of inflation fell, in line with the staff projection, monetary restriction might prove to be stronger than was expected. In any event, monetary developments should be carefully examined during the next review. The degree of monetary restrictiveness would be determined in part by the market demand for government securities, which was expected to increase in 1984 by Cr$1.3 billion. In the light of the recently reduced propensity of the nonfinancial private sector to hold public securities, he wondered whether the expected increase in demand for government securities would actually occur.

In his comments on the medium-term projections, Mr. Lovato noted, Mr. Kafka had noted the high capital/output ratio. However, the projections did not necessarily represent equilibrium values for 1985-90, and it was possible that external financial constraints would curb the growth of output in the medium term. The projections implied that the capital/output ratio would increase in the second half of the 1980s, a development that could provide the basis for stronger and more solid growth in the future.

Solving the debt problem facing Brazil and many other countries would require adjustments by individual countries and a global strategy, Mr. Lovato considered. The period of easy financing at low or negative real interest rates was past, and all countries would have to adjust to that reality. It was equally true, however, that it would be easier to solve the debt problem if industrial countries became more sensitive to the external effects of their economic policies, including trade and financial policies; that assumption was the subject of increasing attention, and the Fund could play a substantive role in helping to make it a reality.

While economic policies of industrial countries could facilitate adjustment in other countries, Mr. Lovato concluded, the actual implementation of an adjustment program was the responsibility of each debtor country. Mr. Kafka's opening statement had given the impression that there was little hope for making further progress in price liberalization. That conclusion, together with the staff's remark that "the timing of the downturn of inflation and the speed of its eventual reduction are uncertain," suggested that there was no room for slippages. The proposed decisions were acceptable, but the authorities should be encouraged to maintain their adjustment effort by continuing their firm overall policy stance.

Mr. Hirao endorsed the thrust of the staff appraisal in EBS/84/84 and accepted the proposed decisions. The authorities had made considerable progress in adjusting the external accounts, but, partly because of the shortfall in direct foreign investment and in short-term financing by international banks, the foreign exchange position had remained difficult, exchange restrictions had intensified, and external payments arrears had emerged. Moreover, progress in several areas on the domestic front had not been encouraging: the overall public sector borrowing requirement had remained large and the rate of inflation high. The authorities had responded by adopting various measures and were clearly committed to maintaining their adjustment effort in 1984. They should be encouraged to take further decisive actions when necessary.

Commenting on the program for 1984, Mr. Hirao agreed with the staff that the performance under the 1983 program, although not completely satisfactory, had provided a realistic basis for the implementation of policies in 1984. The steps taken in 1983 to eliminate subsidies, introduce substantive changes in wage legislation, and to establish a mechanism for monitoring the implementation of the budget should have a favorable effect in the second year of the extended arrangement and should support the implementation of appropriate policies. In addition, the external financing arrangements already agreed upon could dispel some of the uncertainties present in the first year of the extended arrangement. Nevertheless, there would be little room for relaxation of the adjustment effort in the second year of the arrangement. In particular, the authorities would have to bring inflation under control in order to maintain and enhance confidence in the program on the part of both the Brazilian and the international financial community.

The decisive steps to eliminate subsidies would help to reduce the distortions in resource allocation and to strengthen public finances, Mr. Hirao continued. Further efforts would be needed to reduce the entrenched rigidities in the economy; in that connection, the relaxation of price controls would play an important role.

The overall public sector borrowing requirement for 1984, Mr. Hirao noted, was expected to be reduced substantially, but would still be within the range of 11-13 percent of GDP. Its continued large size was due in part to the adverse effects of inflation and suggested the need for further strenuous efforts to reduce the operational budget deficit, thereby helping to break the vicious circle of large deficits and high rates of inflation.

The system of monetary correction should be thoroughly reviewed once inflationary pressures had been brought under control, Mr. Hirao went on. The newly established monitoring mechanism should help to improve the implementation of budget policy. In addition, there seemed to be scope for improving the collection of information from the nonfederal public sector.

The substantial reduction in credit subsidies had provided greater scope for a more actively restrictive financial policy in the second year of the extended arrangement, Mr. Hirao commented. Top priority should be given to limiting the expansion of the monetary base; additional measures should be introduced as necessary. An active interest rate policy was also essential in order to keep interest rates positive in real terms.

On exchange rate policy, Mr. Hirao said that he agreed with the authorities' intention to preserve the improved external competitiveness achieved in the first year of the extended arrangement. The reduction of exchange restrictions was welcome, and he hoped that further efforts in that direction could be made.

The success of the 1984 program, Mr. Hirao noted, would depend not only on the steady implementation of adjustment policies, but also on a number of other factors that the staff had identified, particularly the maintenance of an open trading system by Brazil's trading partners. In that connection, Appendix VIII was particularly informative. Finally, the request for a drawing under the compensatory financing facility met all the relevant criteria and should be approved.

Mr. Polak considered that, while certain aspects of Brazil's performance under the extended arrangement could be judged at the present stage, some important ones could not. The external position had obviously improved, and further improvement was clearly in sight. The current account was expected to strengthen substantially, and a 22 percent increase in the volume of non-oil imports was forecast, thereby helping both to ensure a reasonable supply of imported inputs for industry and to encourage the further elimination of quantitative trade restrictions. In addition, the fiscal position was under better control, and the monetary mechanism, which had been difficult to install, obviously was working. The authorities had a solid grip on expenditures, including those of the states, the municipalities, and parastatal enterprises; they had also achieved major price restructuring, although at important costs in terms of the appearance of transitional inflationary pressures. Interest rate subsidies had been largely eliminated, and monetary policy had been sharply changed, thereby bringing the monetary base under control.

However, Mr. Polak continued, there were two important questions that could not be answered at the present stage. First, would the present monetary and fiscal policies sharply reduce the rate of inflation? Thus far, that had not happened. Second, could such a reduction be achieved at an acceptable cost in terms of growth and employment? That question could not be answered for at least one or two months, and much would depend on crop yields. There had apparently been a striking change in the expectations of workers, who had opted to maintain employment rather than real wages. The business community, however, had continued to raise prices despite the tight money conditions reflected in the sharp increases in the velocity of money.

Real wages, one of the most controversial issues during the previous discussion on Brazil, Mr. Polak recalled, were not featured prominently in the present staff reports, which did not provide a clear impression of recent developments in that area. Significant real wage declines had apparently occurred, as real wage outlays of the Central Government had fallen by about 14 percent in 1983 and were expected to decline by more than 16 percent in 1984; the figures for public sector enterprises were similar, an outcome probably not due solely to shedding of labor. The staff appraisal suggested that the authorities were already concerned that real wages might have declined excessively. That concern underscored the importance of achieving quick success in reducing inflation. As the staff had concluded in both the present and previous reports, if the counterinflationary effort did not succeed soon, new approaches would be needed, probably both fiscal and monetary ones. At the present stage, however, it was too soon to say which policies would be appropriate if a new approach were required; much would depend on the course of the economic recovery.

He agreed with Mr. Kafka that the staff's medium-term outlook was somewhat too pessimistic, Mr. Polak said. The compression of the share of consumption in GDP implied in the staff scenario would entail an average fall of 1 percent in real per capita consumption in each year until 1989. Mr. Kafka's more optimistic expectations--including at least positive growth in real per capita GDP--seemed reasonable.

He also agreed with Mr. Kafka, Mr. Polak continued, that there was no need for Brazil or other developing countries to aim over a long period for current account surpluses. It was unlikely that developed countries as a group would continue to run current account deficits--presumably to finance their budget deficits--thereby forcing developing countries to make a sudden and permanent transition from capital importers to capital exporters. After the present period of sharp adjustments, Brazil should be able again to become a capital importer, although not on the enormous scale of recent years.

On the basis of what seemed to be reasonable assumptions, Mr. Polak said, the staff had concluded that Brazil's medium-term debt and debt service burdens were viable. It was of course difficult to be certain that the assumptions--particularly those concerning interest rates--would prove accurate, but, even if they were, the needed voluntary debt rollover could not be counted on. Collective action by commercial banks might be required for some time and preferably should start at an early stage, in order to pave the way for voluntary and spontaneous extension of credit. Finally, he had no difficulty in accepting the proposed decisions.

Mr. Laske commented that Brazil's adjustments to the external imbalance, excessive foreign borrowing, and structural distortions were to have begun early in 1983, upon Fund approval of an extended arrangement. In fact, the implementation of significant adjustment measures had been delayed--in some cases until late in the second half of 1983--for a variety of reasons. Partly as a consequence of the delay, the results of the adjustment effort had been mixed.

Externally, Mr. Laske continued, the dramatic improvements in the accounts for international trade and current transactions had exceeded the program targets, but because of the protracted negotiations on the financing package for 1983 and 1984, the overall balance of payments target had not been met. Compensation for that development would however be made in 1984, and the overall balances for 1983 and 1984 should be seen as a single unit. Domestically, however, serious imbalances had continued, even though the authorities had implemented important structural adjustment measures, for instance, to strengthen their control over public sector finances. The most conspicuous and worrying development was the further intensification of inflation, which had caused the 1983 targets for the public sector borrowing requirement and operational deficit to be missed by wide margins.

In 1983, Mr. Laske went on, the rate of inflation had been more than twice the rate projected in the original program. The staff had explained that one reason for that was the maxidevaluation of February 1983, which had given a sudden and strong push to the prices of imports. The corrective adjustments in the administered prices of such items as gasoline, wheat and wheat products, and in certain utility tariffs, as a result of the phasing out of costly consumer subsidies, had also contributed to the acceleration in inflation. The subsidies had been phased out not only because they had distorted the allocation of resources, but also because they had become a source of nearly uncontrollable fiscal deficits and excessive monetary expansion.

The prospects for inflation in the rest of 1984 had understandably been approached with great caution by the staff, which had not made even indicative projections for the year, Mr. Laske remarked. It had instead merely stated its uncertainty about the time needed to achieve a significant reduction in the rate of inflation, given the deeply entrenched inflationary expectations and the pervasiveness of indexation. In their letter of intent the authorities seemed confident that their policies would cut the rate of inflation in half, but even that favorable development would leave the rate in excess of 100 percent. The uncertainty about reducing inflation underscored the need for additional progress in the adjustment effort.

Three factors apparently stood in the way of achieving a rapid and lasting reduction in the rate of inflation, Mr. Laske continued. The first was the wage indexation mechanism. As a result of a protracted and politically difficult process, the automatic indexation of wages had been reduced in 1983 to an average of 86 percent of past inflation, a considerable improvement over the previous norm. The second factor was monetary correction. Terminating it would require constitutional amendments that would be even more difficult to approve than the reduction in wage indexation. Nevertheless, in the longer run the problems caused by monetary correction would have to be faced. The adverse effects of monetary correction had been amply demonstrated in 1983, when the adjustments in the exchange rate and in administered prices--both essential parts of the opening stage of the stabilization effort--had made the fiscal objectives unachievable.

Inflationary expectations were the third factor that made it difficult to reduce the rate of inflation in Brazil, Mr. Laske continued. Given the persistent high rates of inflation over many years, the deep-seated nature of the inflationary expectations was unsurprising. The long-term indexation of incomes and money assets had obviously contributed to those expectations, which, in turn, were an important factor in the determination of business and consumer behavior. The tight financial policy had not yet broken inflationary expectations; money illusion was obviously an important factor in Brazil. Fiscal restraint, tight monetary policy, and structural changes would be needed for some time, until the environment was clearly less inflationary.

None of the budgetary objectives for 1983 had been achieved, Mr. Laske noted. The overall fiscal deficit--affected by the rate of inflation and the monetary correction--and the operational deficit had exceeded the original program targets, which had subsequently been revised upward. That the revised targets had been met was a source of some reassurance, but the fiscal performance had been less favorable in 1983 than in 1982. The central administration had not gone as far as the states, municipalities, and public enterprises in making needed adjustments, thereby suggesting that the coordination of the fiscal effort with the monitoring of the implementation of other policies must be enhanced; the newly established interministerial commission for that purpose apparently had already had a favorable effect.

On the operational side of the public sector accounts, Mr. Laske went on, a turnaround from a deficit to a small surplus was expected in 1984, mainly, it seemed, because of the planned progressive reduction in consumer subsidies. The staff had suggested that the authorities' effort to implement fully their policy intentions with respect to consumer subsidies and certain other areas needed reinforcement. Close monitoring of developments in all those areas would be essential, and the authorities should be prepared to act more quickly than they now planned if deviations from the program path seemed likely. The rather favorable revenue performance in the first quarter of 1984 and the reduction in the public sector deficit showed that the corrective fiscal measures introduced in 1983 were beginning to produce the desired results. However, the indication of a possible change in the seasonal revenue pattern suggested that caution was called for, at least for the time being, in drawing optimistic conclusions on the basis of the latest fiscal developments.

As for monetary policy, Mr. Laske commented, there was an urgent need to decrease the rate of monetary expansion significantly if the rate of inflation were to be reduced. The targets for the rate of growth of the monetary base and of M-1 appeared to be tight, particularly in the light of the latest reported rate of inflation. Pressure to exceed the targets might become strong, and the authorities would have to be vigilant in monitoring and, if necessary, reacting to credit market developments.

Commenting on the structural aspects of monetary policy, Mr. Laske said that he welcomed the steps taken to deal with important sources of excessive monetary expansion, namely, the interest-free credit facility at the Central Bank, and the large-scale interest subsidies. The authorities had indicated in their letter of intent that the system of interest subsidies was to be further reduced. The planned progressive elimination of consumer subsidies, the financing of which had relied heavily on the monetary authorities, was another important part of the strengthening of the role and effectiveness of monetary policy. Were the subsidies to be terminated later in 1984 financed exclusively by the Treasury, or was the assistance of the monetary authorities still required?

Over the years, Mr. Laske observed, there had been high rates of inflation and a marked shift in the composition of the monetary aggregates;

the share of money balances had fallen, and the share of quasi-money, which was indexed, had progressively increased, while at the same time the velocity of money had been rising rapidly. As long as the rate of inflation continued to be high and savings and time deposits were fully indexed, that pattern probably would not change significantly. The shift in the shares of money balances and quasi-money might have been due to a considerable extent to the flight from money stocks, which were commonly used for transactions purposes. With the emergence of positive real interest rates, money assets with longer maturities might be preferred for money balances. In any event, making certain that overall interest rates--and not merely rates on borrowing by the private sector--remained positive in real terms in the coming period would be important. The practice of permitting some interest rates to fluctuate on the basis of corrective monetary action seemed to invite significant portfolio shifts. The authorities should consider unifying the application of such corrective action to the various interest rates in order to facilitate the conduct of monetary policy in an environment of rapid inflation. The authorities intended to separate their open-market policy from other aspects of short-term liquidity management. They were also preparing to remove from the Central Bank the responsibility for development and government debt management. The schedule for implementing the reform was imprecise, and the authorities should be urged to press ahead vigorously.

Good progress had been made thus far in improving the external accounts, Mr. Laske noted, despite the failure to restrain fiscal and monetary policy sufficiently through most of the first program year. The maxidevaluation of February 1983 and the subsequent flexible exchange rate policy and tightening of the import regime had contributed to the favorable performance of the external accounts. During 1983, the cruzeiro had depreciated in real effective terms by 25 percent against the dollar and had been volatile vis-à-vis the currencies of Brazil's trading partners. He wondered whether the real value of the cruzeiro had contributed sufficiently to external competitiveness since the policy of continuous devaluation in line with domestic inflation had been introduced in March 1983. Chart 13 in SM/84/87 suggested that the real effective value of the cruzeiro might have been lower in late 1979 and early 1980 than at the end of 1983.

Import liberalization should be an important topic during the August 1984 review, Mr. Laske commented. The substitution of tariffs for quantitative restrictions, an important step in the reform of the trade system, should take place as soon as possible.

The viability of Brazil's balance of payments over the medium term, Mr. Laske continued, would depend not only on the growth of world trade and the movement of international interest rates, but also on the continued implementation of the adjustment policies to which the authorities had committed themselves under the extended arrangement. Without strict adherence to the program, the projections for the current account and for autonomous capital inflows probably would not be realized. On the basis of Mr. Kafka's relatively optimistic version of the medium-term outlook, somewhat more policy emphasis could have been placed on growth rather than on strengthening the foreign balance. For the time being, he himself advocated a cautious approach, particularly in the light of the exceptionally high rate of inflation, which would be very difficult to reduce to the level of the early 1970s without substantial changes in the indexation mechanism. The large external debt could be serviced and refinanced only when foreign creditors had been given proof that no deviations from the adjustment path would be permitted. The debt service ratio was not expected to fall below 50 percent until the late 1980s, and total debt was expected to continue to rise for another four years before the first faint signs of reduced reliance on foreign savings began to emerge.

Commenting on Brazil's request to use the compensatory financing facility, Mr. Laske said that the decline in the country's exports in 1982, one of the preshortfall years, must have been strongly influenced by the real appreciation of the exchange rate in that year. Hence, to some extent, the shortfall was attributable to exchange rate policy and thus not overwhelmingly to factors beyond the authorities' control. Brazil had already drawn more than half of its quota under the compensatory financing facility, and he was satisfied that the adoption of the program for 1984 met the required stricter test of cooperation. The proposed decisions were acceptable.

Mr. Nimatallah agreed with the staff's analysis and conclusions and supported the proposed decisions. The request to use the compensatory financing facility met all the relevant criteria; the export shortfall was due largely to factors beyond the authorities' control, such as the effects of the world recession on Brazilian exports; there was a clear balance of payments need; the stricter requirement of cooperation had been met through the implementation of the program under the extended arrangement.

The authorities were to be commended for the important corrective measures introduced under the extended arrangement, Mr. Nimatallah said. Subsidies on many important commodities had been removed, wage and price indexation had been reduced from 100 percent to 86 percent on average, and fiscal and monetary policies had been tightened. The domestic adjustment effort thus far had been significant and should pave the way for improving the economic situation in the coming period. That the Finance Minister was optimistic that the economy would begin to grow again in 1984 was heartening.

Adjustment in the external sector had also been significant, Mr. Nimatallah commented. The flexible exchange rate policy introduced after the maxidevaluation in February 1983 had led to a major improvement in the trade balance. The Brazilian authorities had normalized relations with their creditors, had eliminated external arrears, and had increased the chances for receiving adequate flows of external financing.

Nevertheless, Mr. Nimatallah continued, some problems remained, the most serious being the high rate of inflation, which, if allowed to remain unchecked, could have unpredictable adverse consequences on the economy in the coming period. The authorities had missed the opportunity to tighten monetary and fiscal policies to offset the effect of the sharp increase in administered prices, and inflation was more difficult to control in Brazil than elsewhere because of its entrenched system of indexation. Moreover, the recent reduction in wage indexation had not been spread in such a way as to affect consumption habits: low-income earners, whose wages were still highly indexed, had a high propensity to consume and could not be expected to reduce their expenditures significantly in the coming period; upper-income earners were still able to maintain a high level of expenditure by drawing on their savings. Hence, the combination of the mistiming of the implementation of adjustment measures and the impact of some of the measures on the different sections of Brazilian society had contributed to the continuation of inflation. It was fortunate that, over time and through persistent efforts, inflationary expectations could eventually be reduced, thereby leading to better control over inflation. There would be greater assurance of that outcome if there were no need for further sharp increases in administered prices, and if weather conditions improved.

A successful fight against inflation, Mr. Nimatallah considered, was a prerequisite for the increase in investment and resumed economic growth that would play a critical role in enabling Brazil to service its debts. Mr. Kafka's analysis of the growth prospects for the Brazilian economy over the medium term was interesting. Brazil had a large resource base and a sizable pool of entrepreneurial people. With appropriate policies and the political commitment to implement them, growth could be resumed and sustained while needed adjustments were made. The authorities were performing well, and the economy was on the road to an appropriate kind and level of performance under the extended arrangement.

Mr. Wicks said that he, like other speakers, was impressed by the authorities' courageous and far-reaching actions in a difficult social and political environment. The authorities deserved the Fund's full support. That Brazil had been able to meet the revised performance criteria by wide margins was encouraging. The improvement in the trade balance was particularly striking, and progress had been made in reducing the operational fiscal deficit.

However, Mr. Wicks continued, it would be misleading to conclude that the course of the economy in the coming period would be smooth. Some of the improvement in the trade balance was a reflection of direct controls on imports and of restrictions on the availability of foreign exchange. While those measures might have been necessary in the short run and had certainly been effective, they clearly did not provide a satisfactory basis for restoring the health of the economy in the medium term. Achieving a healthier economy would require both the implementation of appropriate--and, for the time being, restrictive--fiscal and monetary policies, together with a decisive break in inflation and inflationary expectations, as Mr. Kafka had acknowledged in his opening statement. The need to curb inflation was perhaps the key task at present.

Without a decisive break in inflation, Mr. Wicks went on, the prospects for achieving a sustainable balance of payments in the medium term would be greatly reduced, for two reasons. First, inflation had distorted price signals and misallocated resources, thereby adding to the difficulty in achieving the structural adjustment needed to permit the restoration of economic growth in the longer run. Second, inflation also added to the difficulty in formulating and implementing effective monetary and fiscal policies, a problem that was a cause for particular concern in a highly indexed economy. It was certainly appropriate to seek a reduction in the rate of monetary growth, but, as monetary velocity was increasing rapidly and unpredictably--at least partly because of the substantial switch into indexed government debt--it was hard to say exactly where the levers of monetary policy should be set and what effect monetary policy was having. The combined effects of inflation and indexation on the fiscal position made it particularly difficult to control the amount of government debt. He wondered whether some aspects of indexation should be re-examined with a view to enhancing the effectiveness of policy implementation, particularly the ability of policymakers to reduce the rate of inflation.

Fiscal performance thus far in 1984 had been encouraging, partly because of early payments of income taxes, Mr. Wicks commented. However, a number of fiscal issues were still unresolved. The control of both local government and state enterprise expenditures remained unsatisfactory, and the data on their activities were inadequate. The most recent information showed that, while the central administration and, even more encouraging, the state enterprises, had met all their monthly borrowing requirement targets thus far in 1984, the states had missed each one. That the operational deficit of the states in 1983, and, presumably the overall operational deficit as well, had perhaps been underestimated because the states had reacted to controls on access to bank credit by building up arrears, was a cause for concern in itself, but it also highlighted the difficulties in monitoring the program from the financing side, and in detecting increases in arrears. He was pleased that the Interministerial Committee monitoring the Implementation of Public Budgets (COMOR) had been working well, and further comments by the staff on the means by which public expenditure controls could be improved would be helpful.

As for monetary policy, Mr. Wicks said, the recent move to nearly universally positive real interest rates, and the improvements in monetary management since November 1983, were welcome. Monetary policy would have to remain tight if the rate of inflation were to be reduced, but it was difficult to assess in an environment of very high rates of inflation and velocity.

The performance of the trade and current accounts in 1983 had been impressive, Mr. Wicks commented, although the reduction in imports had been due partly to import restrictions. The preliminary data for 1984, which suggested that the good trade performance had continued, were encouraging. However, the projections for the services account seemed rather optimistic. Given the recent rise in U.S. interest rates, the assumed LIBOR of 10.5 percent seemed to be somewhat on the low side. In addition, the welcome termination in March 1984 of the centralized foreign exchange system, which had inhibited remittances of profits and dividends in 1983, could result in a higher than expected outflow under the category "other services."

According to the staff's medium-term projections, Mr. Wicks observed, direct investment would remain relatively low, being no higher in 1988 than the figure achieved in nominal terms in 1982. The Chairman had appropriately stressed the importance of direct investment in developing countries because it was a noninterest-creating inflow. The matter of direct investment should be the subject of greater attention during future reviews. In particular, the staff should examine whether or not any policies of the Brazilian Government discouraged such investment, and whether anything could be done to ensure that the medium-term projection would be exceeded.

He was pleased that work was well under way to replace the present complex and inefficient system of import restrictions by a system of tariffs, which would be more efficient and should provide a welcome increase in federal revenue, Mr. Wicks stated. He hoped that a timetable for the restrictions and their replacement could be set during the next review under the extended arrangement.

The list of barriers to Brazil's exports in the staff report was helpful, Mr. Wicks commented. It would also have been helpful to have an indication of the number of protectionist measures that could be classified as countervailing duties or antidumping measures. Mr. Erb's comments on that matter were useful. He hoped that the authorities could soon reduce the interest rate subsidy for certain export financing and shorten the export credit terms in line with the internationally accepted consensus. The export finance arrangements certainly benefited Brazilian manufacturing, but reducing them would benefit Brazil's balance of payments in the short and medium term and would avoid any accusations of unfair competition with exporters in other countries. He hoped that that matter could be examined in detail during the next review.

His reaction to Brazil's export shortfall was the same as that of Mr. Laske and Mr. Erb, Mr. Wicks remarked. However, he fully supported the proposed purchase. The draft decisions should be approved.

Mr. de Groote said that the results of the first year of the extended arrangement had been mixed. While considerable progress had been made on the external front, with the improvement in the current account and the inflow of needed capital, progress on the domestic front had been less positive. Monetary policy had not been maintained consistently, thereby encouraging inflationary expectations, and the budget deficit had remained large, mainly as a result of accelerating inflation. After a full year of repeated efforts, the authorities' policies seemed to be on track to achieving the desired reduction in inflation and to channeling resources toward the export sector. The structural changes that had been made in the Brazilian economy in 1983 had established an appropriate framework within which to make an effective adjustment effort.

Although he broadly agreed with the general thrust of the program, Mr. de Groote commented, he wondered whether the reliance on the monetary program to check inflationary expectations was not exaggerated. The program applied strict limits on monetary expansion, and real interest rates had risen to very high positive levels, mainly as a result of the adjustment of the monetary correction factor from 75 percent to 100 percent. The increase in interest rates had caused budgetary expenditures to rise and would keep the public sector borrowing requirement for 1984 at 13 percent of GDP, even under very optimistic assumptions about the rate of inflation. In those circumstances, and given the ceilings on net domestic assets, public sector borrowing would crowd out credit to the private sector; in fact, private sector credit had contracted by 17 percent in 1983 and would contract again in 1984. Adjusting for past inflation by setting the monetary correction at 100 percent of past inflation, at a time when the inflation rate was declining, resulted in overcorrection for inflation and high real interest rates.

Consideration should be given to providing a somewhat larger increase in credit to the private sector by lowering interest rates, thereby reducing the public sector borrowing requirement, Mr. de Groote continued. The basic question was what purpose was served by setting very high interest rates. He doubted whether they encouraged financial savings. Was there not some fear that the holders of financial assets would switch to real assets, thereby adding to inflation? Instead of increasing financial savings, high interest rates affected the composition of financial assets by encouraging a shift from unremunerative, or less remunerative, assets to more remunerative ones. In passing, he noted that a shift into real assets was unlikely to occur even if interest rates became slightly negative in real terms.

There was a distributional element to the credit creation issue, Mr. de Groote went on. Was there sufficient justification for granting large real income increases to the holders of financial assets at a time when the rest of the economy was experiencing large income reductions? Would it not be better to set interest rates at lower levels in order to permit a somewhat larger expansion of economic activity, especially exports, thereby facilitating the external adjustment of the economy and a more rapid dismantling of import restrictions? Mr. Kafka was much more optimistic than the staff about the forecast for economic growth in 1984 and beyond. He hoped that Mr. Kafka's expectations would prove to be accurate, but he harbored some doubts whether that would happen, especially as the recovery in the United States seemed to be starting to flatten out.

He had not meant to criticize the program, Mr. de Groote said, but--as Mr. Nimatallah had mentioned, and as the Chairman had stressed at a recent meeting of the UN Administrative Committee on Coordination--in designing adjustment programs, the Fund and member countries should be trying to achieve a new external equilibrium at higher levels of income and should therefore ensure that the policy mix promoted an expansion of activity. The medium-term scenario for Brazil underscored the need to expand activity to increase per capita income and consumption. He agreed with Mr. Polak that the program should aim at restoring Brazil's status as an importer of capital. It would be unacceptable for developing countries to be forced to run current account surpluses over a long period, thereby experiencing a real resource transfer to the industrial countries. Such an outcome would be a failure on the Fund's part.

He hoped that the adjustment effort would be fully effective in containing inflation, Mr. de Groote said. Given the large degree of indexation in the economy, the process of deflation was bound to be gradual. Finally, the proposed purchase under the compensatory financing facility met the relevant criteria, and all the draft decisions should be approved.

Mr. de Maulde noted that, under the medium-term scenario, domestic savings would increase by the equivalent of 9 percentage points of GDP. By the end of the six-year period covered by the scenario, gross domestic savings would represent nearly 27 percent of GDP--compared with 23 percent in the early 1970s--allowing the economy sufficient room for a strong investment effort, equivalent to 22 percent of GDP, as well as a surplus on current account. He had no difficulty in accepting that scenario, especially as the previous pattern of a large excess of domestic consumption and investment over available resources had led to an unsustainable situation in 1982. The main question at present was whether or not Brazil had already begun to move along the path described in the scenario and, if so, whether it could continue to do so in the coming period.

The measures under the programs for 1983 and 1984 were classical and were consistent with the objective of reducing public and private consumption while improving the mechanism for resource allocation, Mr. de Maulde said. He was pleased that the quantitative targets had been met, but he was not fully convinced that all the structural imbalances had yet been addressed. Important measures still had to be introduced to improve public sector efficiency, wage determination, and import liberalization. At the same time, there had clearly been progress in prices, subsidies, and monetary policy.

The latest available indicators contained favorable news concerning the external accounts and unfavorable news on domestic inflation, Mr. de Maulde continued. The favorable news was in effect partly cosmetic, given the artificial character of the restrictions on imports and foreign exchange. He hoped that the unfavorable developments would prove to be temporary. In the absence of adverse developments in the real economy, such as poor crops, the rate of inflation should fall sharply in the coming period. The authorities should therefore be urged to adhere to the present policy stance.

Brazil had no alternative but to achieve a major increase in domestic savings over the longer term, Mr. de Maulde considered. The increase would help to meet the development needs of the country.

Further information on the likely consequences of the present longer-term strategy on the overall economy would be helpful, Mr. de Maulde went on. In 1984-89, GDP growth was expected to average 4 percent annually, and the share of domestic consumption in GDP was expected to fall by some 9 percentage points while the population continued to grow. He wondered what implicit rate of growth of per capita purchasing power had been assumed in estimating the economic growth and consumption trends. What employment rates were compatible with the GDP and investment forecasts?

He wondered whether the distribution of the external debt among short-term, medium-term, and long-term debt in 1989 would be the same as at present, Mr. de Maulde continued. Was some restructuring of the debt supposed to take place? What were the possible consequences of such a restructuring?

The World Economic Outlook and the staff scenario contained the same forecast for the external environment in the coming period, Mr. de Maulde noted. What would be the consequences for Brazil's economic growth prospects of better or worse world economic conditions than the staff had forecast? Finally, he strongly agreed with Mr. Erb and Mr. Wicks that Brazil should make every possible effort to attract nondebt capital inflows in the future, and particularly private direct investment.

Mr. Joyce stated that he generally agreed with the staff appraisal. The measures that the authorities had adopted in the previous several months, if sustained and complemented by the actions proposed in the 1984 program, should enable Brazil to make substantial progress in achieving the necessary adjustments in the economy.

Significant gains had been made in the external sector in 1983, and further progress seemed to have been made thus far in 1984, Mr. Joyce continued. However, the most encouraging recent development was the progress in implementing the needed measures on the domestic side, although it was regrettable that many of the measures had been delayed until the latter part of 1983. It was too soon to assess their likely effects, and the authorities would therefore have to persist in the policy changes that they had been making and should take whatever additional steps might be needed if progress faltered. Nevertheless, his authorities were much more optimistic than 12 months previously that Brazil was maintaining appropriate policies. There were obviously still a number of uncertainties, particularly with respect to inflation, and progress in some areas might not be as rapid as the authorities expected, in which event the authorities' resolution would certainly be tested.

Even if developments were more favorable than the staff expected, Mr. Joyce went on, the authorities would come under pressure to ease their policy stance. Looser policies would be a mistake, as they would not permit Brazil to become less reliant on foreign borrowing and better able to finance its development from domestic savings. He agreed with Mr. Polak that it was unrealistic to expect Brazil or other developing countries to run current account surpluses over an extended period.

Those countries should remain capital importers. In any event, the authorities, the staff, and the Executive Board would have to monitor a number of program areas carefully through 1984, especially as there would be little room for maneuver.

He agreed with previous speakers that inflation was the most urgent problem facing the authorities, Mr. Joyce said. Failure to reduce it substantially in 1984 would undermine the adjustment effort. The authorities' intentions to maintain their fiscal and financial policies until inflation was reduced to a more manageable level, and also to reassess and tighten the overall policy stance if the expected decline in inflation did not occur, were welcome. He agreed with the staff that, because of the entrenched nature of inflation, the strength of inflationary expectations, and the high degree of indexation in the economy, there was no certainty that a significant and lasting reduction in the rate of inflation would occur in the coming period. Mr. Kafka was more optimistic, and it was true that there had been some deceleration in the monthly rate of inflation. However, the monthly rates and the year-on-year rates remained high, and he doubted whether the authorities would be able to reduce the rate of inflation to 20 percent by the end of the 1980s. Indexation would have to be drastically reduced and eventually eliminated if the rate of inflation were to be brought down to reasonable levels.

Reducing the public sector financing deficit was a crucial adjustment objective, Mr. Joyce noted. The measures introduced since mid-1983 had strengthened the fiscal stance and provided a more solid base for achieving a small operational surplus in 1984. The removal of the subsidies on oil products, the recent reductions in, and planned elimination by midyear of, the subsidy on wheat, and the reduced indexation of wages were particularly welcome. On the revenue side, the tax measures adopted in late 1983--including the closing of major loopholes, the tightening of tax administration procedures, and the increase by 1 percentage point in the value-added tax at the state level--had been positive steps, and the success of the advisory group COMOR in improving coordination among various levels of the public sector and in increasing discipline with respect to budgetary decisions was encouraging.

Continued tight supervision of the overall fiscal performance was needed, Mr. Joyce continued, and any deviations from the program would have to be quickly offset by appropriate measures. In particular, given the impact of interest rates on the Government's overall fiscal position and on the financial position of the state enterprises, it was essential to maintain maximum flexibility in pricing. A further reduction in the total public sector borrowing requirement was also important, as lasting economic recovery could be achieved only if adequate financing were available for private enterprise. The public sector's share of total domestic credit had increased rapidly, from 14 percent in 1979 to 25 percent in 1983, and the private sector appeared to have occasionally been crowded out. Every effort should be made to reverse that trend in 1984.

The authorities' intention to adopt a more active interest rate policy with a view to raising the volume of savings and improving the efficiency of their allocation was welcome, Mr. Joyce said. The reduction in subsidized credit was an important step toward ensuring more efficient use of available credit. It was his understanding that most interest rates were indexed, but some rates still seemed to be negative in real terms, and a further comment on the situation by the staff would be helpful. A consistently firm monetary policy was needed to break inflationary expectations. He recognized that there had been some difficulty in finding an appropriate monetary target. The objective of limiting the growth of M-1 to 50 percent during 1984, and the monthly monitoring of that target, would undoubtedly be helpful, but the target might well be difficult to achieve. In any event, there was no certainty that achievement of the target would be a signal that monetary restrictiveness was appropriately vigorous.

The use of price controls on items produced under what were thought to be oligopolistic conditions was a cause for concern, Mr. Joyce considered. The controls would inevitably cause distortions in the economy, and the authorities should be urged to relax them as quickly as possible.

In the external sector, Mr. Joyce continued, he welcomed the elimination in late 1983 and early 1984 of many of Brazil's exchange restrictions and multiple currency practices. The authorities should be encouraged to maintain the policy of liberalization and to implement as soon as possible the proposed trade system, which would provide protection to domestic activity through tariffs rather than through quantitative exchange and trade restrictions.

In his opening statement, Mr. Joyce noted, Mr. Kafka had stressed that protectionist tendencies in the industrial countries were a potential impediment to the growth of Brazil's exports in the medium term. That danger certainly existed, but many of the items on the list of so-called restrictive actions in Appendix VIII described safeguard measures taken by industrial countries in accordance with the internationally agreed trading rules of the GATT, of which Brazil was a member. Many of the antidumping and countervailing duties would have been unnecessary if Brazil had been able to achieve a greater degree of international competitiveness without resorting to export subsidies; adjustment efforts or a more flexible approach to exchange rate policy at an earlier stage might have facilitated that process.

The program for the second year of the extended arrangement and the request to use the compensatory financing facility were acceptable, Mr. Joyce remarked, although he agreed with Mr. Erb that characterizing 1983 as a shortfall year, during which in fact there had been a substantial improvement in the export performance compared with the two preceding years, was an anomaly. The calculations of the export shortfall were correct, but the anomaly should perhaps be examined on another occasion.

He was pleased that Brazil had made progress under its adjustment program, and he recognized that it had been at a considerable cost, Mr. Joyce said. The medium-term projections were encouraging, although the staff had not indicated the policy conditions under which they could prove to be accurate. Mr. Kafka was more optimistic than the staff about the prospects for economic growth in Brazil, and he hoped that he was proved correct. However, if Mr. Kafka's optimism was widely shared in Brazil, it might be difficult for the authorities, even at the present early stage in the adjustment process, to continue to insist on the implementation of difficult measures needed to achieve the program objectives. In that event, there would be some temptation to return to business as usual by accommodating higher economic growth rates that, although socially desirable, might be unsustainable. Such an outcome would negate the benefits from the sacrifices that the Brazilian people had been asked to make thus far.

Mr. Tvedt remarked that, although the authorities had faced serious problems and had had to modify the extended arrangement, they had made important progress and had set the stage for a smooth but vigorous adjustment of the economy. The problem causing the greatest concern to the outside world, namely, the external payments imbalance, had been tackled successfully, thereby paving the way for a return to more favorable terms on Brazil's foreign borrowing.

Nevertheless, Mr. Tvedt went on, serious problems remained, and he agreed with Mr. Kafka that controlling inflation was the most urgent task facing the authorities. During the previous discussion on Brazil, it was clear that the staff and the authorities had agreed that a gradualist approach to reducing the rate of inflation was not possible; inflation should be reduced quickly. In fact, inflation was being tackled through restrictive demand management policies, which, according to the latest projections, might reduce the rate of inflation to 100-130 percent in 1984, and to 50 percent in 1985. Such reductions were important, but hardly abrupt, and they suggested that the ingrained inflationary expectations would be difficult to eliminate. Mr. Kafka had mentioned in his opening statement that they would have to be removed before the counterinflationary policies could be fully effective.

In the first four months of 1984, Mr. Tvedt continued, prices had risen at an annual rate of 220 percent. Accordingly, the rate of inflation on a yearly basis would have to be held to 70-90 percent during the remainder of 1984 if the target of 100-130 percent for the whole year were to be met. Since the indexation of wages remained largely intact, he strongly doubted whether the rate of inflation could be reduced, even to the relatively moderate pace projected by the staff. The indexation system in itself might not cause inflation, but when coupled with the continuous depreciation of the cruzeiro, it clearly maintained the momentum of inflation. The rate of inflation probably could not be reduced through the policy approach that the authorities had adopted without triggering a sharp rise in unemployment and exerting serious adverse effects on economic growth. In November 1983, the staff had indicated that it might be possible to reduce the rate of inflation to 2-3 percent a month during the final quarter of 1984. Did it still believe that such an outcome was likely?

The authorities had made important progress in public finance, Mr. Tvedt remarked, and he continued to attach importance to the COMOR's efforts, which could be expected to increase efficiency in the public sector. As for monetary policy, it had been aimed principally at reducing the growth of the monetary and credit aggregates, eliminating interest rate subsidies, and restoring positive real interest rates. Significant steps had been taken in the interest rate area, but developments in the money and credit aggregates were worrying. The demand for money had fallen continuously over recent years, but, once the inflation subsided, the demand for money--at least for certain types of it--could be expected to rise again, as individuals restored their liquidity holdings to more normal levels. M-1 had dropped in real terms by almost 40 percent in 1983, following a decline of a similar magnitude in 1979-82. The 50 percent growth target for M-1 in 1984 indicated that a further sharp reduction in real terms was anticipated. A further comment from the staff on the implications of meeting the 50 percent limit if the rate of inflation did not fall as expected would be helpful. He wondered what kind of developments would encourage the staff to propose a change in the target for M-1.

The exchange rate policy was appropriate, Mr. Tvedt considered. In the medium term, the economy should be able to rebound vigorously, given its rich resource endowment. Nevertheless, debt would continue to constitute an important constraint, as the debt service burden would remain in the range of 50-70 percent through 1988.

He understood the substantial difficulties facing the Brazilian authorities and the intense effort that had been made to design and introduce an adequate adjustment program, Mr. Tvedt commented. He hoped that the Government's policies would quickly produce the desired results, and that Mr. Kafka's relatively optimistic outlook would prove to be accurate. However, given the difficulties encountered thus far and the limited chances for meeting the inflation target, his own position on the outlook for the economy was a guarded one. Still, all the proposed decisions were acceptable. The proposal to use the compensatory financing facility met all the relevant criteria, although the mere existence of a program, thereby meeting the stricter test of cooperation, did not necessarily provide assurance that its objectives would be achieved, as developments in 1983 clearly showed. The inclusion of the paragraph on the adequacy of economic data, Appendix V on performance under the program, and Appendix VIII on restrictive measures affecting Brazil was welcome.

Mr. Zhang said that he broadly agreed with the staff appraisal and Mr. Kafka's interpretation of the Government's policies. He fully supported the proposed decision on the review under the extended arrangement.

It was important to recognize that the remarkable turnaround in the trade account and in the current account in 1983 had strengthened the basis for the adjustment process in coming years, Mr. Zhang commented. The importance of that accomplishment should not be underestimated. The implementation of domestic adjustment policies focused on reducing the public sector deficit and on making other important structural changes had also been successful.

Brazil's extended arrangement, Mr. Zhang continued, was one of the few that aimed at setting the stage for a resumption of growth, rather than merely stressing the achievement of a sustainable payments position. Indeed, over the medium term, gross domestic investment in relation to GDP was projected to rise steadily. Moreover, the staff had recognized that many of the internal imbalances had been due in part to adverse external influences and had been a consequence of rapid growth in Brazil in the 1970s.

He broadly shared the view that inflation continued to be the most urgent problem facing Brazil in 1984, Mr. Zhang remarked. However, it was important to remember that the authorities had introduced restrictive counterinflationary policies in 1983 and that all the measures under the 1984 program were designed to reduce inflation. In the light of Brazil's history of rapid and continuous inflation, time would be needed to reduce inflationary expectations and for the Government's counterinflationary policies to become fully effective. There was no obvious way of accelerating the reduction in the rate of inflation without creating new distortions in the economy. The rate of inflation had decelerated in recent months, but developments in the real and external sectors might present its further reduction in coming months. For instance, continued sharp improvement in the external balance in 1984 and the consequent expansion of domestic demand would inevitably increase the overall inflationary pressures in the domestic economy. In fact, some increases in prices had been the result of counterinflationary measures. He doubted whether it was advisable to tighten further monetary policy in the present circumstances.

The urgent need to reduce inflation should not be viewed in isolation, Mr. Zhang considered. Close attention should be paid to Mr. Kafka's warning that the authorities would consider their adjustment program a failure unless progress against inflation were linked to a recovery from the recent frightening decline in real per capita GNP.

Commenting on the medium-term prospects for the economy, Mr. Zhang said that he fully agreed with Mr. Kafka that the staff's estimates for the rate of growth were unjustifiably pessimistic. It was not clear to him why the staff in its calculation of GDP growth rates had assumed a continuous rise in the capital output ratio after 1985. The assumed continuous and large growth in the share of consumption in GDP was also surprising.

A worrying development in the medium-term perspective, Mr. Zhang went on, was the likelihood that, despite the expected continued success in making needed adjustments, Brazil's external debt would increase by another $19 billion between 1983 and 1989, more than one fifth of the present level. The increase could be even larger if interest rates in world markets rose in the coming period.

During the next review, Mr. Zhang said, the staff should explicitly analyze both income redistribution--which had played a role in the inflation and in the adjustment process in Brazil--and the impact of a change in wages on imports. The proposed decisions were acceptable.

Mr. Alfidja remarked that the implementation of Brazil's economic and financial program had generally been successful, despite the floods and droughts that had adversely affected agricultural production for export and domestic supplies of basic foodstuffs. The authorities were to be commended for the significant progress made in the external sector, where they had achieved the principal objective of narrowing the current account deficit by expanding exports, cutting imports, reducing the expenses of Brazilian banks abroad, and conducting leasing operations by the state oil company.

Despite the progress, Mr. Alfidja continued, Brazil had encountered foreign exchange difficulties in 1983, largely because of the shortfall in expected net capital inflows. The new external financing arrangements were reassuring, as they should help the authorities to make further progress toward external payments viability during the second year of the extended arrangement. The additional steps that they intended to take to eliminate the remaining exchange restrictions and multiple currency practices and to maintain a flexible exchange rate policy should help to preserve Brazil's competitive position--which had improved in 1983--and should further strengthen the external payments position in 1984, when the overall balance of payments was projected to show a surplus of about SDR 4.3 billion.

Domestically, Mr. Alfidja said, the authorities were to be commended for their policy flexibility in making major changes in mid-1983 to ensure that the efforts made to correct the domestic financial imbalances would achieve the desired results. Subsidies to agricultural credit, as well as other credit subsidies and subsidies on petroleum products and wheat, had been removed. The wage legislation had been amended to provide for the return to free wage bargaining. These steps relative to the determination of prices and incomes were important.

In the fiscal area, Mr. Alfidja continued, the reductions in the revised public sector borrowing requirement and in the deficit of the operational budget of the public sector were welcome. The COMOR system established to monitor the public sector budget had certainly proved effective. The authorities' flexibility had also been reflected in monetary policy, which had been strengthened but had still failed to keep the rate of inflation from more than doubling to in excess of 200 percent. Inflation remained a cause for serious concern, and the authorities' intention of maintaining a demand management policy that would ensure a substantial reduction in inflation in 1984 was welcome. They should be urged to persevere with their efforts to keep the program for 1984 on track.

The request to use the compensatory financing facility met all the relevant criteria, Mr. Alfidja considered. The shortfall in merchandise exports had been due to factors that were beyond the authorities' control, a balance of payments need had been clearly established, and the export shortfall was temporary. The implementation of the new program under the extended arrangement had enabled the authorities to meet the more rigid test of cooperation. The proposed decisions should be approved.

Mr. Camara said that, while the problems facing Brazil were relatively large, they were similar to those confronting the majority of countries in his constituency. His authorities had been keenly following Brazil's adjustment efforts to see what lessons might be learned.

The significant structural changes in the first year of the program, including the progress in the external sector, were welcome, Mr. Camara said. However, they had clearly proved to be more difficult than had been expected, partly because of the ingrained nature of the causes of the economic disequilibria, such as the indexation scheme, and partly because of the prolonged global recession and high interest rates in international capital markets. Delays in implementing certain measures had helped to intensify inflationary pressures, but it was important to stress that the program objectives had not been abandoned. The flexibility that the Fund had shown was the most practical way of helping the authorities to solve the problems facing the economy. The Fund's experience in Brazil should help in designing adjustment programs for other developing countries facing structural payments imbalances.

The staff's projection of a steady decline in the debt service ratio was encouraging, Mr. Camara noted, but he wondered whether it was not somewhat overoptimistic. The staff could usefully comment on alternative scenarios for interest rate movements over the medium term. Brazil admittedly had a large, diversified economy and could depend on its own resources and production to a large extent. However, at approximately 80 percent, the debt service ratio was extraordinarily large. It was important to keep in mind the potential problems that could occur because of rising interest rates abroad, protection in major markets, and fluctuations in the prices of primary export commodities, any of which could throw the adjustment effort off course. The solution to the debt service ratio problem would require, in part, an organized effort to stretch out the debt to reflect more fully the gestation period of the projects financed by loans and the capacity of Brazil to generate adequate foreign exchange. In addition, interest rates would have to ease somewhat.

The thrust of the policy actions in the second year of the adjustment program was generally satisfactory, Mr. Camara considered. However, the rate of inflation remained worrying, especially as inflationary expectations were still pervasive. The difficulty in predicting the course of inflation and the high rate of inflation itself had added to the problems of fiscal and monetary policy management. It was important for the authorities to break inflationary expectations by, inter alia, demonstrating their determination to deal with the underlying problems, including indexation.

The proposed purchase under the compensatory financing facility was acceptable, Mr. Camara said. The balance of payments need had been clearly established, and the test of cooperation was met by the implementation of the 1984 adjustment program. The proposed decisions should be approved.

Mr. Finaish commented that economic developments in Brazil during the previous year had reflected the implementation of the adjustment program introduced in early 1983. There was broad interest in the program, not only because of its regional and global implications, but also because of the lessons that others might learn about the conduct of economic policy in a particularly difficult situation. No final judgment on Brazil's performance could be made at the present early stage, but some tentative conclusions could be drawn on the basis of the experience during the previous year.

The most significant development in the external sector during 1983, Mr. Finaish continued, was the impressive performance of the current account, which had exceeded expectations. Another encouraging sign was the continued strong performance of the current account in the first four months of 1984: exports had risen by 20 percent over the same period in 1983, and imports had risen at a significantly slower pace. One qualification to the positive picture that had been painted in the staff reports and during previous Board discussions was that the achievements had been made at the expense of an increase in trade restrictions. However, it was important to bear in mind that the program had been started in the midst of a severe debt crisis, and that top priority had had to be given to the need for a sharp and immediate improvement in the external balance in order to restore confidence. Furthermore, some of Brazil's exports still faced protectionist barriers. In its appraisal, the staff had stressed that it "considers that access for Brazilian exports to international markets is a critical requirement for the success of Brazil's economic adjustment program." Mr. Kafka had noted in his opening statement that the extent and continued intensification of protectionist measures were "truly frightening."

There had been serious setbacks during 1983 in the effort to reduce the rate of inflation, Mr. Finaish commented. The authorities had originally hoped to reduce the rate from 100 percent in 1982 to 90 percent in 1983, 40 percent in 1984, and 20 percent in 1985. Instead, the annual rate had accelerated to 211 percent in 1983 and to nearly 230 percent at end-April 1984, although the monthly rate had slowed slightly in the first four months of 1984.

The factors contributing to that disappointing performance had been described extensively in the staff reports and during previous Executive Board discussions, Mr. Finaish continued. As many of those factors were not expected to be in evidence in 1984, it seemed natural to expect greater certainty about the rate of inflation for the year. The staff had clearly indicated that 1984, compared with 1983, "should be free from major cost-push pressures, as there are indications of a good agricultural crop and there is no need to repeat the large changes in the structural relative prices brought about in 1983 by the devaluation and the elimination of subsidies." Moreover, the external situation should be improved in 1984, and tight financial policies were being firmly applied. Nevertheless, the staff felt that no precise inflation target could be set for 1984, apparently owing to the high degree of indexation in the economy and to deeply entrenched inflationary expectations. Those underlying factors highlighted the strength of the roots of the inflationary process in Brazil and led one to doubt whether the target of cutting the rate of inflation in half in 1984 could be achieved.

One of the major difficulties in the counterinflationary effort in 1983 had been the slippage in the fiscal performance, particularly in the early part of the program year, Mr. Finaish commented. The authorities had originally hoped to reduce the public sector borrowing requirement from 15.8 percent of GDP to 8.8 percent in 1983; in fact, the deficit had increased by 2 percentage points of GDP. That the 1984 program included substantial cuts in the fiscal deficit and specific measures to ensure success in that area was particularly significant. The public sector borrowing requirement was expected to fall by 5-7 percentage points of GDP in 1984 on the basis of an improvement in the performance of state enterprises, further reductions in subsidies, continued control of expenditures, and further strengthening of tax collections. One source of optimism in that area was the implementation of measures in late 1983 to increase overall public sector revenues by about 2 percentage points of GDP; that move contrasted sharply with the revenue experience for 1983 as a whole. Another source of optimism was the staff conclusion that the Interministerial Committee for Monitoring the Implementation of Public Budgets had "proved to be effective in providing the required coherence and discipline to budgetary decision making." The inclusion in the program of monthly targets for the main components of the public sector, thereby providing for an early warning of deviations from desired performance, was also encouraging.

The performance in the monetary area during 1983 had been mixed, Mr. Finaish remarked. Progress had been made in eliminating interest rate subsidies to agriculture, exports, and certain enterprises, but the 90 percent increase in the monetary base, the apparently unexpected decline in the demand for money, and what the staff had described as the lack of steadiness of monetary policy, had undoubtedly contributed to already considerable inflationary pressures. Monetary policy was expected to be tightened in 1984, and the growth of the monetary base was expected to slow to 50 percent. If no significant increase in the velocity of money occurred, the slowdown in monetary expansion should make a positive contribution to the effort to control inflation in 1984.

Recent developments had contributed to a general feeling of cautious optimism regarding the outlook for the Brazilian economy, Mr. Finaish said. The supplement to the staff report confirmed certain positive signs, such as the deceleration in the monthly rate of inflation, the stronger performance of revenues--resulting in a central government surplus twice as large as the program projection--a cut in public sector borrowing below the established ceiling, and an overshooting of the overall balance of payments projection by $1 billion, due mainly to the performance of exports. Mr. Kafka had a more optimistic view than the staff on output growth during 1984 and in the medium term, and he certainly hoped that Mr. Kafka proved to be right. While recent developments were encouraging, the Government's ability to make further improvements would remain uncertain unless there were decisive success in fighting inflation. As Mr. Kafka and a number of other speakers had stressed, inflation was the most urgent problem facing Brazil. The recent positive achievements should not lead to any relaxation of the authorities' resolve to continue the adjustment effort needed to control inflation and to facilitate more sustainable growth. In that connection, different policy approaches might be needed in the future, particularly in the effort to control inflation.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/73 (5/7/84) and EBM/84/74 (5/9/84).

3. STAFF RETIREMENT PLAN - RECALCULATION OF 1983 PENSION SUPPLEMENTS

The Executive Board approves the recommendations to recalculate 1983 pension supplements due to the revised increase in the price index for 1982 to 1983, and to increase the total estimated to be made in 1984 from $2,142,000 to $2,268,000 as set forth in EBAP/84/93 (5/3/84).

Decision No. 7694-(84/74), adopted
May 8, 1984

4. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 83/181 and 83/182 are approved. (EBD/84/129, 5/1/84)

Adopted May 7, 1984

b. The minutes of Executive Board Meeting 83/183 are approved. (EBD/84/131, 5/2/84)

Adopted May 8, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/94 (5/4/84) is approved.

APPROVED: November 1, 1984

LEO VAN HOUTVEN
Secretary