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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/75

3:00 p.m., May 9, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	L. E. J. M. Coene, Temporary
	X. Blandin
	M. Teijeiro
R. D. Erb	M. K. Bush
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	
G. Laske	
G. Lovato	N. Coumbis
R. N. Malhotra	
	S. El-Khouri, Temporary
J. J. Polak	
A. R. G. Prowse	
	H. Alaoui-Abdallaoui, Temporary
	M. Camara, Temporary
	S. E. Conrado, Temporary
J. Tvedt	A. Lindø
	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: M. Guitian, R. L. Sheehy. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Research Department: N. M. Kaibni, T. K. Morrison. Western Hemsiphere Department: 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: S. R. Abiad, H.-S. Lee, W. Moerke, J.-C. Obame, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, R. L. Bernardo, J. Bulloch, Chen J., G. Ercel, I. Fridriksson, V. Govindarajan, H. Kobayashi, M. J. Kooymans, E. Portas, D. J. Robinson, A. A. Scholten, Shao Z., Wang C. Y., M. A. Weitz.

1. BRAZIL - 1984 ARTICLE IV CONSULTATION, REVIEW UNDER EXTENDED ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/84/74, 5/9/84) their consideration of 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 extented 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/84/77, 4/25/84).

Mr. Malhotra said that he agreed with the general thrust of the staff analysis. In his opening statement, Mr. Kafka had clarified a number of issues, especially with respect to the medium-term outlook.

Despite difficult conditions, the authorities had made considerable progress under the 1983 program, Mr. Malhotra considered, especially with the external accounts and in improving relative prices. However, the economy had experienced adverse weather conditions, which had hurt agriculture, and an inadequate supply of imports. As a result, GDP had fallen by 3.3 percent in 1983, after falling by 2 percent in 1981-82, and per capita income had declined by an estimated 12 percent in the period 1980-83. In addition, the unexpectedly high rate of inflation was a cause for concern.

Substantial steps had been taken in 1983 to rationalize interest rates and the prices of key commodities, Mr. Malhotra observed. The prices of petroleum products had been raised to eliminate subsidies on them and were continuing to be adjusted in line with the depreciation of the cruzeiro. The price of wheat had been increased by more than 200 percent, and further steps were being taken to eliminate the subsidy on that item. Prices of steel and electricity had been raised by some 5 percent in real terms, and those of other public sector services corrected in line with inflation. Legislation establishing a sliding scale of wage indexation had yielded an average adjustment of 86 percent of past inflation, a significant step toward the desired de-indexation of wages. Legislation had also been passed to limit fringe benefits.

On the fiscal side, Mr. Malhotra went on, the authorities had contained the operational public sector deficit at 2.6 percent of GDP, in line with the revised program target, but the overall public sector deficit was still large at 17.7 percent of GDP. Public expenditures had fallen by 1.6 percent of GDP, with the wage bill falling by 14 percent in real terms, as wage increases had been held below the rate of inflation and promotions and new hiring had been frozen. The current and capital expenditures of federal and state enterprises had been reduced by 3 percent and 24 percent, respectively. Tight controls had been imposed on domestic and foreign borrowing by the public sector, and the establishment of the Interministerial Committee to Monitor the Implementation of Public Budgets was an indication of the authorities' determination to bring the fiscal situation under control.

On the monetary side, Mr. Malhotra noted, the authorities had taken steps to reduce interest subsidies, and particularly those for agriculture, exports, and small and medium-sized enterprises. The staff had indicated that the monetary controls had not been effective in checking inflation in 1983. Although the revised monetary targets had been achieved, they had not helped to reduce inflation.

Externally, Mr. Malhotra said, Brazil had had considerable success in achieving the 1983 program objectives. The trade surplus had amounted to $6.5 billion, as exports had risen by 8.6 percent in dollar terms to $21.9 billion, and imports had been compressed by nearly 20 percent. The current account deficit had been reduced to $6.2 billion, about $1.5 billion below the target, owing to the exceptionally severe import compression together with the satisfactory export performance. However, Brazil's balance of payments difficulties were expected to continue even in the medium term, mainly because of the large debt service obligations. The cruzeiro had depreciated by 25 percent in real terms against the U.S. dollar and by 21 percent against the basket of currencies of Brazil's major trading partners. He wondered whether the staff had estimated the contribution to the high rate of inflation made by the several cost-push measures introduced by Brazil under the program, such as the large depreciation of the cruzeiro, the adjustments in interest rates, and the increases in the prices of agricultural commodities, petroleum, and other goods and services.

He agreed with the authorities and the staff that breaking the inflationary momentum and expectations should be the central policy objective of the 1984 adjustment program, Mr. Malhotra continued. There was some indication that the rate of inflation would decelerate in 1984. For instance, the strong cost-push factors in 1983 were unlikely to recur in 1984, and the crop should help to moderate inflation; supply-side conditions generally were likely to be more favorable in 1984 than in 1983. Moreover, the authorities intended to maintain a vigorous demand management policy stance to reduce substantially the monetary base and including an active interest rate policy. At the present stage, the staff understandably was unable to specify the time by which the Government's policies would yield a significant and lasting reduction in the rate of inflation. In the circumstances, constant monitoring and prompt adoption of corrective measures would be needed.

Commenting further on developments in 1984, Mr. Malhotra said that a small public sector operational surplus and a substantial reduction in the public sector borrowing requirement were expected, and that all the performance criteria for the first quarter had been met by significant margins. The monthly rate of inflation had declined from 12.3 percent in February to 8.9 percent in April, and the trade performance in the same period had been satisfactory.

Fiscal policy was aimed at reducing the operational deficit of the public sector, Mr. Malhotra noted. While for analytical and policymaking purposes the division of the total public sector deficit into two segments--the operational deficit, and the deficit caused by monetary and exchange correction--was understandable, controlling the public sector borrowing requirement had to be an important part of the effort to contain inflation. Since indexation had made the task of tackling inflation extremely complex, it would be useful to take a comprehensive look at all its ramifications with a view to dismantling it progessively, as the rate of inflation declined.

He generally agreed with the staff's analysis of Brazil's request to use the compensatory financing facility, Mr. Malhotra said. However, with the acceptance of the proposed decision, Brazil's access under the facility would reach the ceiling of 83 percent of quota, and although the export shortfall was estimated at SDR 895 million, the proposed financing was limited to SDR 247.9 million. Hence, while Brazil had a balance of payments need, a large export shortfall, and a strong adjustment program, sufficient financing under the compensatory financing facility could not be provided, because the level of permissible access was inadequate.

Executive Directors had differing views on the medium-term outlook described by the staff and Mr. Kafka, Mr. Malhotra observed. If Mr. Kafka's projections were to prove accurate, as he hoped, certain important conditions would have to be met. First, it was of the utmost importance for Brazil to reduce inflation to a reasonable rate and to implement the adjustment program vigorously. Second, an increase in efficiency, especially in the public sector, was essential. Third, interest rates in the international capital markets would have to moderate; the recent increase in interest rates was a cause for serious concern. Fourth, protectionist measures, especially in industrial countries, must not be intensified and, indeed, should be rolled back. Fifth, more comprehensive and imaginative solutions should be found to the serious debt servicing problem, solutions that would have to go beyond the present annual rescheduling exercise, so that Brazil could again become a net importer of capital. Finally, he supported the proposed decisions.

Mr. Conrado joined in supporting Brazil's request to use the compensatory financing facility, which met all the established criteria. The country's balance of payments need was clear, and its cooperation with the Fund was reflected in the implementation of the extended arrangement. He agreed with the staff that the export shortfall was attributable largely to factors beyond Brazil's control, particularly the continuing effects of the world recession on Brazil's exports. And the staff projections showed that the export shortfall was temporary.

He broadly agreed with the staff appraisal for the 1984 Article IV consultation and the review under the extended arrangement, Mr. Conrado commented. The proposed decision should be approved, although he also agreed with most of Mr. Kafka's comments on his minor analytical differences with the staff.

Performance under the 1983 program had been mixed, Mr. Conrado remarked. Considerable progress had been made in reducing the external imbalance but not on the domestic front, as the rate of inflation had remained high and economic activity had declined substantially. Those disappointing developments had been caused in part by important slippages in the implementation of domestic policies, but they were also attributable to exogenous factors and, equally important, to the initial shocks and disruptions that the adjustment measures had had on economic activity, prices, and expectations. On previous occasions his chair had stated that it was not always realistic to expect immediate positive results when major adjustments were being made not only in the overall policy stance, but also in the whole structure of an economy's relative prices. During the previous 18 months, far-reaching changes had been made in Brazil's economy, and the results in the domestic economy should perhaps be judged in the light of the positive effects that the changes should have in the near future; the focus should not be on the immediate effects of the changes. The authorities were to be commended for their courageous initial actions, and for the further steps taken to reinforce their policies. As the staff had concluded, the performance during the first year of the extended arrangement had provided a realistic base for the implementation of policies in 1984.

The high rate of inflation was still the most urgent problem facing the authorities, Mr. Conrado said, and reducing it had been made the main policy objective for 1984 and beyond. That approach was correct, as inflation had become a serious constraint on the recovery of economic activity and on the restoration of equilibrium in the economy. While a number of factors suggested that the rate of inflation could decelerate, the inflationary expectations entrenched in the Brazilian economy should not be underestimated. Although a much better monetary and fiscal policy basis for fighting inflation had been established, economic conditions were still somewhat uncertain, and it was too soon to judge whether or not the present policies were fully sufficient to achieve a substantial reduction in inflation. After all, wage indexation had been maintained, and the present system of monetary correction made it difficult to formulate adequate overall demand management policies to cope with the inflation. The present approach of using successive reviews to gauge the progress under the program and to set quantitative targets for short periods was therefore appropriate. It would provide the needed flexibility, should the rate of inflation not slow as rapidly as was expected, thereby necessitating some liberalization of the limits on the expansion of the monetary base and the overall money supply. Otherwise, the effects of the adjustment effort would become intolerable and unsustainable, and alternative solutions to the problem of inflation might have to be sought.

The other major problem facing the economy was the external debt and debt service, Mr. Conrado remarked. Increases in interest rates obviously had a significant effect on Brazil's financial situation and could offset the gains achieved through improved export performance. Brazil's adjustment effort was therefore somewhat vulnerable, a fact that Directors should bear in mind when assessing the performance under the extended arrangement.

Brazil was making a significant adjustment effort, and other countries should play their proper role in achieving durable solutions to the problems facing Brazil's economy. As the Chairman had stressed, there was a clear need for an open trading system and for a continued flow of funds from commercial banks and other sources.

He agreed with Mr. Kafka's relatively optimistic assessment of the medium-term prospects for the economy, Mr. Conrado commented. In the past, the economy had shown great resilience, and its present potential for growth at high rates had clearly not been exhausted. More important, Brazil would certainly revert to its normal position as an importer of capital. Like Mr. Polak, he did not believe that Brazil and other developing countries would permanently run current account surpluses and export capital. The overreliance on external debt evident in previous years certainly should not be repeated, but at some future date Brazil should again become a net importer of capital. Moderate and sustainable current account deficits would facilitate the achievement of higher potential growth rates in the medium term than would otherwise be the case.

Brazil had made considerable progress, especially in making the structural changes needed to establish a better base for policy formulation and management, Mr. Conrado concluded. Much remained to be done, however, and the authorities should be prepared to make necessary adaptations as circumstances warranted.

Mr. Prowse said that the proposed decisions were acceptable. The request to use the compensatory financing facility met all the relevant criteria.

He agreed with the thrust of the staff appraisal for the 1984 Article IV consultation and the review under the extended arrangement, Mr. Prowse continued. The staff had clearly shown that the adjustment of the real economy in Brazil had only just begun, and that the Fund's relationship with Brazil should be seen in the light of that conclusion. It was important to consider whether the adjustment effort had the wide support needed to ensure that it would be fully effective. His own support of the proposed decisions rested to a considerable extent on the staff's assurance that the needed policies were in place and that the program was appropriate. In the light of the complexity and large degree of uncertainty in the situation in Brazil, firm judgments on economic conditions were difficult to make.

One of the main uncertainties had to do with the likely course of inflation, Mr. Prowse remarked. The program targets for the rate of inflation were a central part of the adjustment effort. Both the staff and Mr. Kafka had stated that the high rate of inflation was the most urgent problem facing the economy, but progress in dealing with inflation in 1984 had not been encouraging. Inflationary expectations apparently had not been broken, and even if overall developments in coming years were favorable, the rate of inflation probably would still be as high as 30 percent at the end of the decade. The time the authorities planned to take to reduce the rate of inflation seemed excessively long. Inflationary expectations could not be broken during a period on gradual reduction of the rate of inflation from a very high level.

Indexation was still important in Brazil, Mr. Prowse noted. It was too soon to assess the consequences of the new wage indexation formula, but it seemed that the Fund was being asked, with the proposed program, to act on faith in the important area of inflation. Recent press reports on an apparent partial breakdown in wage policy, including the policy for the public enterprises, were a cause for concern.

There was also uncertainty about the likely course of the external accounts, Mr. Prowse remarked. Although considerable progress had been made in adjusting the current account, a surplus on that account did not seem to be the appropriate medium-term or long-term objective for Brazil or any developing country. Developing countries should not be capital exporters over an extended period. At the same time, they should of course bring their debt service ratio under control. Brazil's creditors had been most understanding of the country's difficult situation, but they might well have to be even more flexible in future.

The authorities had begun to replace the present highly complex system of trade protection, which involved considerable distortions, with a tariff system, Mr. Prowse noted. Work on replacing the restrictive system should have been started sooner, and further comment on the schedule for the introduction of the tariff structure would be helpful.

Given the uncertainty about the changes of achieving the program objectives, Mr. Prowse said, the staff's suggestion for providing for contingency plans was appropriate. The staff had explained that it had explored with the authorities alternative policy packages and procedures, which had however not been described in detail, and a further comment on them would be useful.

While he was not fully confident about the prospects for the implementation of the program, Mr. Prowse commented, there was clearly no alternative to proceeding with it. While it was relatively easy to find fault with the program, it was difficult to propose policy alternatives. Still, the projected real rate of increase in central administration transfers to states and municipalities in 1984 and 1985--10.9 percent--and in transfers to the social security system--nearly 16 percent--seemed high, and he wondered whether the staff felt that they were a cause for concern.

In addition, Mr. Prowse said, there had apparently been little progress in reducing the public sector borrowing requirement (PSBR), which, under the revised program for 1984, was expected to be in the range of 11-13 percent of GDP, compared with the original program target of 5.5 percent. In relation to GDP, the PSBR had grown from 12.5 percent in 1981 to 15.8 percent in 1982, and the preliminary figure for 1983 was 17.7 percent. Presumably that trend was related to the monetary adjustment. What were the implications of a public sector borrowing requirement that was quite large because of the monetary adjustment? Was the requirement in fact a real borrowing requirement? Was the indexing of the capital value of the debt a real factor in the size of the borrowing requirement? Further clarification of the nature of the public sector borrowing requirement would be helpful. Finally, while the reasons for the present emphasis on the monetary adjustment in the operational surplus were not fully clear to him, the staff had obviously gained an impressive grip on the complex Brazilian economy.

The staff representative from the Western Hemisphere Department remarked that the entrenched inflationary expectations and near-full indexation of the economy constituted new analytical terrain. The staff had noted that there were a number of reasons why the rate of inflation was likely to decelerate in 1984. In particular, the major cost pressures evident in 1983 appeared to be absent in 1984, although the staff had been unable to estimate the contribution of each of the various factors to inflation. Nevertheless, appropriately restrictive demand management policies would inevitably lower the rate of inflation. There was little more that the staff could say with certainty at the present stage about the likely course of inflation.

For the first program year of the extended arrangement, the staff representative explained, the staff had estimated the demand for money and built the program around it. The estimate had proved to be inaccurate, and for the 1984 program the staff had estimated a reasonable increase in the money supply in view of the programmed fiscal restraint; the velocity of money had been determined as a residual, and the actual velocity would depend on the movement in the rate of inflation. The targets for the monetary base under the 1984 program had been agreed with the authorities and reflected their planning for 1984, but they were not performance criteria.

The staff intended to keep a close watch on developments concerning international reserves and the balance of payments during 1984, the staff representative continued. Monetary policy was appropriately restrictive and would eventually produce the desired break in inflation. It was impossible to make a firm prediction of the rate of inflation for end-1984. The achievement of a 3 percent rate for December 1984, which had been forecast in November 1983, seemed increasingly doubtful; however, it could conceivably prove feasible, since the rate of inflation could decelerate quickly once the break occurred. The working hypothesis in the present program was a rate of 4.5-5 percent for the end of 1984. The rate that had been included in the medium-term outlook exercise was not a target; it was more like a working hypothesis and was based essentially on the historical average.

De-indexation had been attempted in 1980, with disastrous results, the staff representative commented, including a sudden increase in consumption, a substantial decline in savings, the threat of a deterioration in the balance of payments, and considerable distortions in the financial system that had taken nearly two years to correct. The authorities had concluded that the rate of inflation would have to be reduced to a more manageable level before a process of gradual de-indexation could be started. For practical reasons, the exchange rate could not be de-indexed at the present stage without jeopardizing the achievement of the external program targets and undermining the whole structure on which the debt negotiations had been built. One possible alternative at present was to de-index financial assets, although that move was likely to result in negative real interest rates; it would certainly be odd to provide for such rates in a program that was meant to curb aggregate demand and increase aggregate savings. There would probably be a shift from the main items of domestic savings and financial assets, namely, passbook savings and treasury bonds, either toward foreign exchange--thereby endangering the external goods sector and fueling inflation--or toward financial assets with flexible interest rates. A flight out of passbook savings would have a devastating effect on economic activity in general, and on construction in particular. A flight out of treasury bonds would be even more dangerous, as it would prevent the rollover of the huge public sector debt. The desired increase in public sector savings would permit the gradual decline in the public sector debt and would subsequently permit the de-indexation of the economy.

Commenting on the issue of indexation, the staff representative remarked that information on wages in Brazil had traditionally been particularly weak. The staff had been hard pressed during 1983 to analyze the effects of the various proposals concerning wages, and it had no hard information to use in assessing the new wage indexation formula. That assessment would probably have to wait until the end of 1984, when the various statistical bureaus would begin to produce the relevant information, although even those data would be suspect to some extent. The description of wage indexation developments in the staff report was based on the information provided by the authorities in February 1984 and in subsequent press reports. The new wage formula was clearly taking hold in the public sector, where strong wage compression had occurred. The decline in the wage bill in the public sector had not been due solely to layoffs; there had also been a decline in real wages. The staff had concluded earlier, through press reports and discussions with the authorities, that the private sector had been adhering more or less to the wage law. There had subsequently been press reports of discontent with the wage law in the steel sector near São Paulo in early April 1984, and the staff could not say for certain whether or not it was part of a trend.

There was no possibility of renewing loans made at subsidized interest rates, the staff representative explained. Past debt was rolled over at currently prevailing interest rates. Most of the loans in question had been to agriculture and were tied closely to the crop season.

There was clearly a problem with the disbursement through the monetary budget of counterpart funds for loans by the World Bank, the staff representative remarked. However, the problem was not a cause for alarm. The monetary budget provided for the equivalent of some $900 million, compared with a loan disbursement commitment by the World Bank of more than $1.2 billion. Hence, approximately three quarters of the World Bank's total disbursement was already covered in the monetary budget. The staff had been told in February 1984 that additional funds had been allocated to serve as the counterpart for loan disbursements by the World Bank, and the gap between the counterpart funds provided for in the monetary budget and the actual commitment by the World Bank was probably less than one quarter. The staff had taken the position that the counterpart funds were vital for the disbursement of the World Bank loans, which were needed to improve the balance of payments and were an important part of the financing of Brazil's investment program. The amount that had to be accommodated in the monetary budget was certainly reasonable. The very purpose of having a monetary budget was to plan for the various types of credit and money creation that would be required during the year.

The staff shared Mr. Lovato's concern about the relationship between the monetary base and its individual components, the staff representative said, and had been in touch with the authorities about certain discrepancies that it had noted. For instance, the way in which the reserve requirements were being quantified had caused a problem for the staff. The fact that the money supply had been growing more quickly than the monetary base was due in part to the decline in the actual reserve requirements, and the staff was attempting to determine the precise extent of the deline. Some financial instruments, such as treasury bills, had a prefixed interest rate, which could be negative in real terms, but there was clearly no demand for such instruments. It was also important to remember that many of the prefixed interest rates had been set in a period of accelerating inflation. Persons estimating future inflation at the time they had contracted for prefixed interest instruments had consistently underestimated the rate of inflation, thereby ending up with negative real interest rates. It was also important to remember that there were official ceilings on interest rates on certain other assets, particularly time deposits, but that, in practice, the ceilings were easily circumvented by compensating deposits and certain banking procedures. Hence, the reported interest rates did not reflect the actual rates that lenders paid, and the staff had therefore hesitated to publish information on interest rates. It had finally decided that the information would probably be useful, but it should be understood that there were a number of problems with the data, and that the underlying rates were higher than the reported rates.

It was possible, as Mr. Wicks had suggested, that arrears by the states and municipalities were not reflected in the public sector borrowing requirement, the staff representative explained. Those arrears could be a source of finance that had escaped the control of the authorities. The staff had discussed the matter with the authorities and had found that in some cases the unavailability of credit to the states had resulted in firms refusing to deal with states and municipalities. The problem apparently was not a major one, although on occasion a large number of state or municipal employees had had to be dismissed.

The staff and the authorities had agreed on procedures for considering contingency fiscal and monetary measures, the staff representative commented. The staff made periodic visits to Brazil, and there was an agreed schedule of reviews of the 1984 program. In addition, understandings had been reached with the authorities on the circumstances--particularly deviations from program targets, notably in the rate of inflation--under which special consultation would be called for. A broad range of possible policy actions had been discussed, but the situation was still too fluid to permit the determination of specific measures that might be needed. Fiscal measures, rather than monetary ones, would probably be required, but it was too soon to say precisely which taxes would probably be adjusted, or which expenditure items would be cut, if necessary.

The staff report contained data showing substantial real increases in transfers from the central administration to the social security system and the states and municipalities, the staff representative commented. The amount for the social security system was small and was part of the effort to place the system on a sound footing. The increase in the transfers to the states and municipalities had occurred for several reasons. First, in 1983 the Congress had approved a constitutional amendment mandating an increase in resources to the states. Second, under the Brazilian system, revenues were earmarked for the states; as the revenues of the Central Government increased, there was a corresponding increase in the earmarked transfers. Third, under the tax reform gradually being implemented, the financial independence of the states was being enhanced, while revenues for, and expenditures by, the Central Government were being reallocated to the states.

The figure of $700 million in external direct investment represented $900 million in direct foreign investment in Brazil and a $200 million outflow of Brazilian direct investment abroad, the staff representative explained. In that area, Brazil was not a net exporter of capital. Reinvested profits had been netted out of most of the figures in the staff reports; they had amounted to $700 million in 1983. Total foreign investment in Brazil in 1983 had amounted to some $1.5 billion. The authorities believed that the present legislation governing foreign investment was flexible and encouraged such investment, and no changes in it had been proposed. The tendency of foreign investors to refrain from investing in Brazil was a reflection of the present crisis, which had reduced confidence in international financial circles. The authorities believed that, once the overall economic and financial situation improved, the traditional level of direct foreign investment in Brazil would be restored.

Commenting on the LIBOR projected for 1984 in the proposed program, the staff representative said that there was a six-month lag in the payment of interest on foreign debt. Hence, the LIBOR that would matter for the purpose of the program would be the rate prevailing in the second half of 1983 and the first half of 1984. If the LIBOR remained at 11.5 percent during May and June 1984, the relevant average for the 1984 balance of payments would be 10.56 percent, very close to the original assumption. Each change of 1 percentage point in the LIBOR altered Brazil's balance of payments by $800 million.

Thus far, the staff representative remarked, the elimination of the centralized system of foreign exchange allocations had had no effect on the services account. There had been some fear that the elimination of the system would be followed by a large outflow on the invisibles account. However, the system had been removed almost seven weeks previously, and the large flow had not materialized.

The staff had no direct information to answer the question whether underinvoicing or overinvoicing had been a factor in the results for the balance of payments in 1983, the staff representative said. However, the behavior of the black market exchange rate suggested that underinvoicing and overinvoicing had had a significant impact. At present, the black market rate was less than 8 percent above the official rate, the smallest gap in many years.

The staff did not know the precise timetable for the replacement of the restrictions by a system of tariffs, the staff representative commented. Several initiatives, including measures affecting agricultural products, were scheduled to take place during the first half of 1984. As for other possible measures, a study of a trade reform was in preparation, and the relevant legislation was to be sent to Congress in the coming period. However, the issues involved were politically sensitive, and the staff had no information on the contents of either the study or the related legislation. The staff intended to take a close look at the schedule for the introduction of a revised tariff system during the August 1984 review.

Commenting on the medium-term outlook, including in particular the assumption of a decline in the share of consumption, the staff representative said that an acceptable pattern for the external current account had been agreed, and it had then been determined whether or not that pattern would be feasible. It had been concluded that, to achieve the desired current account position, there would have to be an increase in domestic savings and, therefore, a decline in the share of consumption in total GDP. In index number terms, GDP was expected to increase from 100 in 1983 to about 120 in 1989, while the share of consumption was expected to fall to 76. However, nearly all the decline in the share of consumption was to occur during the present program period, and most of it would be due to the compression of government consumption.

The medium-term projections assumed a rollover of amortizations coming due in the relevant period, the staff representative explained. Any worsening of the world economic outlook would affect Brazil's growth prospects. The present assumptions included a reasonable increase in imports, but any compression of imports would have an immediate adverse effect on economic growth.

The medium-term outlook exercise had not been built around an assumption about the capital/output ratio, the staff representative from the Western Hemisphere Department explained. The annual growth of GDP had been conservatively assumed at 4 percent, and investment was expected to increase gradually. As a result, the capital/output ratio would tend to increase over the medium run.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Prowse had raised a question about the nature of a public sector deficit that reflected only monetary correction and had wondered whether such a deficit was real and had an impact on the economy. In the staff view, the answer was clear: it was of course a deficit and would have definite effects on the economy. If the Government decided to protect the real value of the domestic debt, it had to generate the resources with which to do so. That would imply that the overall nominal deficit would have to be significantly reduced, if not eliminated. In terms of the so-called operational deficit--excluding monetary correction--such a requirement would mean that a commensurate surplus would have to be achieved. The global deficit affected financial behavior, as could be observed in the development of unindexed financial assets which, as a proportion of GDP, had declined rapidly; as could be expected, concurrently the share of indexed financial assets in GDP had increased. Those trends clearly underscored the important role that indexation played in the inflationary process in Brazil.

The indexation mechanism would have to be eliminated for inflation to be effectively brought under control, the staff representative from the Exchange and Trade Relations Department noted. A relevant policy issue would be the speed at which the mechanism could be removed and the precise method that should be used. One solution would be to program an operational surplus that would provide the resources needed to finance the cost of monetary correction, and thus bring the overall public sector deficit to a manageable level in a reasonable period. In that fashion, the large use of resources by the public sector would be ended, thereby increasing the effectiveness of monetary policy, and eventually reducing the need for indexation.

The staff representative from the Research Department recalled that some Executive Directors apparently felt that the export shortfall had been influenced by the exchange rate policy during the previous several years. In fact, the real effective exchange rate of the cruzeiro against the currencies of Brazil's main trading partners had appreciated in both of the preshortfall years 1981 and 1982, and it had depreciated significantly during the shortfall year. To the extent that the appreciation in the two preshortfall years had had the effect of reducing exports in those years, the export shortfall for 1983 had been reduced. As for 1983 itself, the depreciation had had the effect of increasing exports, thereby lowering the export shortfall for the year. Hence, the combined effect of the exchange rate movements in the previous several years had been to reduce the export shortfall, rather than to contribute to it.

Mr. Kafka remarked that Executive Directors clearly appreciated the problems facing the authorities and the efforts that they had made to achieve the needed adjustment. The authorities would undoubtedly continue to make progress in reducing the rate of inflation, even if the progress was not as rapid as many would wish. The experience of the previous year clearly showed the authorities' ability to continue to improve the current account position despite the unusually high rates of inflation. The authorities were monitoring all the various policy instruments, with the help of the useful monetary targets which, although not performance criteria, were being taken seriously by the authorities; necessary corrections would be made whenever necessary.

The level of reserves was not sufficient to permit the elimination of the exchange restrictions at the present stage, Mr. Kafka remarked. However, on May 8, 1984 the authorities had announced the abolition of several hundred import prohibitions, most of which covered luxury items. The removal of the restrictions would not in itself result in a large increase in imports, but it was clearly a step in the right direction.

Some Executive Directors apparently felt that countervailing duties were not a form of protection, Mr. Kafka remarked. Whether or not that was true was a matter of definition. There was a considerable debate on the extent of subsidies and of dumping that should be deemed sufficient to trigger countervailing or antidumping duties.

As to direct investment in Brazil, Mr. Kafka explained that, with the exception of certain public utilities and new commercial banks, there were no restrictions on foreign private direct investment. There were several bills in Congress to liberalize the present treatment of investments in those entities; moreover, the tax treatment of foreign investment was identical to that of domestic investment.

The question had been raised, Mr. Kafka recalled, whether the estimate of the capital/output ratio did not reflect a measure of necessary restraint beyond capacity restraint. He doubted whether that conclusion was accurate. He agreed with the staff that it had been cautious in its capital/output ratio estimates; somewhat more optimistic estimates seemed appropriate.

There was certainly no need to fear that the authorities would relax their adjustment effort, Mr. Kafka stated. Finally, his relatively optimistic view on the outlook for the Brazilian economy was based on the assumption that interest rates would not increase, and that the Fund and the GATT would have some success in preventing a further substantial rise in protectionism.

Mr. Erb said that the staff should examine the environment in which direct foreign investment in Brazil took place. It was his impression that it was still difficult for foreign investors to invest in certain areas of the economy, such as the pharmaceuticals industry.

The Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal contained in the staff report for the 1984 Article IV consultation with Brazil. They welcomed the progress made toward achieving the objectives of the program of economic adjustment, which the authorities had adopted to cope with the severe foreign financing constraint faced by Brazil and with the sizable imbalances affecting the domestic economy.

Directors commended the authorities for the very impressive results achieved in the balance of payments in 1983, and welcomed the major changes made in relative prices in the first year of the program. They noted that the progress made in the external area had not been matched on the domestic front. There had been delays and shortfalls in the implementation of financial policies at the beginning of the program, in particular in the first part of 1983, which had contributed to the acceleration of inflation.

Directors agreed that a durable and major reduction in inflation continued to be the major challenge facing economic policymaking in 1984. They expressed concern about the strength of inflationary expectations and the high degree of indexing in the economy, and about the resulting uncertainty as to the timing of the downturn in inflation and the speed of its eventual reduction. One of the crucial questions at this time, Directors emphasized, was whether Brazil's demand policies would indeed bring inflation down soon and at an acceptable cost in terms of output and employment. In this context, Directors welcomed the signs of recovery shown by the Brazilian economy in the first months of 1984. Directors urged the Brazilian authorities to make more rapid and resolute progress in creating the conditions for the de-indexation of the economy, which should reinforce the policies of financial restraint to break inflation. They stressed that a rapid reduction in inflation was essential for the lasting achievement of the other objectives of the program and for laying the foundation for the resumption of growth.

Directors said that in present circumstances a vigorous application of monetary policy was necessary to achieve the major reduction in inflation that is being sought. They welcomed the active interest rate policy being followed by the authorities and stressed the importance of maintaining positive interest rates in real terms. Directors commented favorably on the positive effects that the elimination of credit subsidies had had in reducing the dispersion of interest rates in the economy and lowering the real rate applicable to nonsubsidized credit operations. The point also was made that financial deregulation should proceed further to ensure an adequate allocation of financial resources. The view was emphasized that in the longer run the restoration of internal equilibrium would require the elimination of the practice of monetary correction. Directors agreed that developments in the monetary area should continue to be monitored closely.

Directors welcomed the strengthening of public sector finances evidenced during the first quarter of 1984. They noted that the fiscal targets contained in the program for 1984 still involved a substantial public sector borrowing requirement, and that additional public sector savings would need to be generated in the years to come. Directors stressed the need for a continuous improvement of the tax system and of the application of tight control over public sector spending. Directors also emphasized the importance of a continuous monitoring of the behavior of public sector finances; they welcomed the positive results obtained so far in this area, and underscored the effectiveness of the COMOR procedure.

Particular concern was expressed about performance of the state and municipal governments, whose borrowing requirements are exceeding the targets. Directors commended the authorities for the improvement achieved in the finances of the state enterprises but emphasized the need to reduce this deficit further in 1985, in particular through further cuts in current expenditures. In this connection, Directors welcomed the strengthening of the pricing policies of these enterprises. The authorities should be prepared to adopt additional measures in the fiscal area in case inflation does not abate in order to be in a position to keep a tight credit policy without damage to private investment.

Directors warmly welcomed the fundamental changes in pricing policies made by the Brazilian authorities, commenting favorably on the elimination of subsidies for certain key commodities and for certain credit operations. Directors considered it essential that the remaining subsidies, such as they are applicable to wheat, be eliminated, and that administered prices be revised often enough to avoid the re-emergence of subsidies. Price surveillance and controls were still being maintained, and Directors expressed concern because of the distortions that these controls produced.

Directors welcomed the results obtained so far in 1984 in the trade account and in the overall balance of payments. They noted that the exchange rate policy followed has enhanced the competitiveness of Brazilian exports. Directors observed that the continuation of this exchange rate policy should create the conditions for the elimination of the remaining exchange restrictions and multiple currency practices. Directors commended the Brazilian authorities for fulfilling most of their intentions for 1983 with respect to the elimination of exchange restrictions and multiple currency practices. In particular, Directors welcomed the elimination of external payments arrears and of the centralized system of foreign exchange allocation. Directors emphasized the importance of the authorities' intentions to provide protection to domestic activity through tariffs rather than through quantitative exchange and trade restrictions; the early adoption of a timetable in that regard was urged. Directors hoped that the need for restrictive measures would decline rapidly in view of the progress made in strengthening Brazil's external position. They urged Brazil to eliminate subsidies on exports and export financing, which, in turn, should obviate countervailing practices in foreign markets.

Directors noted the encouraging outlook for Brazil's current account of the balance of payments in the medium term. They considered that the favorable prospects for the attainment of a sustainable external position for Brazil by the end of the program period were reassuring, but several Directors expressed concern about the large burden of external debt servicing, particularly in the light of higher interest rates. Directors, generally, emphasized that the restoration of a viable external position depended upon the continued maintenance of fiscal discipline and the improvement in domestic savings. Strict adherence by Brazil to the adjustment path, Directors noted, would help to strengthen the cooperation of foreign creditors, which will be indispensable in the years to come in securing the necessary external financing. At the same time, Directors noted that open access to foreign markets for Brazilian exports would play a critical role in strengthening the country's balance of payments. They also encouraged Brazil to take all possible advantage of the contribution that direct foreign investment could make to its progress.

Directors emphasized the importance of the Brazilian program not only for the country, but also for the international system. They welcomed the authorities' determination to take substantial and timely action and stressed the need for a thorough and steady implementation of the economic program. Directors noted from Mr. Kafka's statement that the Brazilian authorities' medium-term growth forecast is more optimistic than the staff's. This should facilitate the implementation of the fundamental changes in growth strategy which Brazil was seeking with the support of the extended Fund facility. However, some other Directors warned that the Brazilian scenario might also create or strengthen the temptation to relax demand policies prematurely. Directors urged the authorities to continue to resist that temptation, because they firmly believed that there was no viable alternative to Brazil's new strategy of growth without inflation.

It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Brazil's exchange measures subject to Article VIII, Sections 2(a) and 3, in concluding the 1984 Article XIV consultation with Brazil, and in the light of the 1984 Article IV consultation with Brazil conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. In view of the circumstances of Brazil, the Fund grants approval of the multiple currency practices and exchange restrictions that are described under points 1(b) and (c) through 5 on page 34 in EBS/84/84 (4/11/84), until November 20, 1984, or the completion of the review pursuant to paragraph 4(b)(ii) of the extended arrangement for Brazil (EBS/83/33, Sup. 4, 3/3/83, as amended), whichever is earlier.

Decision No. 7695-(84/75), adopted
May 9, 1984

Review Under Extended Arrangement

1. Brazil has consulted with the Fund in accordance with paragraph 4(b)(i) of the extended arrangement for Brazil (EBS/83/33, Sup. 4, 3/3/83, as amended) and paragraph 29 of the letter dated January 6, 1983 from the Minister of Finance and the President of the Central Bank of Brazil, in order to review progress made by Brazil in implementing its program and reach understandings with the Fund regarding policies, measures and performance clauses for the calendar quarters ending June and September of the second year of the arrangement.

2. The letter dated March 15, 1984, together with the attached memorandum from the President of the Central Bank, the Minister of Planning, and the Minister of Finance, shall be attached to the extended arrangement for Brazil; and (a) the letter dated January 6, 1983, with attached memorandum, from the Minister of Finance and the President of the Central Bank, (b) the letter dated February 24, 1983 from the Minister of Finance and the President of the Central Bank, (c) the memorandum dated March 31, 1983 from the Executive Director elected by Brazil, (d) the letter dated September 5, 1983 from the Minister of Planning and the Minister of Finance, (e) the letter dated September 15, 1983, with attached memorandum, from the Minister of Planning, the Minister of Finance and the President of the Central Bank, (f) the letter dated November 14, 1983 from the Minister of Planning, the Minister of Finance and the President of the Central Bank, (g) the letter dated February 27, 1984 from the Minister of Planning, the Minister of Finance, and the President of the Central Bank, and (h) the quantitative performance criteria specified in Table 2 of EBS/84/39 (3/2/84) for the period ended March 31, 1984, shall be read as modified and supplemented by the letter dated March 15, 1984 with attached memorandum.

3. Paragraph 4 of the extended arrangement shall be amended to read as follows:

"Brazil will not make purchases under this arrangement:

(a) (i) during any period in which the data at the end of the preceding period indicate that the target for the net international reserves of the Brazilian Monetary Authorities, as specified in paragraph 1 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(ii) during any period in which the limit on the public sector borrowing requirement, as specified in paragraph 2 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(iii) during any period in which the limit on the operational deficit of the public sector, as specified in paragraph 3 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(iv) during any period in which the limit on the net domestic assets of the Brazilian monetary authorities, as specified in paragraph 5 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(v) during any period in which the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 7 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(vi) during any period in which the cumulative quarterly target on the depreciation of the cruzeiro, as specified in paragraph 8 of the Technical Memorandum of Understanding dated March 15, 1984, is not observed, or

(vii) if the intentions to eliminate certain exchange restrictions and multiple currency practices that are specified in paragraph 20(b), third and fifth sentences, of the letter dated March 15, 1984 and in section 3, first paragraph, of the letter dated February 27, 1984, are not carried out on or before April 30, 1985, on or before December 31, 1985, or on or before January 2, 1985, respectively;

(viii) if the intensifications of exchange restrictions that took place on September 14, 1983 and arose from reduced limits on foreign exchange allotments for travel abroad, as specified on page 24 of EBS/83/227 (10/19/83), are not eliminated by December 31, 1984; or

(b) if the reviews with the Fund contemplated in paragraph 2 of the letter dated November 14, 1983 have not been completed in accordance with the following schedule:

(i) The "February" review, including the specification of performance clauses for the calendar quarters ending June and September 1984, shall be completed before May 20, 1984;

(ii) The "August" review, including the specification of performance clauses for the calendar quarter ending December 1984, shall be completed before November 20, 1984;

(iii) The "November" review, including the specification of performance clauses for the third year of this arrangement, shall be completed before February 27, 1985; or

(c) throughout the duration of this arrangement, while Brazil has any overdue financial obligation to the Fund, or if Brazil

(i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes new or intensifies existing restrictions on imports for balance of payments reasons.

When Brazil is prevented from purchases under this extended arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Brazil and understandings have been reached regarding the circumstances in which such purchases can be resumed."

4. The Fund decides, pursuant to paragraph 4(b)(i) of the extended arrangement for Brazil, that the respective review, including the specification of performance clauses for calendar quarters ending June and September 1984, is completed.

Decision No. 7696-(84/75), adopted
May 9, 1984

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Brazil for a purchase of SDR 247.9 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Brazil and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7697-(84/75), adopted
May 9, 1984

APPROVED: November 6, 1984

LEO VAN HOUTVEN
Secretary