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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/40

10:00 a.m., February 28, 1983

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

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	C. Taylor
	H. G. Schneider
B. de Maulde	
A. Donoso	M. Teijeiro
R. D. Erb	C. Dallara
	S. R. Abiad, Temporary
A. H. Habib	Jaafar A.
T. Hirao	
	M. Casey
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; R. O. Carstens, M. Edo, T. Oyama, M. Reichardt, A. C. Woodward. Asian Department: C. M. Browne. Central Banking Department: L. M. Koenig, Deputy Director; S. P. Leite. European Department: W. E. Lewis. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; H. M. Flickenschild, H. W. Gerhard, S. Kanesa-Thasan, C. M. Loser. External Relations Department: H. O. Hartmann, H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; C. A. Aguirre, P. R. Rado, J. C. Tavares. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans Jr., Deputy General Counsel; A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; K.-Y. Chu, N. M. Kaibni, E. A. Milne, B. Rourke. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. E. Sansón, Deputy Director; A. Baumgarten, M. E. Bonangelino, J. A. Buyse, A. Caetano, M. Caiola, J. Fajgenbaum, J. Ferrán, A. M. Jul, A. S. Linde, J. P. Pujol, T. M. Reichmann, S. C. de Sosa, H. J. Struckmeyer, E. V. Zayas. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, J. R. N. Almeida, S. El-Khouri, L. Ionescu, M. A. Janjua, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, L. Barbone, J. Bulloch, L. E. J. Coene, T. A. Connors, R. J. J. Costa, G. Ercel, M. Hull, M. J. Kooymans, P. Leeahtam, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, M. Toro, J. C. Williams.

1. MALAWI - 1982 ARTICLE IV CONSULTATION; REVIEW UNDER STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with Malawi and the review under the stand-by arrangement (EBS/83/27, 2/3/83; and Cor. 1, 2/7/83). In addition, they took up a request by Malawi for a purchase equivalent to SDR 12.2 million under the compensatory financing of fluctuations in the cost of cereal imports (EBS/83/28, 2/4/83; and Sup. 1, 2/24/83). They also had before them a report on recent economic developments in Malawi (SM/83/25, 2/9/83).

The staff representative from the African Department explained that the staff had received information on the performance of Malawi's economic indicators in December 1982. Page 11 of the staff report presented the targets for net domestic assets and credit to the Government for that month. The actual outturn for net domestic assets had been MK 474.6 million, compared with the target of MK 488 million, and credit to the Government had amounted to MK 211.3 million, compared with the target of MK 215 million. Moreover, the latest figures on the budget in Malawi indicated that the deficits for the current fiscal year would fall below the target specified under the program.

Mr. Sangare made the following statement:

I would like to express the appreciation of my Malawian authorities as well as my own, to the staff for its constructive approach to the discussions held in Lilongwe last November on the 1982 Article IV consultation with Malawi and the review of the stand-by arrangement. The staff papers prepared on the subjects are informative and well balanced and should enhance better understanding of the performance of the economy of Malawi in recent years.

When the Executive Board considered the current stand-by arrangement on August 6, 1982, it was clear that the Malawian economy had shown little or no growth over the past few years, reflecting the impact of continued bad weather and intermittent transport disruptions. The situation had been aggravated by the recession in the world economy, which had led to a reduction in exports and a sharp deterioration in the terms of trade, as well as by high international interest rates, which had increased the debt service burden. At the same time, rising public sector deficits had resulted in an intensification of inflationary pressures and a weakening of the balance of payments position. Although efforts had been taken to redress the situation through a medium-term stabilization program, the authorities had not been able to achieve much.

It was against this background that the Malawian authorities embarked upon the current stabilization program, supported by the Fund under a one-year stand-by arrangement. The principal objectives of the program were to reinvigorate the private sector and stimulate economic growth, while bringing the balance of payments position to a sustainable level in the medium term. The authorities have thus far succeeded not only in meeting the quantitative performance criteria but also in stimulating the agricultural sector, where output was estimated to have grown by 3.9 per cent in 1982, reflecting the provision of adequate incentives to farmers and the return of good weather.

However, the stabilization program was being implemented under difficult conditions imposed by severe transport disruptions outside Malawi's borders that occurred in the second half of 1982 and affected the flow of import and export traffic. These developments greatly influenced, among other things, the pattern of budgetary expenditures as additional costs were incurred by the Government to avert shortages of key imported inputs like fertilizer and fuel. In these circumstances, the economy remained depressed with a growth rate of real GDP estimated at only 1.2 per cent in 1982, well below expectations. Nineteen eighty-two was the third successive year when output has either fallen or grown by less than the population growth rate, indicating a decline in real per capita income. Meanwhile, inflationary pressures, which had subsided somewhat in the last two years, may intensify with emerging shortages of imported commodities and domestically manufactured goods that depend on imported inputs.

It will be recalled that when the Executive Board approved the current stand-by arrangement with Malawi, Executive Directors stressed that the difficult economic situation facing the country required sustained adjustment efforts. The staff assessment of the immediate and medium-term prospects confirm this position, as the balance of payments situation is expected to remain under pressure. The authorities are also well aware of the need for perseverance in their adjustment efforts and are consequently proposing to undertake a medium-term stabilization program within the framework of their five-year development program, 1981-85. The program aims at promoting and diversifying agricultural production and primary processing mainly for export. It is also intended to reduce the share of the real financial resources going into the public sector. The rate of growth of real GDP has been targeted at 5 per cent annually, comparable to Malawi's average growth rate betwen 1975 and 1978.

The authorities expect to achieve their objectives by revitalizing the private sector, which they hope will provide the major stimulus to growth as resources are made more readily available. In this connection, the system of price controls will be applied more flexibly and the price mechanism will be allowed to play its role in allocating resources. At the same time, the Government's efforts will be devoted to the promotion of smallholder agriculture through the implementation of the National Rural Development Program (NRDP). These integrated agricultural development projects are designed to improve efficiency and yields by emphasizing better land use through the provision of agricultural inputs, extension services, and marketing and credit facilities.

Developments in the fiscal area have been rather mixed since the Board approved the current stand-by arrangement. In the first half of 1982/83, expenditures followed budget plans, partly reflecting effective control measures put in place at the beginning of the program. In the latter part of the fiscal year, however, disruptions to supply routes through Mozambique necessitated extra costs, which were accommodated through further and painful adjustments to the original budget in order to remain within the original targets. Accordingly, amounts involving MK 5.8 million and MK 2 million were postponed from the development budget affecting programs in education and public sector buildings, respectively. The recurrent budget was also reduced by MK 3.1 million. On the revenue side, a fuel levy was imposed and was expected to yield MK 3 million, while a total of MK 3.4 million was expected to be collected from sales of fertilizer by the Agricultural Development and Marketing Corporation (ADMARC), a state enterprise in charge of the procurement and distribution of smallholder fertilizer requirements. These measures were in addition to those already implemented under the program. Revised revenue estimates indicate that company income tax collections will yield additional revenue of about MK 2.1 million, reflecting increased agricultural incomes and better tobacco prices, which increased profitability in the tobacco industry. As a result, the overall budget deficit as a percentage of GDP was expected to remain at its original level of 7 per cent in 1982/83, compared with 10.7 per cent in 1981/82.

The prospects for the 1983/84 fiscal year remain worrisome since the underlying tax base continues to be small. Nevertheless, the authorities in consultation with a Fund mission now in Malawi are actively examining the possibilities of raising additional revenue by increasing the surtax on imports and domestic manufactures as well as raising rents on government housing units.

The financial situation of the public corporations remains weak, reflecting mainly heavy external debt service payments, management problems, and the existence of some marginal investments that have been obvious victims of the current recessionary conditions. Investments in sugar production, for example, since export prices for sugar have fallen well below production costs, have experienced considerable losses. Other such investments include some manufacturing and distribution ventures. The authorities are continuing their efforts to reorganize these corporations by restructuring their boards of directors, including recruitment of qualified chief executives with a view to improving management. They are also examining the reports submitted by expatriate consultants following the completion of the studies on these corporations, which were commissioned to enable the Government to take appropriate measures.

In recent years, monetary and credit developments have been dominated by the need to provide for the growing financing requirements of the public sector, and, in 1980/81 and 1981/82, net credit to the Government was high. This reflected, among other things, shortfalls in external financing and an increase in subventions to state enterprises. Developments in the period of the current stand-by arrangement have been satisfactory thus far, as all performance criteria on domestic credit have been observed. The ceilings for the end of December 1982 and March 1983 were drawn, taking into account recent developments in the budget. However, they remain consistent with the original objectives of the program: to ensure the availability of credit to the private sector while limiting credit to the public sector and containing inflationary pressures. Meanwhile, interest rates, which were adjusted in 1980, remain positive in real terms.

The balance of payments experienced renewed pressure in 1981, when the overall position recorded a deficit of $40.6 million and widened further in 1982 to $45.2 million following a small surplus recorded in 1980. The turnaround reflected, in part, a shortfall in capital inflows, particularly government long-term capital, the rise in external debt service payments, and, in 1982, substantial shortfalls in export earnings mainly as a result of further deterioration in the terms of trade. Consequently, gross external reserves fell below one month of imports in 1982. The external payments position could have been worse had it not been for external debt relief obtained by the authorities within the context of the current stand-by arrangement. The balance of payments position will remain under pressure in 1983 as the overall position is expected to show a further deficit of $15 million.

With regard to the request by my Malawian authorities to purchase the equivalent of SDR 12.2 million under the compensatory financing facility, it is clear from the foregoing that a balance of payments need exists. It is also apparent that Malawi satisfies the test of cooperation, as the authorities have been successful thus far in implementing the stand-by arrangement. They are willing to continue consulting with the Fund in their efforts to find solutions to their problems. In this connection, a mission has already arrived in Malawi to explore with the authorities the possibility of arranging a medium-term program.

The shortfall in export earnings was caused by factors beyond the control of my authorities, which involved transport disruptions as well as unfavorable world prices, particularly for sugar and groundnut exports. Projections for the two postshortfall years show that export earnings will increase, mainly as a result of favorable world prices and an easing of the transportation difficulties.

In conclusion and in light of the foregoing, I urge Executive Directors to approve the draft decisions on page 20 of EBS/83/27 and on page 13 of EBS/83/28.

Mr. Taylor observed that the achievement of balance of payments equilibrium in Malawi would require strong adjustment efforts for several years to come. He therefore welcomed the authorities' resolve to pursue the stabilization effort, with the advice and support of the Fund. As the authorities had encountered some difficulties with the current stand-by arrangement in the final quarter of 1982, he was glad that they had appreciated the need to restore balance. The additional actions taken or proposed in the letter of January 24 should get the fiscal deficit back on track; it was estimated to be just below 11 per cent of GDP for 1982, a little lower than envisaged at the beginning of the program. After allowing for debt relief, the overall external balance for 1982 would turn out better than had been expected six months previously.

There was, however, no room for complacency, Mr. Taylor continued. Malawi's current account deficit for 1983 was still projected to be about 10.5 per cent of GDP, and there was no doubt that the adjustment effort would have to be sustained beyond the end of the current program. The authorities had done well in controlling expenditure in the first half of the present fiscal year, and it had been particularly unfortunate that the disruption of rail links to Indian Ocean ports, among other occurrences, had obliged the authorities to take further measures to safeguard the fiscal position. They were to be commended for carrying out those difficult measures, which should help to keep the fiscal deficit below the target, or well below the outturn for 1981/82.

The lower projected deficit would depend greatly on the rescheduling of Malawi's external debt, Mr. Taylor went on. Therefore, it would be important to retain the confidence of creditors: the authorities' renewed determination to reduce the fiscal imbalance was of great value. Rescheduling arrangements for 1983/84 had yet to be made, and without them the external situation would remain difficult. The authorities would therefore have to persevere with their efforts.

One area that needed further attention was the management of parastatal enterprises, Mr. Taylor said. In the past, nonpayment of taxes and debt service charges had been a drain on the budget. The authorities were right to reform the parastatals as part of the stabilization effort, especially since the parastatals' debt was being restructured under the rescheduling arrangements. He was glad that the authorities were aware of the need to take further measures to restore financial discipline, improve the operations of unprofitable subsidiaries, and attract new investment capital. Perhaps the staff or Mr. Sangare could provide more information about the kinds of measures being considered.

The fall in inflation to an estimated 11 per cent in 1982 was a welcome development, partly reflecting the authorities' success in overcoming shortages in food, fuel, and fertilizer in the previous two years, Mr. Taylor observed. Interest rates on the lending side were strongly positive in real terms, but deposit rates appeared to be less so. He would therefore encourage the authorities to keep the deposit rates under review and perhaps consider raising them as part of a further effort to mobilize domestic resources.

Whether Malawi would achieve the results projected for the current account in the present fiscal year and indeed a sustainable balance of payments in the medium term would depend on continued import restraint, Mr. Taylor went on. In 1982, capital inflows had fallen off, and imports had had to be curtailed following the slowdown in the major investment programs. The authorities should avoid initiating unnecessary prestige projects and unessential development spending, if imports were to be kept under control without seriously damaging the economy.

The more the authorities corrected the underlying current account deficit, the less they would need to resort to burdensome fiscal measures, Mr. Taylor noted. Thus, they should continue to be flexible in their exchange rate policy. The April 1982 devaluation of the kwacha had been a welcome step, but since then the real exchange rate had appreciated slightly. Moreover, neighboring countries that had recently devalued their currencies might have acquired a substantial competitive advantage over Malawi. It thus seemed particularly important for the authorities to maintain a realistic exchange rate and accept the associated increase in producer prices. Did the staff believe that a further adjustment in the exchange rate might be desirable?

The debt relief obtained for 1982/83 was gratifying, Mr. Taylor said. The authorities were to be commended for having taken the unusual step of requesting rescheduling before they had incurred any payments arrears, a sensible and timely procedure. They should press ahead to conclude agreements with commercial banks under which the bulk of commercial debt due in 1983 would be rescheduled over the coming two years.

Successful completion of the current stand-by arangement would be vital to providing a sound basis for medium-term adjustment efforts supported by the Fund, Mr. Taylor considered. There was a question about what form any further arrangements might take. The authorities had requested an extended arrangement, but a further one-year or perhaps a two-year stand-by arrangement might be considered. Perhaps the staff could comment in a preliminary way on the form of future Fund support for Malawi.

In any event, he welcomed the continued involvement of the World Bank through a structural adjustment loan, which should make a useful contribution to the development effort in Malawi in the medium term.

As the balance of payments need was manifest, and the test of cooperation had been clearly met, he had no difficulty in supporting the request for a purchase under the compensatory financing facility, Mr. Taylor stated. The projections underlying the export shortfall appeared realistic, as did the price projection for tobacco in the postshortfall years. The fall in the volume of tobacco exports in 1982 had been attributable mainly to factors beyond the authorities' control. In addition to transportation difficulties, expectations of a revival in Malawi's tobacco sales after the devaluation of the kwacha had been frustrated by the decision in Zimbabwe to adjust the price of tobacco. As the price change had been equal to the full amount of Malawi's exchange adjustment and had occurred on the same date, it had effectively nullified any advantage in tobacco sales coming to Malawi from the devaluation of the kwacha.

Mr. Prowse commented that, in reading the staff report, he had been impressed by the frank statement on page 9 that Malawi's representatives had initially been reluctant to take further fiscal measures because of what they had regarded as the severity of the existing budget. The staff went on to say that the authorities had then been convinced that an unsustainably large budget deficit would have an adverse impact on the economy and the external situation; in recognition of which the authorities had decided to take several measures outlined in detail in the paper.

As he understood it, the kwacha had been pegged to the SDR since 1975, Mr. Prowse went on. From October 1980 to March 1982, it appeared to have appreciated by about 11 per cent in real terms. In April 1982, it had been devalued by 15 per cent, but had since appreciated again. Did the staff believe that a discrete adjustment, rather than movement within the basket, might be worth considering as an aid to Malawi's competitiveness?

The authorities had taken a commendable attitude toward the budget deficit, Mr. Prowse noted. Moreover, the current account deficit was to be reduced from almost 18 per cent of GDP in 1982 to about 11 per cent in 1983. What possibilities did the staff see for export diversification? What were the chances of finding other transport routes? Otherwise, he supported the review and the ceilings for the forthcoming period.

In 1981 Malawi had made a purchase of SDR 12 million under the cereal imports decision; therefore all further purchases under the compensatory financing facility in the next two years had to come under the cereal imports decision, Mr. Prowse noted. Because Malawi's export shortfall of SDR 16.9 million was offset by an excess of SDR 4.1 million on cereal imports, there was another offset to avoid double compensation for the buffer stock drawing made in December 1982. Malawi was the first case in some time in which there had been an offset under the cereals decision, and the shortfalls were largely the result of developments beyond the authorities' control, such as world commodity prices and transport problems. By any stringent measure, it was also evident that Malawi met the test of cooperation with the Fund because of its existing stand-by arrangement.

Miss Diallo observed that the adjustment initiated by Malawi under the August 1982 stand-by arrangement was progressing satisfactorily; the authorities had shown a will to implement the program, and the criteria had been fully observed. She was therefore confident that the strong commitment would remain in force in coming years and that the authorities would find solutions to the country's economic and financial imbalances.

Given the difficulties facing Malawi, a medium-term program putting more emphasis on the supply side of the economy would be better adapted to the country's situation, Miss Diallo said. She was confident that the authorities would persevere within the framework of the medium-term arrangement to make the required adjustment and meet all conditions required for continued support from the Fund. Accordingly, she lent her full support to the proposed decisions.

Mr. Dallara noted that the authorities had successfully carried out a number of measures under the current stand-by arrangement, which, with the absence of drought the previous two years, had contributed to a number of improvements in the economy of Malawi. The authorities were to be commended for their efforts. He was in general agreement with the staff appraisal and supported the proposed decisions.

Like Mr. Taylor and others, he particularly commended the authorities for deciding to implement additional measures that would reduce the revised projected deficit during the current fiscal year in response to the adverse developments that had occurred, Mr. Dallara went on. In taking those measures, the authorities had been able to keep the deficit at about 7 per cent of GDP, no small accomplishment under the circumstances. Nevertheless, the two-year program agreed between the Fund and the authorities in May of 1980 had originally envisaged a budget deficit in 1981/82 of about 6.8 per cent of GDP.

On monetary policy, he was not concerned about the revisions made in credit ceilings in the light of changed external circumstances and fiscal developments, as long as the authorities met the revised targets, Mr. Dallara remarked. In that connection, he had been pleased to hear the latest information concerning Malawi's fiscal and credit performance. He was also pleased to note that interest rates were positive in real terms. However, he agreed with the staff that the spread between deposit rates and lending rates was a source of concern and could merit additional attention.

With regard to corporations in the large private sector, he fully supported the staff view that reorganization of those corporations would be an important part of the country's adjustment effort, Mr. Dallara said. The measures already taken in that direction were welcome, and he urged the authorities to continue their efforts to strengthen the operations of those organizations.

As Mr. Taylor had noted, the Malawian authorities had been particularly farsighted in initiating discussion with both the Paris Club and the London Club to reschedule debt coming due in 1982 and 1983, Mr. Dallara observed. The amount of debt relief obtained, although somewhat less than previously foreseen, had made Malawi's debt service obligations for 1982, 1983, and 1984 more manageable. However, his authorities viewed with concern the rescheduling fee of 2.18 per cent, which appeared high even in present circumstances. His authorities had also noted the differences in treatment accorded to official and commercial creditors under the rescheduling agreements. Moreover, while recognizing the need to make certain assumptions concerning future debt relief operations in order to develop a medium-term debt scenario, his authorities had pointed out the difficulties in making any assumptions regarding future action by the Paris Club.

On Malawi's medium-term economic prospects, he was glad that the World Bank was formulating a broad-range medium-term program, Mr. Dallara continued. After reviewing the past efforts and future needs relating to structural adjustment in Malawi, he was uncertain whether an extended arrangement was the most suitable vehicle by which the Fund could support Malawi's adjustment efforts. On page 18 of EBS/83/27, the staff had referred to the need for further structural adjustment. It had struck him that, after an initial two-year program with the Fund, and halfway through another stand-by arrangement, the authorities had yet to come to grips with some of the central structural issues.

A study of the fiscal system, including the yield of present tax measures, should be conducted, Mr. Dallara remarked. Like other Directors, he would also appreciate additional information on the possibilities for diversification of exports and improvements in productive efficiency. Given the extent of the authorities' efforts, the statements in the staff appraisal on those points appeared to be rather general.

He supported the proposed decision on the request for a drawing under the compensatory financing facility, Mr. Dallara commented. However, he would have appreciated more information on the extent to which changes in maize prices had contributed to the groundnut shortfall. Furthermore, he had found it difficult to relate the balance of payments table in EBS/83/28 to the balance of payments table in EBS/83/27.

In conclusion, the authorities' effort under the adjustment program had been impressive, in view of the difficulties that they had faced, Mr. Dallara said. He would urge them to persist in those efforts, which would bring about positive results in a number of fields.

The staff representative from the African Department explained that the data in one of the balance of payments tables were expressed in U.S. dollars, while those in the other were expressed in SDRs.

The importance of the parastatal sector in Malawi, both public corporations and the quasi-corporations, was such that the staff had paid a great deal of attention to it, the staff representative continued. The major parastatals were ADMARC--the Agricultural Development and Marketing Corporation; ESCOM--the electricity corporation; the Malawi Development Corporation; the Malawi Housing Corporation; the Water Board; and a large private corporation that was in some respects a quasi-public corporation. Studies of each of those major institutions had been completed, and some of the recommendations had already been implemented, including a change in management. In many of the large institutions, both the boards of directors and the managing directors had been replaced. The new appointees had been selected more on the basis of technical and financial criteria. Furthermore, increased emphasis had been placed on financial accounting, regular reporting by subsidiaries to the holding companies, and regular reporting by the holding companies to the Government. In 1980, a department had been created to concentrate on the activities of various public sector corporations.

On the price front, the fares of Air Malawi had been increased in 1982, the staff representative recalled. Many of the airline's routes had been closed down; the only major routes remaining open were those to South Africa and other countries in the region. Electricity and water rates had also been increased earlier in the year, and there was a proposal to increase them again. A more difficult area was the rationalization of the subsidiaries in which major holding companies had interests. In other plans discussed with Fund and World Bank staff, the authorities were proposing to examine each of the subsidiaries carefully, close down the loss-making ones that were unlikely to become profitable in the near term, and reorganize the remaining subsidiaries under more efficient management. Both the staff and the authorities recognized that the success of those endeavors was vital to regenerating the economy in the medium term.

An exchange rate adjustment had been made in April 1982, but in effective terms the kwacha had appreciated somewhat since that time, the staff representative explained. The staff planned to discuss the appreciation with the authorities, since a reasonable appropriate exchange rate was vital to maintaining the competitiveness of Malawi's exports on international markets. One possibility was to peg the kwacha to a different basket, and another possibility was to make discrete and periodic adjustments in order to prevent the effective exchange rate from appreciating over time.

The diversification into sugarcane in the late 1970s had been intended to decrease Malawi's dependence on tobacco exports, but the international price for sugar had fallen recently, just when the country was beginning to produce large crops of sugarcane, the staff representative explained. In the medium term, there was a possibility of encouraging cotton, as Malawi had formerly exported much more cotton than it did at present. The lack of incentives for cotton exports meant that the domestic use of cotton had accounted for much of the crop and left a smaller supply available for export. Malawi had also exported many more groundnuts in the past than at present. With suitable price incentives, the authorities might well succeed in improving groundnut production.

Malawi was landlocked, and the nearest routes to the sea by rail lay through Mozambique, the staff representative noted. From the border, it was 300 kilometers to Beira and 600 kilometers to Nacala. By comparison, the route to Dar es Salaam was 1,500 kilometers, and, through Lusaka to Dar es Salaam, 2,000 kilometers. Transportation difficulties had been examined under several programs; the United Nations Development Program was examining whether Malawi's transportation network could be linked to the networks in Zambia and Tanzania, and whether links through Zimbabwe to ports further south would be feasible.

In light of Directors' observations that the Fund might consider a new program with Malawi, they should recall that, since independence in 1964, the authorities had correctly emphasized agriculture and agro-based industries, the staff representative continued. Those policies had served them well until the late 1970s, when a number of factors, both domestic and external, had created difficulties that the country was now experiencing. Because policy was based on agriculture, a medium-term framework was more suitable for discussing development policies. The World Bank was now considering an arrangement of about $55 million, under which Malawi was preparing a three-year investment program. The World Bank would be sending a mission to Malawi in late April or early May 1983 to discuss the investment program. The Fund staff considered the program appropriate to enable the needed policies to be implemented.

There were few solutions in the short term to Malawi's transportation difficulties, especially if the insurgent activity in Mozambique should continue, the staff representative remarked. The restructuring of public sector corporations and quasi-public sector undertakings would require the appointment of new managers, the introduction of new accounting systems, the closing of inefficient subsidiaries, and the use of new management techniques to improve the efficiency of production. Those goals might be easier to consider in the medium term. Some of the specifics to be considered would include the rationalization of the domestic distribution system for agricultural products, since at times the collection and distribution of products had been undertaken more for social and political reasons than economic ones.

A study was also being made of fertilizer use, the staff representative said. Because of Malawi's fiscal problems during the past few years, the practice had been to order fertilizer only at the start of the growing season. Under a program with the International Fund for Agricultural Development, the proposal was to order fertilizer regularly throughout the year in order to have assured supplies at the start of the season.

One last point mentioned by the Executive Directors was pricing policies, the staff representative from the African Department concluded. The staff considered that appropriate exchange rate action was useful to help the marketing agency raise producer prices and still maintain financial viability. In that light, the shift to maize that had taken place in 1982 might in hindsight appear to have been unduly large. At the time, it had seemed sufficient, because Malawi had experienced two years of drought and had to import some maize. At present, there might be room for a shift to other crops for export.

The staff representative from the Research Department noted that Malawi had been the first country to make a request under the provisions for the compensatory financing of fluctuations in the cost of cereal imports, in September 1981. That purchase had been based on an excess in cereal import costs partly offset by an excess in merchandise exports. By contrast, as noted by Mr. Prowse, the present request was based on an export shortfall that was partly offset by an excess in cereal import costs. The aggregate amount of purchases outstanding by Malawi with respect to both cereal export costs and merchandise exports would, if the present request were approved, be 102.8 per cent of quota, of which 97.5 per cent would be in relation to exports and 5.3 per cent would be in relation to cereal import costs.

Mr. Abiad noted that, in Table 1 of EBS/83/28, net services and transfers for 1982 seemed to have been estimated at SDR 87.2 million, yet the figure in the balance of payments table on page 5 of EBS/83/27 was about $141 million. Could the staff explain the difference?

The staff representative from the African Department explained that in one table the staff had included private transfers in the current accounts, while in the other the staff had had separate entries for private transfers and official transfers.

The staff representative from the Research Department added that in EBS/83/28, which dealt with the use of Fund resources under the compensatory financing facility, the staff had felt it preferable to show the balance of payments table in SDR terms, since all the calculations were made in SDRs.

Mr. Sangare recalled that the authorities had adopted a strong stance to ensure effective control of state enterprises: subsidies had been cut and tariffs raised. Meanwhile, they had been examining recently completed studies with a view to taking suitable action. On exchange rate policy, Malawi's competitiveness had remained generally satisfactory since the devaluation of the kwacha in April 1982. Nevertheless, the authorities would be willing to review any new developments within the context of a possible successor arrangement.

Substantial increases in producer prices had been awarded in the most recent growing season based on a formula agreed with the World Bank, Mr. Sangare continued. The authorities felt that smallholders should be insulated, as far as possible, from excessive swings in commodity prices on world markets. Accordingly, they continued to guarantee a certain minimum price for smallholder production. As for tobacco, the authorities had developed a scheme for making a second payment to producers when the Marketing Board obtained a favorable price on the auction floor. In 1982, farmers had been awarded such payments, although they had been small. Meanwhile, the authorities had indicated a willingness to review producer prices whenever necessary.

The Chairman made the following summing up:

Executive Directors have generally agreed with the view expressed in the staff appraisal in the report for the 1982 Article IV consultation and the review of the stand-by arrangement. Directors welcomed the fact that after the slippages observed under the previous two-year stand-by arrangement, when budget expenditures had been permitted to increase at unsustainable rates, and when substantial foreign commercial borrowing had taken place, the authorities had performed better under the current stand-by arrangement.

Fiscal performance in the first half of the current fiscal year, 1982/83, April to March, had been in accordance with the objectives of the arrangement, and the authorities had recently taken measures to ensure that despite renewed transportation disruptions and the need for some extrabudgetary expenditures, the fiscal targets for the fiscal year as a whole would be observed. The Malawian authorities were commended for their courageous fiscal action under difficult circumstances. Directors noted that the Paris Club and the London Club had responded to the timely requests of Malawi for debt rescheduling, and that the rescheduling exercise would effect some relief during the next two years.

Notwithstanding the improvement in the current fiscal year, the economic situation remains difficult. Directors noted that the real rate of economic growth was low, that the scope for future increases in budget revenue appeared to be limited, and that the debt service ratio was projected to remain somewhat high. The external current account deficit for 1983 would still run at a rate of about 10 per cent of GDP. In this situation, the Directors agreed with the staff that a sustained adjustment effort was needed. Malawi should implement measures to improve the efficiency of production and to promote export diversification. Important measures in this regard would include appropriate producer prices, implementation of a realistic exchange rate and of flexible interest rates on deposits, as well as adequate demand management measures and the containment of wage increases to improve the competitiveness of exports and to strengthen the budget.

The need to avoid public expenditure for prestige projects as well as nonpriority capital expenditures was stressed. The need to improve the efficiency of the tax system to increase its yield and to identify possible new sources of revenue was also underscored. The reorganization of the operations of the parastatals and the strengthening of their financial position were also regarded as important and urgent. Finally, Directors urged Malawi to address its structural problems constructively with the support of appropriate arrangements with the World Bank and the Fund.

The Executive Board then took the following decision:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in concluding the 1982 Article XIV consultation with Malawi in the light of the 1982 Article IV consultation with Malawi conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Malawi continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 7345-(83/40), adopted
February 28, 1983

Review Under Stand-By Arrangement

1. Malawi has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Malawi and paragraph 3 of the letter from the Minister of Finance of Malawi, dated June 11, 1982, attached to the stand-by arrangement for Malawi (EBS/82/126, Sup. 1), and in order to review progress under the program and reach understandings with the Fund regarding policies and measures that Malawi will pursue during the remaining period of the stand-by arrangement.

2. The letter from the Minister of Finance of Malawi dated January 24, 1983 shall be annexed to the stand-by arrangement for Malawi, and the letter of June 11, 1982 shall be read as supplemented by the letter of January 24, 1983. Accordingly, the understandings referred to in paragraph 4(b) of the stand-by arrangement for Malawi relating to domestic assets of the banking system and net bank credit to the Government shall be those described in paragraph 4 of the attached letter of January 24, 1983. Moreover, with respect to exchange rate policies, the Fund finds that no further understandings are necessary.

Decision No. 7346-(83/40), adopted
February 28, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Malawi for a purchase of SDR 12.2 million under the Decision on Compensatory Financing of Fluctuations in the Cost of Cereal Imports (Executive Board Decision No. 6860-(81/81), adopted May 18, 1981).

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

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

Decision No. 7347-(83/40), adopted
February 28, 1983

2. BRAZIL - 1982 ARTICLE IV CONSULTATION; REQUEST FOR EXTENDED ARRANGEMENT; AND USE OF FUND RESOURCES - FIRST CREDIT TRANCHE, AND COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1982 Article IV consultation with Brazil, together with a request for an extended arrangement equivalent to SDR 4,239.375 million and for a purchase in the first credit tranche equivalent to SDR 249.375 million (EBS/83/33, 2/11/83; and Sup. 1, 2/24/83; and Sup. 2, 2/25/83). In addition, they took up a request by Brazil for a purchase equivalent to SDR 466.25 million under the compensatory financing facility (EBS/83/38, 2/16/83; Sup. 1, 2/25/83; and Sup. 2, 2/25/83). They also had before them a report on recent economic developments in Brazil (SM/83/33, 2/15/83).

The Chairman said that he had recently had the opportunity to review with the Brazilian authorities the economic program to be discussed at the present meeting. His discussion with the Minister of Planning and the Governor of the Central Bank, among other people, had conveyed to him the determination of the Brazilian authorities to implement a far-reaching and difficult economic program.

Three main points had emerged from the discussion, the Chairman continued. First, interest rates for bank credit to agriculture were determined at the beginning and middle of each calendar year for the following six months according to then-anticipated rates of inflation; thus, the real rate of interest for agricultural loans was likely to be negative by a wide margin during the first half of 1983. Higher rates of inflation were now projected in the wake of the recent devaluation of the cruzeiro, which had not been foreseen when interest rates had been set for the first half of 1983. The Brazilian authorities had pointed out during the discussion that legal provisions prevented them from revising the interest rate immediately, which would have been the best course of action. In any case, because of seasonal factors, only about 25 per cent of total agricultural credit was normally disbursed during the first half of any year. He had reached an understanding with the authorities that the implicit additional subsidy likely to arise during the first half of 1983 would be offset by a higher rate of interest on agricultural loans in the second half of the year. In other words, the subsidy derived from the higher inflation would be offset later by further increases in the interest rate. Thus, for the year as a whole, the results projected at the beginning of the negotiations would be attained.

Second, the cost of the currency devaluation would be passed through in full within a short time, the Chairman said. Products particularly affected would include oil and wheat, the pricing of which could have a major impact on Brazil's balance of payments. In the future, prices of those products would be raised gradually in real terms so as to eliminate any remaining subsidies. He had been assured that the authorities would not shy away from the principle of passing through the local costs stemming from the devaluation.

Third, the authorities had restated their determination to implement tight incomes policies, the Chairman pointed out. Not only was the wage formula, as modified in late January 1983, expected to result in a decline in real wages during the year, but the authorities were also determined not to change the rate of increase of national nominal wages, which had been reduced for employees of the central administration before the devaluation had taken effect, despite the likelihood that during 1983 inflation would be higher than earlier foreseen. The authorities had also reiterated their intention to issue guidelines to labor courts to prevent the granting of adjustments for productivity increases that were often not geared to gains in real productivity.

The financing package for Brazil had attracted a great deal of interest during the previous few months, the Chairman said. He had asked various commercial banks to give him a written reply in order to be able to give the Executive Board the proper assurances that the program for Brazil would be financed.

The Deputy Managing Director explained that contractual legal documents had been signed between the international banking community and the Brazilian authorities with respect to Projects 1 and 2. Under Project 1, a full $4.4 billion of medium-term lending had been formally arranged for Brazil. Under Project 2, a rearrangement of maturities in bank lending amounting to about $4 billion had been formally arranged.

Project 3 and Project 4 were of such a nature that formal contracts would not be signed by the authorities and the banks, the Deputy Managing Director continued. However, by February 25, total commitments under Project 3, dealing with export or import credits, had reached $10 billion, even though the initial expectation had been for $8.8 billion. Thus, Project 3 had been oversubscribed by more than $1 billion.

Project 4 concerned interbank deposits outstanding in agencies or branches of Brazilian banks, the Deputy Managing Director remarked. On the basis of a consistent set of figures, those deposits had been about $9.2 billion at the end of June 1982 and had reached a low point at the beginning of February 1983 of about $5.8 billion, a reduction of well over $3 billion. From the low point at the beginning of February, the outstanding balances had risen to about $7.3 billion by the previous Wednesday, the weekly reporting day established by the banks. Thus, an increase of a full $1.5 billion had taken place, and, since that time, the outstandings under the interbank project appeared to have reached perhaps $7.5 billion, the intermediate target established by the banks.

As the Managing Director's telex had indicated, there would still be a question of at least $1-1.5 billion that might be needed during the course of 1983, the Deputy Managing Director explained. At least informally, the banks seemed to be quite open to the possibility of returning to Project 1, the medium-term commitment project.

Mr. Kafka made the following statement:

The Brazilian authorities are deeply grateful to the Managing Director, the Deputy Managing Director, and the staff for the unstinting help they have given us and for the excellent work they have done in carrying out the negotiations on the extended arrangement and in preparing the papers before us.

I would like to recall that this is the first time since 1965 that Brazil has requested a drawing on the Fund in the credit tranches and also the first time since 1965--except for the first compensatory tranche drawn in December 1982--that Brazil has requested any drawing on the Fund. Brazil has had no drawings outstanding in the credit tranches since 1966 and has been a net creditor of the Fund from 1970 to end-1982. As the staff notes, Brazil did negotiate a succession of one-year first credit tranche stand-by arrangements until 1973, but did so for the sole purpose of maintaining the same type of intensive relations that would exist under a genuine stand-by arrangement. It was then decided, by mutual agreement, that these intimate relations could be maintained even without a stand-by arrangement, and they have been so maintained--with almost regular twice-yearly missions--ever since. Obviously, the close relations between the Fund and Brazil were helpful not only in formulating our policies throughout the past 19 years but also in making possible the quite exceptional speed and smoothness with which the negotiations for an extended arrangement could be concluded.

The causes of the present crisis, which motivate the extended arrangement and the purchase under the compensatory financing facility, are well described by the staff. I would stress particularly the 1982 deterioration in the world economy and the liquidity crisis that burst upon Latin America toward the end of August. Until then Brazil had been borrowing in the international capital markets at a gross rate of about $1.5 billion a month, and, in fact, in August alone, loans of $2 billion had been negotiated. If the original rate of borrowing had continued, which at that time there was every reason to expect, there would obviously have been no, or only a minor, reserve loss in 1982.

Irrespective of the liquidity crisis, the Brazilian authorities had already decided to reinforce their efforts to reduce the current account deficit. After the liquidity crisis, the authorities moved expeditiously to accelerate their program. Actually, the essence of the foreign sector program agreed with the Fund was approved by the National Monetary Council and published on October 25, 1982. The monetary budget incorporating the credit ceilings was published on October 16. The federal budget was submitted to Congress on August 30 and approved on December 6, and the budget of the state enterprises was published on December 28. Changes were made in these budgets in connection with the recent maxidevaluation that are consistent with the modifications of the Government's economic program described in the staff papers.

The nature of the program is well described in the staff paper, and I shall have only a few words to add. Immediately after the liquidity crisis of August 1982, we scaled down our forecast of resources available to us from the international capital markets. Everything had to be adapted to the amount of sustainable foreign funding available to finance the current account deficit. There was no escape from the consequent radical speedup of our adjustment program despite the heavy burden that such a program would unavoidably place on our economy and our people. The amount of resources available from the capital markets was established on the basis of understandings with our principal international bankers, and we and they agreed from the outset that these forecasts must be conservative in order to make sure that the program would hold. The Fund mission--working from the same sources--had no difficulty in agreeing to the current account deficit established in our program for 1983. Everything else in the program is a corollary of the current account limitations, which in turn derive from the international economic and liquidity crises.

The basic thrust of the program is a switch from foreign to domestic savings. This is the essential structural change that must be brought about. The switch is indispensable in order to assure employment and an improvement in the standard of living of our growing population in the future. Because of the limitations of the international capital markets, which have come upon us more rapidly than we expected, the first year of the program will be one not only of reform but of great tightness. But in view of the flexibility and broad resource base of our economy, we agree with the staff that already in the second year of the program a much better growth rate should be achievable. The extent to which all this will be possible will, of course, depend on the recovery of the world economy. One can assume that, at least for the time being, the world economy will not impede the modest growth of our exports that underlies the program. But more generally, in an economy of continental size like ours, the impact of the behavior of the world is necessarily less constraining to growth than it would be in a smaller country or one less well endowed with resources than Brazil. The way we propose to go about this basic structural change is clearly set out in the staff papers. It is a multifaceted approach that from the outset relies not only on demand restraint, but on other policies to bring about the necessary increase in domestic savings and to contribute to increasing efficiency.

At the same time a determined effort is being made to break the inflationary spiral. The widespread indexing system does protect the various sectors and classes of the economy against the most catastrophic but by no means against all effects of inflation at the same time as it makes combating inflation more difficult. A drastic reduction in the rate of inflation is, therefore, an essential part of our program. The recent maxi-devaluation, to which I shall return shortly, will necessarily delay, but not interrupt, the progress against inflation laid down in the program. I would note that we shall try our best to remain below the estimates of inflation mentioned in the supplementary paper. In this connection, I would like to stress that we face complicated technical indexing problems.

The recent change in wage policy merits special emphasis. The new wage law itself is particularly effective in helping to bring down inflation in comparison with the former law in the context of price, supply, and exchange rate shocks. By administrative action, guidelines will be set so that productivity adjustment will not create inflationary pressures but reflect only productivity increases that have actually taken place.

The central objective of raising the domestic rate of savings, as well as reducing the rate of inflation and removing distortions that hamper efficiency, will rely largely on an increase in the current account surplus of the budget of the central administration and a reduction in the deficit of the consolidated budget of the state enterprises, as well as change in the structure of expenditures.

The surplus mentioned will be further increased in terms of GDP, by measures attendant upon the maxidevaluation, as described in the supplementary paper. This surplus will be available to offset the rise in the deficit of the consolidated budget of state enterprises that have large foreign currency obligations, although their increase will be met largely by stepped-up price adjustments in line with the net increase in cost and rate of inflation consequent upon the maxidevaluation.

The change in the structure of expenditures emphasizes the rapid elimination of subsidies. In this first year of the program, a substantial reduction in real public sector investment is also programmed. This however reflects to a large extent the conclusion of major investment projects.

In addition to fiscal policy in the widest sense, major structural changes are being undertaken in the field of monetary policy. While a reduction in the public sector deficit will by itself reduce pressure on the banking system, the monetary policy for 1983 is designed to contain credit expansion through quantitative controls and higher interest rates. The main burden of these rate adjustments will fall on the heavily subsidized interest rates for agricultural production credit. Only time will tell whether or to what extent some subsidization through the federal budget, either of interest rates or more likely of agricultural inputs, will still have to be maintained in the light of similar practices by countries that compete with us in the world export markets. The credit ceilings in real terms have been substantially revised downward in the context of the recent maxidevaluation to guarantee its efficacy.

Far-reaching structural changes are foreseen in external sector policies. The original program aimed at a gradual real increase of close to 20 per cent of the cruzeiro price of U.S. dollars at the end of this year.

In the meantime, as the Board already knows, the unexpectedly unfavorable developments in our export and financial markets in January have forced a change in our original intentions, i.e., a maxidevaluation, in order to ensure achievement of the crucial trade surplus of $6 billion. The periodic minidevaluations will continue in line with domestic inflation. The maxidevaluation is far in excess of the rate of real depreciation of the U.S. dollar originally foreseen for 1983 and should give a strong stimulus to exports. The maxidevaluation of 1979 produced its effects on exports rapidly. The size of the present maxidevaluation comprises a safety margin because the devaluation should give confidence to the market that it would not need to be repeated in the foreseeable future. We believe that the present major devaluation, in the context of present expectations of developments in the world economy, is more than adequate for this purpose. At the same time as they announced the devaluation, the authorities, therefore, announced their intention at the appropriate time of reviewing the multiple currency practices affecting trade and current payments as well as the temporary export taxes that have been imposed on certain primary products, the planting season for which has passed. But, obviously, the timing of any change cannot be determined at the moment but must await the lesson of experience. Some of the measures to be eliminated may be replaced by measures outside the exchange system. During the first year a number of minor restrictions and multiple currency practices are to be eliminated, and, as noted in the report, a start has already been made in this area.

The program foresees a considerable reduction in imports. Part of this reflects the reduction in petroleum imports where substitution by local fuels or sources of energy stimulated by the policy of adjusting import prices promptly to exchange rate changes plus a fall in the international price of oil are likely to bring considerable relief. The reduction in the value of non-oil imports is substantial. However, the effect of the cut should be seen in the context of the experience of the mid-1970s. Since that time, it has been clear that there is no stable relationship in Brazil between real nonpetroleum imports and GDP growth, in view of the continued development of import substitution. Owing to the broadening of the resource base since then and the substantial underutilization of capacity, it is likely that the level of output today is even more independent of imported raw materials or intermediate inputs than in the 1970s. Reduced capital goods imports will affect future but not current growth rates. The debt problem is also well described in the paper.

Altogether, therefore, we feel that our program, with the assistance of banks and the Fund, should make it possible to re-establish Brazil's credit and therefore lay the ground for next year's and subsequent years' recovery.

Brazil is in close contact, as it has been at all times, with the World Bank. A World Bank mission recently visited Brazil and discussed with the authorities the Government's economic program for 1983-86. The mission took the view that the Government's program was consistent with the objective of reaching a sustainable balance of payments situation over the program period and indicated its disposition to increase substantially its level of lending to Brazil over the next three years, particularly in the form of quick-disbursing so-called sector and supplementary loans.

There is no question that Brazil has a difficult path ahead. However, as the recent maxidevaluation shows, there is no lack of preparedness to react with dispatch to the emergençe of any need for action additional to that foreseen in the program. Close contact with the Fund will be maintained at all times, even before the review mission which is expected to go to Brazil in June.

The drawing under the compensatory financing facility is also well justified by the staff, and I fully agree with the staff's assessment.

I would ask, finally, that my colleagues give their support to our program and our drawings.

Mr. Portas commented that, during the previous few years, Brazil's economic policies had been dominated by the need to adjust to increasingly unfavorable external developments. Increases in oil prices compounded by rising interest rates, the decline in international commodity prices, and weak world economic activity had limited the effectiveness of demand management measures and structural reforms adopted by the authorities in 1979-81. More recently, the continued unfavorable economic environment had contributed to a further weakening of the external position of the Brazilian economy. The abrupt reduction in the availability of foreign financing during the second half of 1982 had intensified the difficulties experienced by the authorities in continuing the adjustment effort.

Before commenting on the program itself, Mr. Portas said, he would like to express appreciation to the Chairman and his associates for the negotiations in putting together the final package for Brazil. Like other large developing countries, Brazil would find it of the utmost importance to continue to receive the support of the international financial community.

The program provided for a substantial structural adjustment to reduce external and internal imbalances while contributing to increasing the efficiency of the economy, Mr. Portas remarked. Under present circumstances, that strategy was both necessary and appropriate. In order to raise public domestic savings, a substantial reduction in the borrowing requirement of the public sector, from 16.9 per cent of GDP in 1982 to 8.8 per cent in 1983, was contemplated. To that end, several important policy measures to strengthen revenue and contain expenditure were being implemented. Thus, for the coming year, revenue of the central administration was expected to improve by 3.2 per cent of GDP. The target seemed attainable, given the large modification recently introduced into the tax system, including an income tax law, an increase in taxes on diesel fuel, and a substantial reduction in fiscal incentives.

A large part of the adjustment would be carried out by the state enterprises through pricing policies so as to strengthen their financial position and improve the allocation of resources, Mr. Portas went on. The price adjustments already in place and the planned reduction of subsidies were particularly welcome structural policies consistent with the objective of making the economy more efficient. Given the magnitude of the price adjustment during the first year of the program and the effects of the recent maxidevaluation of the cruzeiro, it would be unrealistic to expect a more rapid reduction in the rate of inflation.

On the expenditure side, a strict austerity program called for a reduction in the wage bill by more than 6 per cent in real terms as a result of a 65 per cent limit on pay raises for central administration employees, Mr. Portas noted. The improved wage formula should prove to be of particular importance in wage determination. The new wage policy would contribute to reducing inflationary pressures attributable to the link of wage increases to productivity gains rather than to previous inflation. It was regrettable, though perhaps necessary, that investment by state enterprises would decrease in real terms. In any event, the reduction in real public sector investment in the first year of the program was largely attributable to the conclusion of major investment projects.

The substantial reduction in the borrowing requirement of the public sector, accompanied by appropriate monetary and credit policies, would contribute to enhancing access by the private sector to domestic credit, Mr. Portas said. The adjustment in the agricultural interest rates in the second half of 1983 seemed to be an important element in that direction.

The gradual approach toward substituting a tariff system for quantitative import restrictions and eliminating exchange restrictions was realistic, Mr. Portas continued. In view of the current imbalances, it would seem difficult to expect a major reduction or an immediate reversal of all those measures during the first year of the program. In any event, the authorities had firmly indicated their intention to eliminate some of the exchange restrictions in 1983 and, as the situation improved, to eliminate the remaining restrictions during the second and third years of the program.

Finally, the Brazilian authorities were to be commended for their commitment to continuing with the flexible exchange rate policy, Mr. Portas concluded. The recent decision to devalue the cruzeiro evinced the authorities' determination to adjust policies in order to obtain balance of payments targets. Furthermore, the devaluation demonstrated the willingness of the authorities to adopt any additional measures necessary to achieve the program's objectives.

Mr. Teijeiro noted that the authorities were showing great determination in addressing the present imbalances in order to put Brazil back on the path of sustained growth. In spite of the current difficult situation, he was confident about the medium-term prospects for the Brazilian economy. Recent external developments, such as the fall in oil prices and the decline in interest rates, were particularly encouraging because the Brazilian current account was highly sensitive to such changes. A reduction of 3 percentage points in interest rates and a fall of $5 in the price of a barrel of oil would reduce Brazil's current account deficit from $7 billion to $3 billion.

The adverse conditions prevailing in world markets had compounded Brazil's problems and shown how externally oriented growth could be affected by external shocks, Mr. Teijeiro remarked. In the mid-1970s, the rise in the price of oil had encouraged the Brazilian authorities to adopt a more inward-looking development strategy. Trading restrictions had been used as a means of supporting weakening current account positions, and the public sector had expanded its role in allocating economic resources. The program under consideration contemplated a strong adjustment in key sectors such as finance and a continuation of realistic exchange rate policies. The authorities should be commended for the major measures taken to alleviate the fiscal burden and improve the allocation of resources.

He agreed with the staff that there had to be a return to the economic strategy prevailing before 1974, Mr. Teijeiro continued. The authorities should give clear signals to the private sector that a shift was under way toward a more outward-looking strategy of export-led growth. A reduction in current trade restrictions and tariffs would be appropriate. Providing the private sector with incentives to channel investments into trade-related activities should lead to an increase in domestic savings, encourage direct inventory investment, and help the economy to adjust while growing.

The evolution of wages would be of crucial importance to the program, Mr. Teijeiro considered. He therefore praised the recent modification of the wage formula to allow for more flexibility in setting wages and the measures taken to moderate the public wage bill. Regrettably, developments in the money markets had been disappointing to Brazil, and the financial community should consider giving priority to the country.

In conclusion, he was confident that the program of fiscal restraint would lead to a successful adjustment by Brazil, Mr. Teijeiro said. The adjustments in the oil markets and the trend in interest rates should ease pressures on the country's external accounts. He strongly supported the requests for the use of Fund resources.

Mr. Lovato stated that one of the crucial aspects of the program was the possibility of obtaining adequate financing to ensure debt service payments. He was pleased to hear that most of the needed financing had been secured, but the situation remained far from comforting. According to the projections contained in Table 9 on page 23 of EBS/83/33, net interest payments would be quite sizable during every year of the program. The debt service ratio was expected to decrease from the high figure reached in 1981 and 1982, but it would still remain at a level that he considered unhealthy. Table 10 showed that the ratio was supposed to climb again in the second part of the 1980s, a feature that spelled difficulties for a long time.

A crucial aspect of the package would be the recovery of access to money markets for foreign branches of Brazilian banks, Mr. Lovato noted. That approach emphasized the reconstitution of the established quota and the increase in the Fund's exposure in Brazil. Could the staff say whether, by so doing, the Fund might not be lending too much of its authority to sustain features of the Brazilian economy that ought to be changed? Table 10 of EBS/83/33 indicated that, of the medium-term debts outstanding in 1982, \$6.7 billion had accrued to Brazilian banks abroad, a fact that seemed to indicate that those banks had been borrowing abroad on short maturities in the money markets to lend in Brazil at medium and long maturities. The policy was definitely unsound, and it was particularly dangerous if the banks in question were exposed, as they were, to the danger of a sudden withdrawal of funds. Thus, Project 4 had indeed restored the access of Brazilian banks to short-term funds and had helped them to balance their balance sheets, but serious mismatches of maturities still existed. Did the staff believe that, once access to money markets had been re-established, funds would again be available, or might they again be subject to a sudden withdrawal? Moreover, was it possible to reconcile that operation with the principle that banks should not mismatch maturities?

On the problem of external management, he would like to know whether the almost trebled level of external financing for state enterprises assumed for 1983 was included in the financial packages, Mr. Lovato continued. If not, he would tend to regard as particularly unconvincing the staff comments on page 18 of SM/83/33 that foreign investors would look more favorably on state enterprises because they were able to offer a better guarantee than private borrowers.

Analyzing the performance of the public sector was a difficult task, given the state of statistical information in Brazil, Mr. Lovato considered. Table 14 of SM/83/33 showed without a doubt that the financial position of the public sector had worsened considerably in 1981 and 1982. Clearly, the financing requirement of almost 17 per cent of GDP was unsustainable. That those financing requirements had been revised by more than 3 per cent in only one month demonstrated either that the forecast in the staff paper had been inaccurate or that statistics in Brazil were unreliable. The sudden appearance of a worrisome deficit in public sector enterprises was also surprising. He was led to conclude that, in the past, transfers to those enterprises had taken place through the Central Bank and had not been sufficiently broken down in official reports.

The intention of the authorities to keep public sector borrowing in 1983 to 8.8 per cent of GDP was commendable, Mr. Lovato considered, and would definitely require strong action and a deep commitment. Exceptionally, measures normally considered detrimental to the achievement of self-sufficiency had to be approved in Brazil as they became necessary. In particular, he was thinking of the export tax, which he hoped would be only temporary and would be replaced by other fiscal measures as soon as possible. In general, the revenue collection mechanism was still weak and in need of reform. He hoped that the Brazilian Government would soon submit a tax reform to Congress. An extended arrangement was supposed to tackle structural problems as they arose, and it would be a pity if the thrust of the Fund program were reduced to a series of measures that failed to bring about the needed structural changes.

The difference between revenue and expenditure in state enterprises had been steeply increasing in 1982, and would still be about 6.5 per cent of GDP in 1983, Mr. Lovato continued. He welcomed the authorities' intention to abolish all subsidies by the end of the program period and to scale down investment projects as well. It was of particular importance, then, that the increased costs caused by the devaluation should be passed on to the consumer, especially since most of internal consumption came from imports. The proposed measures went in the right direction, but the public sector was badly in need of structural reform. He hoped that, during the next review, the staff would be able to reach understandings in those aspects as well.

The target set forth in the two papers should be suitable, Mr. Lovato said. However, he was perplexed by the lack of understanding between the Brazilian authorities and the staff on interest rate subsidies. He would like more information on the level of implicit subsidies, whether a change was expected in view of the higher forecast for inflation, and whether they were expected to affect the fiscal budget in a significant way.

The favorable results of the devaluation of the cruzeiro on Brazil's trade surplus might indicate that a boost in external competitiveness had been necessary, and market expectations had been such as to make the move unavoidable, Mr. Lovato went on. He was, however, worried that the move might be interpreted by other countries as a competitive devaluation, and that it might therefore trigger similar responses from trading partners. Furthermore, could the staff say whether the authorities intended to continue to adjust the exchange rate by about 1 percentage point a month above the rate of inflation, in which case the maxidevaluation would not, as the staff said, be only in anticipation of expected inflation rates? Incidentally, the devaluation was determined on the basis of the domestic inflation rate rather than on the basis of the inflation differential between Brazil and its trading partners. He wondered whether, as a result of that policy, the Brazilian authorities might be valuing the cruzerio at a rate higher than was justified by Brazil's competitiveness, which could not be the best policy for encouraging enterprises to improve productivity.

It was understandable that, in a time of high inflation, the authorities should wish to devise wage policies, Mr. Lovato remarked. However, in the experiences of his own country indexation mechanisms linked to past inflation made no allowance for trade changes or indirect indexation and were bound to result in shifts in real wages that were inconsistent with the adjustment effort; such indexation mechanisms tended to act as perpetuators of inflation. In Brazil, the modest changes made in the indexation formula were still insufficient, and more work had to be done. The task was difficult, particularly at a time when the authorities were seeking to broaden political participation. He would like the staff or Mr. Kafka to discuss the likelihood of further progress on curbing indexation and of restraining wages that were not regulated by indexation systems. The average wage in the private sector and state enterprises was expected to fall by some 2.5 per cent in 1983, while GDP in real terms was supposed to fall by 3.5 per cent. In conclusion, he supported the proposed decisions.

The staff representative from the Western Hemisphere Department explained that the understanding with the Brazilian authorities was that the future pace of exchange rate devaluation would not be 1 percentage point a month above the rate of inflation after the maxidevaluation. Rather, it would simply be in line with the domestic rate of inflation. It was true that the new exchange rate policy was likely to result in a real depreciation of the cruzeiro, higher than the 13 per cent that would have occurred if the pace of devaluation had been 1 percentage point a month above the rate of inflation.

Mr. de Maulde recalled that previous Article IV consultations had provided ample opportunity for stressing the remarkable growth record of Brazil and its outstanding export performance. During the 1970s, Brazil had avoided the consequences imposed on most other countries by the oil shocks, mainly by contracting a large but carefully organized exterior indebtedness. Recently, the country's external position had been undermined by the unfortunate conjunction of at least three factors beyond the authorities' control. First, the appreciation of the U.S. dollar had increased amortization of a debt currently in excess of $80 billion and equal to 25 per cent of Brazil's GDP. Second, high international interest rates had increased the burden imposed on debt service, so that at present debt service payments were equivalent to 85 per cent of the value of Brazil's exports of goods and services. Third, the share of imports of energy in total imports had been estimated at over 50 per cent in 1982. Those developments had made Brazil's position extremely fragile when the liquidity crisis had emerged in Latin America the previous summer.

It was both ironic and comforting that Brazil's request for an extended arrangement had been received when all the factors that he had mentioned appeared to be heading in a more favorable direction: relative exchange rates between large industrial countries appeared to be coming into a better balance; interest rates had come down; and oil prices were falling in nominal terms, Mr. de Maulde noted. To the extent that those developments continued over time, they should provide significant relief to the balance of payments over the life of the program and should therefore enhance its chances for success. Nevertheless, as Mr. Kafka had made clear, in the near future Brazil would be unable to continue to finance its economic development through new increases in foreign indebtedness. Domestic savings would have to match domestic investments if external accounts were to be put back on a level course. He agreed with other speakers that rapid success in the financial program was highly desirable in view of the deepening external liquidity crisis and the nervousness of the international banking community. The target set for the first year of the Fund program would play an indispensable role in building a degree of confidence without which financing the current account of the balance of payments in 1984 and 1985 would appear problematic.

During the first year of the program, observers would focus on the behavior of Brazil's current account, Mr. de Maulde said. Since the balance of services and transfers was a rather stable element over which the authorities had little control, Brazil would have to contain imports to make room for an expansion of exports. The unpleasant but unavoidable consequences of such a policy would be a decline in GDP in real terms during the first year of the program as a precondition for the resumption of growth in future years. To bring about that readjustment, the program focused on the most dynamic element of domestic demand, the public sector, whose borrowing requirement had reached 16.9 per cent of GDP in 1982 and had clearly become inconsistent with available financial resources in Brazil or outside. The intention was to improve the ratio of revenue to expenditure and also to correct various price disequilibria by eliminating subsidies and improving the financial position of state enterprises.

Despite those efforts, it was worrying to note that in 1983 state enterprises, which had originally been expected to require about three times as much external financing as they had in 1982, would probably require about four times as much, Mr. de Maulde observed. At the same time, domestic financing requirements would remain at levels close to those of 1982. He fully understood the difficulty of interrupting ongoing projects, but would like to know whether a downward adjustment would appear feasible in case unforeseen difficulties emerged in the implementation of the program.

He would also like to know the staff's and Mr. Kafka's opinion about the likely impact of a rapid and major reduction in subsidies on agricultural production and agricultural exports, Mr. de Maulde went on. He had also been disturbed by the Chairman's comment about interest rates for agriculture. If he had understood correctly, in the second half of 1983 subsidies would be sharply reduced from the level of the first half of the year, so that interest rates would jump. That decision appeared to have a number of political as well as economic consequences. Could the Brazilian authorities consider phasing in the increase in agricultural interest rates by adjusting them in the first part of the year?

Another major element of the program was the wage policy, Mr. de Maulde noted. Clearly, the authorities had done well to eliminate the old indexation formula, which would have led to granting wage increases in excess of past inflation to two thirds of the labor force. However, for the majority of the labor force, the new formula still provided full compensation against inflation. The staff had said on page 13 of EBS/83/33 that state enterprises had been instructed to limit the annual growth rates of wage and salary outlays in each month to the rate of inflation during the previous 12 months. Would not such a provision allow for a more rapid increase in wages than originally intended, since inflation was expected to accelerate in the first months of 1983 as a result of the maxidevaluation? Could not such a policy, therefore, lead to a higher level of wage and salary outlays than the formula intended to allow at the beginning? It was unclear whether the 65 per cent limit on wage increases in the central administration was a fixed limit that would not allow for any catching up in case the rate of inflation was effectively higher in 1983 than the assumed rate. Were wage adjustments to be determined against the national consumer price index, which was to be modified soon, or against another measure? To what extent would the new national consumer price index reflect the effects of the devaluation on various prices?

The authorities appeared to believe that the February devaluation would not require any change in the external targets of balance of payments projections, Mr. de Maulde stated. Did that attitude mean that a higher level of exchange rate adjustment had been required to achieve the original objectives, and that those objectives had appeared unrealistic on the basis of the original exchange rate levels? In their letter to the Managing Director of February 24, the Brazilian authorities said in paragraph 2 that the February 21 devaluation represented an advance of the real depreciation program to take place gradually in 1983. By contrast, paragraph 9 of the same letter indicated that future periodic devaluations would take place on the basis of the cruzeiro value of the U.S. dollar on February 28--thus, on the basis of the postdevaluation rate--and of the rate of domestic price increases in each quarter. In addition, the size of the periodic devaluations against the U.S. dollar seemed to have been modified or at least made more flexible. Originally, the authorities had depreciated the cruzeiro at a rate equivalent to 1 percentage point a month above the rate of domestic inflation. According to the new formula, the real depreciation of 13 per cent a year in U.S. dollar terms embodied in the old formula would no longer apply. On the other hand, the new formula did not preclude a set of devaluations leading to a higher rate of depreciation than the 13 per cent originally envisaged. Could the staff elaborate?

Taxes on certain products introduced in the wake of the February devaluation were viewed as temporary, and a schedule for eliminating them was to be established by the time of the next review of the program in August 1983, Mr. de Maulde said. The implication was that such taxes would extend somewhat beyond next August, and he wondered whether the timetable was consistent with the nature of the tax described as a windfall tax. Perhaps the windfall profit of certain exporters would in fact have disappeared earlier than next August owing to the rate of domestic inflation. In such an event, the tax would be directly counterproductive to Brazil's trade balance.

He had noted with some concern that the staff had expressed doubts about how much the weakening of the oil market could actually benefit Brazil, because of the particular nature of the arrangements between Brazil and its foreign suppliers, Mr. de Maulde continued. Could the staff elaborate on that point? On export projections, the assumption of a 10 per cent increase in dollar terms appeared to be a middle-of-the-road compromise between what Brazil's previous record would suggest and the present slack in external demand. Changes in exports required careful monitoring. The effects of the February devaluation on the volume of exports would provide some useful information about the degree of response of external demand. He hoped that no further delays in the recovery of the world economy would make such projections overoptimistic.

In conclusion, his authorities appreciated the role that the Chairman and his associates had played in making the program possible through difficult negotiations with Brazil's creditors, Mr. de Maulde said. The program undertaken by the Brazilian authorities was courageous and realistic. Its success was crucial for the resumption of growth in the economy.

Mr. Schneider expressed support for Brazil's request for an extended arrangement and for a drawing under the compensatory financing facility. The program as presented in the staff papers was comprehensive, involving a major adjustment effort by the Brazilian authorities in the budget and also requiring a major contribution by wage earners in order to bring domestic demand better into line with the constraints of the balance of payments.

He thought it curious that the supplementary paper issued to re-evaluate the program following the major devaluation of February 21 contained no revision of the balance of payments forecast, Mr. Schneider said. While the existence of many uncertainties made it difficult to produce accurate projections, the size of the devaluation ought to have called for some revision, especially in the light of the devaluation of 1979, which had triggered a rapid rise in exports. Since the February 1983 devaluation had aimed at achieving more or less the same competitive position as Brazil would have reached by the end of 1983, he would have expected the 1983 data to reflect some of the effects of that devaluation. Nevertheless, the projected export earnings for the first two postshortfall years had been adjusted. Earlier estimates for the program had perhaps been too optimistic, and the program might have gone off track unless the authorities had strongly reacted by devaluing. Could the staff elaborate on those points? Had the possibility of an early devaluation been discussed with the Brazilian authorities during the negotiations?

The attempt to fine-tune the effects of the exchange rate on the composition of exports by levying export taxes and imposing export subsidies was hardly the best way to achieve an efficient allocation of resources, Mr. Schneider continued. It was regrettable that export taxes had actually risen, while other subsidies had not yet been eliminated as planned. He urged the authorities to refrain from that sort of intervention in the exchange rate system in the future.

As Mr. Kafka had indicated, the magnitude of the devaluation provided a safety margin, Mr. Schneider remarked. The main effect appeared to be to give the authorities an opportunity to raise additional fiscal revenue to offset the expected large overall budget deficit for 1982. That approach seemed unusual, and he had doubts about its effectiveness. The beneficial effects of the devaluation on exports would be lessened by export taxes, while higher import prices would exert a major effect on domestic inflation. He therefore wondered whether there were not better means to achieve higher fiscal revenue, especially since export taxes were expected to be phased out gradually and thus would have to be replaced by other types of fiscal revenue. Could the staff explain how the gradual elimination of export taxes would be compensated? The improvement in public finances, if realized, would be dramatic and would generate most of the domestic savings to offset foreign borrowing. However, the staff paper said little about a possible increase in private savings. Although the staff had dealt extensively with interest rates on lending, he had been unable to discover the level at which depositors were remunerated, and would welcome further information.

He was glad to note that most of the difficulties in securing financing for the program had been overcome, and he hoped that the banks would be able to reach agreement soon on the two remaining projects, Mr. Schneider stated. The Chairman and the Deputy Managing Director deserved high praise for their efforts in that field. Experience had shown that splitting up the financing effort into different projects was perhaps not the best formula because each bank was involved in each project to a different degree. Could Mr. Kafka or the staff explain how the financing effort for 1984 would be carried out? Was an operation similar to the one for 1983 being considered, or was it expected that the markets would automatically provide the necessary financing?

Mr. Laske recalled that for two decades the Brazilian authorities had pursued a development strategy that had made the country one of the most rapidly growing economies in the world. The heavy reliance on foreign savings necessitated by that strategy had eventually proved to be unsustainable and had been accompanied by a gradual decline of both the investment ratio and the domestic savings ratio. It was tempting to conclude that, over time, the Brazilian economy had tended to become consumption-prone. It was currently experiencing a balance of payments constraint, so that a reconsideration of the policy priorities had become unavoidable. The adjustment process embarked upon would not allow domestic investment to rise again significantly. Consumption and investment had to be cut back to levels that could be sustained by the available volume of domestic savings and a smaller volume of foreign savings.

In 1979, the authorities had been forced to shift priorities from economic growth to strengthening the external position because foreign banks had been reluctant to continue providing external financing on the scale to which the country had become accustomed, Mr. Laske noted. The authorities had adopted a set of restrictive policies that had led the economy into a sharp slowdown. The substantial improvement in the trade balance in 1981 had led them to reassume a more expansionary stance, which, in combination with the well-known external developments, had led to the present crisis. The authorities would have to make a sustained effort to pursue a consistent, comprehensive policy designed in part to regain the confidence of the international banking community. Monetary, fiscal, and incomes policies had to arrest inflationary trends, generate more domestic savings, and reflect the cost of the devaluation of the cruzeiro. Furthermore, a major reform in the dense network of subsidies, special incentives, and regulations was required. In combination with the policy of accelerating growth, that network had brought about major distortions in the economy.

He endorsed the proposed program and supported the proposed decisions concerning the purchase in the first credit tranche, an extended arrangement, and a drawing under the compensatory financing facility, Mr. Laske continued. Given the unfavorable external environment, the bulk of the adjustment had to be implemented in the first year of the program to bring about immediate improvements. The targets set up for the first year and for subsequent years appeared somewhat ambitious, and he had some doubts about the feasibility of the program. He attached the greatest importance to continuous monitoring of Brazil's progress under the reviews provided for in the extended arrangement.

The core of the program consisted of a strong increase in domestic savings to be contributed mainly by the public sector, Mr. Laske noted. The continuous expansion of the public sector in recent years and its increasing borrowing requirement had hampered the private sector by crowding out its credit needs. Successfully redressing that trend should improve the efficiency of the economy as a whole. In that connection, he welcomed the authorities' attempt to restore a number of public enterprises to private ownership. The public sector deficit was supposed to be cut almost in half, from 16.9 per cent of GDP in 1982 to 8.8 per cent in 1983, by cutting back public expenditure and by generating additional revenue. He welcomed the revenue measures taken at the end of 1982, which were designed to strengthen public finances and to reduce the financing requirements of the public sector.

Following the recent devaluation, revenue would be further boosted by newly introduced taxes imposed on primary commodity exports and by special levies to mop up windfall profits, Mr. Laske remarked. However, as pointed out by other Executive Directors, those measures could not be a durable means of generating additional revenue because of their potential adverse effect on the profitability of exports and because of the multi-exchange rate element involved in those practices. Therefore, he was glad that the authorities intended to establish a timetable for eliminating windfall profit taxes, and he hoped that the delay in eliminating them would be brief.

The ambitiousness of the fiscal targets meant that public administration had to be effective, Mr. Laske said. Regrettably, he had to express some doubts due to the slippages that had occurred in expenditure at all levels of the public sector during 1982. He had also noted that the elasticity of the general government tax revenue had been consistently less than 1, and that it was impossible to produce consolidated accounts of the entire public sector. In view of the lack of comprehensive information, it might be open to question whether the Brazilian Government had a clear picture of the financial situation of the public sector in its entirety. To gain such an overview would be essential in order to counteract undesirable developments without undue delay. With that aim in mind, the authorities might wish to consider expanding their review of the public finances to examine the relationship between the central administration and the monetary authority. It also seemed desirable to redefine assignments within the public sector to regain a comprehensive account of the operations of the Central Government.

As a necessary corollary to fiscal adjustment, the authorities would also have to maintain monetary policy on a restrictive course, Mr. Laske said. To a considerable extent, monetary policy had been used in the past as a direct tool of resource allocation according to priorities established by the Government, by providing subsidized interest rates or imposing credit rationing on some sectors of the economy. The execution of the Government's programs by the monetary authorities had in his view impaired a consistent monetary policy. The problem could be solved by reorganizing the responsibilities within the public sector and by abolishing preferential and subsidized rates of interest over time, but not too gradually. He appreciated the steps taken toward deregulating interest rates, but a number of operations were still subject to rates set by the authorities at levels significantly below market rates and potentially negative in real terms. In the light of Mr. de Maulde's comment on agricultural interest rates, he would like to stress the importance of a monetary policy that affected all sectors of the economy equally so as to avoid the emergence of new distortions or the intensification of existing ones.

He welcomed the authorities' intention to tighten monetary policy further as a support mechanism for the most recent devaluation and to contain the inflationary pressures that would necessarily result from that action, Mr. Laske went on. However, he was somewhat puzzled about the kind of stop-and-go tactics that the authorities appeared to have been following in the past six months. After increasing the minimum reserve requirement in December 1982, the authorities had reduced it at the beginning of 1983. He fully agreed with the staff that it was essential for containing credit expansion to raise interest rates on loans to agriculture as soon as possible. He also hoped that, following the recent devaluation, the price for imported wheat would be increased to prevent higher subsidies from being disbursed by the monetary authority.

With regard to agricultural subsidies, he had not been entirely assured that an early adjustment would indeed take place, Mr. Laske said. Mr. Kafka had maintained that only time would tell whether subsidization would have to be continued. Interest rates for other unsubsidized sectors of the economy had been high in real terms because the system of frequent minidevaluations had generated expectations of exchange rate adjustment, the risk of which had to be covered by correspondingly higher remuneration on other domestic monetary assets. Normally, interest rates should tend to decline at present. But Brazil's capital market seemed to be highly regulated, and a general risk premium probably had to be paid, so that the impact of the exchange rate change on domestic interest rates might not be large. Could the staff make any further comments on the matter?

The modification of the indexing scheme for wages could be only the first step toward the eventual reintroduction of a system of free wage bargaining, Mr. Laske commented. As pointed out by Mr. Lovato, the present version of the indexation scheme continued to be based on previous inflation and, although it was more moderate than the previous one, it continued to have the same built-in disadvantage in that real wages would decline only when inflation accelerated. At present, the inflation rate would be surging ahead as a reaction to the devaluation. On the other hand, should the rate of devaluation tend to slow, wages would be a stumbling block, and profits would be squeezed further. Companies would be forced to resort to laying off more workers. Thus, the authorities ought to make additional changes in the wage determination formula urgently.

The staff stressed the importance of the real wage bill rather than the level of real wages, Mr. Laske noted. It was correct to emphasize the real wage bill with regard to the restoration of profits, but as long as wages could not reflect the deterioration in the external sector, the costs in terms of employment could hardly be adequately assessed. He therefore welcomed the guidelines issued by the Government as a first step toward making wage settlements more flexible. He also welcomed the planned modification in the national consumer price index, which was to exclude the effects of currency devaluation and corrective price increases. While such a modified indexing scheme was not a totally satisfactory basis for government decision making, it might help to make the system less rigid and less inflation-prone.

Major uncertainties were involved in the projected development in the balance of payments, a point stressed by other speakers, Mr. Laske considered. To achieve a reduction in the current account deficit by one half in 1983, as was projected, a record surplus on the trade account was required. The major part of the adjustment was supposed to come from a substantial reduction in imports. In the following years, the improvement was expected to be made mainly through higher exports. Unfortunately, Brazil had directed its trade in manufactured goods increasingly toward markets in Eastern Europe, oil exporting countries, and countries in Latin America and in Africa; for the moment a number of those countries could no longer be regarded as expanding markets. The development raised the question whether Brazil's export targets were realistic. On the import side, by contrast, the recent fall in oil prices might well increase the possibility of a more favorable trade outcome. The recent devaluation should assist in the realization of the programs targets on both the import and the export side, but both it and the formula used for further mini-devaluations in the period ahead raised some questions. The international competitiveness of Brazilian goods as commonly measured seemed to have been restored at the beginning of 1983 after the cruzeiro had experienced a real appreciation in 1982. The crisis of confidence in the financial markets had certainly impressed on the Brazilian Government the necessity to resort to the drastic action of a large devaluation, thus advancing the consecutive minidevaluations provided for under the program orginally. The original performance criterion of depreciating the cruzeiro by 1 percentage point a month over domestic inflation seemed to him to be a competitive exchange rate policy.

The modified criterion was more acceptable, Mr. Laske remarked, although it still left some questions open with regard to the competitive advantage that Brazil might gain. The coming minidevaluations were to be in line with domestic inflation rather than inflation differentials, and they might thus give rise to further real depreciations of the cruzeiro of some magnitude. What would the effects of the policy be on Brazil's competitors who did not provide exporters with special subsidy-like incentives? It was disappointing that subsidies on export credits and restrictions on payments abroad would remain in effect for the time being. He urged the Brazilian authorities to remove those incentives and restrictions as quickly as possible. The recent devaluation should give the Government scope for early action in that field.

The adjustment effort was designed to alleviate the burden of the debt service, which had taken up more than 85 per cent of export revenue in 1982, and to achieve sustainable financing of the balance of payments, Mr. Laske explained. For the first program year, a drop in the debt service burden to 69 per cent was foreseen, and during the rest of the program the ratio was expected to decline further, to about 55 per cent. Thereafter, the debt service ratio would climb again to about 60 per cent, despite the assumption of a 12.5 per cent annual growth rate of exports, a projection that clearly demonstrated the seriousness of Brazil's external problems. It was also surprising that the staff projections presumed that Brazil would be constantly contracting short-term debt of $9.5 billion a year in coming years.

The staff had mentioned the favorable maturity structure of Brazil's medium-term and long-term debt, Mr. Laske noted. The obvious need to rely also on large lines of short-term credit, mostly from an international market with strict codes of behavior, indicated to him that Brazil was in fact faced with a maturity problem. The various cables sent from the Fund in recent weeks to international banks proved that the maintenance of those lines of credit would be crucial for the success of the Brazilian adjustment effort. Those lines would be maintained only if the actions of the Brazilian authorities were designed to restore the confidence of international banks in the authorities' willingness to deal with the problems in a comprehensive and determined way. In addition, public sector enterprises would have to make a major contribution to a higher level of domestic savings. Also important would be the fiscal behavior of the states and municipalities, which had until recently contributed substantially to the public sector deficits. Finally, he could agree to the temporary approval of Brazil's various exchange rate restrictions, but hoped that the authorities would eliminate them in the near future.

Mr. Erb observed that in the face of an overwhelming balance of payments constraint in a troubled world economy, Brazil currently faced the most difficult period of adjustment in its modern history. In requesting an extended arrangement under the policy of enlarged access, the authorities were indicating their desire to make a comprehensive adjustment in their economic policies that would not only restore domestic and external financial stability in the near term, but would also lay the basis for a more efficient allocation of resources and a more open economy in the longer term. He would thus comment not only on the policy adjustments needed to restore domestic and external financial stability in the short term, but also on the structural policy adjustments needed.

The economic program for Brazil aimed at substantial adjustments in the first year and more gradual adjustments in the second and third years, Mr. Erb observed. As other Executive Directors had noted, the key would be Brazil's ability to achieve a major reduction in public sector financial imbalances, especially during the first year. The elimination of trade and exchange restrictions, however, was largely reserved for the second and third years of the program. Brazil's recent major devaluation of the cruzeiro made attainment of the program's external payments objectives much more likely in 1983 and could even provide a basis for more comprehensive trade reform later in the year.

In that connection, Mr. Erb went on, the authorities had stated in their January 6 letter of intent that, should there be a significant decline in the external value of the U.S. dollar, the resulting real depreciation of the cruzeiro against the currencies of Brazil's major trading partners would not lead to any modification of the exchange rate policy described in paragraph 24, but rather would be used to reduce exchange restrictions. As the recent large devaluation had an effect similar to that of a fall in the exchange rate of the U.S. dollar against the cruzeiro, the authorities and the Fund staff should take a close look at Brazil's trade and exchange restrictions during the mid-term review to see whether financial considerations warranted an acceleration of reform.

To prevent a resurgence of implicit subsidies and the resulting unacceptable financial drain, the Brazilian Government should undertake needed corrections in administrative prices for fuel, wheat, and non-agricultural goods and services, including utility rates, to reflect the increased cost in cruzeiros of imports of those items or imports of goods used in local production of those items, Mr. Erb recommended. Failure to make timely adjustments and to monitor those prices closely could lead to serious undermining of the public sector financial objectives. He had been pleased to hear from the Chairman that the Brazilian Government did intend to pass through the effects of the devaluation on domestic prices in various categories.

He shared the concern of the Fund staff for the inflationary impact of wage indexation in Brazil, since wage and salary adjustments were in fact tied to past inflation, Mr. Erb continued. The modifications made in Brazil's wage formula in January--elimination of the 110 per cent of inflation adjustment for the lowest wage groups--had been a major improvement and provided a sound basis for better controlling the wage formula. Before the recent devaluation, and on the basis of projected patterns of world devaluations, the Fund staff had estimated that the new wage formula would result in real wage increases in 1983 of 2-5 per cent, compared with the projected 12-15 per cent under the old law. Given Brazil's commitment to hold the average wage increase to a nominal 65 per cent in 1983, representing an implicit cut of about 7.5 per cent in real terms, it appeared that substantial cuts in public sector employment would have to be endured in order to attain the original targets. That problem of perverse employment effects would be largely eliminated as a result of Brazil's major devaluation. Because of resulting higher inflation, real wages in 1983 probably would not increase, so that a reduction in the real wage bill could be more easily accommodated. For those reasons, it was important that Brazil should not weaken its recent wage formula reform in the face of possible pressure following the major devaluation. The Fund staff indicated that the Government of Brazil had cited the planned modification of the national consumer price index--to exclude the effect of accelerating currency depreciation and corrective price increases for items such as fuels and wheat--as one factor in the expected decline in the real wage bill. The most recent devaluation required that those planned modifications should be implemented at once in order to prevent any serious erosion of the fiscal and monetary budgets.

Turning to fiscal policy, the quarterly ceilings on the borrowing requirement of the public sector initially presented in Fund documents had been reasonably sound, Mr. Erb said. While they had been particularly stringent for 1983, no alternative appeared to have been possible. While understanding that the revisions made in those quarterly ceilings had been required to take into account the higher costs associated with the recent maxidevaluation, those revised targets were, if anything, quite generous in the initial periods of 1983. For that reason, he urged the authorities to make every effort to stay within those targets within the first two quarters so as to increase the chances of success during the latter half of the year, when demand on funding and credit typically escalated. Given the continuing delicate international financial market, Brazil should attempt to defer any recourse by public sector enterprises to those markets as much as possible into the second half of the year in order to relieve pressure on private market borrowers.

Further efforts should be made to increase public sector revenue, Mr. Erb continued. In addition to already announced reforms in indexing tax liabilities and corporate obligations, the Brazilian Government should give urgent consideration to other revenue measures such as broadening the coverage of the value-added tax on manufactures--IPI.

Brazilian monetary policy continued to be affected unfavorably by the existence of substantial subsidies to interest rates and special credit programs largely dependent upon funds from the monetary authorities, Mr. Erb noted. Although the initial Brazilian program called for a tight monetary budget in 1983, he was still concerned that adequate policy measures were not yet in place to ensure successful attainment of those goals. Although Brazil had agreed to increase average rates of interest on investment loans to 65 per cent, from 45 per cent, he wondered whether even that rate would be adequate in light of the recent devaluation. Consequently, an immediate adjustment in those rates to offset the devaluation's impact on inflation was needed. Furthermore, rates of interest should be increased significantly to offset the higher rate of expected inflation. The January cuts in the discount rates of the Central Bank and the commercial lending rates of the Bank of Brazil had gone in the wrong direction. Before the program, the discount rate had ranged from 47 per cent to 58 per cent, and the original program had called for the discount rate to be in the range of 105-130 per cent, but the discount rate was now in the range of 70-93 per cent. Again, the commercial loan rate from the Bank of Brazil in the pre-program period had ranged from 60 per cent to 74 per cent; under the original program it had been expected to be in the range of 80-95 per cent, but, as a result of the January change, the new rates were in the range of 70-78 per cent. In the monetary field, he was concerned about the decision taken by the authorities to reduce the legal reserve requirement from the 45 per cent planned the previous October to the old rate of 35 per cent, but he assumed that the reduction was consistent with the desired growth rates in overall aggregates.

The monetary policy component of the program might well be its weakest segment, Mr. Erb said. For that reason, the authorities should consider undertaking a comprehensive reform of the financial system to be implemented at the time of the mid-term review. That reform would have as its primary objective the reunification of Brazil's financial markets: there should be a reduction in the role of subsidized credit and administrative credit to permit much-needed expansion in the small free market. The reform would quickly reduce real average rates of interest in the Brazilian economy and would lead to far more efficient allocation of scarce financial resources. Unification of markets through simplifying and reducing subsidized credit programs could easily lead to major reductions in the real rates of interest paid by Brazilian businesses while eliminating the major source of arbitrage and inefficiency among sectors.

In the meantime, the authorities should be prepared to make major and timely adjustments in their monetary variables in response to problems in the coming months, Mr. Erb remarked. They had to be willing to use all the tools at their disposal, including reserve requirements and discount rates, to assure that the monetary targets were consistently attained. In addition, they should be prepared to make timely adjustments in factors that might influence the monetary budget, such as fuel prices. Brazil's experience in 1980 with the so-called petroleum account in the monetary budget pointed out the danger of neglecting timely corrective measures.

Normally, investment policy was a major element in an extended arrangement, Mr. Erb continued. He thus found it disturbing that investment policy with respect to state enterprises would not be reviewed until 1984. While the authorities' general intention to scale down the size of the public sector and reduce the number of state enterprises appeared to be prudent, a much more precise description of what should be done with regard to state investments would be more desirable. He hoped that progress could be made by the time of the August review.

In the light of the recent devaluation, domestic price and interest rate adjustments were going to be necessary, Mr. Erb noted. He would emphasize that the authorities should immediately implement the price changes so as not to lose any of the momentum in adjustment. As Mr. Kafka had explained, there was a complicated technical indexing problem. During the coming weeks, the Fund staff should work closely with the Brazilian authorities in evaluating the various price changes and interest rate changes that would be required. If there were any technical problems in implementing the price adjustments or indexing adjustments that would delay any shift in the adjustment of domestic prices, he hoped that they would be reported back to the Board in a timely fashion.

Brazil's planned improvements in its external position were essentially attainable following the recent major devaluation, Mr. Erb considered. As in other areas, Brazil would have to be cautious and tenacious if it was to reap the benefits of the new policy. He was hopeful that global economic recovery, lower oil prices, and firmer prices for other commodities would help Brazil to obtain the projected modest growth in exports, while lower interest rates should also ease the payments position. In addition, the recent devaluation of the cruzeiro would make the attainment of a $6 billion trade surplus more feasible. In fact, the devaluation should place the country in a sufficiently advantageous position by mid-1983 to permit consideration of comprehensive trade and exchange rate reform later in the year, as opposed to the initial target of 1984 and 1985.

Brazil's recent adoption of an export tax on a variety of agricultural products had been prompted by the desire to capture windfall profits and improve fiscal revenues, Mr. Erb remarked. His concerns were similar to those raised by other Directors. An export tax was not a preferred source of fiscal revenue, and that tax should be removed by the latter half of 1983, if not sooner. Moreover, he was concerned that Brazil should not introduce unfair trade practices or economic distortions through such taxes. Thus, for example, export taxes on soybeans should be accompanied by appropriate temporary export tariffs on soy products to prevent unfair competition with non-Brazilian processors dependent upon Brazilian soybean supplies. In addition, the authorities should re-examine their system of export subsidies at the time of the mid-term review, in view of the first-half trade performance, and should consider the early phased withdrawal of those subsidies, and perhaps a parallel reduction in some of Brazil's impediments to imports.

In sum, Brazil was faced with difficult economic circumstances, Mr. Erb concluded. Major adjustments would have to be made to establish a more efficient and open economy. The Brazilian authorities had taken some major steps in that direction. He wished to be sure that the pricing adjustments that had to be implemented in the light of the maxidevaluation were in fact implemented within the next few days, if not weeks. As the program evolved, his authorities would be examining some of the major structural adjustments that would normally be expected under an extended arrangement with the Fund, especially one that contemplated drawing the full amount under the policy of enlarged access.

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/83/39 (2/25/83) and EBM/83/40 (2/28/83).

3. YEMEN ARAB REPUBLIC - PURCHASE TRANSACTION - FIRST AND SECOND CREDIT TRANCHES

1. The Government of the Yemen Arab Republic has requested a purchase equivalent to SDR 9.750 million.

2. The Fund notes the intentions of the Government of the Yemen Arab Republic as stated under paragraphs 5 and 6 of Attachment I dated January 18, 1983, and approves the purchase in accordance with the request. (EBS/83/26, Sup. 1, 2/24/83)

Decision No. 7348-(83/40), adopted
February 25, 1983

4. ZAMBIA - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/48 (2/23/83). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Zambia until not later than April 15, 1983.

Decision No. 7349-(83/40), adopted
February 25, 1983

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/82/443, Supplement 1 (2/24/83), EBAP/83/62 (2/24/83), and EBAP/83/63 (2/24/83) is approved.

APPROVED: August 3, 1983

LEO VAN HOUTVEN
Secretary