NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/41

3:00 p.m., February 28, 1983

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	C. Taylor
	L. E. J. Coene, Temporary
	G. Ercel, Temporary
B. de Maulde	
	C. A. Salinas, Temporary
	C. Dallara
	S. R. Abiad, Temporary
	Jaafar A.
T. Hirao	
	M. Casey
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
Zhang Z.	Wang E.

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

Also Present

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; H. M. Flickenschild, H. W. Gerhard, M. Guitian, C. M. Loser. External Relations Department: A. F. Mohammed, Director; 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: N. M. Kaibni, E. A. Milne. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; A. Baumgarten, M. E. Bonangelino, J. A. Buyse, J. Fajgenbaum, J. Ferrán, M. E. Hardy, A. M. Jul, A. S. Linde, T. M. Reichmann, H. J. Struckmeyer. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, J. R. N. Almeida, J. Delgadillo, S. El-Khouri, M. A. Janjua, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, L. Barbone, T. A. Connors, C. Flamant, M. Hull, M. J. Kooymans, P. Leeahtam, W. Moerke, 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.

1. BRAZIL - 1982 ARTICLE IV CONSULTATION; EXTENDED ARRANGEMENT; PURCHASE TRANSACTIONS - FIRST CREDIT TRANCHE, AND COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/83/40, 2/28/83) their consideration of 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; 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).

Mr. Casey commented that the proposed extended arrangement represented a turning point in Brazilian economic policy. In the past, the Government's economic strategy had been based on achieving rapid economic growth while accumulating external debt; the strategy under the proposed arrangement was based on the achievement of sustainable growth together with an increase in domestic savings. If the transformation was to succeed, the private sector would have to play a larger role in economic activity, and true opportunity costs would have to be the basis for pricing. Ideally, all four sets of prices in an economy--the prices of goods and services, interest rates, the external value of the currency, and the prices of factors of production, including labor--should be free of restrictions. The structural adjustments needed to achieve the policy transformation in Brazil were well under way and, indeed, most of them would be accomplished in the first year of the proposed arrangement, which would undoubtedly be a difficult one for the authorities. They expected to achieve a positive rate of growth of GDP, but the staff had forecast a negative rate, and a further comment on the growth projections would be helpful, particularly in view of their importance for wages and other crucial factors. Still, achieving a reduction in the rate of inflation and eliminating the trade and payments restrictions would understandably take more than one year. Reducing inflation to the targeted level of 20 per cent in 1985 would constitute a remarkable achievement.

The strategy for achieving sustainable growth would have to be led by investment, Mr. Casey considered. Brazil's export sector was small, contributing only about 7 per cent to GDP, and even a large increase in exports would not contribute significantly to overall growth in the near term. The investment-led economic strategy should aim not only at increasing the investment ratio, but also at improving the capital/output ratio and at reorienting investment toward the tradables sector, thereby increasing the ability of the economy to earn foreign exchange and to service its external debt. Another, often overlooked, factor was the need to encourage export marketing through means other than the export subsidies that had caused considerable distortions in the past.

The recent large devaluation of the cruzeiro was appropriate, Mr. Casey commented, particularly in the light of unexpected deterioration in the balance of payments and the excessively cautious reaction by Brazil's foreign creditors. The exchange rate adjustment clearly did not constitute a competitive depreciation; rather, it was a kind of anticipatory move that gave the authorities the opportunity to make additional fiscal corrections through adjustments of export taxes. Although those taxes constituted temporary multiple currency practices, the large devaluation was on balance justified. However, he agreed with Mr. de Maulde that the export taxes could become counterproductive over time. Had the authorities originally expected the devaluation to help the balance of payments, the fiscal position, or both?

The new graduated wage formula would not add unduly to the inflationary pressures arising from the devaluation, Mr. Casey remarked. Indeed, real wages were expected to fall in 1983, thereby helping profitability and exports in the short run. However, he, like Mr. Laske, felt that the wage trend could be reversed in the future in the absence of further policy measures. The decline in real wages was tantamount to a kind of inflation tax.

Reducing the public sector borrowing requirement from 17 per cent in 1982 to 8.8 per cent in 1983 would constitute a major adjustment, Mr. Casey commented, and the major part of the fiscal deficit was to be financed domestically. On balance, the devaluation and the export taxes would support the adjustment, and additional measures--including tax measures--and improved administration would strengthen revenues. On the expenditure side, a marked decline in wages and in transfers to state and municipal governments and to public enterprises would be essential if the needed improvements in the public finances were to be made. Public investment apparently could be readily reduced in real terms because major investment projects had been completed, but he agreed with Mr. Laske that there was no room for further slippage on the fiscal side.

Monetary policy had become very tight in the period after the large devaluation, Mr. Casey noted, and total domestic credit was expected to decline significantly in 1983, although there should be room to meet the credit needs of the private sector. The authorities' intention to eliminate the credit subsidy for agriculture and the offset mechanism should reduce the distortions in the economy, support the fiscal adjustment, and make lending to industry more attractive than hitherto.

On the external side, as on the domestic side, the planned adjustment was in effect front-loaded, Mr. Casey noted, as the current external deficit was expected to fall to 2.2 per cent of GDP in 1983 and the overall balance of payments was expected to be in equilibrium; imports would have to be curtailed if those objectives were to be achieved. The 1983 external targets were likely to be fully met despite the positive real rate of GDP growth that the authorities anticipated. Mr. Kafka had noted that there was little correlation between the level of imports and the growth of domestic demand in Brazil because of the broad resource base, import substitution, and other factors, and the hope was that those factors would help to lessen the painfulness of the needed adjustment in the short term. Improving the balance of payments in the longer run would depend crucially on reducing the debt service ratio, which had reached 85 per cent in the recent past. Debt service payments had recently placed a sizable strain on the balance of payments and, although the maturity profile was reasonably favorable, the debt service ratio would have to be reduced if the new financial program was to remain viable. The mortgage on the future represented by the outstanding debt would have to be paid off by domestic savings rather than by incurring new debt, but significant refinancing would be needed in the short term in order to smooth the adjustment path, and the authorities' four-point refinancing program seemed to be proceeding reasonably well.

The flow of direct investment was expected to increase in 1983 as a result of the recently introduced tax incentives for converting financial loans into direct investment, Mr. Casey observed, but the likely effectiveness of that ingenuous device seemed almost too good to be true. There were undoubtedly fiscal costs associated with it, and a further comment would be useful.

The international oil price assumption in the staff papers was probably out of date, Mr. Casey remarked. Continued softening of international oil prices could improve Brazil's balance of payments by $2-3 billion in 1983, and the declining trend in international interest rates together with the large devaluation were also likely to help the external position. In that event, the authorities would have to consider how best to use the windfall of foreign exchange earnings. In that connection, a cautious approach seemed to be called for; some buildup of reserves, or acceleration of the repayment of debt, or both, might be warranted.

Brazil's trade and payments system had been complex for some time, and had become even more so in late 1982, Mr. Casey noted. In their letter of intent the authorities had stated that the system would be substantially freed if a real depreciation of the exchange rate occurred, and he wondered whether the authorities were not planning to accelerate the process of liberalization in the wake of the recent exchange rate adjustment. Such a move would eliminate any stigma of competitive depreciation from the maxidevaluation. However, as Mr. Kafka had suggested, some time might yet be needed for the authorities to learn whether such a substantial liberalization was possible.

Although he wished to take up some technical matters bilaterally with the staff, Mr. Casey concluded, the proposed extended arrangement was clearly a solid one. It would of course require careful monitoring, which would be facilitated by the excellent relations between Brazil and the Fund. The proposed decisions should be approved.

Mr. de Vries remarked that, in terms of both substance and use of Fund resources, the proposed program was a major one. It was designed basically to increase domestic savings and efficiency, which had become increasingly important with the fall in the surplus of the major oil producing countries that had constituted the international savings available to developing countries like Brazil. The authorities had not despaired at the evaporation of the supply of international savings. Instead, they had adopted strong measures to shift the basis of savings from foreign to domestic sources, a move that was important not only for Brazil, but also as an example for other developing countries. The dramatic policy shift in Brazil was also reflected in the efforts to increase efficiency, reform wage policy, raise real interest rates, drastically reduce inflation, substantially adjust the exchange rate, and simplify the present complex set of arrangements that restricted the smooth functioning of the price mechanism.

Nevertheless, Mr. de Vries went on, the proposed program naturally raised certain questions. For instance, how firm was the authorities' commitment to the new strategy? The authorities apparently had made a sudden shift in the policy stance--including the system of wage indexation and the exchange rate--that they had defended for years. Executive Directors' main doubt about the program seemed to be the willingness of the authorities to take advantage of new opportunities--created, for instance, by the large devaluation--to introduce additional needed measures.

The exchange rate strategy that had been agreed on February 11, 1983, Mr. de Vries noted, was different from the one that had been agreed on February 21. As Mr. Kafka had mentioned, the maxidevaluation had been more than adequate, thereby providing a safety margin, and Executive Directors understandably wished to consider whether or not the adjustment constituted a competitive devaluation. The situation in Brazil at the time of the devaluation was quite different from the one in Sweden when its major exchange rate adjustment had occurred: the exchange rate in Brazil was but one of a number of instruments that were being employed in a profound shift in the policy strategy, while in the case of Sweden there had been some feeling that the exchange rate was the main, or perhaps only, instrument that was being used to move the economy in the right direction. It was impossible to know at the time an exchange rate adjustment was made whether the new rate was precisely the right one. Experience would show whether the new rate in Brazil was appropriate, and small changes could be made to move the rate further in the right direction. Reaching the proper rate was important for both Brazil and its competitors.

The large devaluation had apparently created the opportunity to accelerate the process of simplifying the exchange regime of Brazil, Mr. de Vries remarked. The staff felt that the present multiple currency practices were not justified and should not be approved by the Executive Board.

The staff seemed displeased by the recent relaxation in monetary policy in Brazil, Mr. de Vries said. The opening statement by the Chairman on the authorities' plan with respect to agricultural credit and interest rates showed that, for the time being, the authorities did not wish to take straightforward action in the monetary policy area. The authorities themselves had stated that the devaluation should have a beneficial effect because of the anticipated decline in real interest rates. Executive Directors, however, clearly felt that a decline in real interest rates would have a negative effect on the economy.

The wage regime had been improved but was still quite complicated, Mr. de Vries noted. Were real wages expected to rise or fall in the wake of the maxidevaluation? An increase in real wages would clearly be a step in the wrong direction. The time was ripe for the authorities to consider excluding the effects of accelerated depreciation of the currency on wages through the wage indexation system.

The increase in public sector savings, and the improved efficiency of the Government and state enterprises, should lead to the decline in the government deficit that was a central objective of the authorities' new strategy, Mr. de Vries remarked. It was also important to note that the decline in the international price of oil would on balance probably help the authorities to implement the new program. As for the proposed drawing under the compensatory financing facility, the relevant calculations were complex. One third of Brazil's exports were classified only as "other exports"; a detailed breakdown had not been provided. He had no difficulty in accepting the proposed purchase, although the compensatory financing facility had clearly been designed for use by simpler economies than that of Brazil.

The proposed program was an imaginative one, Mr. de Vries considered, and he, like Mr. Casey, was somewhat more impressed by its positive features than some other Executive Directors. If the program was forcefully and successfully implemented, it would undoubtedly set an example for other countries.

Mr. Suraisry remarked that the information provided in the supplements to the staff report was particularly useful. All the proposed decisions were acceptable. The Fund's efforts to secure a viable financing package for Brazil, Mexico, and Argentina had helped prevent a major crisis of confidence and had underscored the importance of the role that the institution played in ensuring the smooth functioning of the international monetary system.

The proposed purchase under the compensatory financing facility was in effect a follow-up to Brazil's previous use of the facility, in December 1982, Mr. Suraisry noted. The actual data for the whole shortfall year showed that the overall shortfall was in line with the earlier estimates, and he had no difficulty in accepting the proposed purchase under the facility.

Commenting on the proposed extended arrangement, Mr. Suraisry said that the quantitative performance criteria were comprehensive and provided adequate safeguards. Two of the criteria covered domestic policies and three had to do with external policies. The program for 1983 also included a review clause as a performance criterion, which indicated the thorough nature of the program.

It was important to note, Mr. Suraisry went on, that the authorities had already adopted many of the measures that were to be introduced under the 1983 program. As a result, most of the measures under that program would begin to take effect from the very start of the program period. That fact was also a clear indication of the authorities' determination and ability to implement the policies needed to reduce the imbalances in the economy in the medium term.

The authorities had already considerably increased the administered prices of various goods and services, Mr. Suraisry noted, and they had indicated their intention of making regular price adjustments in order to eliminate the subsidies over the program period. In addition, the modification of the official wage formula in late January 1982 should help to reduce the rate of increase in real wages. The authorities were to be commended for the courage they had shown in making those difficult decisions.

The adjustment that the public sector was to make during the program period was impressive, Mr. Suraisry commented. The ratio of the public sector borrowing requirement to GDP was to be reduced from an estimated 16.9 per cent in 1982 to 4 per cent in 1985. The staff reports clearly showed how the decline in the public sector borrowing requirement was to be achieved in 1983, but they could have usefully also included revenue and expenditure projections for the Central Government, state governments, and state enterprises for the second and third years of the extended arrangement, in order to indicate how the adjustment burden would be distributed within the public sector in the final two years of the arrangement.

Monetary conditions were to be tightened considerably under the 1983 program, Mr. Suraisry observed. The domestic assets of the monetary authorities were projected to decline by some 13 per cent in real terms in 1983, compared with an estimated increase of about 34 per cent in 1982. In addition, the 1983 program should substantially reduce the crowding out of the private sector that had occurred in previous years. The proposed credit ceilings seemed appropriate. The monetary statistics for end-December 1982 were referred to as preliminary in some of the staff papers, but were treated as actual when specifying monetary targets for 1983. Might it not have been preferable to express the quarterly ceilings on net domestic assets in 1983 as changes rather than as absolute figures? That would obviate the need for revising those ceilings if major revisions were to be made in the December 1982 figures.

The large depreciation of the cruzeiro in support of the adjustment effort was courageous, Mr. Suraisry considered. That adjustment, together with the further depreciation expected in the remainder of 1983, should help the authorities to achieve the balance of payments objectives under the program.

That the World Bank supported Brazil's economic program was certainly welcome, Mr. Suraisry stated, and the staff report could have usefully included the usual appendix explaining Brazil's relations with the World Bank. Active involvement of the World Bank could help to strengthen Brazil's adjustment effort under the extended arrangement.

The proposed stabilization program was strong and comprehensive but, as Mr. Kafka had mentioned, Brazil would have a difficult path to follow, and a sustained adjustment effort involving a number of sacrifices would clearly be needed in the period up to 1985, and perhaps beyond. The authorities had shown their commitment to making the needed adjustments by implementing significant corrective measures, and their intention of maintaining close contact with the Fund was encouraging. The success of the new Brazilian program was important for Brazil, the Fund, and the international financial community.

Mr. Taylor considered that the staff recommendations were constructive. The staff had wisely paid close attention to the need to correct fundamental weaknesses in the economy and to introduce appropriate reforms and supply-side measures, particularly increases in both public sector tariffs and the efficiency of the public sector entities and a deregulation of the financial sector. As a result, the proposed program seemed adequate for the solution of Brazil's payments problems. The main strategy for the second and third years of the proposed extended arrangement was well defined, and the priorities, which implied substantial adjustment in the first year and a consolidation in the following two years, seemed appropriate.

He agreed that a current account deficit of the order of some 1 per cent of GDP by 1985 would be sustainable, Mr. Taylor continued. At the same time, it was important to recognize the considerable risks and uncertainties of Brazil's present economic situation. The unexpectedly poor trade performance in January 1983 and the large fiscal deficit in 1982 suggested that the starting point for the new program was somewhat more unfavorable than had been anticipated, and that the stabilization effort would have to be even stronger than the authorities had planned. For those reasons, and given the prominence of the new program, he, like previous speakers, attached great importance to holding thorough reviews of the program at regular intervals.

The strategy under the proposed program, Mr. Taylor noted, was to reduce the reliance on foreign borrowing while increasing savings, particularly in the public sector, which had grown rapidly in recent years and had absorbed a substantial portion of total available resources. The present fiscal deficit, which was the equivalent of nearly 15 per cent of GDP, was clearly unsustainable, and the authorities' vigorous action to curb it was most welcome. The tax measures that had already been introduced and the slowing of the rate of increase in outlays by the public enterprises were important steps in the right direction. A continued determined effort to rationalize and streamline the large number of parastatal enterprises was a major feature of the new program. Although the performance of the parastatal enterprises was projected to improve, their reliance on foreign borrowing was expected to be three times larger in 1983 than in 1982. The Government's intention to review the investment policy in 1984 was welcome, and he wondered whether there were any indications of the investment priorities that were likely to be set. In particular, could the present large number of parastatal institutions be reduced? Were some of them expected to become self-financing?

Although monetary policy was to be tightened, its main objective was to increase the availability of credit in the private sector, Mr. Taylor remarked. That objective, together with the emphasis on deregulating the financial system, was fully appropriate. The tight control of bank lending and the interest rate policy had interfered with the efficient allocation of credit, and the authorities' decisions deregulating interest rates and permitting the provision of credit to be subject to market forces to a greater extent than hitherto were welcome. In the short run, the authorities would have to be careful to keep the remaining interest rate limits from causing significantly negative real rates of interest, particularly in the light of effects of the recent maxidevaluation. The Chairman's opening statement suggested that the authorities were taking appropriate steps in the monetary policy area. He, like Mr. de Maulde, thought that it would be unwise to adjust interest rates on agricultural loans too sharply in mid-1983. Extensive deregulation of financial intermediation in Brazil would be compatible with the decline in the country's access to foreign credit over the program period. He agreed with Mr. Erb that the progress that had been made in deregulating the financial system should be a central concern of the mid-term review.

If the market-oriented credit policy was to help to reduce the strong inflationary pressures in the Brazilian economy, Mr. Taylor commented, it would have to be supported by a considerable effort at wage moderation, and he welcomed the steps that were being taken to reform the established process of automatic wage indexation. Wage restraint was needed particularly in view of the effort to adjust public utility tariffs and to reduce subsidies.

To alleviate the effects of the devaluation, Mr. Taylor went on, the authorities had said that they would attempt to phase the associated increases in the prices of certain commodities, such as oil derivatives and wheat, and of public services. The Chairman's reassurance concerning the authorities' awareness of the need for a full pass-through of costs was welcome. The authorities were in principle clearly committed to make such a move, and he wondered whether there was any recent information on the precise steps that they actually intended to take. Even before the devaluation, the target of reducing the rate of inflation to as low as 70 per cent by the end of 1983 had seemed rather ambitious, and the price effect of the devaluation would keep inflation rates on a year-to-year basis very high through most of 1983. He wondered whether wage settlements, which depended to some extent on the rate of inflation over the previous 12 months, would not also reflect the effects of the devaluation on domestic prices. Apparently the authorities intended to modify the wage indexation system by eliminating the effects of the accelerated depreciation on the consumer price index and, thereby, on wages and benefits, but Mr. Kafka had noted technical difficulties in so doing, and he himself wondered whether technical assistance in the effort might not be useful. The wage indexation system should be kept under review, and the Executive Board should receive early assurance that the steps that the authorities had firmly promised to take, and that Mr. Kafka had endorsed in his opening statement, would in fact be taken at an early stage.

The appraisal in EBS/83/33, Supplement 1, of the latest economic developments in Brazil was somewhat bland, Mr. Taylor considered. The recent devaluation had certainly strengthened the adjustment effort, but the need for such strengthening had become obvious after the disappointing trade performance in recent months. The estimated overall balance of payments deficit in 1982 was somewhat larger than had originally been expected, and he, like some previous speakers, found the uncertainty about the outlook for the balance of payments--and particularly the trade balance--worrying. The prospects for agricultural exports seemed good, but the prospects for manufactures were much less bright. On the other hand, the decline in international oil prices and the major savings from the fall in international interest rates would certainly help the external position. The net effect of the various factors that he had mentioned was difficult to gauge, but the outcome would probably be different than had been anticipated.

The rapid increase in the external debt in the previous two years had been the main cause of the liquidity crisis in Brazil, Mr. Taylor noted, and the need to restore the confidence of creditors and investors in the economy was widely recognized. There seemed to be some uncertainty about the precise size of the external debt at the end of 1982. Some banking sources had estimated it at $89 billion, while the staff figure was $81 billion. The debt service burden was expected to fall until about 1985--mainly because of the rollover of bank amortization--but thereafter it would resume its upward trend. The size of the debt and the debt service burden clearly showed that there was little room for slippage in the adjustment on the balance of payments side.

In the circumstances of Brazil, Mr. Taylor went on, it would be asking a lot to eliminate the major exchange restrictions and subsidies on export credit at an early stage, but the lack of any plans whatsoever for removing them before the end of the proposed extended arrangement was disappointing. The authorities should move as fast as possible, using whatever additional scope was available as a result of the maxidevaluation. They had made a start, and the liberalization measures that had been adopted thus far were welcome. If the proposed arrangement was successfully implemented, Brazil might be in a position to join Mexico and Argentina as Article VIII countries.

He had no difficulty in accepting the proposed purchase under the compensatory financing facility, Mr. Taylor said. In sum, the authorities had made a sober and realistic assessment of the problems facing the Brazilian economy, and had formulated a comprehensive strategy that included all the main elements needed to stabilize and adjust the economy. In addition, many of the necessary policy measures had already been introduced.

Nevertheless, the economic situation in Brazil was still precarious, and the authorities might well need to adopt even tougher measures--particularly in connection with wage indexation and restraint, domestic resource mobilization, and taxes--if developments were not as positive as the authorities hoped. The scheduled reviews would represent important opportunities to assess the authorities' progress.

The proposed program would be feasible only if external financing was available on the required scale, Mr. Taylor continued, and management and staff had achieved substantial success in encouraging the commercial banks to cooperate. He was pleased that the remaining pieces of the adjustment and financing effort seemed to be falling into place. There was still some way to go to achieve the target of full restoration of the money market deposits to the level of June 1982. In any event, it might well be necessary to turn to the banks in due course for further financing--perhaps in the form of medium-term credit arrangements--of the order of $1 billion. The banks' response was reassuring. They had not only gone a long way in providing the required financing, but they had also given the kind of assurance that was needed to proceed with the proposed program. The banks would certainly be carefully following the progress under the new program in the coming months. The staff should closely monitor the implementation of the program and keep the Executive Board fully informed.

Mr. Hirao stated that the proposed decisions were acceptable. The extended arrangement was designed to reduce the rate of inflation and to mobilize savings through a drastic reduction in the public sector deficit. The external current account position was expected to improve as a result of restrictive demand management and a flexible exchange rate policy. The proposed supply-side measures were to play as important a role as the demand management measures in the adjustment effort. The authorities' substantial initiatives designed to modify the wage indexation formula, to reduce protection in the form of quantitative restrictions and exchange measures, and to decrease the budget and credit subsidies to various sectors of the economy were welcome.

The authorities intended to maintain realistic pricing policies and to avoid subsidies, Mr. Hirao noted, and their decision to increase the prices of imported goods to reflect fully the devaluation was encouraging. One of the key proposals under the proposed program for 1983 was for a monthly increase in fuel prices by 1.5 percentage points above the rate of domestic inflation. As the rate of depreciation of the cruzeiro against the U.S. dollar was to be consistent with the rate of domestic inflation, the fuel price adjustments in dollar terms would be rather limited. As a result, the differential between international and domestic fuel prices was likely to remain significant for a long period.

The establishment in January 1982 of a new wage indexation formula was welcome, Mr. Hirao said. It should help to reduce the real wage bill in 1983 and to achieve a significant reduction in the overall public sector deficit. Real wages in the private sector and in state enterprises were expected to fall by 2.5 per cent in 1983. The authorities should certainly continue their efforts to encourage wage moderation.

The authorities were to be commended for the drastic fiscal adjustments under the new program, Mr. Hirao considered. The public sector borrowing requirement was to be reduced from 16.9 per cent of GDP in 1982 to 8.8 per cent in 1983, partly as a result of wide-ranging revenue measures and tight control over wage outlays and investment spending. Revenue-raising efforts would continue to be required in 1984 and 1985 in order to reduce further the public sector deficit, especially as the projected deficit for 1983 was larger than had originally been estimated. Did the staff expect the authorities to adopt additional tax measures in 1984/85?

He agreed with the staff that the authorities' intention of tightening monetary policy in 1983 was appropriate, Mr. Hirao remarked. Their recent decisions to reduce substantially interest rate subsidies on agricultural bank credit and to accelerate the pace of the reduction were welcome. The adjustment would strengthen the monetary authorities' control of domestic bank credit and improve the banks' income position, thereby creating room for lowering interest rates on industrial credit.

The authorities were to be commended for their decision to depreciate the rate for the cruzeiro against the U.S. dollar by 30 per cent, Mr. Hirao commented. Their intention to maintain a flexible exchange rate policy in 1983 was welcome, and he hoped that the policy would be continued in 1984 and 1985. As Brazil's external position improved, the authorities intended to give priority to reducing substantially the quantitative import restrictions. In the letter of intent the authorities had mentioned that "it is impossible to foresee whether the significant exchange restrictions on exports and imports...can be reduced during the first year of the extended arrangement; however, should there be a significant decline in the external value of the U.S. dollar, the resulting real effective depreciation of the cruzeiro...will be used to reduce these exchange restrictions." He attached great importance to the relaxation of the restrictions.

It would be useful to receive a comment on the causes of the unexpectedly small trade surplus in January 1983, Mr. Hirao said. It would also be helpful to have a further comment on the assumption behind the balance of payments projection in the proposed program, namely, that the effective London interbank offered rate (LIBOR) applicable to the variable rate element of Brazil's external debt would gradually decline from 16 per cent in 1982 to 7.5 per cent in the second half of 1985.

Mr. Prowse stated that the proposed decisions were acceptable. The new program was comprehensive, and its emphasis on the mobilization of domestic savings was particularly important. The success of the program would depend on the willingness and ability of the authorities to make a determined effort to introduce the needed adjustment measures throughout the period of the extended arrangement. Indeed, some of the economic indicators suggested that a determined adjustment effort might well be required even after the completion of the extended arrangement. For instance, the debt service in 1987 was expected to be about the same percentage of exports--61 per cent--as in 1980, and the occurrence of another export slump would certainly create major difficulties; the authorities' effort to reduce their reliance on external resources might have to be even more strenuous than they had assumed. The public sector borrowing requirement was to be reduced significantly in 1983, but borrowing by the nonfinancial public sector was still expected to be equivalent to about 7 per cent of GDP.

That Brazil had put its external resources to good use was reflected in both the strong growth performance and the rise in per capita income to $2,200, Mr. Prowse considered. A number of features of Brazil's economy were not characteristic of other developing countries that had relied heavily on foreign resources and had accumulated large external debts. For instance, Brazil's export sector was very diversified; manufactured goods represented 50 per cent of total exports. In addition, Brazil had maintained a flexible exchange rate policy. Although Brazil's debt was heavy, the ratio of short-term debt to total external debt was relatively small--about 10 per cent. Yet, despite those positive features, the country would have to reduce its reliance on external resources, and probably at a faster rate than anticipated. A strong growth performance would help the authorities to deal with the debt problem, and the projected current account deficit in 1985--which was to be equivalent to just 1 per cent of GDP--would certainly be sustainable. Moreover, a developing country like Brazil obviously would continue to be dependent on imports for some time to come. It seemed clear that the nonfinancial government sector in particular must provide much more of its own financing than it had in recent years. The present difficulties facing the Brazilian economy would at least have the benefit of bringing about the needed adjustments more quickly than might otherwise have been the case; those adjustments had been looming on the horizon for some time.

There was a clear need to reduce the extent of wage indexation in Brazil, Mr. Prowse remarked. The present extensive system would clearly be inappropriate in the long run. The link between wages and the exchange rate had become a particularly significant factor, and it seemed likely that, in certain circumstances, excessive wage increases could be compensated by large exchange rate adjustments. In that connection, the relevant policy stance in Austria and Korea, which had been implemented with some success, should be borne in mind.

He was somewhat worried by the inadequate discussion in the letter of intent of wage policy in Brazil, Mr. Prowse went on. The document merely stated that wage policy would be designed to increase employment, and presumably it would entail a reduction in the real cost of labor. What was the outlook for real wages in Brazil in the wake of the maxi-devaluation? Would the staff be concerned if the authorities no longer expected a decline in real wages? The authorities should make the firmest possible commitment to restraining wages in the coming period, and a more explicit discussion by the authorities of the changes they planned to make in the wage determination process would have been welcome.

The flexibility that the authorities had shown in managing the exchange rate had helped to encourage the growth and development of the economy, Mr. Prowse considered. However, their commitment to depreciate the exchange rate of the cruzeiro vis-à-vis the U.S. dollar at a monthly rate that would average 1 percentage point above the rate of inflation could not be recommended to all developing countries facing balance of payments problems. The effect of the policy would depend in part on the trend in the value of the U.S. dollar, but the specific depreciation target seemed to have a competitive flavor, particularly if wage indexation was maintained, thereby limiting the prospect for curbing inflation. The policy package described in EBS/83/33, Supplement 1, constituted a textbook model of appropriate support for a devaluation, although the effects of the devaluation on wages was not as clear, and the authorities' policy in that respect not as firm, as one might have wished.

He wondered whether the staff felt that the recent large devaluation had been essential, Mr. Prowse remarked. Chart 3 in EBS/83/33 did not suggest that, at the time the chart had been prepared, a massive devaluation had clearly been required. Since then, the circumstances of Brazil had admittedly changed and the trade figures for January and February 1983 had certainly been on the minds of decision makers, but developments in the previous two years or so had not constituted an overwhelming case in favor of a maxidevaluation. Still, the likely effect of the large devaluation on exports was not clear to him, and he did not have a firm position on the exchange rate adjustment. At present, Brazil's exports seemed to be constrained by weak markets, rather than by price developments, although in that connection it was important to distinguish between manufactured and primary product exports. He felt even less certain about the likely effect of the maxidevaluation on domestic prices in Brazil. The various distortions--and particularly the agricultural subsidies--in Brazil's trade and payments should be corrected as quickly as possible. On the other hand, such adjustments were admittedly difficult to make on a unilateral basis. After all, Brazil's primary product exports had to compete in markets against highly subsidized products.

The request to use the compensatory financing facility was straightforward, Mr. Prowse considered. The latest calculated shortfall was nearly the same as that calculated in December 1982, although the distribution of the shortfall among the various commodity groups had altered substantially. Moreover, the purchase was based on only one month's estimated data, so that the likelihood of overcompensation was negligible. The export projections had understandably not been revised to take into account the most recent devaluation, which was likely to have a beneficial effect on exports and therefore could conceivably be grounds for a larger purchase than the one proposed. In any event, excluding the effects of the devaluation was one way of reducing the risk of overcompensation. The authorities had clearly been cooperating with the Fund to find solutions to their balance of payments problems, and the proposed purchase under the compensatory financing facility should be approved.

Mr. Zhang stated that the proposed decisions were acceptable. In recent years the economy had been hit by a number of unfavorable factors, and both internal and external imbalances had emerged. To a considerable extent, however, the imbalances were the inevitable result of the rapid economic growth of Brazil during the previous several decades. Nevertheless, the rapid deterioration in external conditions, mainly because of the continued world recession and high international interest rates, had clearly been the most important cause of the imbalances in Brazil's economy.

The authorities had realistically assessed the present difficult situation and had already begun to carry out a well-designed medium-term adjustment program that included essential structural adjustment measures, Mr. Zhang remarked. The program was a good and necessary one, and its implementation should result in the resumption of sustained growth in output and employment. He fully agreed with the staff that implementing the program successfully would be difficult and would require a major effort by the authorities. The staff appraisal did not include a clear and explicit assessment of the importance of likely future external developments on the adjustment program, particularly in the first year of the extended arrangement. Those developments should be taken fully into account in future reviews under the extended arrangement.

Mr. Tvedt said that he accepted the proposed decisions and broadly agreed with the staff appraisal. During the previous 25 years Brazil had had one of the most rapidly growing economies in the world. The trend of real per capita GDP suggested that the golden age of growth had ended in 1980, following a decade of growth averaging 4-5 per cent a year. In both 1981 and 1982, real per capita GDP had fallen markedly, and a further decline of 7 per cent was expected in 1983. The authorities hoped that, by the end of the period of the extended arrangement, the level of real per capita GDP would be restored to the level of 1977 or 1978. That objective was a reflection of the considerable adjustment that would have to be made before a new era of economic growth could begin.

The authorities were clearly aiming at a substantial adjustment in the first year of the proposed arrangement and for more gradual adjustment in the final two years, Mr. Tvedt remarked. Given that fact, and the desirability of closely linking the degree of policy implementation and the phasing of purchases, a good case could probably be made for front-loading the proposed purchases to a greater extent than had been proposed.

The staff had concluded, Mr. Tvedt noted, that the recent maxi-devaluation of the cruzeiro should considerably facilitate the achievement of the balance of payments targets under the proposed arrangement. However, the original balance of payments projections had not been modified.

He agreed with the staff, Mr. Tvedt went on, that the largest contribution to the adjustment effort would be made by the public sector. The projected halving of the public sector borrowing requirement in 1983 was impressive, and he hoped that the authorities' commendable efforts in that area would be successful.

Commenting on monetary policy, Mr. Tvedt said that there seemed to be some difference of view between the staff and the authorities. The staff had urged the authorities to raise interest rates on loans to agriculture as soon as possible, and the Chairman's statement that credit subsidies were to be reduced in the coming year was welcome.

He was somewhat more worried about the incomes policy than the staff appeared to be, Mr. Tvedt commented. The recent devaluation indicated the need for a reorientation of wage policy, particularly in the light of the experience in the wake of the major devaluations in late 1979 and early 1980. However, the discussion on the matter in the staff reports was fairly limited. According to the staff, the average real wage for the labor force covered by the wage formula was expected to fall somewhat in 1983, although it had originally been estimated that there would be an increase in the range of 2-5 per cent. The revised figures for the real wage were based on an inflation rate of 85-90 per cent, compared with the earlier forecast of 70 per cent. In the central government sector, the average general wage increase was to be limited to 65 per cent in 1983, an increase that, on the basis of the earlier inflation estimate of 70 per cent, would have implied a reduction in wage costs of 7.5 per cent in real terms. However, on the basis of the new revised inflation forecast for 1983, the staff, without further explanation, had projected a 10 per cent reduction in real wages in the central government sector. A further comment on the wage situation would be welcome.

The authorities planned to modify the national consumer price index--on which wage adjustments were based--to exclude the effect of the acceleration of a currency depreciation, Mr. Tvedt noted. Finally, he hoped that Brazil would soon be able to obtain adequate private foreign financing.

Mr. Salehkhou commented that during the previous two decades Brazil had made considerable progress in substantially strengthening the productive base of the economy and in increasing both employment and the standard of living. The achievements had been due mainly to the leading role that the public sector had taken in the industrialization of the economy, including the modernization of agriculture, and to the considerable use of foreign resources that had enabled the country to make important progress in meeting its development objectives. Unfortunately, the reliance on foreign resources had become excessive, thereby dangerously raising the level of foreign debt and the debt service ratio to export receipts, despite the relatively high rate of growth in the export sector. In the previous four years in particular, the foreign debt had become a heavy burden on the balance of payments and had adversely affected the overall development of the economy.

A number of other imbalances had plagued Brazil's economy in recent years, Mr. Salehkhou went on. The rapid economic growth during the previous two decades had been supported by expansionary policies, a number of exchange restrictions, widespread price regulations, and important price and credit subsidies that had caused huge inflationary pressures and large budget deficits and created severe price distortions at both the producer and consumer levels. The inadequate wage policy had also contributed to the inflationary pressures. Its inherent strength had enabled the economy to sustain the impact of external shocks throughout the 1970s, but the authorities had been unable to delay the need to make adjustments after the 1979 oil price adjustment. At that time, the authorities had responded quickly with a number of courageous measures, including a maxidevaluation of the cruzeiro and a considerable liberalization of producer and consumer prices. Although their impact on the inflation rate had been quite limited, the new measures had greatly improved the balance of payments performance and had somewhat reduced the distortions in the domestic economy. They had obviously been insufficient to cope with the major crisis of 1982 resulting from the continued high international interest rates in the first six months of the year together with the severely curtailed access to foreign capital markets in the second half of the year. The exogenous developments in 1982 had dealt the Brazilian economy a serious blow, thereby necessitating the adoption of measures designed to make fundamental changes.

The financial program in support of the proposed extended arrangement was appropriate, Mr. Salehkhou considered. It contained all the measures needed to deal with the country's short-term financial crisis and to make the structural changes needed to correct the underlying imbalances in the economy. The early implementation of the program's most important measures, such as the large devaluation of the cruzeiro, underscored the authorities' determination to introduce whatever painful measures might be needed to achieve economic adjustment, and particularly to reduce the external current account deficit and to cut substantially the use of foreign credit. To achieve the external objectives, the program provided for a series of small additional devaluations that were meant to ensure a continuing real depreciation of the cruzeiro. The program also included a large number of domestic measures that were aimed primarily at increasing domestic savings and at substantially reducing the inflation rate, steps that should have a favorable effect on the overall balance of payments and on the allocation of resources. The price and wage policy should correct a number of the distortions in the domestic economy, thereby helping to bring the rate of inflation down to a viable level in the longer run. Those measures, together with a careful tightening of fiscal and monetary policy, should make an important contribution to paving the way for a strong economic recovery in the second year of the extended arrangement.

The effort to reduce the public sector borrowing requirement by almost 50 per cent in 1983 through a significant strengthening of the revenue performance, Mr. Salehkhou said, together with strong expenditure restraint, should improve the public sector's financial position and substantially reduce the crowding out of the private sector. Successful implementation of the proposed program should greatly improve the prospects of the Brazilian economy. Although some favorable external developments had recently occurred, the authorities would nevertheless have to monitor closely all the elements of the program.

The proposed use of the compensatory financing facility met all the relevant requirements, Mr. Salehkhou considered. He agreed with the staff that, despite the projected improvement in the current account deficit in 1983, and in the light of the decline in gross international reserves in 1982, Brazil's balance of payments position would remain weak in the short term. The proposed decisions should be approved.

Mr. Malhotra stated that he warmly supported the proposed decisions. Brazil's performance over the previous two decades had been most commendable. The economy had been greatly diversified, and high levels of exports had been achieved. To maintain rapid rates of growth despite the unfavorable developments in the world economy--especially in the wake of the oil crises of the 1970s--the Brazilian Government had increased its reliance on foreign financing. Although the country had been able to maintain high rates of economic growth, debt service as a proportion of export earnings had risen considerably, thereby rendering the economy vulnerable to the adverse external developments that had occurred, particularly since 1979.

The authorities had responded by adopting a number of important measures, including a large devaluation in 1979, Mr. Malhotra went on. Unfortunately, conditions--particularly external developments--since 1979 had been quite unfavorable, and the massive debt service burden would in itself have required a significant change in policies. Indeed, developments in 1981 and 1982 had caused the authorities to increase their reliance on domestic savings while aiming to reduce progressively the rate of inflation. An extended arrangement was certainly an appropriate means of support for such major changes in economic policy. The proposed program was comprehensive and, if fully implemented, should lead to major improvements in the economic situation in Brazil.

Under the proposed program, Mr. Malhotra noted, domestic savings, which had fallen to approximately 14.5 per cent of GDP in 1982, were to rise to 20 per cent in 1985, and the current account deficit was to fall from 4.5 per cent of GDP in 1982 to just 1 per cent in 1985. Even more important, the rate of inflation, which had reached roughly 100 per cent in 1982, was to be reduced progressively to 20 per cent in 1985. Moreover, the overall balance of payments was to be brought into equilibrium as early as 1983. The projected positive trade balance in 1983 was an indication of the inherent strength of the Brazilian economy. Nevertheless, the major strain in the invisibles account was likely to remain throughout the period of the extended arrangement, as the debt service burden would probably rise to more than 60 per cent.

It was important for both the internal health of the economy and for the credibility of the authorities in the eyes of the international financial community, Mr. Malhotra said, to ensure that the program achieved the well-established objectives. The case of Brazil was one of the few important ones in which the Fund's management had had to take far-reaching steps to ensure that the borrowing country undertook a substantial adjustment program, thereby attracting sufficient foreign financial support. The enlarged access policy enabled the Fund to give the support the Government needed to adopt and implement a credible adjustment program.

If the program was to be successfully implemented, Mr. Malhotra remarked, the assumptions concerning exports, interest rates, and the general international economic environment would have to be proved correct. He strongly hoped that the policies adopted in the major countries would be coordinated to prevent a reacceleration of interest rates and to encourage a steadily rising demand for the exports of developing countries. Such developments were essential for the successful implementation of Brazil's adjustment program.

As things stood, Mr. Malhotra said, the debt service burden would continue to be considerable in the coming years, and he wondered whether steps could not be taken to alleviate the burden in the period after the completion of the proposed extended arrangement. He questioned whether there was any scope for rescheduling some of the longer-term debt. In addition, given Brazil's relatively high per capita income, he wondered whether there was not also scope for increasing the rate of domestic savings above 20 per cent by 1986 or 1987.

Of the particular areas dealt with under the proposed program, Mr. Malhotra said, the authorities should pay especially close attention to the budget in general, and to revenues in particular. The authorities intended to undertake a major reform of the tax structure, and it would be useful to know how it would probably affect the ratio of tax revenues to GDP. Given the need to reduce the budget deficit, improve the revenue performance, and capture certain windfall profits, the recently introduced export taxes were appropriate. The authorities had stated that the taxes were temporary and, in the light of the objectives of the devaluation, he hoped that they would indeed be phased out; in the long run, such taxes could undermine the purposes for which the devaluation had been undertaken.

The extent to which the authorities planned to further devalue the cruzeiro under the proposed program was unclear to him, Mr. Malhotra said. There seemed to be some concern among Executive Directors that the exchange rate adjustments constituted competitive devaluations, but he, for one, was uncertain what the effects were likely to be. He was pleased that the authorities were determined to see that the full effect of the devaluation was felt; accordingly, price increases from the devaluation were to be passed on as quickly as possible. Similarly, the authorities had no intention of increasing wages in response to price increases resulting from the maxidevaluation.

The monetary policy that the authorities intended to maintain seemed to support the proposed program as a whole, Mr. Malhotra remarked. The fairly high proportion of total savings that was to be channeled to the nonfinancial public sector should be seen in the light of the public sector's relatively important role in the overall economy. It seemed more important to encourage greater efficiency in the public sector than to try to set aside a particular share of total savings for the public sector; and the authorities' intention of making major improvements in efficiency were welcome. The main objectives should be to improve efficiency and to meet the genuine credit requirements of both the public and private sectors.

The considerable effort that management had made to provide outside financial support for Brazil's program would probably have to be continued in the medium term, Mr. Malhotra said. It was crucial to ensure that the program was seen as a viable one in the medium run and, to that end, a sufficient flow of financing was a prerequisite. The Brazilian economy was intrinsically strong. The country had a large resource base and a good economic growth record, and the proposed program should enable it to regain strong, if somewhat slower, growth in the future.

Mr. Jaafar said that he broadly agreed with the staff appraisal and warmly supported the proposed decisions. The adjustment task facing Brazil was formidable. The surge in oil prices in 1979/80 had occurred at a time when Brazil's economy had been weakened by the poor export performance, resulting in part from a drought, and by the steep rise in international interest rates. The Government's strategy of relying on foreign savings rather than domestic resources to support its growth objectives had failed because of the deteriorating world economic and financial conditions. Brazil's rising debts had made it extremely vulnerable to external developments, particularly those in export markets, and the authorities had had to increase their reliance on domestic resources. The authorities' recent decision to make a drastic cut in domestic spending in order to mobilize domestic savings was courageous, particularly in the face of the negative economic growth and the decline in the standard of living; and it underscored the authorities' determination to come to grips immediately with the problems facing them.

The reliance in the past on external savings, Mr. Jaafar continued, and the rapid domestic inflation had not helped to encourage gross domestic savings and investment. Indeed, consumption had been maintained at the expense of savings and investment, and it would be important in the coming period to keep interest rates at a positive level in real terms in order to encourage savings. The authorities' intention of gradually increasing interest rates was therefore welcome. In the previous several years the monetary sector had been hampered by the existence of an administered credit market, interest subsidies, and special credit programs that had caused distortions and market segmentation which, in turn, had contributed to the inflation by causing excess credit demand and a misallocation of scarce investment resources. The special credit arrangements had been introduced in order, inter alia, to promote agriculture and they would be difficult and painful to dismantle. The recent action to reduce substantially the long-standing subsidies on agricultural bank credit underscored the authorities' determination to overcome the problems facing the economy. The recent moves to liberalize the economy should help to eliminate the costly subsidies and distortions that had characterized nearly every sector of economic activity for a number of years. However, the liberalization effort should be implemented cautiously.

At the present stage, Mr. Jaafar continued, priority should be given to achieving external balance as soon as possible. Policies designed to liberalize imports were desirable but, in the short run, could worsen the trade position and therefore be counterproductive. Hence, he agreed with the authorities' decision to liberalize domestic price and administrative restrictions in the first year of the proposed arrangement, but to remove the external restrictions only when short-term stability had been achieved.

The key to achieving a more viable external position was to improve the performance of exports, Mr. Jaafar considered, and the staff had rightly stressed the need to improve export competitiveness. The high rate of domestic inflation and the exchange value of the cruzeiro played an important role in the trade performance. Rapid inflation had traditionally been a feature of the Brazilian economy, and the authorities' determination to maintain tight fiscal and monetary policies specifically to contain inflation was welcome, although the continued practice of indexation made it difficult to reduce inflation to a more realistic level. The objective under the proposed program of reducing the rate of inflation from 100 per cent in 1982 to 70 per cent in 1983 and 20 per cent in 1985 was obviously appropriate.

The authorities' intention to maintain a flexible exchange rate policy, including a gradual further depreciation of the cruzeiro, was welcome, Mr. Jaafar continued, although the complex relationship between domestic prices, the exchange rate, and domestic policies was a cause for concern. The economic situation in Brazil would continue to be difficult if the administered depreciation was accompanied by inflationary expectations.

In the longer run, Mr. Jaafar went on, if the export sector was to take full advantage of the devaluation, its productivity and efficiency would have to be increased. It was clear that the prospects for economic growth for Brazil in the immediate future would be constrained by the external sector, and the authorities had cooperated with the Fund in their effort to restore external balance and to make progress on the energy front. The authorities had adopted long-term policies to reduce the country's dependence on oil imports. Brazil had considerable potential hydropower and other energy resources, and the Government's objective of significantly reducing the country's dependence on foreign energy supplies by 1985 should be encouraged. The recent softening of the international petroleum price should significantly reduce Brazil's adjustment burden in the immediate future, but much would also depend on the pace of the world economic recovery and developments in the international capital markets.

According to the staff projections, Mr. Jaafar noted, Brazil's external current account deficit in 1983 would be approximately $13 billion and external debt approximately $85-90 billion. Those figures, which were large in both relative and absolute terms, clearly suggested that structural adjustment in Brazil would take some time. Much had already been done, but a substantial amount of additional external financing would be required. Brazil's track record of economic growth and development was excellent, and it clearly deserved support for its adjustment effort. Recent information suggested that the original projection for the rate of inflation in the first half of 1983 had been somewhat optimistic. The authorities had given the staff additional assurances that they would act to compensate for the subsidy that would be given with a higher rate of inflation in the first half of 1983.

It would be quite difficult to raise the rate on agricultural credits above 65 per cent in the first half of 1983, Mr. Jaafar remarked; there were thousands of individual credit contracts between borrowers and the banks, and a number of legal questions would have to be dealt with. However, because of the seasonality of the demand for agricultural credit, only about 25 per cent would be taken up in the first half of 1983, at an interest rate of 65 per cent. The bulk of the credit would probably be extended in the second half of 1983, when the interest rate could be increased. The share of total credit provided at subsidized rates had been scaled down in the previous year. Only small-scale farmers had access to subsidized credit for all their needs. Medium- and large-scale farmers could satisfy only a portion of their credit needs at subsidized rates; the rest had to be obtained at the going market rate. In any event, the agricultural subsidy had no direct fiscal effect, as it was absorbed by the monetary authorities. Hence, the subsidy took the form of an inflationary increase in the money supply rather than a direct fiscal outlay.

There were a number of causes for concern on the various economic policy fronts, Mr. Jaafar considered. The autonomy of the state enterprises had considerably reduced the ability of the Central Government to control the federal budget, and the recent efforts to streamline the budgetary process were welcome. In the monetary area, the authorities had maintained widespread credit subsidies, and until recently the Bank of Brazil had had a free hand to expand credit. The Government's intention of limiting the Bank of Brazil's role in credit expansion was welcome, but the recent lowering of the legal reserve requirement was contrary to the stated policy of monetary restraint and was likely to undermine the effort to achieve the targets for the external sector.

There was an obvious need for a substantial increase in domestic savings, Mr. Jaafar went on. Under the proposed program, gross domestic savings were to increase by the equivalent of 5.5 per cent of GDP in 1983-85, a goal that, given the 3.5 per cent decline in savings projected for 1983 and the low rate of projected economic growth, might not be attainable. It would therefore be important for the authorities to take additional steps to promote savings.

The authorities had already modified the wage formula, Mr. Jaafar noted, but the change might prove to be inadequate, as the formula was still linked to the cost of living index. The return to a system of free collective bargaining should mitigate the problems caused by large wage increases and the rapid rate of inflation. As some previous speakers had stressed, the modified indexation system should take into account changes in the terms of trade. Ideally, Brazil should move in the direction of relating wages to productivity increases, in part to promote the profitability of industries. On balance, however, the proposed program included strong adjustment measures, a number of which had already been implemented. The draft decisions were fully acceptable.

Mr. Abiad considered that Brazil had established a clear case for adopting an adjustment program supported by the Fund. The authorities' intention of reorienting their policies toward domestic, rather than foreign, savings as the basis for future economic development was particularly important.

The extensive reliance on foreign capital and technology had been the main feature of Brazil's economic policy stance since the mid-1960s, Mr. Abiad went on. The expansion of the productive base and the improvement in the standard of living had been impressive, but the continued successful use of capital inflows had been undermined by the increasing uncertainties and deepening recession in the world economy. In the past few years the authorities had realized the inherent limitations on their economic policy stance, and the problems had become so difficult in 1981 and 1982 that a fundamental policy shift had obviously become necessary. It was important to remember that the Fund had maintained close contact with Brazil through regular half-yearly missions during the previous decade. He wondered whether the Fund could not have done more to encourage an earlier shift in the authorities' economic policy strategy.

The deep-rooted and complex task of shifting from reliance on foreign savings to reliance on domestic savings, Mr. Abiad said, was to be supported by a multifaceted approach that was to go beyond demand management. The recent additional exchange rate measures underlined the authorities' ability to take bold actions in the face of significant setbacks. However, previous speakers had usefully noted the staff's conclusion that, in the present world economic circumstances, it was not clear what effect the maxidevaluation would have on the volume of Brazilian exports in 1983. The potential risk of comparable devaluations by Brazil's trading competitors should also be borne in mind. Still, it was also important to note that the exchange measures had been supplemented by some further tightening of fiscal and monetary policies, thereby increasing the likelihood that the devaluation would have a positive effect on the economy.

He looked forward to hearing the staff's responses to the various questions that had been posed concerning the possible impact of a decrease in oil prices on the balance of payments projections and Brazil's investment policies, Mr. Abiad remarked. Had the staff attempted to assess the potential effects of an oil price decline, if it proved to be durable, on Brazil's investments in the development of alternative energy sources? Finally, the proposed purchase under the compensatory financing facility met all the relevant criteria, and his chair had no difficulty in supporting the draft decisions.

The staff representative from the Western Hemisphere Department remarked that the money market lines in connection with Project 4 had not been particularly stable. Their availability had depended significantly on the confidence of the international banking community in Brazil. It was the nature of such short-term credit lines to fluctuate, and the authorities hoped that, with the completion of negotiations on Projects 1, 2, and 3, confidence would be restored as the new program was being implemented. Indeed, money had started flowing back into Brazil in recent days, and there was reason to hope that, although the lines might not be restored to earlier levels, they might well reach a level that was adequate for liquidity purposes.

The relatively large increase in foreign borrowing by the state enterprises projected for 1983 was not based on the assumption that the financial situation of the enterprises would deteriorate, the staff representative explained. Rather, it reflected a shift in foreign borrowing from the private sector to the enterprises receiving the loans. As foreign financial markets had been drying up for Brazilian borrowers, the few loans that were still obtained had been increasingly concentrated in the hands of official borrowers. In 1983, the private sector in Brazil would have greater access to domestic bank financing than in recent years, while most of the foreign financing that was to be undertaken in 1983 would be for state enterprises.

The staff had been asked, the staff representative recalled, whether it felt that the gap between the revenues and expenditures of the state enterprises was substantial. In examining the relevant data, Executive Directors should bear in mind that the Treasury transfers--of the order of 3.5 per cent of GDP--were to be made to a number of state enterprises that, by their very nature, did not have revenues of their own and were therefore practically an arm of the Central Government. The revenues of the state enterprises together with the transfers from the Treasury gave a much different picture of the situation than the revenues of the state enterprises alone. When the revenues of the state enterprises and the Treasury transfers were taken together, the financing requirement of the state enterprises was projected to decline from 5.7 per cent of GDP in 1982 to 3.6 per cent in 1983.

The interest rate on agricultural credit was expected to increase in the first six months of 1983 to an annual rate of 65 per cent in nominal terms, compared with 45 per cent for all of 1982, the staff representative commented. Prior to the maxidevaluation, it had been assumed that the rate of inflation would fall to 70 per cent by the end of 1983 and that interest rates on agricultural credit would increase further in the second half of 1983, thereby eliminating the subsidy on agricultural credit by the end of the year.

The question had been raised, the staff representative recalled, whether an increase in the interest rate on agricultural loans would not have an adverse effect on farm output. Presumably, agricultural prices would be allowed to increase in response to a rise in the cost of agricultural credit. Much would then depend on the price elasticity of demand for agricultural output rather than on production incentives.

The staff was confident, the staff representative said, that the present wage restraint was adequate and would be maintained. Acting on authority invested in him by the Congress, the President of Brazil had recently decreed a modification in wage policy, and there would be no need for the Congress to approve the change when it reconvened in March 1983.

The Congress could conceivably decide to take its own initiative in the wage legislation field, but it was too early to say whether that was likely to happen.

The authorities were clearly inclined to cut expenditures wherever possible, the staff representative commented. With the change in the wage law, and despite the effects of the maxidevaluation, the ceiling on the wage bill was not likely to be exceeded. The average wage was estimated to decline in 1983 by 2.5 per cent in real terms. Although the limit on the wage bill of the state enterprises was no longer in effect, the new wage law would in itself ensure a smaller wage bill than would have been permitted under the old ceiling. In any case, the authorities had indicated that, if necessary, they would make further cuts in expenditure in general, and in investment expenditure in particular. Of course, a decline in public investment was not a welcome development, but the authorities were certainly determined to take the necessary steps to restrain expenditure.

The authorities were fully aware, the staff representative said, that in order to make the needed change in relative prices they would have to keep wages from being fully adjusted for increases in domestic prices. That would be a difficult task, particularly in the wake of the devaluation and the acceleration of inflation, and the authorities would have to steer a careful course. They were exploring possible ways and means of achieving the needed change in relative prices.

Before the devaluation, the staff representative continued, the policy had been to depreciate the exchange rate by 1 per cent a month over the rate of domestic inflation. In the wake of the devaluation, the rate of depreciation of the cruzeiro would be moved in line with the rate of domestic inflation.

The balance of payments projections had not been revised in the light of the devaluation and the recent movements in oil prices, the staff representative commented. It was, of course, possible to calculate the effect of price variations on Brazil's net oil import bill, after taking into account the fact that Brazil was also an exporter of crude oil and petroleum derivatives. Such calculations suggested that a change of $1 a barrel in the international price of oil could have an effect of $225 million a year on Brazil's oil bill. However, a number of factors made such a quantification less than fully reliable. For instance, because of existing contracts, there was inevitably some delay before a decline in the world price of oil became effective for Brazil. It was also important to note that the authorities were making every effort to obtain more favorable terms on the financing of oil imports, which might limit the decline in oil import unit prices. Hence, the staff thought that it was best not to revise its earlier projections, and to that extent the oil import bill projected by the staff for 1983 might contain a safety margin.

Any reduction in export taxes, the staff representative remarked, could be offset by other taxation measures, or by adjustments of prices in the public sector. The authorities were also planning to improve tax administration and possibly to increase their spending austerity.

Most private savings, particularly those in passbook accounts, the staff representative explained, were protected against inflation; for instance, passbook savings were adjusted by monetary correction (based on the rate of inflation) plus 6 per cent. The nominal interest rate in 1982 on passbook accounts had been 112 per cent, compared with an inflation rate of 100 per cent. There was greater flexibility in the establishment of interest rates on term deposits, most of which were held by the larger corporations. The market in those accounts was fairly free, and the interest rates fluctuated from week to week, reflecting the liquidity needs of the banking system. It was difficult to say how interest rates would behave in the coming period. However, a reduction in interest rate subsidies--such as to agriculture--would lessen the cost of bank operations, thereby enabling the banks to offer higher interest rates on term deposits and to reduce rates on industrial and commercial loans.

It also was difficult to say at the present stage how the balance of payments deficit in 1984 was likely to be financed, the staff representative said. The authorities strongly hoped that, with the support of commercial banks and the implementation of the extended arrangement, confidence--which was crucial for Brazil's access to international financial markets--would grow, and financing would be available in the form of direct investment, other long-term capital, and short-term lines of credit.

As a result of the large devaluation and the continuation of the system of small devaluations, the staff representative remarked, the pressure to maintain high domestic rates of interest would be lessened. The previous policy of a monthly devaluation by 1.5 per cent above the rate of inflation, and the need for an interest differential to attract foreign funds, had implied a high level of domestic interest rates. The development of future domestic interest rates would also depend to an important extent on the steps that were to be taken to liberalize and restructure the financial system. As long as a large portion of total credit involved substantial subsidies to agriculture, commercial and industrial credit would continue to be available only at very high rates of interest. Such high rates were likely to continue in the first half of 1983 and should not be resisted in the light of the renewed acceleration of inflation. It would probably take several months before inflationary expectations weakened and the public became convinced that the rate of inflation was declining, a development that would have important implications for the level of interest rates.

The staff and management had clearly expressed their feeling that the effects of the devaluation must be passed on to domestic prices in order to protect the country's competitive position, the staff representative said, and the staff would of course closely monitor developments in that area and report on them at the time of the next mid-term review. The decision to pass the devaluation effect on to domestic prices was essentially a political one that would not be popular with the public, and much would depend on the authorities' determination to act.

The devaluation had been designed to help the balance of payments, rather than the fiscal position, the staff representative explained. Therefore, the new export taxes were meant to be temporary. The authorities hoped that the provision of appropriate fiscal incentives, together with the restoration of confidence in the Government's policy stance, would encourage the conversion of financial loans into direct investment.

The recent legislative changes and revised inflation projection would affect significantly the projection for real wages in 1983, the staff representative commented. Real wages had initially been expected to rise by 2-5 per cent in 1983. The new formula, with a different inflation assumption, suggested that real wages would fall by some 2.5 per cent, in general, and at a faster rate in the central administration, where the previously decreed average nominal increase of 65 per cent for 1983 was to be adhered to despite the projected acceleration of inflation; as a result, the decline in wages in the central administration was likely to approximate 18 per cent.

Given the many uncertainties about likely economic developments in Brazil, the staff representative said, it would be difficult to make realistic estimates for the public sector accounts in 1984 and 1985. It seemed best to suggest an appropriate framework for the desired overall results without trying to disaggregate it into the various revenue and expenditure components. Public sector developments would clearly have to be followed closely, and during the mid-term review the staff would assess the latest developments in 1983 and attempt to describe the likely developments in 1984 and, possibly, 1985.

It was true, the staff representative remarked, that expressing the monetary ceilings in terms of flows rather than in terms of stocks would have had certain advantages. However, actual data for the end of 1982 were now available, and the conventional method of expressing the ceilings in terms of stocks seemed to be the best solution. As a rule, the staff had no strong preference for expressing ceilings in terms of stocks rather than flows.

It was too early to say what would happen to state enterprise investments beyond 1983, the staff representative commented. The need for adjustment in 1983 was so substantial that it could not be accomplished through an increase in savings alone; some decline in investment needed to take place particularly among the state enterprises, which had undertaken most of the investment effort in the past. In the process of streamlining the public sector, some 100 state enterprises had already been eliminated, leaving approximately 530 others; an additional 80 enterprises were scheduled to be eliminated in the future. The authorities were also re-evaluating their investment priorities. In the energy field, for example, the authorities had taken the politically difficult decision to considerably slow the pace of nuclear development, as there was already an excess supply of hydroelectricity.

A number of different figures on Brazil's national debt had been reported in recent months, the staff representative remarked. The figures in the staff report were the official ones, and the staff had full confidence in them. Other figures that Executive Directors had mentioned might reflect the obligations that some Brazilian agency banks abroad had to other banks; the debt of agency banks abroad was not a part of the national debt, because such banks were nonresident banks and were therefore treated in the same way as other foreign banks for the purpose of the compilation of balance of payments statistics.

The relatively large debt service estimated for 1986 and 1987, the staff representative explained, was due to the repurchases that would have to be made under the extended arrangement, and to the end of the grace period of the jumbo loan under Project 1.

Commenting on the authorities' fuel price policy, the staff representative said that after passing through to domestic prices the effect of the maxidevaluation, the authorities intended to continue to encourage changes in the relative prices of fuels. As a result, there would be further increases in real terms in domestic fuel prices, with the prices of diesel, cooking gas, and some other fuel prices rising somewhat faster than the price of gasoline. Fuel prices would not necessarily rise immediately by the full amount of the 30 per cent devaluation, because the import component was less than the full price; the domestic taxes on fuels were substantial. At end-1982, the prices of gasoline and diesel fuel in Brazil were equivalent to $2.50 and $1.50 a gallon, respectively. It was therefore clear that oil products were priced in accordance with costs.

The staff did not yet know precisely which tax measures the authorities intended to introduce in 1984, the staff representative commented. Much would depend upon the tax reform study, the performance of revenues in 1983, the type of expenditure control that was chosen, and the schedule of the reduction in the export taxes.

On the export side, the staff representative explained, the disappointing trade performance in January 1983 had been due to the unusually long holiday season and to the fact that no major agricultural crops had reached the market in time to be covered by the January trade report. In addition, at that time there had been a growing feeling among exporters that a large devaluation was likely to occur, and exporters had probably wished to withhold exports for a while. On the import side, there had been some rebuilding of oil stocks in the wake of the rapid depletion of those stocks in 1982 following the deterioration in the balance of payments. As for the outlook for the balance of payments in 1984, it was assumed that domestic oil production would continue growing at a rate in excess of 20 per cent, and that an overall balance of payments surplus would be recorded. In making its projections the staff had sought to avoid both excessive optimism and pessimism. As had been suggested, the staff would take into account recent changes in the external situation in its mid-term review.

The staff's projection of a 10 per cent decline in the government wage bill, the staff representative explained, provided a margin to cover the possibility that the authorities might be unable to keep wage increases within the 65 per cent target, particularly in view of the projected acceleration of inflation. Given the assurances that the Managing Director had recently received, the decline in the government wage bill might well be larger than was assumed in the staff reports.

The staff had not yet had a chance to assess the impact of the decline in international oil prices on alternative energy sources in Brazil, the staff representative from the Western Hemisphere Department remarked. The World Bank staff, which had just returned from Brazil after examining the Government's investment program, was expected to look into the matter in the near future.

The Deputy Director of the Exchange and Trade Relations Department said that the staff did not consider the devaluation to be excessive. The staff had originally anticipated that the authorities would effect a monthly change in the exchange rate of 1 per cent in real terms. The devaluation had gone beyond the original program, which had been designed to restore fully Brazil's competitive position in 1984. As a result, the devaluation had clearly strengthened the authorities' program; it would certainly help the authorities to achieve the external targets for 1983. In comparing the devaluation with the exchange rate policy under the original program, Executive Directors should bear in mind that the financial imbalances in 1982--including both the budget and the balance of payments--had been larger than the authorities had originally estimated. The speculation against the cruzeiro that had been evident after the unexpectedly unfavorable January 1983 trade results had suggested the need for an accelerated adjustment effort, including the devaluation. Chart 3 in EBS/83/33 showed that the cruzeiro had appreciated in real terms in 1982 by about 10 per cent against the currencies of Brazil's export market countries. The devaluation meant that the cruzeiro had depreciated by a net 20 per cent against those export market currencies, taking 1982 into account. However, as Chart 3 showed, the 20 per cent net depreciation was calculated on a base of December 1978, some 12 months before the previous large devaluation of the cruzeiro. A comparison of the devaluations in December 1979 and in 1983 indicated that the cruzeiro was somewhat appreciated compared with the period after the 1979 maxi-devaluation.

The latest devaluation should also be seen in the context of the various multiple currency practices and external restrictions maintained by Brazil, the Deputy Director said. On the export side, the authorities had introduced an 11 per cent export tax credit. On the import side, there was a 25 per cent financial transactions tax. The competitive position of the cruzeiro might well have to be bolstered by periodic mini-devaluations if the external restrictions were to be eliminated, and the external current account was to be strengthened, during the program period. In that connection, the system of tight import controls should also be borne in mind.

The staff, like a number of Executive Directors, was somewhat disappointed with the pace of the liberalization of Brazil's trade and payments system, the Deputy Director remarked. Paragraph 6 of the Technical Memorandum of Understanding indicated that the liberalization in 1983 would be minimal. As Executive Directors had stressed, the system of temporary export taxes would have to be liberalized and should not be seen as a permanent source of revenue. It was true that the authorities had made the basic commitment to eliminate all restrictions within the program period, and in assessing the pace of liberalization the staff had concluded that the scale of the adjustment of the budget and the balance of payments required the support of all available measures. Hence, the staff had not given high priority in the short run to liberalization. On the other hand, if the internal and external imbalances were reduced in the coming months, as was expected, and calm returned to the financial markets, significant liberalization would be expected. The first review under the proposed program would provide a good opportunity to assess the room for liberalization.

The staff reports did not contain the usual appendix describing the World Bank's relations with Brazil, the Deputy Director remarked, but the Fund's collaboration with the World Bank was described on page 30 of EBS/83/33. A World Bank mission had recently visited Brazil, and the Bank planned to increase its lending to Brazil from $600 million in 1982 to $1.2 billion in 1983. The Fund staff would maintain close contact with the World Bank staff in the coming period.

The proposed phasing of the Fund's assistance might appear to be front-loaded, the Deputy Director of the Exchange and Trade Relations Department commented. However, the initial purchases would be in terms of the compensatory financing facility and the first credit tranche. The phasing had taken account of the likely availability to Brazil of other resources, including the large amounts to be lent by commercial banks.

The staff representative from the Research Department remarked that EBS/83/38, Supplement 1 contained actual data for the entire shortfall year. Hence, there was no risk of overcompensation under the proposed compensatory financing.

Mr. Dallara noted that Executive Directors seemed agreed on the importance of permitting the effects of the devaluation to be passed through to domestic prices, and of ensuring that the effects were not reflected in the system of wage indexing. In that connection, the commitments and assurance of the authorities were particularly important, and the Executive Board should be informed at an early stage of developments prior to the mid-term review, if only because of the difficulties that might arise if implementation was not full and timely.

Mr. Kafka commented that the financing of the external deficit in 1984 should not prove to be difficult if world economic conditions did not further deteriorate. The net borrowing requirement was expected to be the equivalent of just 1.5 per cent of GDP, and, therefore, the increase in public sector indebtedness to the banking system should be some 6 per cent, compared with 8 per cent in 1982 and 20 per cent in 1981.

The tendency to measure debt service in terms of the relationship between interest and amortization to exports was regrettable, Mr. Kafka said. The ratio of interest to GDP was a much more useful measurement and, on that basis, Brazil's debt service ratio was only about 3 per cent and was expected to decline steadily to about 2 per cent in 1987. Even on the basis of the traditional measurement, the debt service ratio was expected to decline in 1985, rise by an almost negligible amount in 1986, and fall again in 1987.

The staff's assessment of the effect on Brazil of the decline in international oil prices was somewhat excessively cautious, Mr. Kafka considered. The authorities intended to take full advantage of the decline.

Commenting on the geographical distribution of exports, Mr. Kafka noted that Table 63 in SM/83/33 showed that, with the exception of 1981, when the distribution had been significantly affected by the recession in the industrial countries, the figures had not significantly changed. Exports to member countries of the Council for Mutual Economic Assistance (CMEA) in 1980 had been 6.4 per cent of total exports, compared with 7.1 per cent in 1977. The only major increase in exports had been to Latin America, a change that had caused certain problems that the authorities were in the process of solving.

Some Executive Directors apparently felt that the public sector borrowing requirement was excessive. It was important to bear in mind, however, that the borrowing of the public sector reflected that of the state enterprises, whose borrowing was in effect no different from borrowing by a major private corporation. Of course, such a corporation would not be expected to invest only its retained earnings, and a large borrowing requirement in relation to the corporation's income or capital would not be surprising. A similar situation arose when the state ran a large number of enterprises.

Liberalization of the interest subsidy on agricultural credit would have to be undertaken carefully, Mr. Kafka considered, but it had become burdensome, and the reduction would have to be achieved. There was ample scope for such an adjustment.

The question had been raised, Mr. Kafka recalled, whether it was appropriate to reduce overall interest rates at a time when the authorities were attempting to maintain a restrictive program. In the period before the devaluation, the floor on real interest rates had been 36 per cent. Hence, there was ample room in which to lower real interest rates without reaching nonrestrictive levels.

It was incorrect to assume that the compulsory deposits of banks had been lowered from 45 per cent to 35 per cent, Mr. Kafka explained. When the authorities had introduced the 45 per cent requirement, they had stated that it was expected to expire at the end of December 1982. They had subsequently decided that the requirement should be reduced to 35 per cent, but only on the condition that specific use would be made of the difference, namely, the purchase of debentures, which would of course relieve the debenture-issuing firms of the need to press the banks for additional credit.

Under the new wage legislation, the average compulsory adjustment of wages was to be 90 per cent, rather than 100 per cent, Mr. Kafka commented. The 90 per cent adjustment was in theory compatible with a 10 per cent reduction a year in the rate of inflation. Any increase in productivity was accounted for separately. It was useful to note that employment practices were characterized in part by a form of turnover; workers were often laid off by one firm and hired by a second firm at a lower wage rate, as the firms sought to escape the effects of the compulsory wage adjustments. The side effect of the system could be to reduce productivity, but it had also encouraged workers to increase efficiency in order to maintain their attactiveness to their employers even if in the end not all retained their jobs.

The devaluation had greatly improved the chances for recording a positive rate of economic growth in 1983 through an increase in exports, Mr. Kafka said, and he was somewhat disappointed by the skepticism that Executive Directors had expressed about the proposed phasing and likely implementation of the proposed program. After all, there had rarely, if ever, been a proposed program that had been supported by the implementation of so many significant measures even before the negotiations on the program had begun. In addition, he had been somewhat surprised by the suggestion that the mid-term review would result in a full-scale change in policy in Brazil. The purpose of any such review was to ensure that the program was being implemented. Finally, the shift in the attitude of the Brazilian economic team had been a response to the realities of the economic situation in Brazil. Until August 1982 the authorities had been able to borrow some $1.5 billion a month with no major difficulty. When the access to the markets had been shut off, the authorities had immediately adapted to the new realities.

The Chairman remarked that a number of different individuals and institutions had played a critical role in assisting Brazil in the present difficult circumstances. The authorities had adopted a number of courageous measures, and the commercial banks and the Fund staff and management had worked together to secure the necessary external financing. The staff's role had been crucial. The staff had had little time to conduct the necessary negotiations and complete the related reports, and staff members had made considerable personal sacrifices in completing the tasks on time. The work of the staff in the present case was typical of the hard work and personal sacrifice that staff members made in the performance of their duties. In the case of Brazil, Mr. Kafka had also played an instrumental role.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal contained in the staff report for the 1982 Article IV consultation with Brazil. They noted that the much-reduced access of Brazil to international financial markets in late 1982 had called for a fundamental change in economic policies in order to reduce the deficit on current account of the balance of payments to a more sustainable level.

Directors welcomed the decision of the Brazilian authorities to adopt an economic program whose chief objective is to raise domestic savings substantially, particularly in the public sector, thereby reducing the reliance on foreign savings. They noted that the ambitious external targets set for 1983 and beyond will require not only a sustained effort by Brazil, but also substantial financial cooperation from the international community, particularly the banks.

Directors emphasized that under present circumstances the viability of any economic program for Brazil was dependent upon the country being able to secure new loans, to roll over amortization of debts falling due, and to maintain adequate access to international money markets. In view of the current uncertainty in the international credit markets, and in order to restore confidence of investors, Directors believed that it was critically important that the successful implementation of the program become visible as soon as possible during the first year of the program. At the same time, Directors noted the potentially favorable impact on Brazil's current account of the recent downward trend in international interest rates and in oil prices, as well as of the recent major devaluation. But such favorable developments should not lead to any premature relaxation of Brazil's adjustment efforts.

Directors emphasized the need to strengthen substantially public sector savings and, in the process, to improve the efficiency of the public sector. They noted that the fiscal targets contained in the program were demanding. Nevertheless, as projected, the public sector borrowing requirement at the end of the first year of the program would still be equivalent to 8.8 per cent of GDP, and additional public sector savings would have to be generated in the second and third years of the program. Directors stressed that achieving the 1983 fiscal targets would depend to an important extent on the application of a tight control over public sector spending. Directors also stressed the need for a continuous monitoring of the behavior of public sector finances in order to be in a position to take timely corrective action if necessary.

It was underscored that it would be appropriate and necessary for Brazil to undertake basic reforms of its tax system, in order to increase its elasticity with respect to growth of GNP. Directors also emphasized the need for structural improvements in the operation and the financial position of state enterprises during the course of the program. In this connection, they welcomed the strengthening of the pricing policies of these enterprises.

Directors noted the aim of the authorities to tighten monetary policy in 1983. They welcomed the intention to increase interest rates on loans to agriculture and cautioned against delays in implementing this measure. Directors noted the understanding with the authorities that the implicit additional subsidy to agricultural credit that is likely to arise in the first half of 1983 will be offset by a higher rate of interest on these loans in the second half of 1983. Two Directors suggested, however, that particular care be taken when determining the extent of such an increase. Directors urged a speedy reform of the financial system, leading to a reduction in credit subsidies in general. Such a development, coupled with the exchange rate action, should help to reduce real rates of interest applicable to nonsubsidized credit operations. The point was made that financial deregulation should be examined in detail during the midyear review of the program. Several Directors expressed concern over recent indications of a weakening in certain aspects of monetary policy and urged the authorities to hold to a course of tight monetary policy, particularly with respect to interest rate policy.

Directors recognized that the recent modification of the official wage formula represented a particularly difficult policy decision on the part of the authorities. A number of Directors pointed out that this change in the formula made a much-needed contribution to the process of adjustment. They noted that the modified wage formula was expected to result in an evolution in wages that would help to promote growth, output, and adjustment, and that the authorities were determined not to change the rate of increase of nominal wages that had been decreed for the central administration prior to the devaluation. Directors welcomed the authorities' intention to work toward a return to a system in which wages would be determined by collective bargaining.

Directors expressed much concern about the persistence of high rates of inflation in Brazil. They referred favorably to the new wage policy, together with the more restrictive stance that was planned for demand policies, but, taking into account the recent exchange rate action, several Directors were somewhat doubtful regarding the likelihood of achieving the inflation targets of the program. They pointed out that a rapid reduction in inflation would clearly help set the stage for a return to a more sustainable growth pattern in the future.

Directors underscored the significant changes in pricing policies made by the Brazilian authorities with the aim of improving the allocation of resources. In this regard, Directors considered it essential that the cost of the recent major currency devaluation needed to be passed fully through to prices within a very short period. Indexation should not be an obstacle to bringing about a necessary change in relative prices; they welcomed the recent clarification of these policy aspects by the authorities. They suggested that the Board be kept informed of the developments and progress in these fields in the coming weeks.

Directors noted the major exchange rate action recently undertaken by the Brazilian authorities, as well as their intention to continue with the policy of small and frequent adjustments of the exchange rate in line with domestic inflation. These actions should suffice to preserve the competitiveness of Brazilian exports and create the conditions for the early elimination of restrictive exchange measures and export subsidies in the future. A number of Directors welcomed the authorities' intention to eliminate a number of exchange restrictions and multiple currency practices during the first year of the arrangement, and they urged that all remaining exchange restrictions be removed as soon as the improvement in Brazil's external position permits. In the light of the recent devaluation, several Directors urged the authorities to engage in an early liberalization of trade and exchange restrictions. They considered that the first review of the program should provide an opportunity to review the progress in this field.

In conclusion, Directors emphasized the importance of the Brazilian program not only for the country itself but also for the international financial system. They welcomed the authorities' determination to take substantial and timely action and stressed the need for a thorough and unwavering implementation of the economic program, which should be monitored closely by the Fund. They urged the cooperation of the international community in support of this program and hoped that the world economic recovery would adequately support Brazil in achieving its economic objectives.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Brazil's exchange measures subject to Article VIII, Sections 2 and 3, and, in concluding the 1982 Article XIV consultation with Brazil, in the light of the 1982 Article IV consultation with Brazil conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund urges Brazil to eliminate at the earliest possible date the tax on certain industrial exports to a Fund member. In view of the circumstances of Brazil, the Fund grants approval of the multiple currency practices and exchange restrictions that are described under points 1, 2, and 3 on page 13 in EBS/83/33, Supplement 1 (2/24/83) until August 30, 1983, or the completion of the first review under the extended arrangement, whichever is earlier.

Decision No. 7350-(83/41), adopted
February 28, 1983

Extended Arrangement

1. The Government of Brazil has requested an extended arrangement for a period of three years from March 1, 1983 for an amount equivalent to SDR 4,239.375 million.

2. The Fund approves the extended arrangement attached to EBS/83/33, Supplement 1.

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

Decision No. 7351-(83/41), adopted
February 28, 1983

Purchase Transaction - First Credit Tranche

1. Brazil has requested a purchase equivalent to SDR 249.375 million, which is the amount equivalent to its first credit tranche.

2. The Fund approves the requested purchase.

Decision No. 7352-(83/41), adopted
February 28, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Brazil for a purchase of SDR 466.25 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

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

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

Decision No. 7353-(83/41), adopted
February 28, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/40 (2/28/83) and EBM/83/41 (2/28/83).

2. TRINIDAD AND TOBAGO - TECHNICAL ASSISTANCE

In response to a request by the Trinidad and Tobago authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/83/47 (2/23/83).

Adopted February 28, 1983

3. RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the GATT consultations with Hungary, to be held in Geneva, as set forth in EBD/83/50 (2/23/83).

Adopted February 28, 1983

APPROVED: August 10, 1983

JOSEPH W. LANG, JR.
Acting Secretary