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J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
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J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
	C. J. Batliwalla, Temporary
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
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	E. A. Ajayi, Temporary
M. A. Senior	J. L. Feito
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	

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

Also Present

Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila. Research Department: R. R. Rhomberg, Deputy Director. Treasurer's Department: D. S. Cutler. Western Hemisphere Department: S. T. Beza, Associate Director; H. Ghesquiere, A. M. Jul. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: J. R. N. Almeida, S. El-Khouri, K. A. Hansen. H.-S. Lee, Y. Okubo, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. Bernardo, L. E. J. M. Coene, R. J. J. Costa, M. Eran, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, C. M. Hull, H. Kobayashi, P. Leeahtam, G. W. K. Pickering, M. Rasyid, A. S. Scholten, S. Sornyanyontr, Wang C. Y.

1. BRAZIL - CONSULTATION UNDER EXTENDED ARRANGEMENT, AND REQUEST FOR WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors, meeting in restricted session, held a preliminary informal exchange of views on Brazil. They had before them a staff paper on the consultation under the extended arrangement for Brazil, together with Brazil's request for a waiver and modification of performance criteria (EBS/83/227, 10/19/83), and a supplementary letter of intent dated November 14, 1983 from the Brazilian authorities (EBS/83/227, Sup. 1, 11/15/83).

The Chairman noted that, following extensive discussions with the Brazilian authorities, agreement had been reached on a supplementary letter of intent and a set of policy measures. The essence of the agreement was a substantial tightening of monetary and fiscal policy designed to deal with the strong inflationary pressures resulting from the widespread corrections in relative prices that had been part of the original program.

Beginning in June 1983, the Brazilian authorities had engaged in a major readjustment of prices, the Chairman continued. Since then, they had eliminated completely the subsidies on prices for domestic petroleum and steel and had sharply reduced the subsidies on prices for wheat. Those massive readjustments--which had been necessary to correct a severe misallocation of resources--had produced a cost-push effect in the economy, which was all the more dramatic because of the indexation system in Brazil, and inflation had risen far more rapidly than originally expected. It was widely agreed that the success of the program would depend on a reduction in inflation, which required a tightening of monetary policy.

For 1983, it had been thought that a rate of growth for M-1 of 90 percent would be appropriate and consistent with the initial models, which had assumed a deceleration in the rate of inflation to only 6 percent a month by year-end, the Chairman recalled. Unfortunately, the rate of inflation had increased, and the relationship between the growth of M-1 and the rate of inflation needed to be re-examined. In the circumstances, it was now agreed that, for 1984, the increase in M-1 would be limited to 50 percent. Moreover, recognizing that M-1 was only one element of general liquidity creation, the staff had proposed, and the authorities had agreed, that all interest rates in the economy should be positive in real terms in 1984. It might seem odd that such changes were recognized as necessary only after ten months of the program had elapsed. However, Brazil was a complex economy with a complex financial system; and there were some segments of that system that were protected from market forces. With the implementation of the measures contained in the supplementary letter of intent (EBS/83/227, Sup. 1), those protected pockets would be eliminated. Interest rates in agriculture would be set at market rates, and interest rates on credit for exports would be moved progressively toward market rates. The interest rates on overnight open-market operations, which had unfortunately been strongly negative for the past three or four months, would also be shifted to positive levels.

Monetary correction--a monthly adjustment of financial assets--also had an important role to play in the tightening of monetary policy and the interest rate structure, the Chairman commented. In recent months, monetary correction had been at levels that had been heavily negative in real terms, which had considerably complicated the task of the monetary authorities. Because so many savings instruments were geared to the monetary correction, it had been difficult for the Central Bank to increase interest rates on the money markets or on the overnight open-market operations because such increases would have created great discrepancies between different segments of the savings system. Since all savings banks were geared to monetary correction, there would have been some leakage into the money markets, thus placing in jeopardy the way in which states and municipalities financed their own deficits. It had therefore come to be understood that, in Brazil, it was crucial that monetary correction should be at least in line with inflation, and that understanding had been enshrined in the latest agreement with the Brazilian authorities.

On the fiscal side, the Brazilian authorities had committed themselves to a slight surplus in the operational budget for 1984, compared with a deficit equivalent to 2 7 percent of GDP in 1983, the Chairman observed. Given the slippages on the inflation side, the attainment of such a target would be particularly difficult because of a drift toward more expenditures without a compensating increase in revenues. Nonetheless, the authorities had agreed that the targets would be met.

A tightening of fiscal policy in line with a more stringent monetary policy was necessary to prevent a crowding out of the private sector, the Chairman considered. The staff had made some reasonably precise calculations on the effects of the combination of fiscal and monetary policy on the access to credit by the private sector; in general, while there would be some reduction of real credit to the private sector, it would be limited to about 6 percent.

The changes in policy that had been agreed could be implemented successfully only if a monitoring mechanism was in place, the Chairman remarked. In that regard, a breakthrough had been achieved in July/August of 1983 in creating a "mechanical" relationship between the performance of the various segments of the public sector and the performance under the criteria for the public sector as a whole. The breakthrough had been accomplished through the establishment of monthly limits on access to credit for the municipalities, states, and public sector enterprises. The performance would be monitored by both the Brazilian authorities and the Fund staff so that, if slippages occurred, the staff would be able to draw them to the attention of policymakers with a view to ensuring that the performance criteria were met.

Directors would observe that net domestic asset ceilings and fiscal subceilings had been set only for the first quarter of 1984, the Chairman commented. In an economy where inflation was rising rapidly and where the consequences of relative price restructuring on the rate of inflation were difficult to predict, it would be a mistake to emphasize too precisely the path of disinflation in the economy. If quantitative performance criteria had been set for 1984 as a whole, there might be too much dependence on the inflationary path, which could create an element of uncertainty and might damage the credibility of the program itself. The preferred course in the circumstances was to set ceilings for the first quarter and, on the occasion of the first review, to set the domestic asset ceilings and other performance criteria for the next two quarters. Such flexibility was, of course, subject to the two fundamental policy objectives that had been established for the year as a whole, namely, the limit of a 50 percent increase in M-1 and the target for a surplus in the operational budget.

Despite the ambitious objectives of the program, uncertainties about inflation created uncertainty with respect to the budget figures because of the indexation mechanism, the Chairman noted. It was for that reason that a new wage law had been enacted that would keep wage increases somewhat below the rate of inflation. The wage system under the new law would however be more indexed than had earlier been hoped, and the staff had therefore made a study of the likely effects of the new system to see whether additional policy corrections might be needed. The study showed that the consequences of the new system would not be as great as might have been thought; still, a problem persisted in respect of fringe benefits provided to employees in the public enterprises. In that regard, it was understood that Decree-Law 2036--designed to curtail the overly generous system of fringe benefits in the public enterprises--would be reinstated.

Commenting on the effects of the wage law on private sector wages, the Chairman said that enterprises could exceed the guidelines imposed on the public sector; however, they could also offer wage increases that were lower under certain conditions. In general, market conditions and the stringency of monetary policy would be the main determinants of the level of wages in private enterprise.

The Associate Director of the Western Hemisphere Department observed that estimates of the real demand for financial assets in Brazil were not easy to make. Hence, in the three reviews in the course of the coming year, the staff would be carefully examining the evolution of the demand for credit by the private and public sectors with a view to ensuring that private credit would not be squeezed unduly, to the detriment of the recovery of the economy.

On another matter, the intention of the authorities was to continue with the current exchange rate policy, the Associate Director noted. On the occasion of the reviews, however, the staff would seek to ascertain whether competitiveness was being maintained and whether the exchange rate policy was adequate to the objectives of the program.

Mr. Kafka began by mentioning the exceptional role that the Managing Director had played in the Brazilian case. Not only had he supervised the discussions and helped to arrange financing from outside the Fund, but he had also played a direct role in examining with the Brazilian authorities the administrative structure that would make it possible to carry out a difficult program. Using the experience gained as an official in his own country, the Managing Director had taught him and the Brazilian authorities a great deal about the control of state enterprises.

Turning to the program itself, Mr. Kafka remarked that, in addition to facing problems with monetary policy because of the instability in the relationship between the monetary base and prices, the authorities had been obliged to deal with sharply increased prices for foodstuffs because of a poor agricultural year. Those prices had played a large role in the unexpectedly high rate of inflation in Brazil during most of 1983. However, according to the latest index on the behavior of food prices, the first ten days of November were likely to show only a 2.5 percent increase, compared with a 7.5 percent increase in the first ten days of October. It was to be hoped that the lower rate was the beginning of a trend that would help to slow overall inflation in the economy.

With regard to wage policy in Brazil, Mr. Kafka commented that, while the present wage law was weaker than Decree-Law 2045--which the Fund had hoped would be passed--it was stronger than Decree-Law 2012, which had been in force when the extended arrangement had been approved in February 1983. The new law limited wage increases where there was no productivity increase, and it made it possible for enterprises to remain below the mandated percentages if the firms could not bear such increases in wages. Moreover, the law foresaw the phasing out of wage indexing over a period of years.

On the external side, Brazil had experienced large increases in the trade surplus, which had been an additional inflationary factor in 1983, Mr. Kafka continued. The increases had come about mainly through a reduction in imports, but one third represented an increase in exports. For 1984, the further increase in the trade surplus and the reduction in the current account deficit would come about exclusively through an increase in exports; imports, overall, would remain flat. However, as there had been a considerable degree of conservation of energy and substitution in petroleum imports--together with a significant increase in petroleum production in Brazil--nonpetroleum imports would increase by about 16 percent, which should contribute to some growth whi[illegible]g to fight inflation.

Mr. Polak expressed the hope that the further supplement [illegible] EBS/83/227 that would be circulated in advance of the November [illegible] meeting would contain some statistics on important elements of the economy under both the old program and the new program. Comparative figures, for example, on the public sector deficit would be helpful to Directors in analyzing how changes in the deficit would be brought about through changes in current expenditure, investment expenditure, inflation adjustments, changes in taxation, and so on.

There were a number of other differences in the two programs that were also not easily extracted from the staff paper, Mr. Polak continued. On page 8 of EBS/83/227, the staff had made certain assumptions about real wages. While those assumptions were no longer valid, he had been struck by the staff's statement that, on the basis of those assumptions, real wages would decline only marginally, if at all. He wondered whether the statement had been based on some very specific period. In addition, he had difficulty reconciling staff comments on real wages with certain ideas circulating in the press and elsewhere, namely, that wages were not based on the real cost of living index but on some kind of purged index, and that employers used a rotation principle to avoid holding to the real wage level.

Also confusing was the importance of the price controls on 300 commodities, which had been described in the September letter of intent, Mr. Polak commented. Presumably, the purpose of wage controls--which would reduce real wages through partial indexation--was to improve profitability. However, if prices were indexed on the same basis but with some costs--such as raw material costs--not indexed, the net result would be a decline in profitability. Was the explanation that there were no real price controls on the 300 commodities?

Finally, Mr. Polak said, it was remarkable that a country with such a rapid inflation rate would have wage indexation only at half-yearly intervals. It was well known that the period of adjustment was as important as the rate of adjustment in determining inflation; in that regard, he had been surprised to find that the monetary correction for 1984 would be made monthly. He wondered whether that was consistent with the maintenance of half-yearly wage indexation.

Mr. Laske noted that the new wage law in Brazil would apparently provide for a gradual phasing out of wage indexation over a number of years. He wondered whether there had been any discussion with the Brazilian authorities about the possibility of phasing out or discontinuing monetary correction, which had created difficulties with respect to the conduct of monetary policy.

The Associate Director of the Western Hemisphere Department, responding first to Mr. Laske's question, observed that the phasing out of monetary correction would have to be part of a general deindexation, the first step toward which would be the deindexation of wages. However, the matter should perhaps be viewed in a historical context. Monetary correction had been introduced some 18-20 years previously as a way of making interest rates realistic in real terms. Wage indexation had been introduced at the same time as an aid to the deceleration of inflation. Over time, the wage indexation arrangements had ceased to serve the purposes for which they had been introduced, particularly when they had started to provide for more than a 100 percent indexation for some income groups. The problems with indexation systems at present were obvious, and deindexation would require, among other things, the slowing of inflation and the identification of the areas in which to begin a relaxation of the mechanism.

In reply to questions raised by Mr. Polak, the Associate Director noted that the staff's assumption of only a marginal decline in real wages had been based on a specific period; further details would be provided to Mr. Polak outside the meeting. On the price control mechanism and its indexation at 80 percent, he was in agreement with the points made by Mr. Polak. He would only add that, if firms could show justification for higher costs, they could obtain price adjustments. The staff's own preference was that the price control and price surveillance mechanisms should be softened and eventually eliminated.

Mr. Kafka observed that the issue of phasing out monetary correction of securities was even more complicated than had been implied by the Associate Director of the Western Hemisphere Department. A fundamental legal question was involved because any effort to phase out monetary correction would of necessity violate the sanctity of some contracts that were effective over a number of years.

With regard to Mr. Polak's question on half-yearly wage adjustments, Mr. Kafka observed that the law had never prevented firms from offering higher wages than the minimum or making more frequent adjustments, if they could afford it. At present, however, there were few if any firms that could afford to do either. Monetary correction had always been announced on a monthly basis, even though not all items were corrected on a monthly basis. Credit instruments--particularly savings certificates and savings passbooks--had always been corrected monthly.

Mr. Wicks asked how many of the measures in paragraph 5 of the supplementary letter of intent had already been agreed by Congress and how many remained to be agreed. Also, would the decision to move toward positive real interest rates have to be adopted by Congress, or was that a matter that could be taken care of by the Central Bank on its own account?

Mr. Kafka replied that the decision to have positive real interest rates was a matter for the National Monetary Council and did not involve parliamentary approval. The first set of measures under (a) through (g) in paragraph 5 of the supplementary letter of intent had already been passed by Congress; of the three additional measures referred to at the end of paragraph 5, the first required no legislation, the second involved a decree and, subsequently, some legislation, and the third was a matter of discretionary control. Finally, the draft resolution allowing the states to increase the value-added tax would require legislation.

Mr. Polak noted that, if the total government deficit was to be a performance criterion, a problem would arise because the nonoperational part of the public sector deficit was a function of inflation, and it might be difficult to make inflation such a performance criterion.

The Associate Director of the Western Hemisphere Department commented that the staff recognized the problem to which Mr. Polak had referred and had, in effect, attempted to straddle the issue by maintaining the overall deficit as a performance criterion while at the same time stressing the operational deficit. Paragraph 6 of the supplementary letter of intent referred first to the overall deficit and then set, as a performance criterion, a target for the operational deficit through the end of December and for the first quarter of 1984. In countries that did not have indexation systems, where market interest rates resulted in budgetary costs comparable to monetary correction in the case of Brazil, the staff considered the interest outlays as part of the overall deficit and faced the hazards of making the inflation projections that were behind the estimates of such outlays.

Mr. Kafka added that the situation with respect to monetary correction was comparable to what might exist in a system without monetary correction in which there were floating interest rates on the internal public debt, which was practically nonexistent in Brazil. The monetary correction depended on inflation, and, while the Government could control the monetary base, it could not control expectations or, therefore, velocity and prices. It was for that reason that the two budget deficit concepts had been put forward.

Mr. Polak recalled that he had at one time been given an explanation by the staff of why, under an 80 percent indexation mechanism, the real wage would decline only moderately. The staff had suggested that, with a half-yearly wage adjustment in 1983 in response to a rapid rate of inflation, real wages had declined sharply; with less inflation in 1984, they would be unlikely to fall much further. While such a development might well occur in 1984, that specific situation did not justify the general inference that an 80 percent indexation system would not reduce real wages.

The Associate Director of the Western Hemisphere Department replied that he did not regard the indexation system as the determining factor in the path of real wages. If one calculated the wage that would be produced under a given indexation system and then translated the wage calculation into a price change and continued the series, and if one assumed that all wages in the economy were determined by the indexation system, the series would yield the inflation path that the indexation system could produce, provided that it was not disturbed by demand policies. On the assumption that there was less than a 100 percent indexation, it was possible to envisage employment of the same labor force with both prices and wages falling. If demand policies were used to achieve a reduction in inflation that was steeper than might be indicated by the path of wages, some unemployment presumably would result, but those who continued to be employed would have higher real wages.

The Chairman said that he could not fully accept the suggestion by Mr. Kafka that the impact of monetary correction on the budget was the same in Brazil as it would be in a country that financed itself with a floating interest rate on its debt. Monetary correction had two budgetary effects. On the operational side of the budget, it raised the cash to be found in a particular fiscal year to service the interest rate on the debt, because the interest rate was indexed. However, the principal was also indexed, and expanding the nominal value of instruments had an effect on the monetary side of the budget, which was not true in the case where interest rates were floating. In Brazil, the amount of the debt was expanded in line with inflation, which was one of the questionable elements of the mechanism.

Mr. Teijeiro observed that, under the program, there would be two performance criteria for the deficit; one was the operational budget, and the other was the total public sector borrowing. However, the determination of the target for public sector borrowing, which was under the control of the authorities, would implicitly require an inflationary target.

The Chairman agreed that an implicit inflationary path was hidden in the three-month figures that had been provided for the net domestic assets and the fiscal targets. However, there was a great deal of uncertainty about what the actual inflationary path would be in Brazil in 1984. It was clear that the program would be successful only if inflation were broken, and that goal was more important than defining a precise path for inflation in the course of the year.

Mr. Lovato wondered what would happen if the commercial banks were not to commit themselves to the full amount of lending necessary in the Brazilian case.

The Chairman observed that commitments for SDR 5 billion out of a total of SDR 6.5 billion had been received from the commercial banks thus far. The critical amount necessary, as in the Mexican case, was 90 percent of the total if the program was to be brought to the Executive Board. He had indicated those needs to the Advisory Committee of commercial banks and had reminded the Committee that commitments for that amount would be needed in advance of November 22, the date on which the Brazilian request was scheduled for Board consideration. If the needed financial assistance were not forthcoming, there would be no program, a fact that had been made abundantly clear to the commercial bankers and to the sources of official financing for Brazil.

Mr. Laske, referring to paragraph 7 of the supplementary letter of intent, observed that the increase in external indebtedness was to be limited to $2.5 billion in the first quarter of 1984. He would appreciate further clarification from the staff about how it had arrived at that figure.

The Associate Director of the Western Hemisphere Department responded that the staff had taken an estimate for the year as a whole and had adjusted it for seasonal and other factors to arrive at the figure for the first quarter.

Mr. Joyce inquired about the progress toward obtaining additional financing from official sources.

The Chairman commented that management had been working closely with the countries likely to be supplying the needed additional financing, and he had asked the Deputy Managing Director to go to Paris for the meeting of the G-10 Deputies to see whether further clarification could be obtained. In addition, he himself had spoken with Mr. Camdessus, Chairman of the Paris Club, with a view to obtaining the orders of magnitude of assistance that various countries were willing to consider. It was to be hoped that more clarification on official credits to Brazil would be possible by November 17.

Mr. Polak said that it would be helpful if, in the further supplement to EBS/83/227 to be circulated to Executive Directors, a table could be included showing how the balance of payments gap would be financed in 1984 from all sources, including the Fund.

Mr. Zhang remarked that the financing packages being put together for Brazil would obviously mean a net increase in the indebtedness of the country. He wondered what the total addition to Brazil's indebtedness would be over, say, the next five years. Moreover, assuming that interest rates in Brazil would remain at roughly 12 percent, the same level as the projected increase in Brazil's exports, how would Brazil's debt problem ever be solved?

The Associate Director of the Western Hemisphere Department noted that the staff had attempted in Table 9 of EBS/83/227 to show a way out of the debt problem. It had made what it felt were reasonable assumptions about how the situation might develop through 1988 in respect of the current account and the net indebtedness of Brazil. According to the table, the current account deficit would disappear between 1987 and 1988, at which point the country's indebtedness would no longer be growing. Projections beyond the near term were of course subject to great uncertainty, but the staff had attempted to show that there was a way out of the debt problem on the basis of assumptions that were not unreasonable.

The Chairman added that the debt service ratio associated with the table was projected to move from its current level of 45 percent to about 20 percent by 1988. In that respect, what the table was really saying was that Brazil would need a rescheduling of its principal throughout the period and would also need new loans, but that the readjustment foreseen was compatible with a sharp deceleration in the debt servicing costs of the country over the period. The situation would thus be manageable so long as Brazil continued to implement the necessary adjustment policies, creditors made financing possible on reasonable conditions, and exports continued to grow.

The staff representative from the Western Hemisphere Department, in response to a question by Mr. Erb, noted that floating debt with suppliers was included in the financing of the public sector and was also subject to monetary correction.

It was agreed that a further supplement to the staff paper on the consultation under the extended arrangement for Brazil (EBS/83/227, Sup. 2) would be circulated on November 18, 1983. Together with Brazil's request for use of Fund resources under the buffer stock financing facility (EBS/83/228, 10/20/83), it would be placed on the agenda of the Executive Board for discussion on November 22, 1983.

The Executive Directors concluded their discussion, in restricted session, on Brazil at 10:45 a.m.

LEO VAN HOUTVEN
Secretary