

November 12, 1981 - 81/191

Statement by Mr. Kafka on Brazil  
Executive Board Meeting 81/140  
November 13, 1981

1. I should like to thank the staff for their excellent papers. The Brazilian authorities are in broad agreement with the views expressed by the staff. Perhaps more important, they have again appreciated and benefited from the completely frank discussions on past policies and future plans with an outstanding team of objective technicians which these periodic consultations afford them.
2. There is no question that there has been a basic turn around in Brazil's economy in 1981. The obstinate trade deficit which has plagued us throughout the 1970's and which has been uncomfortably large since 1973, except in 1977, has given place to a surplus which continues to increase. The current account deficit is declining substantially in real terms as well as in nominal terms. Inflation, while still very high, has peaked and is declining.
3. These results are the consequence of the policies adopted since late 1980. What is impressive is that they have had such a quick effect on Brazil's situation despite a steadily deteriorating world economy and despite the interest shock which has been particularly damaging to Brazil. These policies have permitted Brazil, as we foresaw at the time of our 1980 Board discussion, less than a year after the end of the second oil shock, to make remarkable progress in its adjustment process during the current year.
4. These favorable results have certainly not been costless, but their burden has been tolerable and, in fact, less than was expected. The Brazilian authorities propose not only to adhere firmly to, but to strengthen, the present policy stance as it is producing the desired adjustment.
5. There is very little to add to the excellent description given by the staff of economic developments during 1980 and 1981 to date. The general stance of the policies pursued in 1981 and to be pursued for 1982 is equally well described by the staff: the priority accorded to reducing the current account deficit and inflation, and to improving the efficiency and the allocation of resources. The Brazilian authorities are fully aware that these objectives could not be attained without a temporary slow down in the rate of growth. But they are confident that the slow down will be relatively short. The rapid turn around achieved in the external situation, the progress on inflation, the first signs of a decline in unemployment, all appear to bear them out. They have not retreated from their objective of improving income distribution, which they continue to pursue by various means. For both reasons they have felt fully justified in avoiding drastic cuts in

investment projects under way, both those with a mainly social content and those that will be required when growth again approaches higher rates.

A. Demand Policies

6. A series of measures additional to those mentioned by the staff have been adopted in order to strengthen fiscal control. Regarding the Social Security System, the Congress recently approved a delay on entitlement to medical benefits for new participants in the system and, as the staff mentions, an increase in the upper limit on income subject to social security contributions. It rejected the proposed reduction of pensions payable to those taking employment after retirement and a reduction in the adjustment factor for minimum pensions. Instead it authorized the government to levy excises of up to 20 per cent on non essentials. The definition of non essentials is left to the Executive and is expected to cover a range of goods possibly including gasoline. Further measures to improve the financial situation of the Social Security System continue under study.

7. The plan to sell to the private sector or to close down government enterprises is being pursued. In addition to a few minor enterprises an important textile factory has just recently been sold to a private group. Further sales are expected before the end of the year.

8. A series of additional income tax changes has been approved. The tax credit for investments in supervised mutual funds has been reduced by 40 per cent. The deductibility from personal income of insurance premia and of interest on personal loans has been eliminated. Beginning in 1983, the deductibility from income of purchases of certain financial assets will be reduced by 50 per cent. The deductibility from profits of financial institutions of reserves against dubious loans has been reduced from 3 to 1.5 per cent.

9. The impact on the 1982 federal budget of the numerous tax changes most of which will not only strengthen revenue but improve post tax income distribution has not yet been established. The original budget bill foresaw expenditures and revenues both of approximately Cr\$4,000 billion, i.e. nominal increases over the likely out turn for 1981 of 72.5 per cent. This would imply stability or a decrease in real terms. However, revenues have probably been underestimated by 3-400 billion to be transferred to the monetary budget and the original expenditure estimates contained close to 100 billion in transfers to the monetary budget. Thus, total such transfers will reach 12 per cent of the budget, i.e. considerably more than this year's eight per cent. (Other) expenditures from the central budget will thus decline in real terms. Contributing to this result is a hiring freeze in the public sector.

10. The budgets for state enterprises will not foresee major new projects except the Carajas Minerals Project which will be financed from the surplus of the highly profitable state owned Companhia Vale do Rio Doce and by its foreign and domestic shareholders and clients. A first meeting with representatives of foreign governments and firms took place in Paris in September under the auspices of the World Bank. Two major hydroelectric works, Tucuruí and Itaipu, will be carried on according to schedule; the former is linked to Carajas, the latter is essential for Southern Brazil and is expected to come on stream early in 1983. The execution of many other investment projects will be postponed or, alternatively, slowed down wherever possible in view of financial costs already incurred.

11. The monetary budget for 1982 is now about to be put in final shape. It is likely to foresee a limit of about 50 per cent for the growth of the monetary base. Perhaps more important it is likely to foresee a limit of about two-thirds for the increase in the credit of the monetary authorities. A limit of about 50 per cent is foreseen. Also for loans by commercial and investment banks and finance companies, except those financed through foreign loans. These rates of credit expansion are again certain to fall short of the rate of inflation. No sizeable recourse to net open market sales is foreseen.

12. The rate of inflation should decline to between 70 and 80 per cent in 1982 which would considerably reduce the size of interest subsidies. Nevertheless an increase in explicit interest rates for subsidized credits is under study. Credit subsidies this year already declined in real terms by one fourth compared to those which prevailed in 1980. Total subsidies declined from nearly 6 per cent of GDP in 1980 to 3 per cent in 1981.

13. The freeing of interest rates other than for subsidized credit has enabled the authorities to sell an unprecedented volume of treasury bills. Financial savings have also appeared to increase in other forms. It is likely that overall savings as a share of GDP has increased considerably though the extent to which they have done so will be known only when the 1981 national accounts become available.

#### B. Supply Developments

14. Under the stimulus of support prices geared to the world market and adequate credit, as well as, so far, favorable weather, planting for the new crop is proceeding apace and the expectation is for another excellent crop.

15. Oil production has increased 20 per cent over 1980 and is expected to rise by one third in 1982 when it should cover close to 30 per cent of the net consumption of oil. A number of new wells have been discovered and exploration is being further intensified both on and off shore. The fact that this year for the first time one of the international firms exploring for oil in Brazil under so called risk contracts in non traditional areas has discovered a well capable of producing in commercial quantities is expected to encourage further exploration by the multinationals.

16. The electricity corporations are actively engaged in promoting the substitution of electricity for heating materials, both gas, of which Brazil produces little, and fuel oil. Price increases for petroleum products continue to encourage both substitution and conservation of oil.

17. There have been some interesting developments on the labor front. There is increasing disillusionment with the present wage law, not only among employers but also among workers and trade union leaders. While no early change in the law appears to be in sight, the government has, just recently taken an important step by adjusting the minimum wage by 100 per cent of the cost of living increase rather than 110 per cent as was the practice in the recent past. Trade unions are showing interest in employment stability rather than wage increases and are increasingly bargaining for a temporary stop on the dismissal of workers rather than for substantial so called productivity bonuses above the mandatory cost of living adjustments. The dismissal of workers and hiring of new ones at lower wages and slower promotions reduce the impact on labor costs of the adjustment factors built into the wage law.

18. Some interesting facts have also become available on unemployment. Its level appears to have peaked in July and August, and to be declining. Like a recovery of industrial output, this is, of course, not surprising. It may be partly seasonal, but mainly, much of the fall in output and employment represented an inventory recession. It should be remembered that industrial output had grown substantially in 1980, and had been reflected in large inventory accumulation in view of the controlled interest rates prevailing in that year. Some firms, particularly in the automobile industry, have found that 38 per cent of those dismissed appear to leave the city of their previous employment and return to their city or state of origin. They draw on their unemployment insurance fund (FGTS) and often establish small businesses in the places to which they return. As for the others, average unemployment for unskilled workers does not seem to exceed 19 weeks and considerably shorter periods for technicians and foremen.

C. External Policies

19. The authorities are and will continue depreciating the Cruzeiro in line with the rate of internal inflation (formerly, of course, the rate of depreciation corresponded roughly to the inflation differential with the trading partners). This will continue to produce a real depreciation corresponding to the world-wide rate of inflation, which is, of course, by no means negligible. The containment of domestic demand policies has already proved to be a most effective promoter of exports. The maintenance of such a policy in 1982 can be securely expected to continue to promote the exportation of industrial products despite the slow growth of the world economy. Brazil, after all, is still a small exporter in the world context.

20. The first estimates for the balance of payments in 1982 have now been prepared. They foresee a slightly more rapid rise in the value of exports than during 1981 (19 per cent as against 17.5 per cent). This is explained by the expectation that the prices of primary products will not again suffer the major falls they did in 1981 while the growth of manufactured exports will continue this year's trend (an increase of close to 30 per cent).

21. Imports, which stagnated in 1981 in view of the slowdown in growth and liquidation of inventories, are expected to rise 11 per cent in value or perhaps 7 per cent in volume. This will permit some resumption of industrial growth in 1982. Under these circumstances Brazil expects a trade surplus of about US\$3 billion in 1982 as against about US\$1 billion this year. The surplus, for the year to date, is over US\$600 million and rising steadily.

22. Net payments for services are expected to increase close to 15 per cent to about US\$13 billion. This is a deliberately pessimistic estimate which assumes a rise in world market interest rates as compared to the average for 1981. Under these conditions the current account deficit should decline substantially further in terms of GDP as well as in nominal terms. Instead of reducing the volume of foreign borrowing from the current year, when it has been relatively high, Brazil expects to maintain it close to its 1981 level in order to add around US\$1 billion to reserves.

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23. Altogether I think that again as during our 1980 discussion, an optimistic forecast appears justified. For reasons already given, the overall growth of the economy can confidently be expected to exceed this year's and to assure a sensible rate of per capita growth. The strengthening of fiscal policies and the maintenance of tight monetary policies will enable further progress to be made on inflation and the current account. Considering the demonstrated resilience and adaptability of the Brazilian economy, it would not be surprising if, by 1983, Brazil once again approached its historical long-term growth trend, and with it, further improvement in income distribution in the context of declining inflation and rising external reserves.