FOR AGENDA

EBS/88/126

CONFIDENTIAL

July 1, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Brazil - Stand-By Arrangement - Letter of Intent

Attached for consideration by the Executive Directors is a copy of the letter of intent from the Brazilian authorities requesting a stand-by arrangement equivalent to SDR 1,096 million, together with related documentation pertaining to Brazil's economic program, and a technical memorandum of understanding. The staff paper describing and analyzing the economic program will be circulated soon.

Mr. Reichmann (ext. 8610) or Mr. Muniz (ext. 8611) is available to answer technical or factual questions relating to this paper.

Att: (1)

Brasilia,
June 29, 1988

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. The attached Note on the Program of Modernization and Adjustment 1988-89, the full text of which is also attached, describes the economic policies that the Government of Brazil has implemented already or will implement to avoid an acceleration of the inflationary process, create the conditions for reducing inflation, recover economic growth on a durable basis, reduce income distribution disparities, and maintain a strong external performance. In support of this program, the Government of Brazil requests the use of the financial resources of the International Monetary Fund for the equivalent of SDR 1,096 million in the form of a stand-by arrangement for a period of 19 months. The program's quantitative targets for the period through December 1988 are specified in the attached technical memorandum.

2. The Brazilian authorities believe that the policies and measures described in the attached program and note are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultations, and on the progress being made in the program and the achievement of its objectives. We will consult with the Fund before February 15, 1989 on the economic policy understandings pertaining to the program for 1989.

/s/	/s/	/s/
Elmo de Araujo Camoes President Central Bank of Brazil	Joao Batista de Abreu Minister of Planning	Mailson da Nobrega Minister of Finance

Attachments

Note on the Program of Modernization and Adjustment, 1988-89

1. The Brazilian economy is at a critical juncture. For some time, the country has been on the verge of hyperinflation while economic activity has been stagnant. At the same time, the economy is facing serious structural problems. The growth model based on state intervention in the economy that was followed in recent decades shows clear signs of exhaustion, investment has increased very little in the last few years, while the domestic and external public debt have become too large with respect to GDP. The program seeks to redress these problems and to promote lasting economic growth, by creating the conditions necessary for a significant reduction of inflation and by modernizing and liberalizing the economy.

2. The modernization of the economy sought by the program emphasizes a redefinition of the role of the State, a new industrial policy, the liberalization of foreign trade and the reform of the financial system. Most of the far-reaching structural measures required to achieve these objectives have already begun to be implemented. As detailed in paragraphs 31 and 34 of the program, the Government is giving renewed impetus to the process of privatization aiming at freeing the State from tasks that can be performed more efficiently by the private sector. The new industrial policy announced on May 19, 1988 emphasizes the area of technology and will involve an in-depth revision of investment incentives seeking to free their application from bureaucratic interference. The preparation, in cooperation with the IBRD, of a reform of the financial system has been advanced, aiming at reducing the segmentation of credit markets and at increasing competition among financial institutions. In addition, the Government intends to limit the scope of price controls to oligopolistic sectors, and to abolish the state monopoly in the marketing of wheat and the exportation of sugar.

3. The reduction in the public sector deficit is the key element of the strategy to fight inflation. Mainly because of a sharp increase in the public sector's wage bill in real terms in late 1987 and early 1988 and a decline in revenue in real terms resulting from the acceleration of inflation, the operational deficit of the nonfinancial public sector was projected to increase from 5.5 percent of GDP in 1987 to more than 7 percent in 1988. In these circumstances, the Government has taken a number of measures, mainly on the expenditure side, that aim to reduce the operational deficit to 4 percent of GDP in 1988. Among the measures listed in paragraphs 31 and 34 of the economic program and that have already been implemented, the Government would like to stress the:

a. unification of the fiscal budget which already has improved expenditure control as well as the transparency of fiscal operations.

b. introduction on May 20, 1988 of cutbacks equivalent to 0.9 percent of GDP in nonwage and noninterest expenditures of the central government.

c. suspension for a period of two months of wage adjustments in the central administration and federal public enterprises with an estimated yield of 1.1 percent of GDP.

d. imposition of limits on credit by the financial system to states, municipalities, and public enterprises expected to result in savings equivalent to 0.5 percent of GDP.

e. elimination of the wheat subsidy to consumers with an estimated yield of 0.1 percent of GDP.

A number of other measures (including limits on the deficit of the social security system) have also been taken to ensure the attainment of the program's fiscal target for 1988.

4. As noted in the economic program, the above actions are being supplemented by several tax revenue measures, including selective increases in income taxes and reductions in fiscal incentives. These measures seek to improve resource allocation and the efficiency of the tax system, and to offset in part the adverse impact of the acceleration of inflation on tax revenue. By and large, public sector tariffs have been brought to appropriate levels, and the Government intends to continue following policies in this regard that would ensure the financial soundness of public enterprises.

5. The public sector absorbs the major share of national financial savings, hindering private investment and intensifying inflationary pressures. The Government intends to strengthen the public finances further in 1989 by reducing the operational deficit to at most 2 percent of GDP. The Government regards this as an upper limit, and it will make every effort to attain such a further reduction in this deficit as is necessary to permit the recovery of investment and the reduction of inflation.

6. The strengthening of the public finances will facilitate the implementation of restrained monetary and credit policies. In addition, and as noted in paragraph 34 of the economic program, the Government intends to restore the effectiveness of monetary policy instruments. The sizeable amount of voluntary deposits held at the Central Bank by savings and loan institutions and by exporters hindered the Bank's ability to regulate the money supply as these deposits fluctuated sharply in response to minor changes in interest rates. Provisions have, therefore, been established for the full withdrawal of the voluntary deposits of savings and loan institutions by June 30, 1988, and of those held by exporters by end-December 1988. The unduly large proportion of the domestic public debt that is held on an overnight basis constitutes another major hindrance to monetary policy, and the monetary authorities have begun to implement measures to improve the maturity structure of the domestic public debt and increase the proportion of debt held by final holders. Altogether, these actions would enable the Central Bank to shift the focus of monetary policy to the targeting of monetary and

credit aggregates consistent with the objectives of the economic program. In line with this policy stance, interest rates would be primarily market determined, and the monetary authorities intend to limit the growth of the monetary base and the money supply during 1988 to 375 percent, which compares with a projected rate of inflation of 600 percent for this year.

7. The policies contained in the economic program will ultimately result in a substantive reduction in inflation. In the meantime, an only modest decline is projected in the monthly rate of price increase during the remainder of 1988. In the present circumstances, the immediate objective of the Government is to arrest the accelerating trend of the rate of inflation that was evident in the early part of the year and to create the conditions that would facilitate a significant reduction of inflation in 1989.

8. The Government intends to maintain the policy of daily adjustments of the exchange rate in line with domestic inflation, and to keep this policy under review so as to ensure the competitiveness of Brazilian exports and the achievement of the program's objectives in the external area. This policy, together with the credit and fiscal policies included in the program, will help to strengthen Brazil's external position beyond the considerable gains achieved in 1987. The trade surplus is targeted to increase from US$11.2 billion in 1987 to US$13 billion in 1988. It should be emphasized that the improvement in the trade balance would result from the continued expansion of exports, as a sizeable increase in imports is also projected, in line with the envisaged recovery of investment and growth and the liberalization of the economy. In 1988, notwithstanding the increase in foreign interest payments, the external current account deficit would remain at 0.5 percent of GDP, and this ratio is anticipated to decline further in 1989. Net international reserves will be increased during the program period.

9. As described in paragraphs 32 and 34 of the program, the Government also intends to carry out substantive structural reforms in the external area that will set the basis for the liberalization of Brazil's foreign trade and will permit the elimination of a number of exchange restrictions. Among the measures already taken, the following should be emphasized:

(a) the introduction of automatic approval of import licenses provided that the regulations relating to price, form of payment, etc., are complied with, up to an amount equal to 1987 imports and with no limit for capital goods imports;

(b) the liberalization of foreign trade in agricultural products;

(c) the tariff reform, effective July 1, 1988, which rationalizes the tariff structure, reduces exemptions and special import systems, and, by abolishing the financial operations tax (IOF) on the purchase of foreign exchange for merchandise imports, eliminates a number of multiple currency practices;

(d) the reduction in the minimum financing requirements for imports of capital goods from a range of three to eight years to a range of two to five years;

(e) the increase from US$100,000 to US$150,000 in the limits up to which payments in cash are authorized for all import categories, with an additional US$200,000 for capital goods imports;

(f) the elimination of prior authorization requirements for the importation of metallurgical products and nonferrous metals; and

(g) the elimination of prior controls on a sizeable number of exports.

In addition, it has been announced that the number of tariff items on the prohibited import list are to be reduced by half by the end of 1988. Further steps to liberalize exchange restrictions will be undertaken in 1989, with a view to their elimination.

10. Achievement of the program's growth objectives will be based on an increase in domestic savings but will also require an adequate flow of external resources. Accordingly, an important objective of the program is the restoration of external inflows through the normalization of relations with the international financial community. Discussions between Brazil and the advisory committee of foreign banks have been concluded for the rescheduling of principal payments due in 1987-93, the reduction of interest rate spreads, the provision of about US$5.2 billion of new money, and the re-establishment of short-term credit lines. Brazil also intends to request a meeting with Paris Club creditors in the second half of 1988 to reschedule principal payments due since early 1987. The successful conclusion of the negotiations with foreign banks and Paris Club creditors would result in the elimination by end-December 1988 of external payment arrears, which shall not be permitted to re-emerge.

11. The program also seeks to strengthen Brazil's external debt position by following cautious policies in this regard. Thus, new net external indebtedness will be limited to amounts consistent with the program's external current account and overall balance of payments targets. Moreover, flexible mechanisms for debt conversions have been introduced, within limits that do not impair the implementation of a restrained monetary policy.

MODERNIZATION AND ADJUSTMENT 1988/89

1. The Brazilian economy is facing one of the gravest crises in its history.

2. The signs of the crisis are made evident by the continued growth of inflation, the high level of the public deficit and the high level of external and domestic indebtedness.

3. If the measures that have been taken to correct these distortions are not maintained and strengthened, the inevitable consequences could be: the stagnation of investment, a decline in employment and real wage levels, and a deepening imbalance in the public finances with unforeseeable repercussions on the economic, political and social order of the nation.

4. To reverse these difficulties, the basic objectives of government action are:

a. to avoid the acceleration of the inflationary process and create the conditions required for reducing inflation;

b. to adopt measures aimed at renewing economic growth, in a way such as to make it possible to generate the jobs that are indispensable to absorb the manpower that annually enters the market; and,

c. to reduce income distribution disparities.

5. The strategy adopted by the Government to achieve these objectives consist of:

- combating the public deficit;
- normalizing relations with the international financial community;
- modernizing the economy; and
- emphasizing the social area.

COMBATING THE PUBLIC DEFICIT

6. The public deficit is now the principal source of inflation, because of its impact on the goods and services market and on interest rates as well as its repercussions on society's expectations.

7. The current level of the public deficit is even more a cause of concern for two reasons. The first is that it is no longer the consequence of the growth of investment, as happened in the past, but rather of a decline in tax revenues and an excessive growth of current expenditures. The second is the virtual exhaustion of the State's sources of financing.

8. The reduction in tax revenues results from a series of factors, including the growth of incentives and subsidies, tax evasion and fraud, and the impact of inflation on the tax revenue of all levels of Government.

9. The public sector absorbs the major share of national financial savings. Continuation of this process could make private sector access to credit more difficult or force the Federal Government to issue large amounts of currency, thus leading the country into hyperinflation.

10. Another cause for concern is the increase in the public sector's interest expenditures that has resulted from the growth in the domestic debt, which in turn, has expanded as a consequence of the problems generated by the external debt.

11. The public deficit accumulated in the past resulted in a large debt stock that burdens the entire public sector. The increased charges on this debt have not been matched and are still not matched by a corresponding growth in the resources available to the state.

12. However, reductions in the domestic debt service costs should not be sought through artificial measures that could cause a loss of confidence in public securities and, in final analysis, have an adverse impact on small savers and the workers themselves.

13. The strategy aimed at correcting these imbalances would, therefore, be concentrated on the gradual but firm reduction of the public deficit, in such a way as to further the reordering of the Government' finances, with the least possible social cost. Thus, every effort will be made to reduce the deficit from the 1987 level of 5.5 percent of GDP to 4 percent in 1988 and a maximum of 2 percent in 1989.

NORMALIZATION OF RELATIONS WITH THE INTERNATIONAL FINANCIAL COMMUNITY

14. To renew the growth process, it is vital that an adequate flow of resources from abroad be re-established. And to achieve this, it is essential that the nation's relations with the international financial community be normalized.

15. Finalization of a pluriannual and mutually satisfactory agreement with the banks--that makes it possible for the country to normalize interest payments and reduce external debt charges, while expanding maturity and grace periods--is of fundamental importance to our economy.

16. As a member of the International Monetary Fund, Brazil should make use of the alternatives the institution makes available. Thus, we will seek that institution's support for the necessary effort that the country will make to adjust its economy and renew the process

of economic and social growth. With due consideration of our needs and conveniences, this adjustment is being carried forward in a sovereign and realistic manner.

17. An arrangement from the International Monetary Fund is indispensable to the renegotiation of the Brazilian debt with the Paris Club. This will make it possible for export credit agencies of industrialized countries to reopen financing operations for Brazilian imports, particularly capital goods, which are essential to the growth and modernization of Brazilian industry.

18. Normalization of relations with the international financial community would also make it possible to regain the confidence of investors in the Brazilian economy, to obtain new resources from financial assistance programs created by governments of developed nations and to recover access to the voluntary capital markets.

MODERNIZATION OF THE ECONOMY

19. Perhaps the greatest challenge before the Government and society in these final years of the century is the redefinition of the role of the state. Preparation of the path towards a more competitive and efficient economy is a task that must be performed with courage.

20. During the course of recent decades, the state has, with undoubted success, played a role of great importance in the transformations through which this country has passed. Our solid industrial base, the sophistication of our financial and capital markets, the change in the foreign trade structure and the modernization of important segments of the agricultural sector are, without doubt, a result of the guidance provided by public authorities, particularly through the management of subsidies and fiscal and financial incentives.

21. Today, however, the growth model based on state intervention in the economy shows clear signs of exhaustion, while it has also created distortions that must be eliminated. Exaggerated growth of bureaucracy coupled with excessive controls have become the antithesis of the initial objective of the process, which was that of making accelerated economic development feasible.

22. For reaching reforms must be introduced with the following objectives: revitalizing the industrial sector, particularly in regard to technology and exposing it with the necessary precautions to increased competition with the international economy; reducing foreign trade controls and implementing a tariff system that is consistent with the objective of modernization, reviewing the functioning of the national financial system for the purpose of reducing the costs of financial intermediation and enhancing the system's contribution to economic and

social development; and, finally abolishing the now outdated system of centralized decision-making that is incompatible with the aspirations for freedom and development.

23. Efforts will be made to increase the role of capital markets as the financing agent of economic development and the driving force behind the process of democratization of property. Corporations whose shares are publicly traded, which now total more than a thousand, already represent a universe of more than four million stockholders and six million quota holders in stock investment funds.

24. Now that 25 years have elapsed since legislation permitted Brazilian companies to issue stock to the public, the moment has come to utilize and multiply the undeniable contribution of the capital market to the modernization and privatization of the economy.

EMPHASIS ON THE SOCIAL AREA

25. The crisis increases the needs of the majority of the population and aggravates personal and regional income disparities.

26. However, Brazil has an enormous potential that must be exploited for the benefit of the well being of its citizens. Consequently, the efforts undertaken in the economic-financial area must have the fundamental goal of improving the living conditions of the population.

27. Social policies cannot be dissociated from economic policies, since the real benefits of development are obtained by increasing the availability of jobs and improving the buying power of wages,

28. Until the stage is reached where it is possible to achieve effective improvement in income levels, programs will have to be implemented that ensure assistance to the more needy segments of the population. Thus, the Government has been giving greater emphasis to initiatives in the areas of health, nourishment, nutrition, urban transportation, housing and sanitation, education and agrarian reform, together with activities in the areas of public safety and social assistance, combatting violence, and regional development and community support.

29. At the same time, the Government is aware that the special attention given to investments in the social area in no way justifies abandonment of the infrastructural sector, which is of fundamental importance to renewed growth.

MEASURES ALREADY ADOPTED

30. The decisions that are essential to achieving the objectives defined by the Government are being taken within the framework of a coherent line of action.

31. The following measures have already been taken with the aim of reducing the public deficit:

a. unification of the fiscal budget, placing all governmental expenditures under the control of the National Congress and, consequently, under that of society;

b. alteration of income tax legislation, levying the tax on those with more than one source of income in the same year in which the earnings are received, thus achieving enhanced fiscal justice;

c. reduction of the income tax that can be invested in fiscal benefits from 50 percent to 40 percent together with the extinction of fiscal incentives to tourism and reduction of those channelled into reforestation;

d. reduction from 15 percent to 10 percent of the amount that enterprises can deduct from their income tax as a result of expenditures on professional training, the supplying of food to workers, worker transportation costs, and training of manpower in informalics;

e. taxation of profits obtained in exports of manufactured goods;

f. increase in the income tax levied on banks and other financial institutions;

g. temporary increase in the rate of the FINSOCIAL contribution from 0.5 percent to 0.6 percent for the purpose of financing the agrarian reform program;

h. implementation of a Special Inspection Program, coupled with coordinated action on the part of federal and state tax inspectors, for the purpose of reducing the level of tax evasion and fraud;

i. greater dynamism in the administrative and judicial collection of fiscal revenues;

j. extinction of the subsidy to wheat consumption;

k. creation of the Federal Privatization Council, with the objective of coordinating the reduction of state participation in the economy. Within the BNDES system alone, 12 companies have already been transferred to the private sector, while an additional nine transfers are underway and should be completed during the current year;

l. introduction of a bill to the National Congress setting down procedures for the transfer of the capital of state companies to the private sector, with the exception of PETROBRAS;

m. prohibition of the contracting of employees by the direct and indirect federal public administration;

n. creation of mechanisms aimed at encouraging voluntary resignations and retirement proportional to time of service, together with automatic extinction of vacant positions;

o. two-month suspension of wage adjustments in the central administration and the federal state enterprises, for the purpose of adjusting personnel expenditures to the situation of public finances; and,

p. imposition of limits on the granting of loans to states, municipalities and state companies by financial institutions.

32. Insofar as foreign trade is concerned, the following measures were adopted for the purpose of expanding trade and reducing exchange restrictions:

a. creation of the system of certified customs deposits, so as to provide exporters with the advantage of foreign sales as if their merchandise had already been shipped, and to grant greater flexibility to importers of Brazilian goods;

b. increase in the number of products that can be exported on the basis of export declarations, thus bringing greater flexibility to foreign sales operations;

c. liberalization of foreign trade in agricultural products (soybeans and derivatives, cotton, corn, and rice), as a first stage in the gradual withdrawal of the state from this sector of activity;

d. increase in the limits of imports exempt from the requirement of prior presentation of import programs; and a reduction in the number of products subject to import suspension.

e. reduction or elimination of the minimum financing period required for imports, particularly benefitting small and medium businesses.

f. elimination of prior controls on imports of steel products and nonferrous metallurgical goods.

33. The following measures can be cited in the area of the external debt:

a. regulation of external debt conversions into risk investment in the country, within limits that will not hinder the implementation of monetary policy;

b. reinitiation of negotiations with the commercial banks, with agreement already obtained as to the following points:

(i) rescheduling of the debt due to mature in the period from 1987 to 1993 over a period of 20 years with a eight-year grace period;

(ii) reduction of external interest payments as a result, for the most part, of cutting in half the spread and modifying the payment due dates from quarterly to half yearly payments, thus producing savings of more than US$4.0 billion.

(iii) additional inflow of US$5.2 billion in long-term resources from the banks, and re-establishment of short-term trade credit lines totalling US$600 million.

MEASURES TO BE ADOPTED

34. In the wake of the measures already adopted, the Government will take the following steps:

a. reformulation of budgetary procedures with the purpose of neutralizing the effects of inflation on the structure of the Federal Government Budget;

b. introduction of cutbacks equivalent to 0.9 percent of GDP in the current and capital expenditures of the 1988 federal budget;

c. re-examination of the remaining fiscal incentives and subsidies, with a view to eliminating those that have already achieved their original objectives;

d. explicit inclusion, already in the 1989 Federal Government Budget, of a projection of the fiscal cost of subsidies and incentives, thus making possible greater transparency and control of these items;

e. improved allocation of government resources to the social area;

f. greater efficiency in assistance programs such as unemployment compensation, the food supplement program, the national school lunch program, the social priority program, and the program of milk for needy children;

g. immediate start of studies aimed at abolishing the wheat marketing monopoly and the consequent transfer of this activity to the private sector;

h. preferential channelling of rural credit to small and medium farmers and the less developed regions of the country;

i. elimination of prior controls on exports of approximately three thousand products;

j. transfer of sugar exports to the private sector;

l. reform of the customs tariff system, including unification of duties on imports, elimination of the financial operations tax and a sharp reduction in fiscal exemptions and special import regimes;

m. gradual elimination of other exchange restrictions that hinder foreign trade;

n. reformulation of the foundations of industrial policy with the aim of revitalizing the sector, particularly in the area of technology. This is to include a complete review of the system of investment incentives so as to reduce bureaucratic interference by simplifying the system and making it more automatic and efficient;

o. extinction of state companies, semi-autonomous agencies and other public entities or their transfer to the private sector, thus releasing the state from tasks that can be carried out more efficiently by the private sector and permitting the Government to assume a more effective posture in the social area. In the process of transferring these entities to the private sector, preference will be given to those companies that originally belonged to the private sector;

p. introduction of improvements in the national financial system, so as to enhance its efficiency and providing it with greater stability, reducing the segmentation of the credit markets, and strengthening competition among institutions;

q. limitation of government price controls to monopolies and oligopolies, including public sector prices and tariffs;

r. recovery of the effectiveness of monetary policy instruments, in such a way as to equip the Central Bank with more adequate mechanisms for regulating the liquidity level of the economic system, including the gradual elimination of the current system of voluntary deposits;

s. negotiation with the World Bank of sectoral loans--aside from the traditional project financing--that would provide significant support to the structural adjustment measures. Negotiations of sectoral loans to be channelled into the recovery of the energy sector, modernization of the agricultural and agro-industrial sectors, reordering of the financial system and reform of the tariff system have already reached an advanced stage.

35. The following will be maintained:

a. the policy of daily devaluations of the cruzado in line with internal inflation; and

b. the current wage policy, which includes: monthly adjustments calculated on the basis of average inflation in the previous quarter

(URP), free collective bargaining at the time of yearly contract negotiations and gradual restoration of the real value of the national minimum wage.

Technical Memorandum of Understanding

In accordance with the authorities' Note on the Program of Modernization and Adjustment 1988-89, this technical memorandum and attached tables define the concepts used in quantifying certain variables of the program and specify targets for the period through December 1988. Targets for 1989 will be specified in the context of the discussions pertaining to the review of the program.

I. Net international reserves of the Central Bank of Brazil

1. The overall balance of payments target for calendar 1988 is a surplus of US$5.4 billion after the envisaged rescheduling and exceptional financing from official sources and foreign commercial banks. For the purpose of this target, the balance of payments performance will be measured by changes in the net international reserves of the Central Bank adjusted for net gold monetization. Consistent with the balance of payments target, the stock of net international reserves, as defined in line 7 of Table 1, will not fall below US$850 million on September 30, 1988 and US$2,430 million on December 31, 1988.

2. The net international reserves levels specified above will be adjusted (a) upward (downward) by the amount by which the cumulative total of new money disbursements from foreign commercial banks exceeds (falls short of) US$4.0 billion at end-September 1988 and US$4.6 billion at end-December 1988; (b) upward (downward) by the amount of foreign exchange savings from retiming interest payments due to foreign commercial banks that exceeds (falls short of) US$600 million at end-December 1988. In addition, the levels for end-September 1988 and end-December 1988 assume rescheduling by official creditors of US$2,042 million and US$2,426 million, respectively, corresponding to principal maturities due from January 1, 1987 through end-September 1988 and through end-December 1988, respectively. The limits will be adjusted upward (downward) by the excess (shortfall) of actual rescheduling from the assumed amounts.

II. Net domestic assets of the Central Bank of Brazil

3. For purposes of the program, the net domestic assets of the Central Bank are defined as currency in the hands of the public, which amounted to Cz$247.2 billion on December 31, 1987, minus net international reserves (line 5 of Table 1) converted into cruzados at previously agreed accounting exchange rates. The net domestic assets so defined will not exceed Cz$313.0 billion on September 30, 1988 and will not exceed a negative Cz$105.0 billion on December 31, 1988. These limits will be adjusted upward (downward) by the cruzado equivalent (at the agreed accounting exchange rates) of any downward (upward) adjustment made to net international reserves in accordance to paragraph 2 above.

III. Public sector borrowing requirement

4. The public sector borrowing requirement (PSBR) is defined as the net financing obtained by the nonfinancial public sector from the domestic financial system, from the nonfinancial private sector, and from foreign sources. It is calculated as the sum of the net change in the stock of public domestic debt and net external financing. The nonfinancial public sector includes the central government, state and local governments, nonfinancial public enterprises, decentralized agencies, official funds and programs (those not consolidated in the credit budget), and the social security system (SINPAS). The domestic financial system includes the Central Bank of Brazil, the Bank of Brazil, commercial banks, and nonmonetary financial institutions: BNDES, BEDES (including carteiras de desenvolvimento of commercial banks), CEF/BNH, CEEs, BNCC, APE, SCI, SCFI, and bancos de investimento.

5. The stock of domestic debt consists of net credit extended by financial institutions to the nonfinancial public sector, suppliers' credits, treasury securities (including LBCs) held by the public less those held by the nonfinancial public sector, and securities issued by state and local governments as defined in Table 2.

6. Net credit extended by the Central Bank to the central government is measured as (a) the Central Bank's holdings of government securities net of central bank bills (LBCs), plus (b) any other credit extended by the Central Bank to the central government, less (c) central government deposits, less (d) the net nominal profit of the Central Bank before the net adjustment for changes in the cruzado value of foreign currency denominated assets and liabilities, and the monetary correction on capital (patrimonio).

7. Net credit extended by the Central Bank to the rest of the nonfinancial public sector is measured as credit extended by the Central Bank net of deposits of the rest of the public sector.

8. Net credit extended by the Bank of Brazil, commercial banks and nonmonetary financial institutions is defined as the sum of (a) the stock of treasury securities (including LBCs) held by these institutions, (b) any other credit extended to the nonfinancial public sector by these institutions, less (c) deposits of the nonfinancial public sector with these institutions, less (d) tax collection liabilities of these institutions to the Treasury or state and municipal governments.

9. Net credit extended by the nonfinancial private sector is defined as (a) suppliers' credit and (b) treasury securities (including LBCs) held by the nonfinancial private sector defined in turn as total securities issued (as reported by the Secretaría do Tesouro (STN)) less those held by the Central Bank, the Bank of Brazil, commercial banks, nonmonetary financial institutions, the social security system and public enterprises.

10. Net external financing is defined as the sum of the monthly net flows (disbursements less amortization) in foreign currencies converted at actual average monthly exchange rates of (a) deposits registered in foreign currencies of the nonfinancial public sector, and (b) other foreign financing (including short-term financing) to the nonfinancial public sector.

11. The PSBR will not exceed Cz$15,000 billion as of September 30, 1988 and Cz$30,000 billion as of December 31, 1988.

IV. Public sector operational deficit

12. The operational deficit of the nonfinancial public sector is defined as the public sector borrowing requirement (PSBR) as defined in section III above less the sum of monetary and exchange correction on the stock of domestic public debt included in that borrowing requirement.

13. The monetary/exchange correction on

(a) the total stock of treasury securities is calculated as the correction accrued on a pro-rata basis on these securities as calculated by STN;

(b) loans and bond holdings (including LBCs) of financial institutions is calculated as the rate of monetary/exchange correction for the respective month applied to the stock of those loans and bond holdings at the end of the previous month;

(c) deposits with financial institutions is calculated as under (b). These deposits refer to the deposits of the Treasury with the Bank of Brazil and the deposits of the trade and programs of states and municipalities with commercial banks;

(d) bond holdings of the nonfinancial private sector, public enterprises and the social security system is calculated as under (b);

(e) the net nominal profit of the Central Bank (as defined in paragraph 6) is calculated as under (a) on treasury securities, and as under (b) on other assets and liabilities.

14. The operational deficit of the nonfinancial public sector will not exceed Cz$1,600 billion as of September 30, 1988 and Cz$3,280 billion as of December 31, 1988.

V. Net disbursements of external debt

15. The limits on total net disbursements of external debt will be defined as the difference between disbursements and amortizations of medium- and long-term external debt of both the public and the private

sector, plus changes in the stock of short-term external debt of the nonfinancial public sector, as described in the attached Table 3. Net disbursements thus defined will not exceed US$4,700 million during the nine-month period ending September 30, 1988; and US$5,700 million during the year ending December 31, 1988. The net disbursements of short-term external debt of the nonfinancial public sector included in the amounts mentioned above are projected not to exceed US$300 million during the nine-month period ending September 30, 1988; and US$545 million during calendar 1988.

Table 1. Brazil: Net International Reserves - Adjusted

(In millions of U.S. dollars)

		March 31, 1988
1.	Assets	6,261.0
	Spot Assets	881.3
	Short-term assets	5,258.3
	Medium- and long-term assets	121.4
2.	Liabilities	9,909.8
	Short-term liabilities	1,430.1
	Bridge loan	955.3
	Other	474.8
	Medium- and long-term liabilities (IMF)	3,638.7
	Arrears	4,841.0
	To foreign commercial banks	3,414.4
	To official creditors	1,426.6
3.	Assets less liabilities (1-2)	-3,648.8
4.	Valuation gains or losses 1/	9.7
	Assets	-82.7
	Liabilities	92.4
5.	Net international reserves (3-4)	-3,658.5
6.	Net gold monetization	91.4
7.	Net international reserves, adjusted (5-6)	-3,749.9

1/ For the purpose of this table, valuation adjustments reflect changes in the value of gold and nondollar assets and liabilities due to prices and exchange rates different from those in effect on December 31, 1987.

Table 2. Brazil: Public Sector Domestic Debt Stocks

(In billions of cruzados)

		December 31, 1987
1.	Net credit from the financial system	6,319
	Central Bank	4,127
	Commercial banks	944
	Nonmonetary financial institutions	1,248
2.	Nonfinancial private sector holdings of federal debt	713
3.	Nonfinancial private sector holdings of state and municipal debt	381
4.	Floating debt of public enterprises 1/	25
5.	Total domestic debt (1+2+3+4)	7,438

1/ To "empreteiros e fornecedores.".

Table 3. Brazil: Net Disbursements of External Debt in 1987

(In millions of U.S. dollars)

		1987
1.	Disbursements (medium and long term)	15,383.0
	Refinancing	12,838.0
	Commercial banks	9,223.0
	Brazilian abroad	1,259.0
	Foreign	7,964.0
	Official creditors	3,615.0
	Other disbursements	2,545.0
	Multilateral	1,218.0
	Bilateral	309.0
	Suppliers	866.0
	Banks	—
	Intercompany	152.0
2.	Amortizations (medium and long term) 1/	13,503.0
	Multilateral	919.0
	Bilateral	985.0
	Suppliers	1,425.0
	Banks	9,460.0
	Other 2/	714.0
3.	Short-term capital (net) 3/	-290.0
4.	Net disbursements of external debt (1-2+3)	1,590.0

1/ Excludes amortization due to debt equity conversions.
2/ Intercompany, bonds, and other loans.
3/ Short-term debt of the nonfinancial public sector.