

ARRANGEMENT

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

EBS/83/4

CONFIDENTIAL

January 6, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Brazil - Request for Extended Arrangement

Attached for consideration by the Executive Directors is a copy of the letter of intent from the Brazilian authorities requesting an extended arrangement equivalent to SDR 4,239.375 million, together with a technical memorandum of understanding and the text of the extended arrangement. The staff paper describing and analyzing the financial program of Brazil will be circulated in due course.

Att: (1)

3851

Brazil: Extended Arrangement

Attached hereto are a letter with attached memorandum dated January 6, 1983, from the Minister of Finance and the President of the Central Bank of Brazil, requesting an extended arrangement and setting forth:

(a) the objectives and policies that the authorities of Brazil intend to pursue for the period of this extended arrangement;

(b) the policies and measures that the authorities of Brazil intend to pursue during the first year of this extended arrangement; and

(c) understandings of Brazil with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Brazil will pursue for the second and third years of the extended arrangement.

To support these objectives and policies, the International Monetary Fund grants this extended arrangement in accordance with the following provisions:

1. For a period of three years from February , 1983, Brazil will have the right to make purchases from the Fund in an amount equivalent to SDR 4,239.375 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Until February , 1984, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 1,246.875 million, provided that purchases shall not exceed the equivalent of SDR 124,875 million until May 31, 1983, the equivalent of SDR 498.875 million until August 31, 1983, and the equivalent of SDR 872.875 billion until November 30, 1983.

(b) Until February , 1985, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,743.125 million.

(c) The right of Brazil to make purchases during the second and third years of the extended arrangement shall be subject to such phasing as shall be determined.

3. Purchases under this extended arrangement shall be made from ordinary and borrowed resources in the ratio of one to one until purchases under this arrangement reach the equivalent of SDR 3,291.75 million and then each purchase shall be made from borrowed resources, provided that any modification by the Fund of the proportion of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Brazil will not make purchases under this arrangement:
- (a) (i) during any period in which the data at the end of the preceding period indicate that the target for the net international reserves of the Brazilian Monetary Authorities, as specified in paragraph 1 of the attached Technical Memorandum, is not observed, or
 - (ii) during any period in which the limit on the public sector borrowing requirement, as specified in paragraph 2 of the attached Technical Memorandum, is not observed, or
 - (iii) during any period in which the limit on the net domestic assets of the Brazilian Monetary Authorities, as specified in paragraph 3 of the attached Technical Memorandum, is not observed, or
 - (iv) during any period in which the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 4 of the attached Technical Memorandum, is not observed, or
 - (v) if the cumulative quarterly target on the depreciation of the cruzeiro, as specified in paragraph 5 of the attached Technical Memorandum, is not observed, or
- (b) if the review contemplated in paragraph 29 of the attached letter has not been completed before August 30, 1983, or if any performance clauses, having been established pursuant to that review are not observed, or
- (c) for the second and third year of this arrangement, if before February 15, 1984 and February 15, 1985, respectively, suitable performance clauses have not been established in consultation with the Fund as contemplated in paragraph 29 of the attached letter, or if such clauses, having been established, are not observed; or
- (d) throughout the duration of the extended arrangement, if Brazil
- (i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or
 - (ii) introduces or modifies multiple currency practices, or
 - (iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or
 - (iv) imposes new or intensifies existing restrictions on imports for balance of payments reasons.

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When Brazil is prevented from purchases under this extended arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Brazil and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Brazil's right to engage in the transactions covered by this extended arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director of the Managing Director, formally to suppress or to limit the eligibility of Brazil. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Brazil and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this extended arrangement will be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Brazil, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this extended arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Brazil will consult the Fund on the timing of purchases involving borrowed resources.

8. Brazil shall pay a charge for this extended arrangement in accordance with the decisions of the Fund.

9. (a) Brazil shall repurchase the amount of its currency that results from a purchase under this extended arrangement in accordance with the provisions of the Articles of Agreement and Decisions of the Fund including those relating to repurchase as Brazil's balance of payments and reserve position improves.

(b) Any reductions in Brazil's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this extended arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the extended arrangement Brazil shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Brazil or of representatives of Brazil to the Fund. Brazil shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Brazil in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with paragraph 29 of the attached letter, Brazil will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria under paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the extended arrangement and while Brazil has outstanding purchases under this extended arrangement, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Brazil's balance-of-payments policies.

Brasilia, January 6, 1983

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Dear Mr. de Larosiere:

1. Over the past 15 years or so, Brazil has been following economic policies that aimed at high rates of domestic growth, the absorption of a rapidly growing labor force, and an appreciable increase in the standard of living of all Brazilians. Matching abundant domestic resources with sizable imports of capital and technology, the Brazilian economy was transformed during this period from a largely agricultural to a highly industrialized one. This transformation, which greatly expanded the size and role of the public sector, also affected the structure of Brazil's external trade. While formerly a few agricultural products like coffee and sugar dominated exports, today industrial products account for over one half of the total export value. Similarly the existence of a domestic market in excess of 100 million people has permitted a successful policy of import substitution; today, Brazil's imports consist overwhelmingly of oil, other raw materials, and investment goods.

2. Brazil's economic and financial policies since 1974 have been dominated by the need to adjust to the steep increase in the price of oil during the period. The substantial progress achieved in that effort suffered a severe setback with the second sharp oil price increase in 1979. The authorities responded by adopting, in late 1979 and early 1980, a comprehensive package of measures that included a major devaluation of the cruzeiro, fiscal and monetary restraint, and a liberalization of the foreign trade system. As the difficult external situation was further compounded by rising interest rates and weakening external demand, the authorities adopted additional measures in late 1980 and in 1981, including the partial freeing of interest rates, improved credit allocation, greater buoyancy of the tax system, tightened control over public spending, especially by state enterprises, and depreciation of the cruzeiro in line with the actual rather than projected rate of domestic inflation. Despite their scope, these measures did not restore domestic and external equilibrium. As a result, Brazil had to resort to considerable amounts of foreign borrowing.

3. The intention of the authorities of reducing the external and internal imbalances and of freeing the economy from restrictions in a gradual way suffered another setback in 1982, when Brazil's external situation weakened considerably. The decline in international commodity prices, the slowdown in the pace of world economic activity, an increase in protectionist policies, economic difficulties in countries that recently had become important buyers of Brazilian products, and the temporary appreciation of the cruzeiro, resulted in a decline in the value of exports that is estimated to reach 14 per cent in 1982. In contrast, the value of exports had grown by almost one third in 1980

and 16 per cent in 1981. Although imports have also declined appreciably this year, the 1982 trade surplus is expected to be no more than US\$3/4 billion, compared with an original estimate of US\$3 billion, and a surplus of over US\$1 billion in 1981. Continued high international interest rates caused an increase of over US\$1 billion in Brazil's net interest payments abroad; this factor, the decline in the trade surplus, and an increase in other service payments are likely to result in a sharp rise in the deficit on current account of the balance-of-payments (exclusive of reinvested earnings) from US\$11 billion (equivalent to nearly 4 per cent of GDP) in 1981 to some US\$15 billion (almost 5 per cent of GDP) in 1982.

4. In order to deal speedily and decisively with this situation, the Government has developed an economic program which, in the short run, will reduce substantially the external and internal imbalances and, in the medium term, will bring about structural changes in the economy that permit a return to high and sustainable rates of growth and employment. The basic strategy of this program is to raise significantly domestic savings, especially in the public sector, and to make the economy more efficient; the latter will be achieved through improvements in relative prices between the various sectors of the economy, an elimination of subsidies, and a reduction in restrictions and direct government intervention into the economic process.

5. In support of this economic policy program, which will be described in more detail below, the Government of Brazil hereby requests access to the financial resources of the International Monetary Fund for the equivalent of 450 per cent of Brazil's quota, under the first credit tranche and in the framework of an extended arrangement, for a period of three years. The Government of Brazil also intends to request the maximum amounts of assistance it can obtain under the Fund's compensatory financing facility for export shortfalls and the buffer stock financing facility.

6. To assure the success of this economic program, it will be essential that Brazil can continue to count on the financial support of foreign commercial banks, international organizations and governments. Such financial support will be of particular importance at the beginning of 1983 when the full adjustment effect of the measures has not yet materialized.

7. In October of 1982, the National Monetary Council approved the Foreign Sector Program for 1983 which aimed at a reduction in the deficit on current account of Brazil's balance of payments to about US\$7 billion (some 2 per cent of GDP) and at equilibrium in the overall balance of payments. Such a significant improvement in Brazil's external accounts, together with the requested use of Fund resources, will strengthen considerably Brazil's international reserve position.

8. For the second and third year of the extended arrangement the Brazilian authorities will be aiming at a further strengthening of Brazil's external position. The deficit on current account is to be

reduced to about 1-1/2 per cent of GDP in 1984 and 1 per cent in 1985; the deficit in the latter year would be equivalent to some US\$4 billion. Such an improvement would reduce substantially the growth of Brazil's external debt and allow for moderate surpluses in the overall balance of payments that would go to rebuilding Brazil's foreign exchange reserves even further.

9. The economic program also aims at a substantial reduction in the domestic imbalance. Because of the price effect of the intended reduction in restrictions and controls, the decline in the rate of inflation will necessarily have to be slower in 1983 than in the following two years. The average annual rate of inflation should decline from 95 per cent in 1982 to 78 per cent in 1983; the rate of price increases during the year is projected to decline from 99.7 per cent in 1982 to 70 per cent in 1983.

10. Recognizing the harmful effects that inflation has on investment and future economic growth, the authorities intend to formulate policies for 1984 and 1985 that will be directed toward major reductions in the annual rate of increase of domestic prices.

11. High foreign interest rates, the prolonged world recession, the tightness of foreign capital markets and other factors beyond the control of the authorities have made it increasingly difficult to follow policies geared to high rates of economic growth and employment. In order to ease the serious social hardships that the combination of high population growth with a stagnating pace of domestic economic activity has created, the authorities intend to stimulate economic activity and employment in 1983 and beyond by:

(1) an all-out effort to raise output for export through an appropriate exchange rate policy, and financial and technical assistance to the export sector;

(2) continued support to agriculture geared to raising investment and productivity in that sector;

(3) strengthening business confidence through this economic program which should stimulate industrial investment;

(4) a wage policy designed to increase employment; and

(5) price policies designed to stimulate output.

The authorities expect higher and sustainable growth during the second and third year of the extended arrangement, as the foreign constraint eases and the structural changes take hold.

12. Despite the wide-ranging price liberalization measures of 1980-81, the prices of some agricultural products and those of certain goods and services provided by the public sector have remained controlled and,

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over the past year or so, were not adjusted in line with cost developments. To redress this situation, the authorities have adopted, or will be adopting, the following measures:

(1) the prices of fuel products will be increased shortly by substantial margins; in general, fuel products will be priced during 1983 in such a way as to lower fuel consumption and therefore oil imports (thus freeing foreign exchange for additional imports of other raw materials and investment goods); to stimulate oil substitution; and to reduce substantially the oil account, which reflects past and present subsidies to these products;

(2) the selling price of wheat will also be raised shortly; the remaining subsidy will be reduced significantly during 1983 and should be eliminated completely by the end of 1985;

(3) the subsidy to sugar producers, which is particularly large at this point in time because of the low international prices, will also be reduced during 1983 and the remainder of the program period; any subsidy that might still be in existence by the end of 1985, depending on the development of international prices for sugar, will be transferred from the accounts of the monetary authorities into those of the Central Government;

(4) the prices of nonagricultural goods and services provided by the public sector were also reviewed and increases were decreed for steel, public utilities and transportation. The prices of a number of other goods and services are being adjusted, taking into account not only the financial situation of the public sector but also supply and demand conditions as in the case of hydroelectricity for which excess capacity exists.

13. During the period of the extended arrangement, the authorities intend to follow a price policy that will prevent the re-emergence of subsidies that have been eliminated on the above-mentioned products and, in general, will be designed to reduce other explicit and implicit subsidies in the economy. In this regard, the authorities also intend to improve transport and storage facilities in agriculture so as to enable the Government to reduce its role in the domestic marketing of agricultural products.

14. Central government revenues will be strengthened considerably during 1983 because:

(1) the income tax law was modified recently providing for an indexation for inflation of tax liabilities and a reduction in the period during which tax obligations have to be paid; this measure alone is expected to yield additional revenues during 1983 equivalent to almost 1 per cent of GDP;

(2) the increase in the taxation of diesel, that was introduced around the middle of this year, will now produce a full year's effect on revenues;

(3) the authorities have taken steps to further improve tax administration that should begin to yield results already in 1983; and

(4) certain fiscal incentives have been reduced substantially and additional action will be taken to further reduce or even eliminate them altogether except in the North and Northeast; also, a number of tax rates and tariffs will be adjusted before the beginning of the requested arrangement.

15. The authorities intend to apply strict austerity in spending. This will apply in particular to personnel outlays and transfers to the state enterprises. Tight control over other outlays of the Central Government will result in economies with respect to budgetary appropriations.

16. Over the past years, it has become evident that the efficiency and equity of the Brazilian tax system could be further improved. Such improvements refer to revenue distribution between states, shifting the incidence of taxes from wage goods to luxury goods, and to the necessity to stimulate savings, investment and exports. The authorities are presently preparing a tax reform bill that will be submitted to Congress in the course of 1983.

17. A significant amount of government expenditures is currently being carried out directly by the monetary authorities without reimbursement from the Central Government. This practice will be all but eliminated by the end of the extended arrangement through a substantial reduction in the transactions involved and a gradual transfer of the remaining expenditures to the budget of the Central Government.

18. The finances of the social security system suffered a serious deterioration during 1981. However, an increase in the rate of contribution and some rationalization in benefits have improved significantly the financial position of the system. The authorities will continue to follow policies that ensure the financial viability of the social security system.

19. A substantial part of the adjustment burden will have to be borne by the state enterprises. Irrespective of the more adequate pricing policy that was referred to above, a substantial cutback in the volume of their expenditures will be required during 1983 and beyond. Capital outlays are to decline considerably in real terms, as no major new investment projects (with the exception of Carajas, which is fully financed from abroad) are to be undertaken in 1983 and the execution of ongoing projects is being slowed. The projected decline in the volume of current spending will be much less, as a sizable increase in the cruzeiro value of interest payments on foreign debt is likely to offset to a large extent the spending economies arising from utmost austerity and restrictive hiring practices.

20. Over the medium term, the authorities will continue to hold to their current policies of reducing the number of public sector enterprises and of subjecting the remaining enterprises to the same market conditions that apply to private sector companies. This implies that, except for those entities that have a special social or development function to fulfill, this sector will have to be financially self-sustaining before long.

21. As a result of the measures described above, the borrowing requirement of the nonfinancial public sector is projected to decline significantly. This borrowing requirement, which had risen from 12.2 per cent of GDP in 1981 to an estimated 13.8 per cent in 1982, is expected to decline to 7.9 per cent in 1983. The Government intends to follow public sector policies in 1984 and 1985 that are consistent with the external objectives.

22. Despite significant improvements in some areas during the past few years, monetary control continues to be unfavorably affected by the existence of interest rate subsidies, and special programs which are largely dependent upon access to Central Bank credit, among others. In order to reduce the present high real rates of interest applicable to nonsubsidized credit operations, the National Monetary Council approved on December 16, 1982 a program of gradual increases in interest rates on loans to agriculture; the average nominal interest rate on such loans should be equal to or slightly above the expected rate of inflation by the end of 1983. However, loans to farmers in the North and Northeast and to small farmers in other parts of the country will still retain some implicit subsidy, which will be covered overwhelmingly by the fiscal budget. These changes are reflected in the Monetary Budget (also approved by the National Monetary Council) which specifies targets for monetary and credit expansion that are consistent with the balance-of-payments and inflation objectives.

23. Over the program period the authorities intend to proceed with the liberalization of the financial system both in terms of interest rates and quantitative restrictions, regulating the amount of domestic liquidity through such instruments as reserve requirements, rediscounting, and open market operations.

24. It will be of utmost importance to achieve a substantial strengthening of Brazil's external position in 1983. In order to compensate for some real appreciation of the cruzeiro that occurred during 1982 with respect to the currencies of Brazil's major trading partners and to set the stage for a reduction in trade and payments restrictions, the Government has decided to continue to depreciate the exchange rate of the cruzeiro vis-a-vis the U.S. dollar at a monthly rate that on average will be one percentage point above the rate of domestic inflation.

25. The export subsidy (credito-premio) was recently extended through April 1985 at its current level of 11 per cent. Certain services and goods equivalent to less than one half of the total value of imports

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are subject to an exchange tax of 25 per cent; also, a wide range of quantitative import restrictions and prohibitions were introduced recently to stem the rapidly widening balance-of-payments deficit. As the economy begins to adjust, the authorities intend to reduce substantially the quantitative import restrictions. In the present circumstances, it is impossible to foresee whether the significant exchange restrictions on exports and imports mentioned at the beginning of this paragraph 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 with respect to the currencies of Brazil's major trading partners will not lead to a modification of the exchange rate policy described in paragraph 24, but will be used to reduce these exchange restrictions.

26. During the first year of the requested arrangement, the authorities also intend to eliminate a number of minor exchange restrictions in an effort to facilitate international payments and transactions, and replace them, where necessary, with measures outside the exchange system.

27. During the second and third year of the arrangement the authorities intend to maintain the policy of minidevaluations of the cruzeiro in such a way that it will ensure the competitiveness of Brazilian exports and allow for the elimination of the remaining exchange restrictions. The authorities also intend to introduce during the period of the arrangement a trade system that would provide protection to domestic activity through tariffs rather than through quantitative restrictions.

28. Given the size of Brazil's public and private external debt, the authorities intend to limit new external net indebtedness, both short and long term to amounts that are consistent with the current account and the overall balance of payments targets.

29. The Brazilian authorities believe that the policies and measures described are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose. During the period of the requested arrangement Brazil and the Fund will consult periodically, in accordance with the policies on such consultations, to examine progress being made in implementing the program and achieving its objectives. With respect to the program for the first year, the Brazilian authorities will consult with the Fund before August 30, 1983 on the progress made in implementing the program. Moreover, before February 15, 1984 and February 15, 1985 the Brazilian authorities will consult with the Fund on the policies, measures and performance criteria for the second and third year of the requested arrangement.

Sincerely yours,

Carlos Geraldo Langoni
President of the Central
Bank of Brazil

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Minister of Finance

