Brasilia, December 20, 1984

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. We wish to inform you of the progress achieved to date in the implementation of the economic and financial program undertaken by the Government of Brazil and supported by the extended arrangement from the International Monetary Fund. We also wish to take this opportunity to communicate to you our policy intentions for 1985.

2. The strengthening of Brazil's external position has gone far beyond what at the beginning of the program had been regarded as an ambitious objective. On the basis of an active exchange rate policy and more favorable demand conditions in markets abroad, Brazil's export performance improved substantially; at the same time, a far-reaching import substitution effort, particularly with regard to petroleum products, has resulted in a significant decline in imports. Accordingly, the trade surplus is projected to amount to US$12.8 billion in 1984 compared with a target of US$9 billion originally set for 1984 and a surplus of only US$0.8 billion obtained in 1982. As a result mainly of this strong trade performance, Brazil has surpassed already the targets the program had set in the external area for the entire period 1983-85. The program had envisaged a decline in the current account deficit from nearly US$15 billion in 1982 to US$4 billion in 1985, as well as a net accumulation of reserves of US$3 billion during this same period. The current account is now projected to be virtually in balance in 1984 and the overall balance of payments is expected to show a surplus of some US$7.0 billion, which will bring the net accumulation of international reserves in the first two years of the program to almost US$4 billion.

3. The strengthening of our external position also has permitted us to make faster than envisaged progress in the elimination of multiple currency practices and exchange restrictions. An exchange restriction on profit remittances, a number of multiple currency practices, and all restrictive bilateral payments arrangements with Fund members were eliminated in 1983. Further substantial progress was made in 1984 with the elimination of external payments arrears, the termination of the centralized system of foreign exchange allocation, and particularly, the elimination of certain restrictive features of the import programs and minimum financing requirements.

4. Progress also has been made in the domestic area. There has been a change in relative prices favoring internationally traded goods; subsidies, both direct and through the credit mechanisms, have been

largely eliminated; the operational deficit of the public sector has been transformed into a surplus; and significant measures have been taken to increase the effectiveness of monetary policy. The increased economic efficiency provided by these changes, together with the favorable consequences of the adjustment in the external sector, have begun to produce the desired effect in terms of economic activity, and we expect real GDP to grow by some 4 percent in 1984.

5. The progress in restoring balance to the domestic economy, however, has been marred by the difficulties we have encountered in imparting the intended restrictive stance to demand policies and reduce inflation. The Brazilian economy is highly indexed, and this indexation retards the speed at which inflation can be brought down while it maintains the vulnerability of the economy to pressures that move inflation to higher levels. Thus, in view of the inability of demand policies to impede the inflationary pressures carried forward by indexation, the change in relative prices effected in 1983, together with unfavorable developments in agricultural supplies in that year, contributed to an acceleration of the rate of inflation from about 100 percent per annum to some 200 percent, level at which it has remained stubbornly pegged throughout 1984.

6. The program for the second year of the extended arrangement contemplated a reduction equivalent to some 5 percentage points of GDP in the overall borrowing requirement of the public sector (PSBR) in 1984. This decline was to come from lower expenditures for the maintenance of value of the public debt as a result of the expected deceleration of inflation, and from the elimination of the deficit in public sector operations other than those related to monetary correction; indeed an operational surplus equivalent to 0.3 percent of GDP was projected. The failure of inflation to decline precluded the expected reduction in monetary correction expenditures and, despite an intensification of our efforts which will result in an operational surplus equivalent to 0.5 percent of GDP, we now cannot expect a decline in the PSBR in 1984. Nevertheless, the adjustment obtained in regard to the operational outcome of the public sector, which thus far in the program is equivalent to almost 7 percentage points of GDP, points to the advance made in implementing the program's objective of reducing the size of the public sector.

7. In view of the limited assistance that could be provided by fiscal policy, monetary policy was unable to neutralize the monetary impact of the higher than expected accumulation of international reserves, and the objective of the program of an expansion of the monetary base of no more than 50 percent in 1984 was exceeded by a wide margin. We now estimate that, for the year as a whole, the monetization of the excess in the balance of payments surplus with respect to the program's projections is likely to amount to about Cr$5.6 trillion, or the equivalent of 130 percent of the monetary base at the beginning of 1984. The expansionary effect of this accumulation of international reserves has been offset in part by a larger than programmed reduction in the net

domestic assets of the monetary authorities, in particular by an increase in transfers from the Treasury to the Central Bank and by higher net sales of government securities in the open market; we estimate, however, that the monetary base will grow by some 170 percent in 1984.

8. The progress made thus far toward the achievement of the objectives of the program reinforces our determination to break inflation and thus advance in the main area of the program which has eluded our efforts. Demand policies, which thus far have been prevented from having the intended restrictive stance, should be used to break the pace of inflation and start the rate of price increase on a downward path. We have little doubt that a substantial reduction in inflation can be obtained and, in spite of the uncertainty about the timing and speed of such reduction, we believe that a rate of about 120 percent in 1985 is possible.

9. The cornerstone of the demand policies underlying the domestic adjustment effort continues to be the reduction of the imbalance in the public sector. We believe that a program of strict fiscal austerity is the basic condition to reverse the inflationary process and guarantee sustainable and orderly growth of the economy. Moreover, the adjustment of the public finances will permit us to effect the required tightening of monetary policy without negative consequences on interest rates. Our policies for 1985 reflect this stance and are described below.

10. The Central Government is expected to register an operational surplus in 1984 equivalent to 0.4 percent of GDP. This surplus will be obtained in spite of larger than planned expenditures stemming from the interest costs on the public debt that was placed to offset the unexpected accumulation of international reserves. The savings effort of the Central Government is expected to increase in 1985, when the continuation of strict austerity in spending together with the elimination of important subsidies, in particular those to wheat consumption and industrial exports, are expected to result in an operational budget surplus equivalent to 2.0 percent of GDP.

11. The operational deficit of the federal state enterprises in 1984 is expected to decline from the equivalent of 1.6 percent of GDP to 1.0 percent. The 1985 consolidated budget of these enterprises contemplates a further increase in revenues which, together with a reduction in investment outlays, is expected to offset a sizable increase in interest payments on both foreign and domestic debt and result in a balanced operational budget for this sector as a whole in 1985. The federal state enterprises that generate a surplus in their operations are required to transfer such a surplus to the monetary authorities either in the form of purchases of government securities or deposits at the Central Bank. In view of the importance that these transfers have for the execution of the monetary program in 1985, we have defined a set of targets for the net transfers from federal state enterprises to the Central Bank, which are described in paragraph 4 of the attached Technical Memorandum.

12. The operational position of the states and municipalities, and their enterprises, is expected to turn into a surplus equivalent to at least 0.5 percent of GDP in 1985. Revenues to this sector are expected to increase on account of increased revenue sharing arrangements with the Central Government and larger receipts from the value-added tax (ICM) stemming from the recovery of economic activity. In order to guarantee the achievement of the projected operational surplus in the states and municipalities, we intend to control their placement of bonds and their borrowing from domestic banks or abroad. In addition, the rest of the public sector, comprising mainly the social security system and a number of decentralized agencies and funds and programs, is projected to register an operational budget surplus equivalent to 0.4 percent of GDP in 1985.

13. The financial position of the social security system deteriorated in 1984 in spite of our efforts to increase the revenues of the system. We believe that this deterioration is of utmost concern and that prompt and far-reaching legislative action will be required aimed at a thorough overhaul of both revenues and expenditures of the system so as to guarantee the long-term soundness of its financial position.

14. All in all, the Government is determined to ensure a surplus equivalent to at least 2.9 percent of GDP in the public sector's operational outcome in 1985; this would involve an improvement of around 2.4 percentage points of GDP in relation to 1984. With this improvement, and taking into account the expected decline in the rate of inflation, the public sector's overall borrowing requirement will be reduced to about 12 percent of GDP. The corresponding targets for the public sector borrowing requirement and the operational performance for the three-month periods ending March and June 1985 are described in paragraphs 2 and 3 of the attached Technical Memorandum. To help ensure compliance with these budgetary targets, monthly indicative targets for the borrowing requirement of each of the main components of the public sector have been established and are described in paragraph 5 of the Technical Memorandum.

15. During 1984 price controls affecting a broad category of goods were lifted, with the result that at present goods with a combined weight of 53 percent of the wholesale price index, and 74 percent of the consumer price index, are free of controls. We intend to continue this policy in 1985, with the aim of limiting the use of price controls to those cases where they are required to curb unwarranted price increases by firms operating in an oligopolistic market. Similarly, we are proceeding with our policy of liberalizing trade in agricultural commodities in order to align their prices with the comparable international prices. In addition, prices and tariffs charged by state enterprises, in particular for steel and electricity, will continue to be adjusted to reflect fully the evolution of their costs and thus preclude the emergence of subsidies. The price of fuel products will be changed in line with exchange rate adjustments. Thus far in 1984, the price of wheat has been raised by 228 percent, and additional increases will

eliminate most of the existing subsidy to consumption by March 1985. This subsidy will be eliminated in its entirety by June 1985, and thereafter, prices of wheat and wheat products will be adjusted as necessary to prevent the re-emergence of a subsidy.

16. We believe that, under present circumstances, it is of decisive importance to implement a strict monetary policy. To obtain the desired reduction in the rate of inflation, stringent credit policies are needed, implying that the growth of the money supply and the monetary base will be kept under tight control and that an active interest rate policy will be pursued. Accordingly, the monetary correction factor which is used to adjust the value of financial obligations will continue to be determined at the end of each month to be no less than the rate of inflation (as measured by the General Price Index - Domestic Supply) corresponding to that month. The substantive fiscal effort planned for 1985 will permit the achievement of a sharp reduction in the rate of expansion of the monetary base while ensuring a reasonable expansion in the availability of credit to the private sector, thus impeding undue pressures on interest rates. The effective implementation of monetary policy in 1985 will be further helped by the reduced accumulation of international reserves projected for that year. Accordingly, we intend to limit the growth of the monetary base and the money supply to no more than 60 percent for the year as a whole. To this end we have defined indicative targets for these monetary aggregates which are set out in paragraph 7 of the attached Technical Memorandum and will be subject to consultation as agreed. Consistent with these aims in respect to monetary policy and our objectives for the balance of payments, we have also defined a set of limits on the net domestic assets of the monetary authorities at the end of March and June 1985 which are set out in paragraph 6 of the Technical Memorandum.

17. We feel confident that the outstanding external sector performance of 1984 is a sustainable one and that we can look forward to further improvement in 1985. We expect further growth in exports, albeit at a slower pace, which, together with the continued reduction in petroleum imports, will permit a sizable expansion in non-oil imports. Interest payments on the external debt are projected to be larger than in 1984, resulting in a small deficit in the current account of the balance of payments. This deficit, however, will in all likelihood not exceed the equivalent of 1 percent of GDP. Under these circumstances, and in view of projected capital inflows, we have defined a surplus of at least US$100 million as a target for the balance of payments in 1985, as described in paragraph 1 of the attached Memorandum. The Government is determined to ensure that Brazil will continue to remain current on all its external payments and will continue the policy of minidevaluations of the cruzeiro, as defined in paragraph 9 of the Technical Memorandum, in such a way that the competitiveness of Brazilian exports is ensured while allowing for the elimination of the remaining multiple currency practices and exchange restrictions.

18. In the light of the strong performance of our balance of payments and of the improved prospects in this respect, we can look forward to more normal circumstances with regard to Brazil's external finances and thus give proper expression to our objective of reducing reliance on foreign savings in our long-term growth strategy. The improvement of our international reserve position and the favorable circumstances envisaged for our balance of payments in 1985 have reduced greatly the need for foreign borrowing in that year. Accordingly, we intend to limit external net indebtedness, both short- and long-term, to the amounts set out in paragraph 8 of the Technical Memorandum.

19. Substantial progress has been made thus far in liberalizing the exchange and trade system. We intend to continue to administer the import licensing procedure so that no licenses will be denied for reasons of use or availability of foreign exchange, except for purposes of capital controls. We have initiated the phasing out of the export tax credit, and this tax credit will be terminated in April 1985. We are reviewing the deposit requirement associated with the opening of letters of credit with the intention of eliminating the restrictive aspects connected with this deposit before the end of 1985. The exchange allotments for travel abroad will be restored, before the end of 1984, to at least the levels prevailing on September 14, 1983. The coffee contribution quota will be replaced by an export tax with effect from January 1985. We expect to conclude rapidly the few remaining bilateral agreements with official lenders under the auspices of the Paris Club. We also continue to move ahead in the area of trade liberalization; beginning with the coming crop year, foreign trade in agricultural products will be freed from controls, and we are revising and gradually changing the structure of import surcharges and quantitative import restrictions, replacing them where indicated by a suitable tariff. The Government, as stated in our previous letters, remains committed to eliminate the remaining multiple currency practices and exchange restrictions during the period of the extended arrangement; in particular, we intend to eliminate the IOF tax, as it applies to foreign exchange transactions, no later than the end of 1985.

20. The Brazilian authorities believe that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose. During the remaining period of the arrangement, Brazil will consult the Fund, in accordance with the policies of the Fund on such consultation, to examine the progress being made in implementing the program and the achievement of its objectives.

Sincerely yours,

/s/	/s/	/s/
Affonso Celso Pastore President Central Bank of Brazil	Antonio Delfim Netto Minister of Planning	Ernane Galveas Minister of Finance