Brasilia, December 2, 1991

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

Dear Mr. Camdessus:

1. The performance of the Brazilian economy weakened considerably during the 1980s. Per capita income stagnated, investment declined sharply, and large macroeconomic imbalances led to very high levels of inflation at the turn of the decade. The rate of inflation reached 84 percent a month by the time the present Government took office in mid-March 1990. While the economy grew by 3 1/4 percent in 1989, mainly as a result of strong consumption expenditure, real GDP growth decelerated during the course of the year and became negative in the first quarter of 1990. The balance of payments registered an overall deficit of US$3.3 billion in 1989 and was financed by the accumulation of external payments arrears.

2. Upon taking office, the Government introduced an adjustment program aimed at eliminating inflation and at increasing the volume and efficiency of investment to promote the resumption of sustained economic growth. The program included a general price freeze, and a new currency, the cruzeiro, replaced the new cruzado at par. Liquidity was drastically reduced through the blocking of two thirds of financial assets, monetary correction of most financial assets was maintained well below the inflation rate in the initial months of the program, and fiscal policy was strengthened. The program also included key structural reforms aimed at enhancing economic efficiency, alleviating poverty, and promoting the integration of Brazil into the international economy by reducing the role of the public sector in the economy, liberalizing domestic and external transactions, and privatizing a large number of public enterprises.

3. Initially there was a sharp reduction of inflation that was accompanied by a large drop in economic activity. However, the strengthening of the public finances could not be sustained, a sizeable fraction of the blocked assets was released at an early stage, and monetary policy was at times accommodating; as a result, inflation began to rise again. Nevertheless, substantial progress was made in liberalizing regulations affecting domestic markets with a view to broadening competition, and in implementing an administrative reform which eliminated a number of decentralized agencies and other public entities and reduced the number of employees in the federal public sector by some 10 percent. The nonfinancial public sector borrowing requirement dropped from 83 percent of GDP in 1989 to 30 percent of GDP in 1990, when the operational and primary balances registered surpluses of

1 1/4 percent of GDP and 2 1/4 percent of GDP, respectively. Real GDP fell by 4 percent in 1990 and the overall balance of payments deficit widened to about US$8 billion, and there was a further accumulation of external payments arrears.

4. The exchange and trade system was liberalized significantly in 1990-91. In March 1990 the exchange rate applicable to commercial transactions was allowed to be determined in an interbank market, as had been the case of the exchange rate applicable to certain service and capital transactions (the tourist market). Within this system, intervention in the exchange market by the Central Bank has reflected the need to attain the Bank's foreign reserve targets while taking into account the effects of import liberalization and developments in export competitiveness. The spread between the exchange rates in the tourist and in the commercial interbank markets was significantly reduced in the second half of 1990, restrictions--including arrears--on certain external obligations of the private sector were eliminated in 1990 and early 1991, and regulations on private capital movements were liberalized in the first half of 1991. In 1990, most quantitative import controls were abolished, the granting of import licenses was made automatic, the list of prohibited imports was eliminated, external financing requirements for imports were suspended indefinitely, and most fiscal incentives for exporters and import tariff exemptions were eliminated.

5. A far-reaching multiyear program of trade liberalization, including a restructuring of the tariff schedule, was launched directed at opening the economy, promoting Brazil's technological modernization, and improving economic efficiency. Under the program the maximum tariff is to be reduced from 105 percent in 1990 to 40 percent by January 1994 and the average tariff rate on non-oil imports from 32 percent in 1990 to 14 percent by January 1994. The first stage of this program was implemented in early 1991 with the lowering of the maximum tariff rate to 85 percent and the average tariff rate to 25 percent. Also, the government is working with three of its neighboring countries - Argentina, Paraguay and Uruguay - on the establishment of a common market by end-1994.

6. Faced with a deterioration of the public finances and an acceleration of inflation, the Government introduced in late January 1991 a set of measures which included large adjustments in public sector prices and a new price freeze. The Government also eliminated the overnight market in government securities (except for transactions between financial institutions), introduced the Fundos de Aplicação Financeira (FAFs) which are required to invest a certain proportion of their portfolio in federal and central bank securities, and established a new, forward-looking system for calculating interest rates in the financial market (the Reference Interest Rate-TR). As financial and other policies were not sufficient to reduce inflation substantially when price controls were relaxed, as foreseen, the monthly rate of recorded inflation rose to 15-16 percent by September. The rate of price increase has risen further since September as a result of the pass-through effects of the depreciation of the cruzeiro in

late September, the unexpected surge in agricultural prices in between two harvests, corrective adjustments in public prices, and preventive price increases based on unfounded expectations of a new price freeze. Real GDP is projected to show little growth from 1990 to 1991.

7. The release of the financial assets that were blocked in March 1990 was scheduled to start in September 1991 and to be completed in 12 monthly installments. As an earnest of its commitment to the release of these assets, the Government advanced the process by one month by unblocking all accounts with a balance of up to Cr$200,000 and one thirteenth of all other accounts, subject to a maximum of Cr$200,000. At the same time, the Government established a more attractive saving deposit for these assets (the Deposito Especial Remunerado, with an annual yield of TR plus 8 percent compared with TR plus 6 percent earned by regular saving accounts), to induce holders of the assets being released to retain them in the form of domestic financial saving.

8. In view of the difficulties faced by the previous attempts at stabilization in recent years and the entrenched nature of inflation in Brazil, it has become clear that a more comprehensive approach is necessary to address the root causes of inflation. To this end, the Government has designed and has begun to implement a comprehensive medium-term program of adjustment and structural change. The aim of the economic program is to achieve a gradual but sustained reduction of inflation, strengthen saving and public credit, and intensify reforms with a view to fostering sustained economic growth over the medium term in the context of a satisfactory balance of payments.

9. For these purposes the Government has been undertaking measures of immediate effect in the fiscal and credit areas; is advancing work with Congress on institutional changes to facilitate further adjustment of the public finances and to increase the scope for private investment, both domestic and foreign; is engaged in the development of a major fiscal reform that would permanently strengthen revenue, restrain expenditure, and establish new financial relations among various levels of government; is taking further steps to reduce the scope of the public sector and thus increase the role of market forces, including through the privatization of public enterprises; and is liberalizing further the trade system to promote a more competitive environment.

10. The Government is fully committed to the implementation of the policies included in its program in support of which the Government hereby requests a stand-by arrangement from the Fund for the period extending through August 1993 in the amount of SDR 1,500 million. On the basis of this program, the Government believes that after the recent acceleration, inflation will decline steadily and that by the end of 1992 it will permit a further decline during 1993 to around 20 percent. Real GDP is projected to remain virtually unchanged in 1992 and to grow by 3 percent in 1993 and by 5 percent a year thereafter.

11. The Government already has tightened financial policies substantially and is determined to maintain these policies until expectations have been reversed and inflation reduced on a lasting basis. The Government established a 100 percent marginal reserve requirement on time deposits in mid-August and raised real interest rates sharply in late August, including to prevent an undue expansion of credit that could have been facilitated by the release of blocked assets and to encourage domestic financial saving. Since then, interest rates have remained high in real terms. Public sector prices have been increased to regain most of the ground lost in the recent past and the real exchange rate has been adjusted substantially.

12. The adjustment of the public finances is critical for the success of the stabilization effort. The fiscal reform referred to above encompasses not only a major tax reform but also a redefinition of the role of the state in the economy, including a clear specification of the responsibilities of each level of government (federal, state, and municipal). This is a task of great complexity which will demand reflection, negotiation, and support, both within the Government, including Congress, and by society at large. On account of this complexity, the special legal requirements for the consideration of certain fiscal matters by Congress, and the short time remaining until the beginning of the next fiscal year, the Government opted for a two-stage strategy for the fiscal reform.

13. The first stage of this reform encompasses a series of actions which have already been adopted by the Administration or which were sent to Congress in early November. These actions are aimed at promoting tax equity, simplifying tax return procedures, and generating the resources necessary for the immediate implementation of the stabilization program. The second stage, which would be aimed at consolidating the fiscal effort, will be submitted to Congress in the course of the first semester of 1992 and be put into effect not later than the beginning of 1993. The Government has been consulting with a broad range of experts both from the private and public sectors and, in order to benefit from the international experience in these matters, is requesting technical assistance from the Fiscal Affairs Department of the IMF and the staff of the World Bank.

14. The Government is determined to attain in 1992 a primary surplus of the nonfinancial public sector consistent with a sizable reduction of the pressure on resources and to support the pursuit of the tight credit policy that is needed to combat inflation. The primary surplus of the nonfinancial public sector (excluding the proceeds from privatization) will increase from an estimated 1.0 percent of GDP in 1991 to 2.3 percent of GDP in 1992 in the baseline plus a further 0.7 percentage point of GDP through actions involving levels of government other than the Federal Government. The fiscal effort is of the order of 4 percent of GDP in 1992 as the primary balance would have shown a deficit of 1 percent of GDP on the basis of previous policies, mainly due to an increase in social security benefit payments and a projected further decline in revenue.

15. Despite the improvement in the primary surplus, the deficit of the nonfinancial public sector in 1992 would increase to 2.7 percent of GDP because real interest payments on domestic debt would be higher than in 1991 as a consequence of the tightening of credit policy and the rise in the cost of financing public debt resulting from the release of the blocked assets. Further efforts will be undertaken not later than the beginning of 1993 to increase the primary surplus in that year to at least 4 percent of GDP. This is expected to result in an operational surplus of around 0.5 percent of GDP in 1993, which would make possible a reduction in domestic public debt.

16. The strengthening of the primary balance and the projected decline in inflation will permit a reduction of the public sector borrowing requirement (PSBR) from 36 percent of GDP in 1991 to 18 percent of GDP in 1992 and to around 5 percent of GDP in 1993. Quarterly limits for the PSBR and for the operational result as well as indicative quarterly floors for the primary surplus are presented in Sections III, IV, and V of the attached Technical Memorandum of Understanding.

17. To meet the objectives for fiscal adjustment in 1992, the Government intends to proceed rapidly in the areas of income tax reform, indirect taxation, and tax administration. As noted, in November 1991 the Administration submitted for Congress' approval the necessary draft legislation, and expects the law to become effective on January 1, 1992. At the same time, control over expenditure will be tightened further and public sector prices will continue to be adjusted as described below.

18. Under the proposed legislation, all taxes, including those relating to social security, will be indexed through the "Tax Reference Unit" (UFIR), which will be adjusted periodically in line with inflation. The reform of the personal income tax provides for increased taxation of individuals in the higher income brackets and a simplification of tax returns, exempting around 3 million individuals from the obligation to file. In addition, it envisages more stringent limitations to the deductibility of fringe benefit payments from the corporate income tax base. Deductions would remain the same except that education expenses would be deductible up to a certain limit. As for corporations, the income tax would be collected on a current basis in such a way that corporations will pay taxes as profits accrue. This will imply an advance into 1992 of income tax payments equivalent to two thirds of the corporate income tax liabilities which would have been paid in 1993. At the same time, however, to encourage investment, accelerated depreciation over two years will be allowed, if the investment takes place before December 31, 1993. The rate of the withholding tax on capital would be lowered from 8 percent to 5 percent in 1992 and progressively reduced to zero by 1994. Also, the tax on industrial products (IPI) for cigarettes and automobiles already has been raised from 320 percent to 330 percent, and from 26.4 percent to 36.5 percent, respectively, while it has been proposed to the Congress that 27 small levies be eliminated to simplify the tax system.

19. Tax reform measures have been proposed to promote the inflow of foreign capital. The supplementary tax imposed on the remittance of dividends and royalties to foreign investors would be eliminated and the income tax rate payable on the remittance of profits abroad would be reduced in those cases where income tax rates applicable in the country of destination are lower than in Brazil. Also, real interest earnings of foreign institutional investors would be taxed at a lower rate, 15 percent compared with 25 percent at present, and capital gains would be exempted from income tax.

20. The Government is introducing new measures to enforce tax compliance. This effort involves the early hiring of some 1,500 tax auditors and 2,400 assistants to bring the tax auditing system up-to-date, sharing of information on taxpayers between the Treasury and the Social Security System, and improving procedures and the information system needed to collect tax arrears. The legal framework to enforce tax collection will be strengthened through provisions currently before the Congress that would permit the attachment of property and the relaxation of bank secrecy in cases of tax offenses. The collection of tax arrears in litigation will be expedited through negotiations between taxpayers and the Tax Administration. In addition, the Government has decreed the transmittal of information on tax violations to the "Procuradoria Geral da República".

21. Consistent with the law of Budget Directives (LDO), the budget for 1992 will not permit the Federal Government to increase its debt in real terms to cover noninterest outlays. In addition, the Central Administration will continue to implement a policy of expenditure restraint on the basis of a cash management approach and a 10 percent reduction in specified maintenance expenditure. As regards the wage bill, the Administration submitted to Congress a proposal to adjust federal government wages in line with fiscal constraints. This would formalize a policy that has been implemented since mid-1991. The Federal Government is engaged in negotiations with the state and municipal governments with a view to developing adjustment programs to improve their financial position. In addition to the expenditure measures just mentioned, the Government intends to follow a policy of restraint in its net lending to the private sector and to ensure that the full cost of funds lent to the Treasury is passed on to the final user of credit, except in those cases where a budgetary allocation has been provided for.

22. While significant efforts to reduce current expenditure are being made, social security benefit payments are projected to increase by approximately 1 percent of GDP in 1992 as a consequence of the implementation of benefits mandated by the Constitution of October 1988. The increase in benefits that took effect in September 1991, together with the adjustment of the basic benefit to the level of the minimum wage, is designed to protect the living standards of retired and disabled persons and to enhance the social security cover of rural workers. A Committee has been formed to study a long-term redesign of social benefit provisions. In the meantime, certain short-term measures will be adopted to reduce expenditures through the elimination of invalid claims for benefits and to improve collection of social security

contributions. As a result of all these measures, the primary surplus of the Central Administration is projected to increase from an estimated 0.5 percent of GDP in 1991 to 1.2 percent of GDP in 1992, and is targeted to increase further to 1.9 percent of GDP in 1993.

23. The primary balance of the public enterprises is projected to improve from near balance in 1991 to a surplus of 1.1 percent of GDP a year in 1992-93. This improvement will be achieved as a result of the average real increase in public sector prices that is being implemented, the subsequent maintenance of these prices in real terms, and the improvement and better enforcement of expenditure and borrowing controls, including the prohibition of incurring new arrears. With the recent increases, average public sector prices in real terms are projected to be in 1992 some 15 percent above their average level of 1991. At the same time, the Government will permit a better alignment of regional prices with corresponding costs (desequalização) and will liberalize further certain prices in the steel, rail transport, and telecommunications sectors.

24. An ambitious privatization program that is expected to yield approximately US$18 billion over a number of years has been initiated with the sale of USIMINAS--a profitable steel company, which is Latin Americas' largest--in October 1991. Three smaller public enterprises have been auctioned since then. Moreover, the Government intends to proceed with the sale of its majority holdings in some 10 companies in the steel, petrochemical, fertilizer, and transportation sectors. The Government also will sell its minority participation in 16 other firms in the petrochemical sector. The privatization program is open to the participation of foreign investors and, at the pace now envisaged, is expected to yield the equivalent of about 1/2 percent of GDP a year in 1992-93.

25. The primary balance of the state and municipal governments is expected to improve from a surplus of 0.5 percent of GDP in 1991 to 0.7 percent of GDP in 1992 and to 1 percent of GDP in 1993 as the adjustment packages agreed between the federal and state and local governments and the Federal District of Brasilia take hold. The projected result in 1992 reflects a moderate increase in revenue transfers from the Federal Government partially offset by an increase in expenditure. Furthermore, as in the case of public enterprises, the financing of states and municipal governments will be subject to new, more rigid, limits.

26. To facilitate a further strengthening of the public finances, in October, the Administration submitted to Congress proposals for institutional changes that seek modifications in tax sharing arrangements between the Federal and the state and municipal governments for 1992 and 1993, the prohibition of new issues of bonded debt by the states, and a debt restructuring program whereby the Federal Government will assume state debt in return for a two-year adjustment program that would facilitate a restructuring of expenditure by the states; the taxation of entitlements for housing subsidies, which otherwise might jeopardize the fiscal stabilization efforts in the next few years; and the taxation of the distribution of fuel,

the proceeds of which are being applied to road building and maintenance. In this context, any increase in revenue in real terms in 1992-93 over the level of 1991 is to be used entirely by the Federal Government in the fiscal adjustment effort.

27. The Government attaches critical importance to the maintenance of the current restrained credit policies to help attain the desired reduction of inflation. The Government is aware that until the fiscal adjustment takes hold these policies would continue to result in very high real interest rates. The credit program for 1992 has been designed to be consistent with a substantial reduction of inflation in the course of the year and with the external objectives of the program, and is thus based on a conservative projection of the demand for money. Limits have been set on the expansion of the net domestic assets of the Central Bank of Brazil, as described in Section II of the attached Technical Memorandum of Understanding. Moreover, credit policy will be tightened further if needed to ensure that inflation is reduced as projected.

28. The Government has adopted measures aimed at increasing competition and efficiency of the financial system. It has proposed to Congress to reduce the tax wedge that increases the spread between deposit and lending rates, subject to tax revenue considerations. Furthermore, the Government will work with the states on the strengthening of the state banking system.

29. The Government's program continues to emphasize the liberalization of both domestic and external transactions. Price controls established on January 31, 1991 were gradually phased out and now apply only to a small basket of essential goods and to certain oligopolistic sectors. The scope of monitored prices also has been reduced substantially and will be phased out as inflation declines. Further progress in reducing government intervention in the economy and in promoting foreign direct investment is envisaged in the proposed institutional changes which will allow private sector investment in areas that had been reserved to the public sector, such as telecommunications, mining, and the transport of, and trade in, petroleum, and by establishing equal treatment for companies set up with domestic or foreign capital. As described below, the program includes further steps toward external trade liberalization.

30. The Government's economic strategy attaches high priority to measures aimed at alleviating poverty and generating employment. In addition to the widening of the social security system to extend its coverage of poorer groups such as rural workers, as well as the increase of social security benefits of the low-income groups, the Government is proposing to eliminate or reduce the income tax on the same groups and is engaged in a new program to provide comprehensive education to children of low-income families together with on-site nutritional and health care programs. However, the most important beneficial impact of the program on the lower-income groups will come from the elimination of inflation, together with the resumption of sustained economic growth. At the same time, the Government has been improving and strengthening the enforcement of environmental policies.

31. In the context of its efforts to reduce Government intervention in the labor market, the Government has taken actions to reduce indexation in the wage determination process. Indexation of central administration salaries has been abolished and new legislation was passed in September 1991 reducing the extent of indexation for other wages. A system to protect wages up to three minimum wages has been put in place with adjustments every four months linked to past inflation and interim advances every two months of at least 50 percent of inflation during the preceding two months. Wage policy will be kept under review so that it is compatible with the reduction of inflation and the resumption of economic growth that are being sought.

32. The Government will maintain the managed floating exchange system for commercial transactions and the Central Bank will intervene in exchange markets in ways that are consistent with the programmed strengthening of its international reserves and the attainment of a viable balance of payments in the medium term. Targets for the international reserve position of the Central Bank have been specified and are described in Section I of the attached Technical Memorandum of Understanding. Brazil's ability to achieve these targets has been enhanced by the recent real depreciation of the cruzeiro.

33. As was mentioned above, in 1991 exchange restrictions on current transactions and on registered private capital flows have been progressively removed while the spread between the commercial and the tourist exchange rates has stayed on average below 15 percent. The Government remains committed to the timely removal of exchange restrictions on payments and transfers for current transactions and of any remaining multiple exchange rate practices. In this context, the Government intends to eliminate in 1992 the restrictive elements of its bilateral payments agreement with Bulgaria.

34. The Government will continue to open the economy in an effort to increase economic efficiency and foster technological innovation by broadening competition in Brazilian markets. In this context, in January 1992 the Government will implement the second stage of the multiyear import tariff reform by reducing the maximum tariff rate to 65 percent and the average tariff on non-oil imports to 21 percent. In early 1993, these tariff rates will be reduced further to 50 percent and 17 percent, respectively. The Government will seek to eliminate any remaining nontariff barriers to trade. In addition, the Government will extend authorization to issue import licenses automatically to private financial institutions as soon as the necessary facilities are in place. Also, it will abolish the requirement of prior authorization for imports of computers and computer-related products in October 1992. The trade policy reform effort is expected to be supported by loans from multilateral development banks and bilateral creditors.

35. Aided by declines in international interest rates and by the effect of the real depreciation of the cruzeiro, the external current account deficit is projected to average about US$1.5 billion a year in 1992-93. Despite

further sizable debt and nondebt inflows to the Brazilian private sector, the capital account is projected to continue registering large deficits, mainly as a result of the maturing obligations of the Brazilian nonfinancial public sector. The financing gaps projected in the program period are expected to be filled by exceptional financing and other concerted lending.

36. The Government will continue to make every effort to normalize relations with the international financial community consistent with its commitment to reintegrate Brazil into the world economy, compatible with the effort to achieve fiscal adjustment and to secure an adequate and sustainable rate of economic growth. In this context it will:

a. Make every effort to reach agreement with nonbank creditors by March 1992 on the elimination of arrears. To this end, the Government will seek to refinance arrears and current debt service obligations to Paris Club creditors on pre-cutoff date debts of the Brazilian nonfinancial public sector. No new arrears to nonbank creditors will be incurred during the program period;

b. Seek to increase disbursements from the World Bank, the IDB, and official creditors, including resources in support of structural reforms that are being undertaken;

c. Continue to make efforts to reach a comprehensive and lasting agreement with nonresident commercial bank creditors that would address the external financing requirements in the program period, while satisfactorily contributing to a viable balance of payments position in the medium term. In this context, the Government will continue to allow free access to the commercial floating exchange market for the purpose of servicing of debts owed to banks by the Brazilian private sector and by certain public sector entities (Petrobras, Companhia Vale do Rio Doce, and some financial institutions); will continue to allow the payment of market interest rates by all of the above entities in their new borrowings; will continue to pay all debt service falling due on noneligible bank debts; will make partial payments of interest that falls due on eligible debts owed to banks by the rest of the nonfinancial public sector; and will allow the use of foreign debt instruments in its privatization program. To help finance debt reduction operations the Government is requesting that 25 percent of each purchase under the proposed stand-by arrangement be set aside. The Government continues to attach top priority to an early and successful conclusion of its negotiations with commercial bank creditors.

37. In view of the heavy debt service burden both on the public finances and the balance of payments over the medium term, the Government will limit net external borrowing of the public sector, including short-term borrowing by the nonfinancial public sector. Quarterly limits to this effect are set out in Section VI of the attached Technical Memorandum of Understanding.

38. The Government of Brazil believes that the policies set forth in this letter are adequate to achieve the objectives of the program, but will take additional measures that may become appropriate for this purpose. During the period of the arrangement, the Government will consult with the Fund, in accordance with the Fund's policies on such consultations, regarding the progress being made in implementing the policies described in this letter. In particular, the Government's economic program, as described in this letter, will be reviewed with the Fund on a quarterly basis to assess progress made in policy implementation and in accordance with the Fund's policies on financing assurances. In any event, the economic program will be reviewed with the Fund again before August 31, 1992 and before February 28, 1993, in order to establish suitable performance criteria for the second half of 1992 and the first half of 1993, respectively.

Yours sincerely,

/s/

Marcilio Marques Moreira
Minister of the Economy,
Finance and Planning

/s/

Francisco Roberto Andre Gros
President of the
Central Bank of Brazil