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CONFIDENTIAL

September 20, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Brazil - Extended Arrangement

There is attached a copy of the letter dated September 15, 1983 from the Brazilian authorities, together with a technical memorandum of understanding, setting forth the intention of the Government with respect to its economic program in the framework of the extended arrangement for Brazil.

This matter will be brought to the agenda for discussion at a later date.

Att: (1)

Brasilia
September 15, 1983

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

Dear Mr. de Larosière:

1. On February 28, 1983 the Executive Board of the International Monetary Fund approved a request from the Government of Brazil for the use of Fund resources for the equivalent of 450 percent of Brazil's quota under the first credit tranche and in the framework of an extended arrangement for a period of three years. The extended arrangement was in support of an economic program aimed, in the short run, at reducing external and internal imbalances and, in the medium term, at bringing about structural changes in the economy that would permit a return to high and sustainable rates of growth and employment. The basic strategy of the program was to reduce the dependence on external resources by raising domestic savings, especially in the public sector, and to make the economy more efficient; the latter was to be achieved through improvements in relative prices, an elimination of subsidies, and a reduction in restrictions and direct government intervention.

2. In the intervening period, the process of external adjustment has been well underway. The program aimed at a reduction in the deficit on current account of Brazil's balance of payments from some US$15 billion (some 5 percent of GDP) in 1982 to about US$7 billion (2 percent of GDP) in 1983 as well as at equilibrium in the overall balance of payments. The improvement in the current account was predicated on the achievement of a trade surplus of some US$6 billion in 1983. The trade performance in the first eight months of the year, during which a surplus of US$4.3 billion was obtained already, indicates that the target for the whole year is likely to be achieved. The significant improvement in the trade performance reflects to a large extent the substantial adjustment of the external value of the cruzeiro which has taken place since the beginning of this year. In the light of these encouraging developments, we feel reassured that the target for the current account deficit of 1983 can be met by and large, and that the overall balance of payments will be in equilibrium this year. The program also aimed at a deficit in the current account of the balance of payments in 1984 not larger than US$5 billion. This additional improvement was predicated on a further increase in the trade surplus to some US$8 billion in 1984 and a total interest bill estimated not to exceed US$9 billion. Interest rates in the international capital markets have begun to rise again and we see no indications that this disturbing trend will be reversed over the next 12 months. In the light of these developments, and in spite of our intentions to increase the targeted trade surplus to about US$9 billion, it does not appear that we can limit the current account

deficit for 1984 to less than US$6.0 billion. We are nevertheless confident that the targets for the overall balance of payments for 1984 and 1985, specified in paragraph 8 of the letter of January 6, 1983, can be obtained.

3. Notwithstanding the favorable developments in the trade account, Brazil's foreign exchange situation remained difficult during the first half of 1983, as short-term financing fell far short of initially programed levels which, at that time, were deemed appropriate. The reduced access to foreign finance caused Brazil to exceed by narrow margins the maximum balance of payments deficit established for March and June 1983; at the same dates the ceilings on the net disbursement of foreign debt were met. Moreover, the foreign exchange shortage led to the emergence of payments arrears, which amounted to US$2,534 million by the end of August 1983, and to a tightening of the surrender of foreign exchange requirements applying to commercial banks.

4. As regards domestic economic policies, a delay in the full implementation of the pricing measures referred to in paragraph 12 of the letter of January 6, 1983, coupled with difficulties in arresting the momentum that public sector expenditures carried over from 1982, affected adversely the finances of the public sector. The cash surplus of the Central Government during the first half of 1983 fell short of what had been assumed in the program; the consolidated finances of the state and municipal governments continued to exhibit considerable weaknesses; and insufficient progress was made in redressing the financial situation of the state enterprises. The financing needs of the public sector added to the problems caused by the inadequate availability of foreign funds resulting in the nonobservance of the original performance criteria relating to the borrowing requirement of the public sector and net domestic assets of the monetary authorities in both March and June 1983. As a consequence of many factors, including the maxidevaluation of February, catastrophic floods in the South, and a continuing severe drought in the Northeast, as well as the stance of demand policy, the rate of inflation deviated substantially from the path assumed in the program. During the first eight months of 1983 domestic prices rose by 109 percent, to a level that was 153 percent higher than in August 1982.

5. In order to accelerate the domestic adjustment effort, the Government of Brazil has decided to reinforce its economic policies by adopting additional measures, which are described in more detail below. In the light of these considerations, the Government of Brazil hereby requests that the requirements relating to the performance criteria that have so far not been observed be waived, and that some of the performance criteria and targets of the economic program pertaining to the first year of this program be modified as detailed below.

6. The high rate of inflation recorded so far this year makes it impossible to contain annual inflation at the target rate of 85-90 percent during 1983. So far in the second semester we have experienced a continuation of rather high monthly rates of inflation as a result of some corrective price measures that were implemented recently. The continued application of an appropriate monetary policy and, in particular

the limitation of the growth of the monetary base to 90 percent during 1983, should cause the monthly rate of inflation to come down significantly to about 5 percent during the final quarter of 1983. Given recent experience, it may not be possible to reduce inflation in 1984 to the levels originally envisaged. Nevertheless, it is planned to cut inflation in the course of the year to a monthly rate of about 2.5 percent during the last quarter of 1984.

7. In line with the intentions expressed in paragraph 12 of the letter of January 6, 1983, the Government has adopted, or will be adopting, the following measures:

(a) The prices of fuel products were increased on June 9, 1983 by 45 percent on average, thus ending effectively the subsidization of these products; in the future, these prices will be adjusted in line with the devaluation of the cruzeiro in order to prevent the re-emergence of a subsidy.

(b) The price of wheat was raised on June 27, 1983 by 100 percent and on September 1, 1983 by an additional 40 percent; further increases will be introduced which should eliminate any subsidy to new wheat sales by June 1984. The prices of wheat products were also raised substantially and will continue to reflect fully wheat price developments. Subsequently pricing policy of wheat and wheat products will be adjusted so as to prevent the re-emergence of any subsidization.

(c) The prices of steel and electricity have been raised so far in 1983 by 90 percent, and will be adjusted during the remainder of the year so as to yield an increase 5 percent above the rate of domestic inflation (as measured by the adjustment to ORTNs).

(d) The subsidies involved in sugar pricing are being kept under review in accordance with the intentions stated in paragraph 12(3) of the letter of January 6, 1983.

(e) The prices of public sector services are being adjusted frequently, generally in line with domestic inflation and taking into account efficiency considerations and supply and demand conditions.

(f) The prices of over 300 industrial products and services provided by the private sector have been subjected recently to renewed controls, limiting their increase without a show of cause to 80 percent of past inflation. As the monthly rate of inflation begins to decline, these controls will be rescinded gradually.

8. As regards the finances of the Central Government, the authorities announced in June a series of measures that included (a) a withholding tax of 4 percent on profits realized in open-market operations; (b) an advance to 1983 of part of the 1984 income tax payments by financial institutions; (c) various measures designed to improve tax administration and increase personal and corporate income tax collections; and (d) a reduction in the withholding tax on lower incomes and in the tax

on domestic financial transactions. The combined effect of these measures is expected to yield additional revenues equivalent to about Cr$610 billion in 1983. The strict austerity in spending announced in the letter of January 6, 1983 is being maintained.

9. The changes in pricing and wage policies referred to in paragraph 7 above and paragraph 14 below will improve the finances of the state enterprises. Nonetheless, these enterprises will have to bear an additional part of the required adjustment burden, in view of the deviations in their spending policies that occurred in the first half of this year. A recently finalized revision of the 1983 consolidated budget of the state enterprises aims at a reduction in the volume of expenditures. A sharp cutback in investment outlays is unavoidable, and special economies have to be obtained in current expenditures in order to offset the (devaluation-related) sizable increase in the cruzeiro value of imports and interest payments on foreign debt. To ensure their achievement, expenditure control has been strengthened considerably and wage legislation has been changed recently (see paragraph 14 below). In addition, a monitoring system relating to developments in the public sector has been introduced (see paragraph 12 below).

10. The measures described in the preceding paragraph are expected to strengthen significantly the finances of the public sector. However, considering that practically eight months of this year have elapsed and taking into account the unavoidable lag between the implementation and the effect of new measures, the degree of real adjustment of public sector finances contemplated at the beginning of this year cannot be achieved. Nonetheless, it is our intention to reduce this operational deficit, which was calculated at the equivalent of 6.0 percent of GDP in 1982, by more than half to 2.7 percent this year. Still, the correction of public sector debt for domestic inflation and the depreciation of the exchange rate at rates that in 1983 will be noticeably higher than the GDP deflator, will result in public sector borrowing requirement of 15.4 percent of GDP in 1983, about the same as in 1982.

11. The Government is determined to ensure at least a small surplus in the public sector's operational budget position in 1984; this would involve an improvement of around 3 percentage points in relation to GDP between 1983 and 1984, and a reduction in the public sector's overall borrowing requirements to about 7 percent of GDP. Such results would broadly return fiscal performance to that originally envisaged in the program. Most of the measures needed for this improvement have already been taken in the areas of the Central Government and of state enterprises.

(a) As to the Central Government, the already announced phasing out of subsidies will improve government finances by 0.6 percent of GDP in 1984. This, coupled with additional revenues, equivalent to about 0.6 percent of GDP, will result in an increase in the Central Government's operational budget surplus from 0.6 percent of GDP in 1983 to about 1.6 percent in 1984. The improvement would be larger but for increased transfers, equivalent to 0.2 percent of GDP, to state enterprises.

(b) As to state enterprises, it will continue to be the policy to ensure that receipts rise in 1984 approximately in line with inflation. With the change in wage legislation and containment of other current expenditures, a slight increase in the current surplus of the state enterprises is planned and, in addition as noted above, there will be an increase in transfers from the Central Government. It has also been decided to reduce further, by the equivalent of 1.0 percent of GDP, investment outlays in 1984. In total, the operational deficit of the federal state enterprises will decline from about 2.5 percent of GDP in 1983 to around 1 percent in 1984.

(c) The finances of the states and municipalities, and their enterprises, will improve sharply in 1984 as a result of a number of measures and their operational deficit is expected to decline by 0.8 percent of GDP. Their share of tax resources will increase and general fiscal and monetary policies will require a strict limit to be placed on any increase in the indebtedness of those entities. Necessary controls are in place. These apply to borrowing from domestic banks, placement of domestic bonds, and borrowing abroad.

12. To help ensure that budgetary targets are complied with, an Interministerial Committee for Monitoring the Implementation of Public Budgets (COMOR) was formally established on August 2, 1983. Directed by the Vice Ministers of Finance and Planning, COMOR coordinates actions at the central government level that affect the public sector borrowing requirements, including those of the state enterprises and state and municipal governments, so as to comply with the adjustment program. COMOR will have at its disposal monthly data on relevant developments with a lag of four to six weeks. Agreed monthly targets for the second half of 1983 for the borrowing requirements of the Central Government, the state enterprises, and the state and municipal governments are set out in paragraph 3 of the attached Technical Memorandum.

13. In the area of monetary policy, several measures have been introduced recently aimed at strengthening monetary control. These measures are as follows:

(a) Maintenance of restrictive limits on the lending of the Bank of Brazil.

(b) Establishment of tighter limits on domestic bank credit to the public sector.

(c) Increase in legal reserve requirements by 5 percentage points on both sight and time deposits.

(d) Reduction in subsidies to agricultural credits and export financing. Interest rates on loans to agriculture were increased from a fixed rate of 45 percent to a rate equal to 85 percent of past inflation plus 3 percentage points applicable to lending in 1983. The proportion of adjustment for past inflation will be raised to 95 percent in 1984 and 100 percent in 1985. Somewhat lower rates will apply for loans to farmers in the North and Northeast. The rate of interest on export financing has been increased from 40 percent to 60 percent. As of the beginning of 1984, this rate will be established at 70 percent of past inflation, plus 3 percentage points.

The corresponding ceilings that have been established for the expansion of net domestic assets of the monetary authorities are contained in paragraph 4 of the attached Technical Memorandum of Understanding.

14. Despite several important modifications to wage legislation earlier this year, the system of automatic wage adjustments has remained rigid, causing a rise in unemployment and preventing a reduction in the rate of inflation. In order to provide an environment more conducive to the creation of employment, and permit a substantial decline in the rate of inflation, the Government issued on July 13, 1983 Decree-Law No. 2045 which limits the semiannual adjustment of wages and salaries to 80 percent of past inflation. This Decree-Law was read in the Congress on August 16, 1983.

15. With respect to the external sector, the Government will continue to follow the exchange rate policy that was specified in paragraph 9 of the letter of February 24, 1983. As regards exchange restrictions, the Government is proceeding with the elimination, before the end of 1983, of those minor exchange restrictions referred to in paragraph 7 of the attached Technical Memorandum of Understanding and replace them, where necessary, with measures outside the exchange system; it also restates the intentions relating to the other exchange restrictions contained in paragraph 25 of the letter of January 6, 1983. The Government intends during the remainder of this year to restore the foreign exchange surrender regime prevailing before July 30, 1983, and to eliminate external payments arrears. Accordingly, ceilings have been established on these arrears, which are specified in paragraph 8 of the attached Technical Memorandum of Understanding.

16. The Government has initiated steps to compensate the shortfall in the implementation of the original program of external finance (Projects 3 and 4) through increased recourse to medium- and long-term foreign financing; such additional finance will need to be reflected in the limits on new external indebtedness. These new limits, which will continue to be consistent with the current account and the overall balance of payments targets, are specified in paragraph 5 of the attached Technical Memorandum of Understanding.

Sincerely yours,

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

Attachment