

15
3. MARCH, 1984 AMENDMENT TO THE IMF PROGRAM

3.1 - Letter of Intent

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

Dear Mr. de Larosiere:

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 approved by the Executive Board of the International Monetary Fund on February 28, 1983. We also wish to take this opportunity to communicate to you our policy intentions for 1984.

2. The medium-term economic program was adopted in late 1982 not only to cope with a sudden deterioration of the country's external position that caused the loss of a substantial part of Brazil's international reserves, but also in response to the more fundamental need to change the country's long-term strategy from one that relied heavily on foreign borrowing to one based on the generation of domestic savings. The program aimed in the short run at reducing external and internal imbalances and, in the medium term, at bringing about structural changes that would permit a return to high and sustainable rates of growth and employment.

3. The severity of the foreign financing constraint and the size of the domestic imbalances determined the need for a substantial adjustment in the first year of the program. In the external area the program aimed at a reduction in the deficit on current account from nearly US\$ 15 billion in 1982 to US\$ 7 billion in 1983 as well as at equilibrium in the

overall balance of payments, requiring the generation of a trade surplus of about US\$ 6 billion. Reliance on exchange and trade restrictions could not be contemplated beyond the short run, and the bulk of the necessary domestic adjustment effort was to be borne by the public sector which was called upon to reduce its overall borrowing requirement by 8 percentage points of GDP. Moreover, in its first year, the program was to bring about important structural changes, including the elimination of subsidies, thereby increasing the efficiency of the economy and setting the stage for a resumption of economic growth in the latter years of the program.

4. Substantial progress was made in adjusting the external accounts and Brazil's balance of payments has strengthened more than expected. The trade balance for 1983 showed a surplus of about US\$ 6.5 billion, mostly reflecting a sharp contraction of imports but also a recovery of exports which benefited from the significant adjustment of the external value of the cruzeiro that took place during the year. The more favorable result on the trade account, together with lower than expected payments for interest and services, led to a substantially larger than expected reduction in the current account deficit which is now estimated to have amounted to some US\$ 6 billion in 1983 compared with US\$ 14.8 billion in 1982. However, throughout the year, Brazil's foreign exchange position remained very difficult because inflows of direct investment, credits from banking sources and trade-related short-term credits turned out to be significantly smaller than had been projected. The critical foreign exchange situation gave rise to external payments arrears and exchange restrictions. In order to ease this foreign exchange constraint, financial arrangements were made in November 1983 involving the participation of official as well as private creditors, that aimed at securing the external financing needed for the latter part of 1983 and for 1984 as a whole. The program had contemplated that US\$ 3.5 billion of the new financial facility arranged by commercial banks would be disbursed in December 1983. In the event, this disbursement was delayed and this caused the nonobservance of

a number of performance criteria pertaining to the last quarter of 1983.

5. The maxidevaluation of February 1983 marked a radical departure from the original program, as explained in our letter of February 24, 1983. While essential to the dramatic progress in balance of payments adjustment, it also made more difficult the achievement of the domestic objectives of the program and, in particular, contributed to the acceleration of inflation. Numerous and substantial other adjustments in administered prices had a similar impact, but had to be undertaken in 1983 because they were essential to the restoration of economic efficiency and of financial and monetary stability. Because of delays in their implementation and in the adjustment of the public finances progress lagged behind that envisaged in the program. These delays had adverse effects on the conduct of monetary policy.

6. Since June 1983 the Government has taken comprehensive measures to reinforce the adjustment effort. Wage legislation was modified to permit the partial deindexation of the wage adjustment process. The finances of the public sector were strengthened through a concerted effort to increase revenue and to reduce expenditures at all levels. A number of decisive steps were taken to eliminate subsidies. Relative prices for fuel products and wheat were raised and the prices for other public sector services were adjusted by and large in line with inflation. Negative interest rates in real terms on most of the credits to agriculture and exports were eliminated. Monetary policy in general was tightened through an increase in legal reserve requirements and the limitation of the expansion of the monetary base to a target of 90 percent for 1983.

7. Nevertheless, it became necessary to modify the program targets for the latter part of 1983 because of the deviations that had already occurred. The ceiling on the overall public sector borrowing requirement (PSBR) in 1983 was raised from the equivalent of 8.8 percent of GDP to 18.6 percent of GDP, mainly reflecting the effect of the higher inflation on the value of the public sector's debt. The target for

operational deficit was raised to the equivalent of 2.7 percent of GDP. By December 31, 1983, both of these revised ceilings had been met; the PSBR amounted to 17.9 percent of GDP while the operational deficit was the equivalent of 2.5 percent of GDP. Both the monetary base and the money supply grew by and large in line with the target of 90 percent implicit in the program. However, the ceiling on the net domestic assets of the monetary authorities, which was modified to accommodate the revised assumptions in regard to inflows of foreign finance mentioned in paragraph 4 above, could not be met as this inflow failed to materialize.

8. The rate of inflation in 1983 was 211 percent. The high rate of inflation that occurred in the first half of the year was compounded subsequently by the corrective price measures undertaken as part of the adjustment effort, and by the sharp increase in agricultural prices caused by floods and drought, external trade developments and the removal of a number of subsidies. The monthly rate of inflation remained in the range of 12-13 percent from June through October 1983; afterwards, there was a slowing down in the inflationary pace with the rate declining to 8.4 percent in November and 7.6 percent in December.

9. In our letters of September 15, 1983 and November 14, 1983 we indicated our intentions in regard to our economic policies in 1984 and we also specified targets for the first quarter of 1984. In particular, we stated our intention to reduce the public sector's borrowing requirement to 9 percent of GDP in 1984 (although it was stressed that the actual result would depend on the speed at which inflation was reduced); to achieve an operational surplus in the public sector equivalent to at least 0.3 percent of GDP; to limit the expansion of the money supply and the monetary base to 50 percent for 1984; and to seek a further reduction in the current account deficit of the balance of payments. At the present time, we wish to reiterate our intention to keep this policy stance. The policies required to achieve those targets are described in more detail below.

10. As mentioned above, the pace of inflation has remained stubbornly high and has coexisted with increasingly tight financial policies, a modified wage legislation and with an unwelcome degree of slack within the economy. We firmly believe that reducing inflation is of decisive importance from the standpoint of achieving external equilibrium and from the standpoint of laying the foundation for sustained growth. At this time, all needed domestic policies are in place and these should lead to a substantial decline in inflation. However, given the entrenched nature of inflation and the high degree of indexing in the economy, both formal and informal, the time lag between the implementation of policies and their effects on inflation cannot be predicted with confidence. Thus, it is necessary to be cautious about counting on a particular rate of inflation at a particular time in the near term. There can be little doubt, however, that the rate of inflation that prevailed in 1983 and in the opening months of 1984 will be brought down substantially; in fact, in our opinion, the measures already in place should permit a drop of as much as one-half during 1984.

11. Concerns about inflation are not preventing necessary corrective price adjustments and liberalization of pricing policy. (a) Frequent increases in prices of fuel products have been implemented to prevent the re-emergence of a subsidy. (b) The price of wheat and wheat products was increased by a further 50 percent in February 1984 and additional increases will eliminate the subsidy on wheat by midyear, as was intended; thereafter, prices of wheat and wheat products will be adjusted as necessary to prevent the re-emergence of any subsidization. (c) The prices of steel and electricity will be adjusted during 1984 so as to yield an increase 5 percent above the rate of inflation as measured by the industrial wholesale price index and the national consumer price index, respectively. (d) New initiatives are being taken to liberalize trade in a number of agricultural commodities in order to align their prices with the comparable international prices. (e) It is not intended to use price controls to limit or retard needed price adjustments for products and services

provided by the private sector. It is apparent that this sector needs to generate sufficient internal resources for growth and development and it is intended to allow adequate adjustment of prices. Controls will be used to curb unwarranted price increases in cases where firms are operating in an oligopolistic market.

12. As regards the finances of the public sector, an important and very useful development has been the establishment on August 2, 1983 of an Interministerial Committee for monitoring the Implementation of Public Budgets (COMOR). 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. Monthly targets for the six months to September 1984 for the borrowing requirements for each of the elements of the public sector have been established.

13. The Central Government achieved balance on its operational budget in 1983 as against a deficit equivalent to 2 percent of GDP in the previous year. In December 1983 additional measures were introduced that tightened significantly tax administration, in particular as regards taxation of income generated from financial operations. The effect of the recent revenue and tax administration measures, together with the continuation of strict austerity in spending and the elimination of the subsidy on wheat and wheat products, is expected to result in an operational budget surplus for the Central Government equivalent to 0.8 percent of GDP in 1984.

14. The financial position of the state enterprises was better than expected in 1983 on account of higher revenues and higher treasury transfers which more than compensated for a lower than projected reduction in investment expenditures. The operational budget deficit of the federal state enterprises was reduced to the equivalent of 1.9 percent of GDP in 1983 compared with the expected 2.4 percent of GDP. The efforts to restore financial stability to this important sector of the economy will continue in 1984. The 1984 consolidated budget of the federal state enterprises aims at an increase in their revenues from operations of 5 percent in real terms which will

come about mainly through an active pricing policy, the coming on stream of a number of investment projects, and increased output. A further cutback in investment outlays and special economies in current expenditures have to be obtained in order to offset the sizable increase in interest payments on foreign as well as domestic debt. Tight expenditure control and strict implementation of Decree-law 2100 and Decree 89,253 relating to wage and fringe benefits in state enterprises will be required to achieve the intended containment of current expenditures. In total, the operational budget deficit of federal state enterprises will be reduced to 1.2 percent of GDP in 1984.

15. The finances of the states and municipalities, and their enterprises, will improve sharply in 1984. In 1983 their operational budget performance was maintained within the expected limit of a deficit equivalente to 1.3 percent of GDP, mainly because of the effectiveness of the controls placed on their placements of bonds and borrowing from domestic banks or abroad. These controls will be maintained in 1984. The effect of these controls together with the increased revenues for state and municipalities arising from the increase in the rate and coverage of the value-added tax (ICM) and the new revenue sharing arrangements with the Central Government, is expected to result in a balanced operational budget for this sector in 1984.

16. The rest of the public sector, comprising mainly the social security system and a number of decentralized agencies and funds and programs, registered an operational budget surplus equivalent to 0.5 percent of GDP in 1983 exceeding the surplus of 0.1 percent that had been projected. This occurred despite a deterioration of the finances of the social security system, and was due mainly to the receipt by funds and programs of the additional earnings obtained as a result of the elimination of credit subsidies. For 1984 a concerted effort is already under way to restore a sound financial position in the social security system. Through this effort and the continuing effect of measures taken in

1983, it is expected that the contribution in 1984 of the rest of the public sector to the overall operational surplus will amount to 0.7 percent of GDP.

17. All in all, the Government is determined to ensure a surplus equivalent to at least 0.3 percent of GDP 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. The public sector's overall borrowing requirements will be reduced to a range equivalent to 11 to 13 percent of GDP depending on the level of inflation and the speed at which inflation is reduced. The corresponding targets for the public sector borrowing requirement and the operational performance for the three-month periods ending June and September 1983 have been specified.

18. Monetary policy has acquired decisive importance under present circumstances. To ensure achievement of a major reduction in inflation, stringent credit policies are needed, implying that the growth of the money supply and of the monetary base will be kept under tight control and that an active interest rate policy, which will ensure positive real rates of interest, 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 adjusted for accidental factors) corresponding to that month. In addition, we intend to keep the expansion of the money supply and of the monetary base in 1984 to no more than 50 percent. To this end we have defined monthly targets for the period up to September 1984 for these aggregates. Open market operations will be fully geared to the observance of these targets and will be used to correct any impending deviation from them. At the same time, we are managing operations in the overnight market in a steady way aiming at providing no permanent net financing on average to the market. The reduction of subsidized credit and of quantitative restrictions on banks will result in a more efficient allocation of scarce credit resources

and will reduce the wide dispersion of interest rates existing in the past. We intend to proceed with the liberalization of the credit market through further reductions in subsidies and quantitative restrictions. The aims in respect to monetary policy we have described have been translated into a set of limits on the net domestic assets of the monetary authorities.

19. With respect to external sector policies, and in the light of the encouraging results obtained in 1983, we feel reassured that the target for a trade surplus of US\$9 billion in 1984 can be met. In the light of recent experience there are uncertainties with respect to projections of net service payments in 1984. Nonetheless, assuming there are no adverse changes in world market conditions, including international interest rates, we believe it would be feasible to aim at a deficit in the current account of the balance of payments of around US\$5 billion in 1984 which was the original aim contained in our letter to you of January 6, 1983. This expected improvement in the current account for 1984, together with the successful completion of the financial arrangements mentioned above, makes us confident also that the target for an overall surplus in the balance of payments of US\$1 billion for 1983 and 1984 combined can be obtained.

20. The Government continues to be firmly committed to maintain a competitive exchange rate and to eliminate all remaining multiple currency practices and exchange restrictions during the period of the extended arrangement:

(a) During 1983, the exchange rate depreciated by 289 percent in terms of cruzeiros per U.S. dollar, with the real value of the cruzeiro declining by 25 percent in relation to the U.S. dollar. For the period March 1983 through January 15, 1984 the cruzeiro was devalued in line with the General Price Index (IGP) adjusted for accidental factors, thus complying with the performance criterion in the program. In the future the policy of minidevaluations of the cruzeiro will be maintained in such a way that the competitiveness of Brazilian exports will be ensured while allowing for the

elimination of the remaining multiple currency practices and exchange restrictions.

(b) An exchange restriction on profit remittances, a number of multiple currency practices and all remaining bilateral payments arrangements with Fund members were eliminated in December 1983. Two major remaining multiple currency practices are the export tax credit (credito-premio) and the financial transactions tax (IOF) on the sale of foreign exchange. The export tax credit, which will expire at end-April 1985, will be eliminated by that date. In December 1983 the scope of the financial operations tax was enlarged to include sales of exchange for petroleum imports. However, the Government reaffirms its intention of eliminating the IOF tax, as it applies to foreign exchange transactions, no later than the end of 1985. We have already begun to study alternatives to compensate for the resulting revenue losses.

(c) The authorities reaffirm their intention 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. The technical work for the implementation of such a policy has been entrusted to a working group composed of high level representatives of the appropriate departments of government. The authorities intend to submit the relevant legislation to Congress by mid-1984. Progress in the area of import liberalization will be assessed in the August review.

21. Prospective developments in the world economy, combined with the results expected from the policy reforms being undertaken in the context of Brazil's extended arrangement with the Fund, justify a positive assessment of Brazil's medium-term balance of payments outlook. Continued recovery in major economies should provide expanded export opportunities. Our domestic reforms which have strengthened the role of relative prices and reduced the importance of administrative controls, should leave Brazilian producers in a better position to take advantage of these opportunities as they emerge. We hope that conditions in international

capital markets will become more normal resulting in lower interest rates and therefore lower interest payments on Brazil's external debt. Our policies already have reduced substantially Brazil's external current account deficit thereby reducing Brazil's dependence on increased foreign borrowing, and providing us with the opportunity to rebuild our international reserve position to desirable levels.

22. In the light of our strong performance in the current account of the 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. This will permit us to give proper expression to our goal of reducing reliance on foreign savings in our long-term growth strategy. Accordingly, we 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.

23. 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 and the Fund will consult periodically, in accordance with the policies on such consultations, to examine the progress being made in implementing the program and the achievement of its objectives. In particular, the Brazilian authorities will consult with the Fund before August 31, 1984 on the progress made in the implementation of the economic program described herewith.

Sincerely yours,

Affonso Celso Pastore
President
Central Bank of Brazil

Antônio Delfin Netto
Minister of Planning

Ernane Galvêas
Minister of Finance