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CURRENCY EQUIVALENTS

Currency Unit: Cruzeiro (Cr$)

Exchange Rates Effective January 31, 1984

US$1	=	Cr$3,585
Cr$1	=	US$0.00027

Average Exchange Rates

	1980	1981	1982	1983	1984
US$1	Cr$52.71	Cr$93.13	Cr$179.51	Cr$577.04	Cr$1846.90
Cr$1	US$0.019	US$0.011	US$0.0056	US$0.0017	US$0.00054

PREFACE

This report is a product of ongoing Bank economic work on medium-term policy choices for Brazilian economic recovery and development. It is based upon work done by a Bank mission which visited Brazil during May-June 1984. The mission was composed of:

William Tyler (Mission Chief)

Rui Coutinho (Economist - Macroeconomic & Monetary Analysis)

Peter Knight (Economist - Agriculture & Financial Sector Analysis)

Graeme Thompson (Economist - Balance of Payments & Public Sector Analysis)

Lorene Yap (Economist - Employment and Energy Analysis).

Kathie Krumm and Deepak Lal participated in the work during a preparatory mission and have provided a background paper in support of the present report's analytical underpinnings. Statistical assistance in Washington was provided by Mss. Shideh Hadian, Alessandra Caselli, and Maria Benito and Mr. Luis Breuer. The mission received substantial and graciously assistance provided from officials in SEPLAN, the Central Bank, the Ministry of Finance, CACEX, and other government institutions and from individuals in the business, financial, and academic communities.

COUNTRY DATA - BRAZIL

AREA	POPULATION	DENSITY (1982)
8,512,000 km^2	126.8 million (mid-1982)	14.6 per km^2

Rate of Growth: 2.5% (1970-80)

POPULATION CHARACTERISTICS /a	
Crude Birth Rate (per 1,000)	31.2
Crude Death Rate (per 1,000)	8.1

HEALTH (1977)	
Population per physician	1,700
Population per hospital bed	253

INCOME DISTRIBUTION (1980)	
% of total income, highest quintile	60.5
lowest quintile	4.6

DISTRIBUTION OF LAND OWNERSHIP	
% owned by top 10% of owners	45.0
% owned by smallest 10% of owners	1.5

ACCESS TO SAFE WATER (1976)	
Percentage of population	77.1

ACCESS TO ELECTRICITY /a	
% of dwellings - total	67.4
- rural	20.6

NUTRITION /a	
Calorie intake as % of requirements	107.0
Per capita protein intake (grams/day)	60.0

EDUCATION /a	
Adult literacy rate %	76.0
Primary school enrollment %	93.0

GNP PER CAPITA (1982) US$2,240

GROSS NATIONAL PRODUCT (1983) /b

ANNUAL RATE OF GROWTH (%, constant prices)

	US $ Mln.	%	1981	1982
Gross Domestic Product	209,800	100.0	-3.2	1.0
Gross Domestic Investment	37,082	17.7	-4.1	-4.2
Gross National Saving	18,356	8.8	0.2	-10.5
Export of Goods and NFS	23,628	11.3	37.7	-8.4
Import of Goods and NFS	19,594	9.3	10.9	-5.2

OUTPUT, EMPLOYMENT AND PRODUCTIVITY (1983) /b

	Gross Domestic Product		Economically Active Population (EAP) /b		GP per EAP
	US $ Mln.	%	Mln.	%	US $
Agriculture	24,127	11.5	13.9	29.9	1,736
Industry	66,927	31.9	10.6	22.8	6,314
Services	118,746	56.6	22.0	47.3	5,398
Total/Average	209,800	100.0	46.5	100.0	4,512

GOVERNMENT FINANCE

	As % of GDP (at current cruzeiro prices) 1982 /c
Current Receipts	21.2
Current Expenditures	25.4
Current Deficit (-)	-4.2
Capital Expenditures	3.4
Financing (Net)	7.6

/a Most recent estimate, between 1980 and 1982.
/b Estimate.
/c Includes government expenditures effected through the monetary budget and some minor government funds, as well as transfers to the federal enterprises.

COUNTRY DATA - BRAZIL

MONEY, CREDIT and PRICES	1975	1978	1979	1980	1981	1982	1983
			(Billions Cr$ outstanding end period)				
Money Supply (M1)	172.0	463.0	803.0	1,367.0	2,559.0	4,222.0	8,232.0
Commercial Banks Credit to Private Sector	165.0	592.0	1,010.0	1,736.0	3,573.0	7,091.0	18,166.0
			(Percentages or Index Numbers)				
Money as % of GDP	15.6	12.6	13.5	10.7	8.8	7.6	6.8
General Price Index (1977 = 100)	49.6	139	214	428	897	1,754	4,464
Annual Percentage Changes in:							
General Price Index	27.7	38.7	54.0	110.2	95.2	99.7	211.0
Money Supply (M1)	42.7	42.3	73.6	70.2	87.2	65.0	95.0
Bank Credit to Private Sector	55.2	57.0	70.7	72.0	105.8	98.4	156.2

BALANCE OF PAYMENTS	1977	1980	1983
		(US $ million)	
Export of Goods and NFS	13,344	21,896	23,628
Import of Goods and NFS	14,823	27,839	19,594
Resource Gap (deficit = -)	-1,479	-5,943	4,034
M&LT Interest Payments (net)	-2,103	-6,331	-8,473
Other Factor Payments (net)	-455	-290	-1,840
Net transfers	-	126	108
Balance on Current Account	-4,037	-12,438	- 6,171
Direct Private Foreign Investment (net)	810	1,121	657
Net MLT Borrowing			
Disbursements	8,765	10,085	7,331
Amortization	4,135	6,610	3,534
Net Disbursements	4,630	3,475	3,797
Other Capital (net) and capital n.e.i.	-773	4,453	-1,613
Increase in Reserves (+)	630	-3,389	-3,330
Gross Reserves (end year) /c	7,256	6,912	3,757
Petroleum Imports /a	4,081	10,210	8,607

RATE OF EXCHANGE

AVERAGE 1984

US $ 1.00 = Cr $ 1,846.98
Cr $ 1.00 = US $ 0.0005

MERCHANDISE EXPORTS (1983)

	US $ Mln.	%
Coffee (beans + soluble)	2,325	10.6
Sugar	515	2.4
Soy Products	2,101	9.6
Cocoa	283	1.3
Iron Ore	1,519	6.9
Semi-Processed Goods	1,759	8.0
Manufactured Goods	10,873	49.7
Other Commodities	2,519	11.5
Total	21,894	100.0

EXTERNAL M&LT DEBT, DECEMBER 31, 1983 /d

	US $ Mln.
Public Debt, incl. Guaranteed	58,068
Non-Guaranteed Private Debt	21,512
Total Outstanding & Disbursed	79,580

M&LT DEBT SERVICE RATIO (1983) /b 75.3 %

IBRD LENDING (December 31, 1984)

	US $ Mln.
Outstanding & Disbursed	4,597
Undisbursed	3,444
Outstanding incl. Undisbursed	8,041

/a Crude and derivatives.
/b Debt service on both public and private external debt as a percentage of exports of goods and non-factor services.
/c Change in level of reserves differs from reserve change in balance payments by valuation adjustment.
/d Estimate.

BRAZIL - COUNTRY ECONOMIC MEMORANDUM

Table of Contents

GLOSSARY OF ACRONYMS

ACESITA	Aços Especiais Itabira (Itabira Steel Industry)
BCB	Banco Central do Brasil (Central Bank of Brazil)
BdB	Banco do Brasil S.A. (Bank of Brazil)
BNDES	Banco Nacional de Desenvolvimento Econômico e Social (National Economic and Social Development Bank)
BNH	Banco Nacional de Habitação (National Housing Bank)
CACEX	Carteira de Comércio Exterior (Foreign Trade Office)
CDI	Conselho de Desenvolvimento Industrial (Council of Industrial Development)
CIP	Conselho Interministerial de Preços (Interministerial Price Council)
CNPS	Conselho Nacional de Política Salarial (National Council on Wage Policy)
CPPG	Consolidação Plurianual dos Programas do Govêrno (Multi-Year Consolidation of Government Programs)
CVRD	Companhia do Vale do Rio Doce (Valley of Rio Doce Company)
DIEESE	Departamento Intersindical de Estatística e Estudos Sócio-Econômicos (Inter-Union Department of Statistics and Socio-Economic Studies)
DNER	Departamento Nacional de Estradas Rodoviárias (National Department of Roads)
EAP	Economically Active Population
EFF	Extended Fund Facility

ELETROBRAS	Centrais Elétricas Brasileiras S.A. (Brazilian Power Company)
FGTS	Fundo de Garantia de Tempo de Serviço (Guaranteed Fund for Time of Service)
FGV	Fundação Getúlio Vargas (Getulio Vargas Foundation)
FIESP	Federação Industrial do Estado de São Paulo (Industrial Federation of the State of Sao Paulo)
FINAM	Superintendência para Financiamento do Amazonas (Superintendency for Financing of Amazonas)
FINAME	Agência Especial de Financiamento Industrial (Special Agency for Industrial Financing)
FINOR	Fundo de Investimentos do Nordeste (Northeast Investment Fund)
FINSOCIAL	Fundo de Investimento Social (Fund for Social Investment)
FISET	Fundo de Investimento Setorial (Fund for Sectoral Investment)
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GDY	Gross Domestic Income
GNP	Gross National Product
GNS	Gross National Savings
GNY	Gross National Income
GPI	General Price Index
IBGE	Instituto Brasileiro de Geografia e Estatística (Brazilian Institute of Geography and Statistics)
ICM	Imposto sobre Circulação de Mercadorias (Value-added Tax)
INPC	Indice Nacional de Preços ao Consumidor (National Consumer Price Index)

INPES	Instituto Nacional de Pesquisas Econômicas e Sociais (National Institute of Economic and Social Research)
IPEA	Instituto de Pesquisas Econômicas Aplicadas (Institute of Applied Economic Research)
IPI	Imposto sôbre Produtos Industrializados (Industrial Products Tax)
IPLAN	Instituto de Planejamento (Institute of Planning)
LIBOR	London Interbank Offer Rate
LCT	Leis Consolidadas do Trabalho (Consolidated Labor Laws)
LTN	Letras do Tesouro Nacional (National Treasury Notes)
MW	Minimum Wage
NUCLEBRAS	Empresas Nucleares Brasileiras S.A. (Brazilian Nuclear Company)
ORTN	Obrigações Reajustáveis do Tesouro Nacional (Readjustable Treasury Obligations)
PASEP	Programa de Assistência ao Servidor Público (Asset Accumulation Program for Public Servants)
PETROBRAS	Petróleo Brasileiro S.A. (Brazilian Petroleum Company)
PIS	Programa de Integração Social (Program of Social Integration)
PORTOBRAS	Empresa de Portos Brasileiros S.A. (Brazilian Ports Company)
RAIS	Relação Anual de Informações Sociais (Annual Report on Social Data)
RFFSA	Rede Ferroviária Federal, S.A. (Federal Railways Company)
SEAP	Secretaria Especial para Abastecimento e Preços (Special Secretariat for Supply and Prices)
SEPLAN	Secretaria de Planejamento da Presidência da República (Secretariat of Planning - Planning Ministry)

SEST	Secretaria Especial para o Contrôle das Empresas Estatais (Special Secretariat for the Control of State Enterprises)
SIDERBRAS	Siderurgia Brasileira S.A. (Brazilian Steel Company)
SINPAS	Sistema Nacional de Previdência e Assistência Social (National System of Social Security and Assitance)
SOF	Secretaria de Orçamento Federal (Federal Budget Secretariat)
SUNAMAN	Superintendência Nacional de Marinha Mercante (National Merchant Marine Superintendency)
TELEBRAS	Telecomunicações Brasileiras S.A. (Brazilian Telecomunications Company)

LIST OF TABLES

LIST OF FIGURES

SUMMARY: MAJOR FINDINGS AND GENERAL POLICY SUGGESTIONS

i. The Brazilian economy is currently in the midst of a severe economic crisis, although some signs of underlying adjustment and incipient recovery are now becoming more apparent. The depth and severity of the current recession for Brazil parallels that of the Great Depression during the early 1930s. Per capita income, i.e., GPD per capita, fell by at least 12% between 1980 and 1983, with industrial employment declining some 23% between December 1980 and March 1984. Investment levels, affecting the country's capacity to grow, have fallen precipitiously, especially for the private sector. Excess capacity, concentrated mostly in the industrial sector, has reached new highs during the current recession, attesting to an overall lack of effective aggregate demand. The GDP gap, comparing potential with actual GDP, has been estimated at 24% of potential GDP in 1984, amounting to foregone output equivalent to about US$63 billion for this year alone. This represents the true economic cost of the ongoing debt and stabilization crisis for Brazil. The burden of adjustment to the global debt crisis for Brazil has been heavy, both in such economic terms and in social terms as well.

ii. The origins of the current recession for Brazil lie in both external and domestic causes. External economic events have triggered domestic policy responses to deal with those events and circumstances. In 1979 the economy was in a very vulnerable international position as a result of inadequate and delayed adjustment to the first petroleum price shock. With the second oil shock, the dramatic increase in international interest rates, world recession, and weakened commodity prices there was little scope for further delaying necessary adjustment through resorting to international borrowing and increased import restrictions. In late 1980, policy measures for adjustment became unavoidable. But, the policies subsequently pursued plunged the economy into recession without addressing the fundamental internal disequilibrium presented by the burgeoning public sector and the large and increasing consolidated public sector deficit. The virtual cessation of voluntary international bank lending in late 1982 necessitated further and more fundamental adjustment. With the very important and notable exception of the February 1983 maxi-devaluation, this adjustment, while admirably coping with the public sector deficit, has embodied expenditure-reducing, rather than expenditure-switching, policy measures. This has contributed to the decline in economic activity observed in 1983 and the depressed domestic market conditions since then.

iii. While the economic and social costs of the stabilization program have been high, impressive progress in fundamental adjustment has been achieved recently by a determined Government willing to make unpopular, but necessary, decisions. The major source of the internal disequilibrium, the public sector deficit, has apparently been effectively dealt with, especially since mid-1983. According to the official Central Bank estimates, the consolidated operational public sector deficit was reduced

from 6.6% of GDP in 1982 to 2.5% in 1983; for 1984 a small surplus is expected[1]/. It is regrettable, but entirely understandable, that much of these gains came at the expense of reducing public sector investment programs needed for future development.

iv. Accompanying the commendable reduction in the public sector deficit, substantial progress has been evident in external adjustment. The 1983 trade surplus of US$6.5 billion, although regrettably generated mostly through import reduction, represented a remarkable accomplishment. It is especially encouraging that the expected 1984 trade surplus, of at least US$11 billion, is being generated mainly through export expansion. The February 1983 devaluation, a bold and problematic step at the time, has played a major role in the adjustment. Policies to make the devaluation effective were pursued, most notably in the form of the public deficit reduction, and exchange rate policy since then has largely sustained the new real exchange rate. There were changes in relative prices in favor of tradable goods, (although with attendant inflationary pressures), and expenditure switching has occurred as a result of the devaluation. Exports, especially manufacturing exports, have grown dramatically for a variety of reasons including the real exchange rate depreciation, depressed domestic market conditions, and expanding international markets. It is this export growth that is currently sparking the incipient, but as yet fragile, economic recovery.

v. While the devaluation has greatly facilitated adjustment to the new international economic realities, it also unquestionably accentuated the country's inflation. The extensive indexation system in Brazil not only makes relative price changes more difficult (and highly inflationary) but also serves to propagate the inflation itself. External price and domestic supply shocks, including the effects of the devaluation, were largely responsible for the acceleration of the inflation in 1983 (211% versus 100% in 1982). Inflationary expectations in 1983 were also fed by, and in turn themselves fed, the inflationary process. In the absence of significant changes in inflationary expectations and in the Brazilian system of indexation, no appreciable fall in inflation rates appears imminent. Under the present circumstances continuing to live with inflation seems inevitable. Confidence in the Government, perhaps in conjunction with an overall financial reform, will be a key element in breaking inflationary expectations and bringing inflation down.

vi. In the short term, a sustained recovery in the internal market will probably not be possible without a fall in real domestic interest rates from their present very high levels. Over the longer term, the export expansion presently in progress, if it can be sustained, offers considerable promise for building upon the on-going, but still fragile, economic recovery. In addition, under rather conservative assumptions concerning the international economic environment, Brazil's external debt contraints appear surmountable, reinforcing the notion that the country's present balance of payments difficulties are those of

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1/ The operational deficit excludes the indexation adjustment on the internal public sector debt.

temporary illiquidity rather than more fundamental insolvency. This overall, rather promising, outlook does require, however, the continued access of Brazil to international financial and goods markets. Given such access, with the pursuit of sound economic policies in Brazil there is latitude for a reinitiation of economic growth and external payments equilibrium. Balace of payments projections show the economic feasibility of a continually declining current account deficit and significantly improving creditworthiness throughout the rest of the 1980's. Continued new international commercial bank lending will be required during the remainder of the 1980s, although in amounts consistent with real reductions of commercial bank exposures in Brazil. This balance of payments outlook is consistent with increasing GDP growth rates, possibly rising to 7% annually by the end of the decade. More vigorous export promotion policies could produce more positive results.

vii. The key to Brazil's economic success in the foreseeable future will lie in expanding the country's exports. Export growth is essential for improving the balance of payments position and easing the constraints imposed by the country's large external debt. In addition, faster export growth would be consistent with higher rates of overall economic growth, greater economic efficiency, improved access to international financial markets, increased employment generation, more rapid real wage increases, and probably greater equality in income distribution. For these reasons it is felt that the Government should designate and pursue export expansion as a primary policy objective.

Policy Suggestions

viii. Policy suggestions for consideration by the Government are scattered throughout the Report and encompass several major areas. They are:

(a) Export Promotion Policies: Despite the success in expanding exports during the past 12 months, this is not the time for complacency. The pursuit in the short term of an effective export promotion strategy would, inter alia, contain a number of central policy elements. First, and most important, exchange rate policy should be aggressively pursued for export promotion purposes and for realizing expenditure-switching macroeconomic adjustment. The mission believes that, despite the salutory effects of the February 1983 maxi-devaluation, exchange rate policy should be managed, at the minimum, in order to prevent any deterioration in the competitiveness of Brazil's exports. Second, the recently announced anticipated phase-out of the credito premio export incentive should be accompanied by compensatory changes in the exchange rate and in other policies. Third, the present shortage, at internationally competitive costs, of credit for export production and sales

should be eased. Fourth, the extension of the existing drawback system to indirect exporters on an automatic basis would help stimulate both exports and the domestic production of intermediate inputs. Fifth, the adoption of an explicit and articulated target of achieving nominal growth rates for manufactured exports of 15-20% annually could serve as an important point of departure for defining specific policy objectives. Over the longer term a viable strategy of export promotion will necessarily have to come to grips with the incidence and structure of trade policy incentives in general and accordingly will have to reduce excessive protection afforded to domestic market sales.

(b) Public Finance and Fiscal Policies: The overall operational surplus for the consolidated public sector should be sustained. It is essential that large operational deficits be avoided over the next few years. At the same time, steps could be taken to consolidate the gains of the past two years with a view towards improving efficiency, raising revenues, further trimming current expenditures, and beginning an increase in well programmed and economically viable public investments.

(c) External Debt Management: Multi-year international financial arrangements and debt rescheduling should be pursued with the commercial banks as an integral part of a medium-term strategy for economic recovery and development on the part of the Government. At the same time, the Government should consider measures to encourage the transfer of portfolio debt into equity investment.

(d) Medium-Term Strategy for Economic Recovery and Development: The Government should continue, and accelerate, its ongoing background work for developing a medium term framework and strategy for economic recovery and renewed development. Areas for possible policy initiatives would include trade and industrial policies, agricultural policies, energy policies, public sector management, financial sector policies, and employment policies. A number of specific policy suggestions are offered in Chapter 3. In general, these policy initiatives should emphasize export expansion, increased efficiency, and a greater reliance on both market mechanisms and better government economic planning.

RESUMO: CONSTATAÇÕES PRINCIPAIS E SUGESTÕES GERAIS PARA POLÍTICAS ECONÔMICAS

A economia do Brasil enfrenta grave crise econômica, apesar de certos sinais subjacentes de ajustamento e de recuperação incipiente que agora começam a manifestar-se. O alcance e a severidade da recessão atual no Brasil são comparáveis aos da Grande Depressão do início da década de '30. A renda per capita reduziu-se em pelo menos 12% entre 1980 e 1983, e o emprego industrial declinou 23% entre dezembro de 1980 e março de 1984. Afetando a capacidade de crescimento do país, os níveis de investimento caíram violentamente, em especial no âmbito do setor privado. O excesso de capacidade, concentrado principalmente no setor industrial, atingiu níveis sem precedentes na atual recessão atestando uma carência geral de demanda agregada efetiva. Uma comparação entre o PIB potencial e o real mostra, para 1984, um desnível real em relação ao PIB potencial calculado em 24%, o que corresponde, sòmente para o ano em pauta, a uma produção frustrada equivalente a US$63 bilhões. Esta cifra representa o verdadeiro custo econômico da crise da dívida e da estabilização para o Brasil. Tanto em termos econômicos como sociais, o ajustamento do Brasil à crise da dívida mundial tem sido muito oneroso.

As origens da recessão atual no Brasil devem-se a causas tanto externas como internas. Acontecimentos econômicos externos provocaram respostas de política interna a essas ocorrências e circunstâncias. Em 1979, como resultado de imperfeições e demoras de ajustamento ao primeiro choque das cotações do petróleo, a posição internacional da economia era muito vulnerável. Com o segundo choque do petróleo, a extraordinária elevação dos juros internacionais, a recessão mundial e a queda dos preços de produtos básicos, reduziu-se o campo para uma postergação adicional do indispensável ajustamento por meio do endividamento externo e de maiores restrições às importações. Em fins de 1980, tornou-se inevitável recorrer a medidas de ajustamento. Mas as políticas adotadas subsequentemente precipitaram a economia numa recessão sem que fôsse atacado o desequilíbrio interno fundamental representado por um florescente setor público e pelo elevado e crescente déficit consolidado desse setor. A virtual cessação, em fins de 1982, dos empréstimos bancários internacionais voluntários impôs a necessidade de um ajustamento adicional e mais fundamental. Com a notável e importantíssima exceção da maxidesvalorização de fevereiro de 1983, esse ajustamento, embora enfrentando admiràvelmente o déficit do setor público, incorporava medidas de política de redução, e não de recrientação de despesas. Isso contribuiu para o declínio da atividade econômica observado em meados de 1983 e, desde então, para a depressão das condições do mercado interno.

Embora os custos econômicos e sociais do programa de estabilização tenham sido altos, a determinação do Governo disposto a adotar decisões necessárias, ainda que impopulares, fizeram com que o ajustamento fundamental registrasse notável progresso. O déficit do setor público - fonte principal do desequilíbrio interno - foi aparentemente eficientemente enfrentado, especialmente a partir de meados de 1983. Com base em estimativas oficiais do Banco Central o déficit operacional[1/] consolidado do setor público foi reduzido de 6,6% do PIB em

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1/ O déficit operacional exclui a correção monetária e cambial sôbre a dívida interna do setor público.

1982 para 2,5% em 1983; um pequeno superavit é esperado para 1984. Lamentável mas compreensívelmente, grande parte dessas realizações foi obtida à custa de uma redução nos programas de investimento do setor público necessário para o futuro desenvolvimento do país.

Acompanhando a elogiável redução no déficit do setor público, evidenciou-se substancial progresso no ajustamento externo. O superavit comercial de US$6,5 bilhões registrado em 1983, embora gerado em sua maior parte com a redução das importações, o que é de lamentar, valeu como um feito digno de nota. Especialmente animadora é a perspectiva de que o superavit comercial de pelo menos US$11 bilhões esperado para 1984 esteja sendo gerado principalmente por meio da expansão das exportações. A desvalorização de fevereiro de 1983, medida que, na época, foi ousada, desempenhou importante papel no processo de ajustamento. Adotaram-se políticas para uma desvalorização efetiva, notadamente na forma de redução do déficit publico e, desde então, as novas taxas de câmbio real vem sendo sustentadas em grande parte por uma política cambial. Observaram-se mudancas nos preços relativos a favor de bens comerciais - tradables - (ainda que acompanhadas de pressões inflacionárias) e, em decorrência da desvalorização, ocorreram reorientações da despesa. As exportações, especialmente de manufaturas, têm crescido extraordinàriamente por várias razões, nomeadamente a depreciação da taxa de câmbio real, a redução da procura interna e a expansão dos mercados internacionais. Este crescimento das exportações é o fator que atualmente ativa a recuperação econômica incipiente, mas ainda frágil, ora observada no Brasil.

É inquestionável que, embora haja facilitado em grande escala o ajustamento às novas realidades econômicas internacionais, a desvalorização também acentuou a inflação no país. O extensivo sistema de correção monetária do Brasil não só torna mais difíceis (e altamente inflacionárias) as mudanças nos preços relativos como também serve para propagar a própria inflação. Choque de preços externos e da oferta interna, incluindo os efeitos da desvalorização, foram os fatores principais da aceleração inflacionária observada em 1983 (211% contra 100% em 1982). As expectativas de inflação em 1983 tanto alimentaram como foram alimentadas pelo processo inflacionário. Na ausência de mudanças significativas nas expectativas inflacionárias e no sistema de correção monetária do Brasil, não parece iminente uma queda apreciável das taxas de inflação. Nas circunstancias atuais, parece inevitável o prosseguimento de um convívio com a inflação. A confiança no Govêrno, talvez em conjunto com uma reforma financeira geral, constituiria um elemento essencial para desfazer expectativas inflacionárias e reduzir a inflação.

A curto prazo, sem uma redução dos níveis muito altos em que se situam atualmente os juros internos reais, será provàvelmente impossível uma firme recuperação do mercado interno. A prazo mais longo, o atual processo de expansão das exportações, se puder ser sustentado, oferece consideráveis promessas de fortalecimento da frágil recuperação econômica que se verifica. Ademais, no âmbito de hipoteses conservadoras concernentes ao ambiente econômico internacional, as restrições causadas pela dívida externa do Brasil parecem superáveis, assim reforçando a noção de que as dificuldades atuais de balanço de pagamentos do país são mais de iliquidez temporária do que de insolvência mais fundamental. Mas essa visão geral bastante promissora exige a continuidade de acesso do Brasil aos mercados comerciais e financeiros internacionais. Se dispuser desse acesso, e com a observância de judiciosas politicas econômicas, terá o Brasil campo suficiente para uma retomada do crescimento econômico e do

equilíbrio dos pagamentos externos. Projeções da balança de pagamentos revelam a possibilidade econômica de um déficit de conta corrente em constante declínio e uma significativa melhoria do crédito para o restante da década de '80. Haverá necessidade de novos e contínuos empréstimos bancários comerciais internacionais, ainda que em montantes compatíveis com reduções reais da exposição bancária comercial no Brasildurante o resto da década de 80. Essa visão da balança de pagamentos é compatível com o incremento de crescimento do PIB, que se elevará em 7% ao ano no final da década. Políticas mais enérgicas de promoção das exportações poderiam produzir resultados mais positivos.

A chave para o êxito econômico do Brasil em um futuro previsível está na expansão de suas exportações. O crescimento das exportações é essencial para melhorar a posição da balança de pagamentos e para aliviar as pressões exercidas pela grande dívida externa do pais. Além disso, a aceleração do crescimento das exportações seria compatível com maiores taxas de crescimento econômico geral, maior eficiência econômica, melhor acesso a mercados financeiros internacionais, a maior geração de emprêgo, aumentos salariais reais mais rápidos e, provàvelmente, maior eqüidade na distribuição da renda. Por essas razões, a opinião é de que o Govêrno deveria indicar e considerar a expansão das exportações como objetivo fundamental de política.

Políticas Sugeridas

As políticas sugeridas à consideração do Govêrno constam em diferentes partes do Relatório e abrangem diversas áreas principais, a saber:

(a) Politicas de Promoção das Exportações. Apesar do sucesso em expandir as exportações nos últimos 12 meses o momento atual não permite complacência. A adoção, a curto prazo, de uma efetiva estratégia de promoção de exportações incluiria, inter alia, vários elementos de uma política central. Em primeiro lugar, e principalmente, cumpriria adotar uma agressiva política de câmbio para fins de promoção das exportações e para proceder a um ajustamento macroeconômico de reorientação de despesas. A missão considera que, apesar dos salutares efeitos da maxidesvalorização de fevereiro de 1983 e da coerente política de câmbio desde então adotada, a política cambial deve ser conduzida no mínimo, para impedir uma deterioração da competitividade das exportações do país. Em segundo lugar, a antecipação da defasagem do crédito-prêmio como incentivo de exportação, recentemente anunciada, deveria ser empreendida na presença de alterações compensatórias nas bases de câmbio e de outras políticas. Em terceiro lugar, cumpriria aliviar a atual escassez, a custos internacionalmente competitivos, de crédito para a produção e as vendas de exportações. Em quarto lugar, a extensão do atual sistema de devolução de direitos de reexportação a exportadores indiretos, em bases automáticas, contribuiria para estimular tanto as exportações como a produção interna de fatores intermediários de produção. Em quinto lugar a adoção explícita e articulada do objetivo de atingir taxas de crescimento nominais para as exportações de manufaturas em torno de 15-20% ao ano, poderia servir como um importante ponto de partida para definir específicos objetivos de política. A prazo mais longo, uma estratégia viável de promoção de exportações teria, necessariamente, que fazer frente a incidência e à estrutura de políticas de incentivo comercial em geral, tendo assim que reduzir a proteção excessiva outorgada às vendas no mercado interno.

(b) Políticas Fiscais e de Finanças Públicas. Cumpriria manter o superavit operacional geral do setor público consolidado. Nos próximos anos será essencial evitar grandes deficits operacionais. Simultaneamente, para consolidar os avanços dos últimos dois anos poderiam ser adotadas medidas para melhorar a eficiência, aumentar a receita, introduzir cortes adicionais nas despesas correntes e começar a incrementar investimentos públicos bem programados e econômicamente viáveis.

(c) Administração da Dívida Externa. Cumpriria proceder a entendimentos financeiros internacionais plurianuais e ao reescalonamento da dívida com os bancos comerciais, como parte integrante de uma estratégia governamental de recuperação econômica e desenvolvimento a médio prazo. Ao mesmo tempo, deveria o Governo considerar medidas de estímulo à transferência da dívida de carteira para os investimentos acionários.

(d) Estratégia de Recuperação Econômica e Desenvolvimento a Médio Prazo. Deveria o Govêrno continuar a acelerar sua atual atividade básica de desenvolvimento de uma estrutura e uma estratégia a médio prazo para a recuperação econômica e a reativação do desenvolvimento. Seriam áreas de possíveis iniciativas as de políticas comerciais e industriais, políticas agrícolas, políticas energéticas, administração do setor público, políticas do setor finaceiro e políticas de emprêgo. Algumas sugestões específicas sôbre as políticas econômicas são oferecidas no Capítulo 3. Em geral, essas iniciativas de política poderiam dar ênfase à expansão das exportações, ao aumento da eficiência e a uma maior dependência de mecanismos de mercado e melhor planejamento econômico governamental.

BRAZIL

COUNTRY ECONOMIC MEMORANDUM

Vol. 1 - Main Report

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Chapter 1

RECENT MACROECONOMIC DEVELOPMENTS

A. Background

1.1 The current economic situation in Brazil is the culmination of events over a number of years, involving both international economic circumstances and domestic economic policies adopted to deal with those circumstances. The high growth period of 1968-73 was brought to an end by the petroleum price shock of 1973-74. The terms-of-trade loss and the concomitant balance-of-payments pressures presented a policy dilemma to Brazilian economic policy-makers. If viewed as permanent, the orthodox approach to the new international economic situation would have called for adjustment through a combination of currency depreciation and expenditure-switching policies to effect a net contraction of the economy in recognition of the terms-of-trade loss. Instead, based upon the hypothesis that the terms-of-trade loss was temporary, the Government pursued a series of ad hoc measures, involving principally expanded foreign borrowing and a dramatic increase in import restrictions.

1.2 In the aftermath of the 1973-74 oil price shock, Brazil's international indebtedness increased markedly, growing from US$9.5 billion at the end of 1972 to US$28.4 billion by the end of 1975 and then more than doubling again to US$66.2 billion by 1980. Contracting such indebtedness in the middle and late 1970s was facilitated by the high dollar liquidity of the large US and European banks associated with the 1975 recession and petrodollar deposits. Much of the borrowing was contracted at variable interest rates, linked to either LIBOR or the US prime rate. During most of the 1970s these interest rates were very low and frequently negative in real terms.

1.3 Brazilian policy-makers also reacted to the balance-of-payments pressures by increasing import restrictions. Beginning in 1974, there were widespread tariff increases, the average nominal legal tariff rate for manufacturing jumping from 55% to 95% by 1978, and to 99% by 1980. More important than the upward drift of tariff levels was the increase in nontariff barriers. Increased direct controls were extended on imports by public firms and agencies, and the ability of private firms to obtain tariff exemptions through official incentives programs was sharply curtailed. In addition, the importation of a large number of products — particularly finished consumer goods — was effectively prohibited. A restrictive system of negotiated firm-by-firm annual import budgets was established.

1.4 Accompanying the balance-of-payments difficulties and the increase in import restrictions was a renewed push for import substitution. The cautious steps towards trade liberalization and greater economic openness evident in the late 1960s and early 1970s, strongly associated with the favorable export and overall economic performance of that period, were reversed. Major government efforts were mounted in the remaining

areas of possible import substitution, principally basic intermediate products and capital goods. Generous protection for these activities was provided in the late 1970s, along with heavy doses of subsidized official credit, mostly channeled through the National Economic Development Bank (BNDE) and its affiliates. Large investments in these industries, frequently by public firms, resulted.

1.5 These policies served to stave off adjustment. Economic growth (Table 1.1), although reduced compared to 1967-73, continued at high rates but adjustment measures were deferred. In retrospect, had the 1973-74 international economic shocks been met with a real exchange rate depreciation and macroeconomic policies to reduce absorption, instead of increasing external debt and import restrictions, the balance-of-payments problems emanating from the second petroleum price shock and accompanying interest rate explosion might have been much less severe.

1.6 When oil prices again increased in 1979 and 1980, and with the dramatic rise in interest rates, the Brazilian economy was immediately in difficulty. The external shock was greater, in terms of the current account imbalance, than that of 1973. Net interest payments rose from US$2.7 billion in 1979 to US$6.3 billion in 1980, representing 29% of exports, and the net oil import bill increased from US$4.2 billion to US$9.9 billion, equal to 47% of exports, despite a slight reduction in import volumes. The current account deficit increased from US$6.0 billion in 1978 to US$12.5 billion in 1980, even though exports grew by nearly 60% over the two-year period, assisted by a 30% cruzeiro devaluation in December 1979.

1.7 A major difference between the two shocks, however, was that the latitude for policy responses in 1979 was much more circumscribed than was the case in 1973-74. The external debt and the associated debt service were, of course, much higher, with medium- and long-term indebtedness having reached US$46.3 billion by the end of 1978. Moreover, imports by early 1979 had been severely compressed, suggesting that further import restrictions would be increasingly costly in terms of output and inflationary pressures. The initial efforts of the Government in early 1979 to impose contractionary macroeconomic policies were not sustained, and the measures adopted to cope with the crisis were similar to those introduced after 1973. Import restrictions were again tightened, and increased recourse was made to the international financial markets. At the same time, the consolidated public sector deficit grew, as partially indicated by the expansion in the monetary base,[1/] and, in general, macroeconomic policies became more expansionary. One study conservatively estimated that the consolidated operational federal public sector deficit

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1/ For example, monetized loans to the Banco do Brasil from the Central Bank, including the agricultural credit programs, amounted to 143% of the total 1979 expansion of the monetary base. During this period there was no real increase in the internal federal debt. Monetary expansion in 1979 also reflected the 1977-78 reserve growth, as mandatory deposits in the Central Bank matured.

Table 1.1: BRAZIL - MACRO ECONOMIC PERFORMANCE, 1951-83

Years	Annual Growth Rates (%) GDP	GDP per Capita	Industry	Agri-culture	Exports (US$ Billion)	Imports (US$ Billion)	Implicit GDP Deflator (%)
1951-1955	6.8	3.7	7.7	5.1	1.5	1.6	15.6
1956-60	6.9	3.7	10.1	3.8	1.3	1.4	20.6
1961-65	4.5	1.6	3.8	5.8	1.4	1.4	61.7
1966-70	7.2	4.7	9.7	0.8	2.1	2.1	26.9
1971-73	12.8	10.0	14.3	6.4	4.0	4.7	19.0
1974-78	7.0	4.4	7.7	5.1	10.4	12.6	39.3
1979	6.4	3.8	6.4	5.0	15.2	18.1	57.6
1980	7.2	4.6	7.9	6.3	20.1	23.0	94.6
1981	-3.2/a	-5.6	-10.2/a	6.4	23.3	22.1	97.8
1982	0.9	-1.5	0.6	-2.5	20.2	19.4	96.4
1983/b	-3.2	-5.5	-6.8	2.2	21.9	15.4	146.0

/a Bank mission estimates based upon preliminary industrial output data.

/b Preliminary estimates.

Source: Getúlio Vargas Foundation, Conjuntura Econômica, various issues; and Central Bank, Relatório Anual, various issues.

equaled 8.1 % of GDP in 1979, as compared to 5.3 % in 1978.[2]/ The monetization of this deficit led to the acceleration in the rate of inflation during the second half of 1979.[3]/ Finally, as it became evident that the adjustment measures were not functioning adequately and in order to deal with the deteriorating external situation, the Government announced a 30% devaluation in December 1979. To make the devaluation effective, however, would have required absorption-reducing and expenditure switching macroeconomic policy measures. Some such measures were introduced but not sustained, and overall aggregate demand management policies continued to be highly expansionary. As a result, the inflation continued to accelerate.

1.8 In January 1980, the Government announced that cumulative monetary correction and nominal exchange rate depreciation for the year would be pre-fixed at rates of 45% and 40%, respectively. These measures were intended to promote borrowing abroad, provide improved incentives for investment through lower interest rates, and dampen inflationary expectations. Inasmuch as expected inflation significantly exceeded the pre-fixed rates, the effect was a sharp reduction of expected returns on financial assets. The consequent adjustment in asset holders' portfolios involved a flight from financial assets to goods and physical assets, resulting in substantial speculative inventory accumulation; increased demand for consumer durables; real estate market activity, including a rapid appreciation in housing values; expanded new construction, and expanded industrial output. The effects of this portfolio adjustment were important in accounting for the relatively high GDP growth rate in 1980 (7.2%). On the external side, pre-fixation of the exchange rate resulted in increasing overvaluation. Pre-fixation of both kinds was abandoned in November 1980, and new steps were taken to stabilize the economy, restore confidence, and reduce inflation.

1.9 Beginning in late 1980 and early 1981 cuts were made in public investments, and monetary policy, as reflected by the real monetary aggregates, became increasingly restrictive. The monetary base and money supply fell sharply in real terms. At the same time, lending ceilings imposed on the commercial banks were made more effective, and interest rates were freed in the relatively uncontrolled portion of Brazil's highly segmented financial markets.[4]/. These rates, covering most industrial and commercial working capital operations, increased dramatically to 40-45% in real terms. Firms sharply cut production, as they tried to work down their

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2/ Carlos von Doellinger, "Estatização, Finanças Públicas e suas Implicações, "Relatório de Pesquisa No. 1, Câmara de Estudos e Debates Econômicos e Sociais (CEDES), Dezembro 1981. Also see his "Consolidação das Finanças da União, 1979-1982," Conjuntura Econômica, Vol. 36, No. 3 (March 1982), pp. 176-178.

3/ Comparing the 12-month cumulative averages, the rate of inflation jumped from 45.2% to 77.2% between June and December 1979. The comparable 12-month rates of expansion of the monetary base, i.e., high powered money, were 49.9% and 84.4% for June and December 1979, respectively.

4/ See IBRD, Brazil - Financial Systems Review (Washington: IBRD, 1984).

swollen and increasingly expensive inventories, consumers readjusted their portfolios and consumption habits away from consumer durables, the industrial economy plunged into recession. The principal burden of this adjustment and related recession was borne by the private sector, especially those firms not benefitting from subsidized credit programs. The public sector, typified by the state enterprises, continued to expand in 1981, although at reduced rates.

1.10 The recession beginning in 1981 has been largely an industrial recession. Industrial output during 1981 declined by an approximate 9.8%, triggering an estimated reduction in GDP of 3.2%.[5/] In the beginning, at least two features characterized the recession. First, as noted, it was industrial in nature, with the greatest output declines being registered in the durable consumer goods and capital goods industries (Table 1.2). Particularly hard hit in 1981 was the automotive industry. A second characteristic of the recession in the beginning was its regional concentration. Reflecting the concentration of the automotive and capital goods industries, the State of Sao Paulo, bore the initial brunt of the recession. Between December 1980 and December 1981 industrial employment in Greater Sao Paulo fell by 13.4% (Appendix Table 1.5). Since 1981, the recession has spread to other sectors and other regions.

1.11 During 1981, the consolidated federal public sector deficit remained large, amounting to 7.2% of GDP.[6/] During 1980, with the pre-fixation of monetary correction, the Government had difficulty in selling its debt instruments to the public. Consequently, the consolidated deficit was financed largely through monetary expansion and foreign borrowing. In 1981, however, with the return of full monetary correction, the public sector financed much of its deficit through increasing the federal internal debt, taking pressure off monetary expansion but creating problems for the future. Inflation in 1981 began to fall, perhaps

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5/ The official national income account estimates for 1981 are still regarded as preliminary, owing to changes in the methodology for IBGE's estimation of industrial output for that year. The initial estimates, roughly corresponding to those reported in Table 1.2, showed a 9.6% decline in mining and manufacturing. A second estimate, based on a subsequent IBGE survey and using different weights and an expanded sample, showed a fall of 6.3%. A more recent and unofficial estimate, not yet reflected in the national income accounts, is reported to show a decline of 11.2%.

6/ See IBRD, Brazil - Economic Memorandum (Washington: IBRD, 1984), pp. 61-64. This report develops and applies a methodology for measuring the consolidated federal public sector accounts on the basis of expenditure and revenue information, as opposed to financing requirements data. For 1980 and 1982 the comparable consolidated federal public sector deficits amounted to 5.9% and 10.5% of GDP, respectively. The public sector deficit is difficult to measure because of the necessity to consolidate information from three major budgets, i.e., the treasury, public enterprise, and monetary budgets. Moreover, indexation is applied in differing degrees to different accounts.

Table 1.2: BRAZIL - ANNUAL GROWTH RATES OF INDUSTRIAL PRODUCTION, BY SUBSECTOR, 1980-83

(Percent)

Region	1980	1981/a	1982	1983	1984/b
Mining	12.6	2.0	8.7	14.5	28.1
Manufacturing	7.6	-10.1	0.1	-6.3	5.9
Nonmetallic Minerals	6.5	-5.9	-3.2	-15.9	.5
Metallurgy	12.1	-15.5	-0.8	-1.4	13.3
Machinery	15.3	-16.2	-15.2	-11.3	14.8
Electric & Comm. Equip.	5.2	-16.7	-3.3	-13.0	1.8
Transport Equipment	2.0	-27.2	6.7	-8.8	9.1
Paper	9.6	-8.5	4.7	2.9	6.4
Rubber	9.0	-12.8	-1.6	0.4	11.1
Chemicals	3.9	-8.9	2.8	-6.2	8.8
Pharmaceuticals	13.1	0.6	1.6	-5.4	8.0
Perfumery, Soap & Candles	9.4	1.2	-2.8	-1.5	-1.0
Plastics	12.4	-22.5	10.9	-10.9	.5
Textile	6.8	-7.4	4.3	-10.3	-4.3
Apparel	6.2	-2.1	3.1	-10.8	3.7
Food Products	7.1	0.1	1.0	4.3	0.4
Beverages	2.7	-6.4	-6.0	-7.7	0.1
Tobacco	-0.9	1.2	-1.2	-2.9	1.0
TOTAL - Mining & Manufacturing	7.8	-9.8	0.4	-5.7	6.6
Subtotals:					
Capital Goods	6.5	-19.0	-10.8	-20.2	12.4
Intermediate Goods	8.3	-10.6	0.4	-3.0	10.0
Consumer Goods	6.0	-6.4	2.7	-5.0	0.0
Durable	10.7	-26.3	8.0	-4.0	-5.3
Nondurable	5.2	-2.0	1.8	-5.2	1.0

/a The 1981 estimates would be slightly different if the revised IBGE weights and sampling techniques were employed. IBGE has not yet published its subsectoral revisions for 1981.

/b Through November, as compared to the previous comparable period.

Source: IBGE, Indicadores Conjunturais da Industria, various issues.

partially as a result of the decreased rate of monthly monetary base and M1 expansion. After peaking at 121% in March, the 12-month inflation, as measured by the general price index (the IGP-DI), began to decline, falling by the end of the year to 95%.

1.12 In terms of external adjustment, significant improvements were registered in 1981. Brazil went from a merchandise trade deficit of US$2.8 billion in 1980 to a trade surplus of US$1.2 billion. As a result, despite an increase of interest payments, the current account deficit fell by US$1.5 billion. In early 1982, these improvements continued, although it soon became apparent that Brazil was having increasing difficulties with its exports. Nevertheless, as of mid-1982 there were reasons for guarded optimism. Petroleum prices were falling, the LIBOR was showing some weakness, and there were some initial signs of recovery in the US economy. The outlook changed dramatically, however, in July 1982, when Mexico suspended principal payments on its external debt and the international commercial banks discontinued voluntary lending to Latin America.

1.13 Gross medium- and long-term borrowing amounted to US$17.4 billion in 1981, and it was effected without difficulty, although at spreads above LIBOR averaging 2.25%. Borrowing at this level continued in early 1982, amounting to US$12.4 billion by August. However, in the wake of the crises in Poland, Argentina and Mexico, lending by the commercial banks virtually ceased, and short-term credit lines and interbank deposits were withdrawn. Brazil's liquid international reserves were rapidly depleted, and there was an accumulation of short-term debt, mainly in the form of bridging loans associated with special reserve operations. The consequent financial difficulties undermined confidence in the country's medium-term prospects. Commercial bank lending actually stopped only briefly, but when resumed in October it was at a much reduced level, averaging US$400 million a month in the last quarter of 1982, instead of the US$1.5 billion average for the first eight months. Also, this lending took place in a dramatically changed environment. Medium- and long-term borrowing amounted to US$14.4 billion in 1982, about US$3 billion less than originally targeted, and the prospects for new commercial bank lending, at the levels of the recent past, were poor. Emergency measures were called for to secure a modicum of international financial support for 1983. The stabilization program agreed with the International Monetary Fund late in 1982 provided the basis for this support but inevitably deepened and prolonged the recession.

B. The 1983-84 Stabilization Program

1.14 While the external liquidity crisis in 1982 was precipitated by events beyond Brazil's control, it also underlined the need for more basic changes in the structure of the economy. The strategy adopted to sustain growth in the 1970s relied heavily on generous credit and tax incentives for industry and agriculture, the expansion of state enterprise, and large foreign borrowing both to ease domestic resource constraints and for general balance-of-payments support. Reflecting such borrowing, the consolidated public sector deficit increased significantly, reaching the equivalent of 6.6% of GDP in 1982, as measured by the public sector's borrowing requirements in operational terms. When measured in nominal

terms, i.e., including the stock adjustment on the public debt because of monetary correction, the public sector borrowing requirements were equal to 15.8% of GDP (Table 1.3).

1.15 The measures taken from 1979 on, in the effort to adjust to increasing domestic and external pressures, had not by 1982 resulted in any major improvements in resource mobilization and use. The claims of the public sector on resources continued to rise. Efforts to generate increased revenues, which had been declining as a proportion of GDP until 1979, were initially successful but then were undermined by the recession. The volume of fiscal expenditures effected through the monetary budget expanded, and the capacity of the Treasury to reimburse the monetary authorities for them declined. By 1982, only about 15% of monetary budget expenditures on programs for agriculture and for consumer subsidies was being reimbursed by transfers of Treasury surpluses. Subsidies and fiscal incentives for exports did not prevent a real decline in exports in 1982 in the face of a deteriorating world economy. Meanwhile, Brazil's increased dependence on foreign borrowing, at rising costs, exerted mounting pressures on the economy.

1.16 The stabilization program adopted in late 1982 and early 1983, with the support of the IMF, based on an estimate of the reduced commercial bank financing likely to be obtainable in 1983, aimed at a reduction of the current account deficit from US$14.8 billion to US$6.9 billion and a trade surplus of US$6.0 billion (Table 1.3). A 30% devaluation in February 1983 was undertaken as a means to assure the targeted trade surplus. As will be discussed below, the external targets in the stabilization program were met and exceeded. The 1984 external accounts objectives, although implying domestic austerity, have also been met, and Brazil's international reserve position has improved markedly.7/

1.17 The program has also aimed at reducing internal imbalances, most importantly through the reduction of the public sector deficit. Ceilings on public sector borrowing requirements and targets for net domestic asset expansion were established. Monetary austerity, with monetary expansion held at rates considerably less than inflation, has also been an important part of the stabilization program. Specific elements included the reduction of credit subsidies, improved domestic pricing policies for public enterprises, and a tightening of wage policy.

1.18 On the basis of these measures, originally elaborated in late 1982 and early 1983, agreement was reached with the International Monetary Fund on an Extended Fund Facility which, with an accompanying Compensatory Finance Facility, would allow drawings of US$5.4 billion over a three-year period from March 1983. This was followed by an agreed financial package

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7/ Somewhat paradoxically, the better-than-expected external sector performance in 1984, and the resulting reserve accumulation, have undermined the achievement of the monetary expansion targets agreed with IMF. The Government has had difficulty in sterilizing the expansionary monetary impact of the reserve accumulation and has considered reserve restoration the higher priority objective.

Table 1.3: BRAZIL - STABILIZATION PROGRAM PERFORMANCE TARGETS, 1983-84

	1982 Realized	1983 Original Target/a	1983 Revised Target/b	1983 Realized	1984 Original Target/c	1984 Projected
External						
Trade Surplus (US$ billion)	0.8	6.0	—	6.5	9.1	12
Current Account Deficit (US$ billion)	14.8	6.9	—	6.2	5.3	2.6
Internal						
Public Sector Borrowing Requirements (% of GDP)						
Nominal	15.8	8.8	18.6	17.9	n.a.	—
Operational	6.6	-1.7/d	2.7	2.5	-0.3	—
Net Domestic Assets (Cr$ trillion)	5.1	5.8	3.5	6.6/e	n.a.	—
Monetary Expansion (% increase)						
Monetary Base	84.7	70.0	—	91.6	50.0	—
M1	82.7	70.0	—	84.0	50.0	—
Inflation Rate (%)	99.7	70.0	152.0	211.0	n.a.	—

/a As stated in the Conselho Monetario Nacional, Programa Externo para 1983, October 25, 1983 and in the Government's first letter of intent to the IMF, dated January 6, 1983.

/b As stated in the Government's letter of intent to the IMF dated September 15, 1983, and as amended November 14, 1983.

/c As expressed in the Government's letter of intent to the IMF of March 1984, along with the accompanying technical memorandum. IMF internal performance requirements were only set for March, June, and September. The monetary expansion targets were lifted to 95% each in August 1984.

/d This is the subsequent, i.e., June 1983 SEPLAN estimate, showing an implicit public sector surplus, based upon compliance with the nominal PSBR ceilings and the projected average inflation and monetary correction of 90% for 1983. It should be noted that the operational PSBR for 1982 had then been estimated at 5.8% of GDP rather than 6.6%.

/e The ceiling was exceeded owing to delays in the disbursement of the committed external financial resources.

Source: SEPLAN and Central Bank information.

with the international commercial banks consisting of (a) new loans of US$4.4 billion, (b) rescheduling of US$4.6 billion in medium- and long-term loans due in 1983, and (c) US$9.4 billion in trade-related, short-term credits. In addition, as a part of the package, the deposits held by foreign banks in Brazilian overseas banks were to be restored to a level of about US$6.0 billion. Similar arrangements were made for 1984 with the commercial banks agreeing to extend new loans amounting to US$6.5 billion during the year. The 1984 international financial package also consisted of a rescheduling of official borrowing under a Paris Club arrangement and the extension of official trade line credits on a bilateral basis. For both 1983 and 1984 the IMF played a key role in negotiating the financial packages. Commmercial bank disbursements were made contingent upon IMF disbursements and, therefore, upon Brazil's compliance with the stabilization program agreed with the Fund.

1.19 The domestic financial performance targets originally agreed with the IMF for 1983 were not met, but an amended program agreed later in the year was substantially achieved. To comply with the revised program the Government adopted (a) a partial de-indexation of wages, (b) additional fiscal measures to increase revenues and reduce expenditures, (c) steps to reduce or eliminate a number of consumer subsidies, and (d) an acceleration of the phase-out for agricultural credit subsidies. Also, and very importantly, institutional improvements were instituted for monitoring and controlling government expenditure and financing programs. The resultant informal and high-level inter-ministerial agency, called COMOR, has met weekly since its establishment and has been instrumental in better controlling and reducing government spending.[8/]

1.20 The performance criteria under the IMF agreement were all attained through the end of June 1984, including the nominal public sector borrowing requirement, which was rendered more difficult by the underprojection of inflation. Moreover, the reduction of the operational public sector borrowing requirement, roughly corresponding to the public sector deficit in countries without indexed public debt, from 6.6% of GDP in 1982 to 2.5% of GDP in 1983, was a dramatic accomplishment (Table 1.3). Few countries have been able to achieve such a drop in one year. For the Brazilian Government to have done so in the midst of political redemocratization is all the more impressive. A major challenge will now be to consolidate the gains made in controlling the public sector so as to increase efficiency and prevent a slippage back to undisciplined spending.

1.21 Also remarkable has been the attainment of the balance-of-payment targets. When originally set, the US$6.0 billion trade surplus target appeared overly ambitious even though necessary, given the international borrowing environment for Brazil. As seen in Table 1.3 and as noted above, this target was surpassed. For 1984, the expected trade surplus is some US$11 billion, again surpassing an original target of US$9.1 billion. As discussed below, continued trade surpluses will be necessary in the future. It does, however, make a considerable difference for the economy whether such surpluses are generated through export expansion or import

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8/ The acronym COMOR stands for Comitê para o Monitoramento dos Orçamentos Públicos. It is presided over by the Secretary General of SEPLAN.

contraction. In 1983, the trade surplus was mainly created through the reduction of imports, with deleterious effects for the economy. For 1984 the situation was far more promising. Export growth has been instrumental in generating the monthly trade surpluses, and, although total imports are down again, non-oil imports are increasing.

1.22 The economic rationale underlying the stabilization program has been to achieve the balance-of-payments adjustment necessitated by the heavy debt burden and the fall in the availability of new external financing in two major ways. Expenditure-reducing policies, involving lower levels of absorption and aggregate expenditure, and, to a lesser extent, expenditure-switching measures have both been pursued. With expenditure-reducing, restrictive aggregate demand management policies for imports accordingly have been reduced, and resources are freed for producing exports, thereby generating the trade surpluses required to service the debt. While import levels in Brazil have also been reduced by direct controls, absorption and aggregate expenditure reductions have been achieved through contractionary aggregate demand management policies. Fiscal policies, as reflected in the reduction of the real public sector deficit, have been contractionary in their overall effect.9/ Monetary policies have also been contractionary, with the real money supply, defined either narrowly or broadly, falling in real terms. Together, these policies have resulted in high real interest rates and reduced levels of economic activity. Nevertheless, they have achieved the desired current account improvement in the balance of payments. Difficulties with this analytical framework are that it presupposes substantial internal price flexibility and makes no distinction between tradable and nontradable goods.

1.23 A second approach to adjustment, also pursued in Brazil, emphasizes the distinction between tradable and nontradable goods. This is adjustment through expenditure-switching and involves changes in domestic consumption and production patterns and in trade flows, induced through relative price changes. Measures to increase exports, or to increase the price of tradable goods relative to nontradables, lessen the reduction in absorption required to achieve a specific trade balance. In Brazil the February maxi-devaluation has had this favorable effect, although it also exacerbated the difficulties of reducing inflation.

1.24 The effort to reduce inflation, as embodied in the stabilization program, has focused principally on the control of aggregate demand via reductions in the public sector deficit and restrictive monetary and credit policies. The nature of the relationship of aggregate demand and monetary variables to inflation, however, is far from certain in the present environment of high unemployment and idle productive capacity. The roles played by Brazil's extensive indexation system and inflationary expectations is not well understood. It is apparent that these factors

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9/ The lack of comprehensive and widely disseminated macroeconomic models of the Brazilian economy precludes the estimation of the effect on income of a given real reduction of the consolidated public sector deficit. Models for the industrial economies frequently possess such multipliers in the 1-2 range.

complicate anti-inflation efforts and worsen the trade-off between price stability and output and employment objectives. Alternative approaches being discussed in Brazil include a variety of schemes for dismanteling indexation and adopting other forms of incomes policy. Completion of the electoral process and the installation of a new Government may serve to resolve some of the uncertainties of the current situation. In any event, even though the economy is not overheated in conventional terms, the likely sensitivity of inflationary expectations to changes in aggregate demand policies requires that the Government continue to exercise great caution in any moves in a more expansionary direction.

C. The Recession and Levels of Economic Activity

1.25 The costs to the economy of stabilization and balance-of-payments adjustment have been high. The accumulated decline in GDP from 1980 through 1983, as measured by the adjusted Getulio Vargas Foundation's national income account estimates, was 6.0%. Per capita incomes during this period have fallen by 12.1%. The decline in overall economic activity observed so far during the 1981-84 recession is comparable to that during the Great Depression years of 1929-33.[10/] During the Great Depression, however, Brazil was mostly a rurally-based economy, as opposed to the industrially-oriented society of today. Since the beginning of 1984 signs of a still fragile recovery, led by export growth, have been observed.

1.26 Table 1.4 presents some indicators of economic activity for the past several years. The partial recovery begun in 1982 was shortlived, as more vigorous stabilization and balance-of-payments adjustment measures were necessitated in the second half of the year by the external financial situation. As noted above, the manufacturing sector has borne a major load of the recession, and the downturn has been particularly hard on the capital and durable consumer goods industries. Yet, by 1983, the recession had become more generalized and had spread to practically all manufacturing industries (Table 1.2). Nondurable consumer goods production showed a decline of 5.2% in 1983. Construction activity, as shown indirectly through cement production, has also dropped markedly. Agricultural and other primary sector output showed some fluctuation over the 1981-83 period (Table 1.1), mostly stemming from climatic conditions and concentrated in certain crops, such as coffee in 1983 (Appendix Table 7.1). The revenue generated by the states' value-added tax, the ICM, is a reasonably good indicator of domestic economic activity; such collections fell by 10.9% in real terms in 1983 after showing a modest recovery in 1982. Retail sales also fell precipitously and continued their decline in 1984, reflecting

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10/ For gross output estimates for earlier periods, see Ralph Zerkowsky Maria Alice Gusmão Veloso, "Seis Décadas da Economia Brasileira através do PIB." Revista Brasileira de Economia, July-September 1982; Annibal Villela and Wilson Suzigan, Política do Govêrno e Crescimento da Economia Brasileira, 1889-1945 (Rio de Janeiro: IPEA/INPES, 1973); Cláudio Haddad, Crescimento do Produto Real do Brasil, 1900-1947 (Rio de Janeiro: Fundação Getúlio Vargas, 1978).

Table 1.4: BRAZIL - INDICATORS OF ECONOMIC ACTIVITY, 1981-84

(Annual Growth Rates-%)

	1981	1982	1983	1984
GDP	-3.2 /b	0.9	-3.2	n.a.
Manufacturing Output	-10.1	-0.3	-6.3	5.9/b
Real ICM Collections/a	-5.2	3.8	-10.9	-3.9/b
Real Retail Sales in Sao Paulo/a	-19.0	3.5	-3.4	-2.1
Cement Production	-4.2	-2.4	-17.9	-5.4

/a Deflated by General Price Index. The ICM is the state value added tax.

/b Mission estimate based on revised industrial output estimates.

Source: FGV, Conjuntura Econômica, various issues; IPEA, Indicadores Conjunturais, various issues; Banco Central, Informativo Mensal various issues; and IBGE information.

persisting depressed domestic market conditions. In addition to becoming more generalized, the recession has expanded beyond its original confines largely in Greater Sao Paulo to practically the entire country. In 1983, the only region showing a real increase (1.9%) in ICM collections was the frontier area of the Center-West (Statistical Appendix Table 5.1).

1.27 The cessation of economic growth and the fall in output have produced a large permanent loss of potential GDP, as measured by the deviation from the trend established by the growth of productive factors and technological progress. This deadweight loss for 1984 alone has been estimated at 24% of Brazil's potential, full employment GDP, amounting to US$63 billion.[11]/ (Table 1.5).

1.28 Growth for the economy requires investment, and both national savings and capital formation over the past few years have fallen precipitously. From the national income accounts, it is conservatively estimated that gross capital formation fell by 16% in 1981 and 4% in 1982, with the largest declines occurring in the private sector (Statistical Appendix Tables 2.7 and 10.2). While reliable aggregate information is not yet available beyond 1982, disaggregated data show a pattern of substantial investment declines continuing into 1984. As noted above, construction activity has registered large reductions. In addition, both domestic capital goods production and capital goods imports have suffered sizeable declines throughout the 1981-84 period. The gross investments of state enterprises subject to SEST (the Secretariat for the Control of State Enterprises) control were reduced in real terms by 30% in 1983 as compared to 1982.[12]/ Finally, the real value of fixed investments for projects approved by the Council of Industrial Development (CDI) fell by 64% in 1983. The reductions in investment over the 1981-84 recession period have been brought about by high interest rates and the cutting of investment programs in the public sector. While investment reductions of this magnitude can be borne temporarily without lasting effect, sustaining such reductions over a protracted period will inevitably reduce the country's ability to grow in the future.

1.29 Reflecting the country's depressed economic activity, there has emerged substantial underutilized productive capacity. The estimated average utilization of installed capacity in manufacturing fell from a rather steady 84-85% in 1980 to 74% by the end of 1981 (Table 1.6). After

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11/ Potential GDP (Y*) for the Brazilian economy has been estimated from a trend computed on the basis of an average real rate of growth for GDP between 1920 and 1980. The GDP estimates from Zerkowsky and Veloso (op cit.) were used to compute a trend annual growth rate of 6.3% as estimated with ordinary least squares. The assumption was then made that 1980's realized GDP was the full employment, potential GDP for that year. That GDP was then projected to grow at the trend rate following 1980. Alternatively, if 1976 had been used as the potential GDP year, a slightly larger GDP gap would have been estimated for 1984.

12/ SEST, Relatório Annual, 1983, p. 18

Table 1.5: BRAZIL - GDP GAP ESTIMATES, 1980-83

	GDP Gap expressed as a % of Full Employment GDP	GDP Gap/a (US$ billion)
1980	0	0
1981	9.0	22.6
1982	12.1	35.3
1983	19.9	52.2
1984 /b	23.9	63.3

/a Average exchange rates were used for the conversion.

/b Estimate for 1984 was based upon a projected 1% growth rate for GDP.

Source: Bank estimates.

Table 1.6: BRAZIL - AVERAGE UTILIZATION OF INSTALLED CAPACITY, 1981-84

(Percent)

	January	April	July	October
1980	84	84	85	84
1981	82	78	76	74
1982	74	76	77	76
1983	73	74	72	73
1984	72	74	74	76

Source: Quarterly Survey of IBRE/CEI as reported in Conjuntura Econômica, various issues.

increasing slightly during 1982, it has settled back into the 72-74% range since then. While the prevalence of this excess capacity is indicative of the deadweight production losses associated with the recession, it suggests that, with an economic recovery, output is capable of increasing very quickly. Moreover, during a recovery the incremental capital-output ratio may be very low. In other words, short-term output growth may be cheap in terms of new investment.

D. Inflation

1.30 The most commonly used measure of price changes in Brazil is the general price index for domestic supply (the IGP-DI).[13/] As measured by this index, inflation, after increasing to 110% in 1980, remained about 100% in 1981 and 1982, and then accelerated sharply to 211% in 1983 (Table 1.7). Through August 1984, the 12-month cumulative inflation rate was 219%.

1.31 Another widely used price index in Brazil is the national consumer price index (the INPC).[14/] While the IGP-DI is used as the basis for the indexation of financial assets (i.e., monetary correction) and nominal exchange rate changes, the INPC is employed for making adjustments in rents, some prices, and, very importantly, wages and salaries. The INPC, since its inception in April 1979, has generally lagged the IGP-DI

13/ The IGP-DI is constructed as a weighted average of three separate price indices, all estimated by the Fundacao Getulio Vargas (FGV). The sub-indices (along with their weights) are the wholesale price index for domestic supply (0.6), the cost-of-living index for Rio de Janeiro (0.3), and the construction cost index, also for Rio de Janeiro (0.1). Since it is a composite index with rather arbitrary weights for the individual indices, movements in the overall index are difficult to interpret. Also, the weights within the indices are open to question. For example, the wholesale price index (the IPA-DI) and its component parts have shown some marked differences in the past from the price indices estimated by IBGE. In addition, the household survey from which the weights for the cost-of-living index were computed was undertaken in the 1960s. The fact that at least 40% of the IGP-DI is based upon prices in Rio de Janeiro also raises doubts about its suitability as a national index for inflation. Given the policy importance attached to the IGP-DI, some revision and refinement would appear warranted.

14/ The INPC is computed by IBGE and consists of an average of consumer price indices for ten major metropolitan areas. The within-index weights for these indices are based upon a large household survey conducted by IGBE for 1974-75 (the so-called ENDEF survey); the weights purport to represent the expenditure basket for families earning four times the minimum wage.

slightly; in 1983 this lag became accentuated, creating some difficulties for the indexation system.

1.32 Table 1.7 shows movements in a number of the major price indices for the period 1979-84. Prior to 1983 the indices moved roughly in line with only small differences among them. In 1983, however, substantial differences appeared. These divergences can be attributed primarily to the 1983 increases of agricultural product prices, amounting to 334% for the year. Domestic crop shortages, efforts to maintain export earnings, and the reduction of credit subsidies for agriculture all served to put upward pressures on domestic prices. In addition, government administered prices were also substantially readjusted in 1983, resulting in a "corrective" inflation and contributing to the increase of prices in general.

1.33 Both the IGP-DI and the INPC were adjusted in 1983 for the domestic supply shocks emanating from agriculture and "corrective" inflation. Adjustments reducing the measured inflation, and the subsequent indexation based upon the indices, were made for both "accidental factors", such as crop failures and transport problems, and "corrective" inflation, resulting from the withdrawal of subsidies or from large increases in world commodity prices. The overall rationale of the price index adjustments was to moderate, albeit in an ad hoc fashion, the effects of supply shocks on an inflexible and highly indexed price system, thus forcing the economy to "accept" the real income losses that these shocks engendered. The introduction of the price index adjustments, however, had also the effects of undermining the credibility of the price indices, reducing the attractiveness of assets whose values were tied to the indices, eroding confidence in the Government's economic policies, increasing uncertainty, and accelerating inflationary expectations. Such adjustments to the indices were accordingly discontinued by late 1983.

1.34 As indicated, the acceleration of inflation to record levels in 1983 occurred in spite of a reduction of the consolidated real public deficit and increased restrictions on monetary and credit expansion. It resulted primarily from a combination of corrective price changes and a sharp fall in the domestic market availability of basic domestic foodstuffs, caused partly by drought in the Northeast and floods in the Center-South. As noted, agricultural wholesale prices increased by 334% for the year, increasing especially rapidly during mid-1983 and contributing in a major way to the monthly rate of inflation of 12-13% from June to October. The main price adjustments influencing the rate of inflation in the short run were the 30% nominal devaluation of the cruzeiro in February 1983, the subsequent maintenance of the new exchange rate parity, the elimination of the subsidies on petroleum products in June 1983, and the reduction in the wheat subsidy. These changes in relative prices, while both beneficial and essential, unquestionably had the effect of increasing the general price levels in 1983.

1.35 Some of the observed inflation acceleration in 1983 can probably be attributed to an increase in inflationary expectations. In mid-1983, international commercial bank disbursements were halted as a result of Brazil's non-compliance with the internal performance criteria of the IMF agreement. Consequently, there was an increased perception of drift in economic policies, a very rapid depreciation of the parallel market

Table 1.7: BRAZIL - SUMMARY OF PRICE INDEXES, 1979-84

(Annual Changes, as Measured at End of Period in Percent)

	1979	1980	1981	1982	1983	1984
General Price Index, Domestic Supply (IGP-DI)	77.2	110.2	95.2	99.7	211.0	223.8
Adjusted General Price Index, Domestic Supply/a	n.a.	n.a.	n.a.	n.a.	175.3	n.a.
Wholesale Price Index, Domestic Supply (IPA-DI)	80.1	121.4	94.3	97.7	234.0	230.3
Wholesale Price Index, Overall Supply (IPA-OG)	79.5	118.6	90.5	96.8	283.3	233.2
- Agriculture	80.5	138.2	70.7	89.5	335.8	230.5
- Industry	78.9	110.3	99.7	99.8	200.5	233.2
Cost of Living Index - Rio de Janeiro	76.0	86.4	100.6	101.8	177.9	208.7
National Consumer Price Index (INPC)	n.a.	95.3	91.2	97.9	179.2	203.3
Adjusted INPC/a	n.a.	n.a.	n.a.	n.a.	172.9	n.a.
Construction Price Index - Rio de Janeiro	63.1	113.0	86.1	108.0	148.9	213.4
Other Indices						
- Monetary Correction Index (ORTN)	47.2	50.8	95.6	97.8	156.6	215.3
- Nominal Exchange rate	103.5	54.0	95.1	97.7	289.4	223.6

/a Adjusted for corrective inflation and accidental factors.

exchange rate,[15]/ speculation about an impending external debt moratorium and overall economic pessimism. These factors were destabilizing and had the effect of exacerbating inflationary expectations. When incorporated into wage and price settlements, inflationary expectations in turn fed into the inflationary process.

1.36 The failure of inflation to fall in 1983-84, despite the contractionary nature of aggregate demand management policies, can be attributed to an important degree to the comprehensive indexation system existing in Brazil and the resilience of inflationary expectations. Through making price adjustments on the basis of previous inflation, indexation serves to propagate an existing inflation, even after an original demand or supply impulse or shock has been removed. In fact, over the past ten years each major shock has ratcheted inflation up to higher plateaus through the impact of the shocks themselves, the interaction with indexation, and accomodating monetary and fiscal policies. Inflationary expectations in turn interact with the indexation system, rendering the on-going inflation more resilient. Inflation has thus achieved a high measure of inertia in Brazil, limiting the effectiveness of contractionary demand management policies in bringing inflation down.

E. Employment and Wages

1.37 The impact of the current recession on the industrial labor force and construction trades has been severe. Wage earners in manufacturing and construction throughout the country have been negatively affected, and workers in Sao Paulo, especially in the consumer durables and capital goods industries, have been hardest hit. According to estimates by the Sao Paulo Federation of Industries and the Ministry of Labor, manufacturing employment in Sao Paulo fell 20 to 29% in absolute terms between 1980 and early 1984. For Brazil as a whole, manufacturing employment fell by 21%, according to IBGE data (Table 1.8). One must be very careful in interpreting such data, however, because of their focus on manufacturing alone and their failure to include the informal sector. The recovery, beginning in early 1984, is also reflected here.

1.38 Total employment as measured by household surveys, however, has continued to increase during recent years, although at a slower rate than in the 1970s.[16]/ According to the PNAD (the national household survey, which includes self-employed, informal sector, and part-time workers), the employed labor force grew from 42.7 million in 1979 to 47.9 million in 1982, a growth of 3.9% per year. Employment in services and the public

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15/ During 1983 the difference between the parallel market rate and the official exchange rate oscillated considerably, with the parallel market premium reaching a high of about 80% in late 1983.

16/ Household surveys tend to produce higher employment estimates than enterprise surveys; self-employed, part-time workers, and workers in small enterprises are typically included in the former but not the latter.

Table 1.8: BRAZIL - MONTHLY INDEX OF INDUSTRIAL EMPLOYMENT, 1980-84 /a

(1981=100)

Month	1980	1981	1982	1983	1984
January	104.9	106.9	92.7	89.3	83.3
February	105.9	106.9	93.3	88.7	83.5
March	107.6	106.1	94.2	88.5	83.9
April	108.3	104.3	94.4	88.2	84.2
May	108.8	102.6	94.9	87.9	84.5
June	108.9	101.0	94.3	87	84.4
July	109.0	98.9	93.9	86	84.2
August	108.9	97.0	93.6	85.4	86.5
September	108.8	95.9	93.1	84.5	86.9
October	108.4	95.0	92.6	84.3	87.3
November	107.8	94.4	91.8	83.9	88.0
December	106.9	94.0	90.6	83.0	

/a The index includes production workers only in manufacturing and mining.

Source: IBGE, Indicadores Conjunturais da Industria, various issues.

sector continued to increase, and agricultural employment was stable, with a slight trend upward, during this period. Since the beginning of 1984, export industries have been enjoying a mini-boom at the same time that producers for the domestic market are suffering a sharp drop in demand.

1.39 Brazil has only a rudimentary system of unemployment insurance;[17/] thus, the recession has forced many workers into part-time work at low wages where they are no longer covered by the national labor laws. The data, through 1982, show this trend clearly. For the country as a whole, the percentage of workers with a signed worker card fell from 60% to 57% between 1979 and 1982. In manufacturing, the decline was similar. Jobs in formal sector firms reporting to the RAIS, a government-mandated annual report on employment, fell from 77% to 74% of total manufacturing employment over the same period. The percentage of workers working less than 40 hours per week in their main job rose from 17% to almost 21% during this period, with persons working less than 40 hours per week and earning less than one minimum weekly wage increasing from 7% to 10%. The percentage of self-employed workers in the non-agricultural labor force, another indicator of informal sector activity, increased from 18% to 20%, with the increase proportionately greater in Sao Paulo.

1.40 These trends through 1982, while significant in themselves, tend to underestimate the full impact of the recession, since there was a slight upturn in 1982 which was reversed in 1983. Moreover, there has been an adaptation to difficult labor market conditions which, if anything, tends to disguise the full extent of the recession's economic costs. Open unemployment, a major employment indicator in many countries, measures only part of the employment problem in Brazil. Unemployment in the six major metropolitan areas, for which estimates are reported on a monthly basis, have remained relatively low. In March 1984, unemployment rates for Sao Paulo and Rio de Janeiro were slightly over 7%, while unemployment rates in the other cities ranged from 8% to 9.5%. Nonetheless, these rates have been rising since 1980, when adjusted for a change in the definition which occurred in early 1982.

1.41 Disaggregated unemployment trends reflect some of the same patterns discussed earlier. Construction workers in the six metropolitan areas suffered unemployment rates of 14-22% in early 1984, in contrast to industrial unemployment rates of about 8%. As is usual, the highest unemployment rates are found among new job entrants (10-17 year olds), who now have rates between 15% and 20% in all six of the reported metropolitan areas.

1.42 Without a strong economic recovery in the near future, the training and upward mobility available to young Brazilians will be substantially reduced compared with the 1960s and 1970s. As of mid-1984, a slight recuperation in employment and output in Sao Paulo was being witnessed. However, there is some doubt about its longevity, given the weak level of internal demand.

17/ Persons who are fired from their jobs may withdraw their contribution to a compulsory fund for workers in the organized sector (FGTS), if they have not already done so for other purposes.

1.43 On the basis of interviews with industrialists in Sao Paulo, it appears that during the recession firms have reduced their unskilled work force in greater proportion than production. At the same time, they have tended to maintain the employment of skilled workers and management personnel. While is is not possible to say at this point whether this is a purely cyclical phenomenon or a permanent change, survey data confirm this trend. For manufacturing as a whole, output per worker rose by 4.7% per year between December 1980 and December 1983. The gains in productivity have been largest in several of the sectors which employ large numbers of unskilled labor, such as textiles, metals, and food products.[18/] If the employment reductions have indeed been accompanied by genuine efficiency improvements, the competitiveness of the industries affected and their demand for labor could be substantially different with economic recovery than they were earlier.

Trends in the Industrial Real Wage

1.44 While employment opportunities in industry have decreased since the recession began, the average real wage in the sector (as measured by the IBGE average wage, deflated by the General Price Index) continued to increase until 1983, as shown in Figure 1.1.[19/] One reason for the increase in the average real wage has been the selectivity of the employment cuts, as described in the previous section. With disproportionate layoffs of unskilled workers, the IBGE average industrial wage, which is measured as the total wage bill divided by the number of workers, would be expected to increase with the change in the skill mix.[20/] Another possible explanation is the wage indexation formula in effect at the time. Between November 1979 and January 1983, workers who were earning 1 to 3 minimum wages were entitled to nominal wage adjustments every six months equal to 110% of past inflation (measured by the INPC), while workers in higher wage brackets were to receive progressively lower wage adjustments (Appendix Table 1.8). Since almost 70% of the work force subject to the wage laws were earning 1 to 3 minimum wages, the formula mandated an average increase exceeding 100% of the consumer price index during this period. One of the two wage series which focus on unskilled workers — the hourly wage rate for laborers in the construction industry in Sao Paulo — also show a similar trend, while the minimum wage series records a continuous decline since the late 1970s.[21/]

1.45 In 1983, the average real wage in industry, as well as the real minimum wage and the hourly real wage rate for construction workers in Sao Paulo, declined substantially. On average, mandatory wage adjustments for inflation in 1983, which underwent four changes in formula

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18/ Appendix Table 1.6 shows the trends.

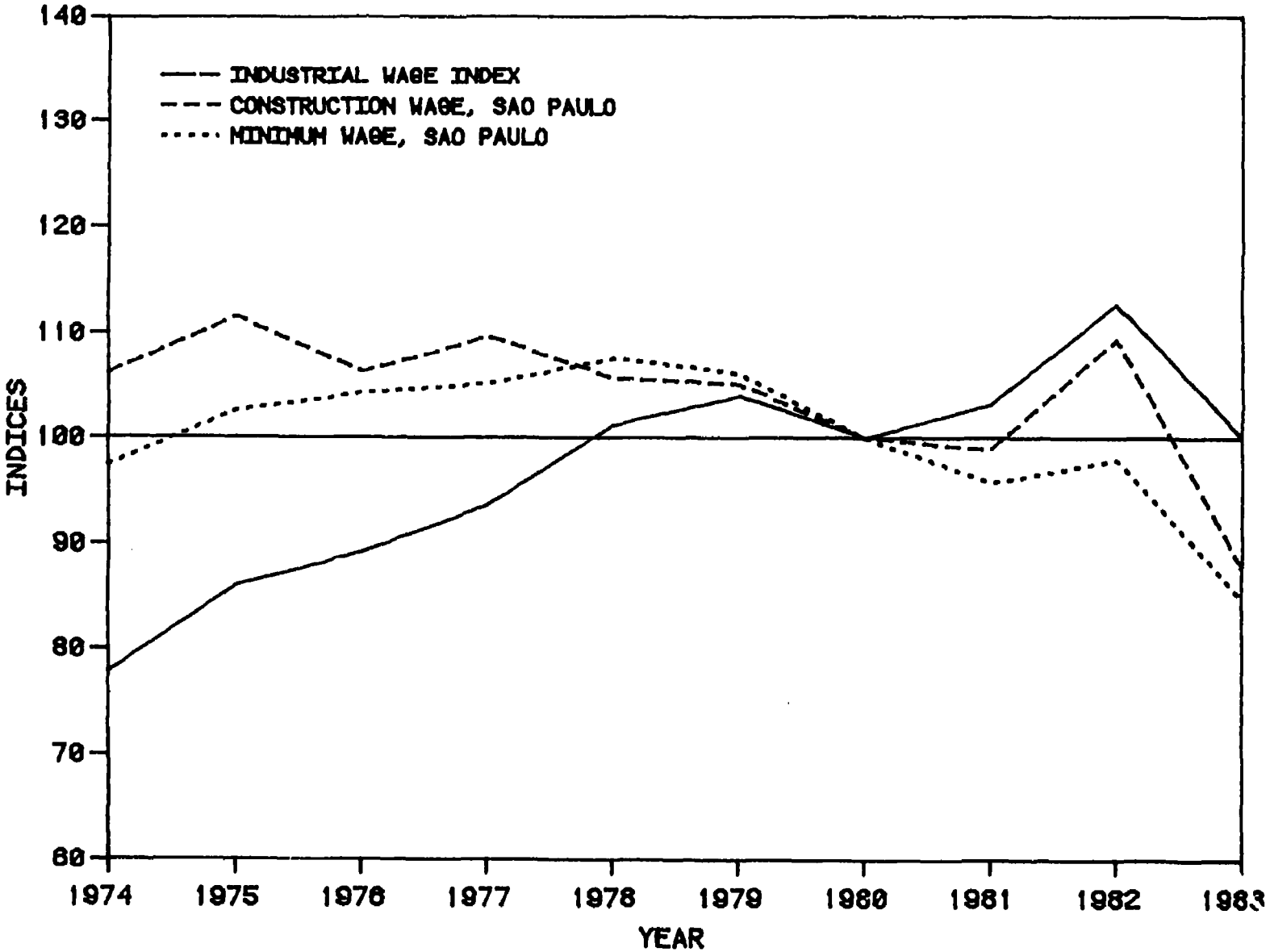
19/ As measured here, the real wage is an indicator of producer costs.

20/ The wage series also includes payments for overtime work, the thirteenth salary, other bonuses, and social contributions.

21/ A shorter series on the average rural wage, published in Conjuntura Econômica, shows a fall in that wage, in real terms, since 1980.

Figure 1.1: BRAZIL - TRENDS IN REAL WAGE INDICES, 1974-83 - ANNUAL AVERAGES

(1980 = 100)



Source: See Appendix Table 1.6. All wage series deflated by the general price index (IGP/DI).

during the year, fell to 80% of the INPC in mid-year, before settling to 86% of the INPC in October 1983, with the issuance of Decree Law 2065. In this wage law, indexation for the lowest paid workers (up to 3 minimum wages) was decreased from 110% to 100% of the INPC. Equally important, inflation rose dramatically in 1983; the INPC, which lagged behind the IGP-DI, grew at an annual rate of 173% at the end of 1983 compared to an annual rate of 104% at the beginning of the year. Since wage indexation is related to inflation in the previous six months, rising inflation automatically produces reductions in the average real wage even with 100% indexation. Finally, with recession into its third year, across-the-board employment cutbacks in those industries which continued to reduce production probably became more common than at the beginning of the recession.

1.46 Although data for most of 1984 are not available yet, the average industrial wage will probably not fall as much as in 1983. Inflation rates have stabilized, and the wage indexation formula presently in effect (D.L. 2065) no longer appears to be binding in practice. Many private sector firms have reportedly been paying more than the stipulated adjustments, although the raises typically do not exceed 100% of the increase in the cost-of-living index. Demands for restoration of real wages to the level of the previous year and lump sum payments in anticipation of future inflation have become more common. Even public sector enterprises have sought (and received) permission to increase salaries above the limits of the wage law, in order to compete with the private sector for its executives and to adjust the salary curve within the firm between its highest and lowest paid personnel.

F. Energy Developments

1.47 In 1983, energy use grew 3.5%, raising energy consumption to a level slightly higher than it had been at the beginning of the recession. Table 1.9 shows energy consumption by major fuel for the period 1980-83. Among the major fuels, petroleum derivatives have fallen as a percentage of total consumption, while electricity has grown in importance. Among the principal petroleum products, fuel oil and gasoline consumption have dropped substantially (15.6% and 8.1% per year, respectively) while diesel oil consumption has been stable. Appendix Table 9.1 shows the details.

1.48 Domestic energy production has expanded significantly during this period. The hydro-electric program, including the Itaipu project, is proceeding, although at a slower pace than first expected owing to slower increases in demand and financial constraints. Domestic crude oil production reached 500,000 barrels of oil per day (bpd) in mid-1984, the target originally set for the end of 1985. In 1980, Brazil was producing an average of 187,000 bpd; for 1984, production is expected to average 470,000 bpd. If domestic oil consumption in 1984 continues at the 1983 level of 962,000 bpd, domestic production this year will satisfy about 50% of the country's needs, as compared to 15% in 1979. Because of excess capacity in its refineries, Brazil has also begun processing imported crude oil for re-export. In 1983, some 120,000 bpd of petroleum derivatives were exported.

Table 1.9: BRAZIL - ENERGY CONSUMPTION, 1980-83

	1980		1982		1983		Annual Average Growth Rate	
	MMTOE /b	%	MMTOE /b	%	MMTOE /b	%	1980-83	1982-83
Petroleum Products /a	53.25	41.5	48.98	37.8	45.96	34.3	-4.8	-6.2
Gas: Natural Gas	0.92	0.7	1.17	0.9	1.59	1.2	20.0	35.9
Other	0.92	0.74	0.94	0.7	1.08	0.8	5.5	14.9
Coal, Coke, Charcoal	7.23	5.6	7.64	5.9	8.72	6.5	6.4	14.1
Electricity	35.26	27.5	38.09	29.4	41.07	30.7	5.2	7.8
Wood	20.37	15.9	20.40	15.8	20.26	15.1	-0.2	-0.7
Bagasse	6.23	4.9	7.71	6.0	9.37	7.0	14.6	21.5
Alcohol	2.27	1.8	2.81	2.2	3.83	2.9	19.0	36.3
Other Sources	1.79	1.4	1.74	1.3	2.11	1.5	4.8	21.3
Total	128.24	100.0	129.48	100.0	133.99	100.0	1.5	3.5

/a Includes non-energy uses.

/b MMTOE = million tons of oil equivalent.

Source: Ministério des Minas e Energia, Balanço Energético Nacional, 1984, Table 5.2.

1.49 Two other domestic fuels, which are now only minor components in the country's energy balance, have potential for substantial growth. To meet a growing demand, alcohol production has more than doubled in the past few years — from 3.4 billion liters in the 1979-80 crop year to 7.9 billion liters for the 1983-84 crop year. Anhydrous alcohol continues to be mixed with gasoline in a ratio of 20:80, and hydrous alcohol consumption has increased steadily, especially after technical problems with the alcohol engine were resolved in 1982. In 1983, new alcohol car sales were 80% of total new car sales. Natural gas received considerable attention last year, as plans were made to use the associated gas from the Campos oil fields, and sizable natural gas deposits in Jurua, in the Upper Amazon, became a more likely possibility.

G. Balance-of-Payments Performance and External Debt

1.50 Brazil's export performance in 1983 demonstrated the underlying strength of both the industrial and agriculture sectors and their capacity, given appropriate exchange rate policies, to offset through exports the strong recessionary forces within the economy. As shown on Table 1.10, total merchandise exports increased in 1983 by 8.5% in current US dollars. For their part, industrial products exports grew by 11.8%, after falling 16.4% in 1982. These increases, while substantial, were not enough to bring exports back to their 1981 level, even in current US dollars, (although 1984 exports will be substantially higher). Moreover, the overall growth secured in 1983 was approximately equal only to the performance achieved, on average, in the years 1974-80, in constant dollar terms, and below that average for exports of industrial products.

1.51 Two major developments contributed to the positive turnaround in export performance. The 30% devaluation of the cruzeiro in February 1983 strengthened the competitive position of Brazilian exports, which had been eroding over the previous two years. Subsequent and continuous small devaluations since then, roughly in line with domestic inflation, have sustained this real depreciation. Depressed domestic market conditions, reflecting the recession, have also made export sales more attractive to industrial producers, thereby stimulating exports. Second, the strong performance of the U.S. economy provided much of the scope for Brazil's export growth. Some 60% of the increase in merchandise exports in 1983 (US$1.0 billion of a total increase of US$1.7 billion) was directed to the United States.

1.52 Manufactured exports were also promoted by the system of fiscal export incentives which, while largely unchanged in 1983, have sustained the relative returns to export production during the recession. The key element of that system is the export tax credit (crédito premio), which is currently paid at an ad valorem rate of 11% but is scheduled for elimination by April 1985. The availability of export financing for both sales and production has been decreasing over the past two years, in reflection of the general monetary austerity. An additional export

Table 1.10: BRAZIL - ANNUAL GROWTH RATES OF EXPORTS, 1964-83

(Percent)

	Average Annual Growth Rates/a			Yearly Growth Rates			
	1964-74	1974-80	1980-83	1981	1982	1983	1984
Total							
In Current US$	16.4	14.8	1.1	15.7	-13.4	8.5	23.3
In Constant 1980 US$/b	12.0	6.6	-2.8	6.0	-15.2	7.1	20.4
Primary Products							
In Current US$	12.8	8.4	-0.6	5.3	-7.6	3.4	3.4
In Constant 1980 US$/b	8.4	0.2	-4.5	-3.5	-9.5	2.9	1.0
Industrial Products							
In Current US$	25.7	22.2	2.4	23.1	-16.4	11.8	37.0
In Constant 1980 US$/b	21.4	14.1	-1.5	12.8	-18.2	10.3	33.8

/a Average growth rates were computed by ordinary least squares.

/b The US wholesale price index was used to deflate current US dollar export receipts.

Source: CACEX materials and International Financial Statistics.

incentive, however, was provided by drawback system reforms in mid-1983, under which intermediate inputs used for exports can be freely imported.

1.53 The benefits to exporters of most agricultural, livestock, forestry, and mineral products of the February 1983 devaluation were reduced by the imposition of commodity export taxes ranging from 10% to 20%. Most of these taxes were subsequently reduced and eliminated by April 1984, although most primary product exports continue to be subject to a de facto export tax in the failure to rebate the ICM from such products when exported. Product-specific export taxes have also been used in the effort, not wholly successful, to avoid countervailing duties on some steel and other manufactured products considered, primarily by the United States and the European Community, to be subsidized.

1.54 Despite the export growth, the positive trade balance of US$6.5 billion in 1983 was primarily the result of a more than 20% decline in imports, which fell in current dollar terms for the third consecutive year (Table 1.11). The main factors in this decline were devaluation, the recession, increased domestic oil production, and tightened direct controls over imports and foreign exchange. Private sector imports were tightly controlled through the CACEX import-budgeting system, and state enterprises were subject to direct import limits and were also limited indirectly through investment and fuel use controls.

1.55 Table 1.11 shows the changes in the overall balance of payments for 1979 to 1983. The positive trade balance of US$6.5 billion in 1983 was accompanied by a reduction of US$1.2 billion in the non-factor services deficit, as payments for transport and insurance declined with imports, and foreign exchange allowances for overseas travel were cut. Net interest payments and other factor incomes contributed US$1.6 billion less to the deficit than in 1982, and the combined result was a reduction in the current account deficit from US$14.8 billion in 1982 to US$6.2 billion in 1983.

1.56 There was a large fall also in medium- and long-term lending to Brazil in 1983, which in gross terms declined from US$17.2 billion to US$14.8 billion, and on a net basis from US$9.0 billion to US$4.4 billion. Amortization payments on medium- and long-term lending were held to US$2.6 billion in 1983, after the rescheduling of nearly all principal payments on commercial and official bilateral medium- and long-term loans falling due in that year. Net short-term capital outflows amounted to US$1.8 billion, as these resources were replaced by longer-term commercial bank disbursements, and as the financing requirements for imports declined. The overall balance-of-payments deficit was reduced from US$6.5 billion to US$3.3 billion.

1.57 Thus, Brazil achieved the key external adjustment objectives sought in 1983. The overall deficit of US$3.3 billion exceeded the target only because of delays in the completion of negotiations with the commercial banks, which resulted in a shortfall of net capital inflows. This left payment arrears of US$2.3 billion to be made up in 1984.

Table 1.11: BRAZIL - BALANCE OF PAYMENTS SUMMARY, 1979-83

(Millions of US$ at Current Prices)

		1979	1980	1981	1982	1983
1.	EXPORTS (g+nfs)	16,698	21,892	25,579	21,994	23,628
2.	Merchandise (fob)	(15,244)	(20,132)	(23,293)	(20,175)	(21,899)
3.	Non-Factor Services	(1,454)	(1,760)	(2,286)	(1,819)	(1,729)
4.	IMPORTS (g+nfs)	21,916	27,901	27,240	24,802	19,594
5.	Merchandise (fob)	(18,084)	(22,961)	(22,091)	(19,395)	(15,429)
6.	Non-Factor Services	(3,832)	(4,940)	(5,149)	(5,407)	(4,165)
7.	RESOURCE BALANCE	-5,218	-6,009	-1,661	-2,808	4,034
8.	Net Factor Income	-4,821	-6,621	-9,531	-11,938	-10,313
9.	(Interest on M&LT Debt)	(4,717)	(6,558)	(7,956)	(9,299)	(8,463)
10.	Net Transfers	10	168	198	-8	108
11.	CURRENT BALANCE	-10,029	-12,462	-10,975	-14,755	- 6,171
12.	Direct Investment, Net	1,491	1,146	1,585	991	657
13.	Net M&LT Loans	5,366	4,730	9,908	8,896	4,414
14.	Other Capital, Errors and Omissions	480	3,200	351	- 1,759	- 2,230
15.	Change in Net Reserves (- indicates increase)	2,692	3,386	-849	6,537	3,330

Source: Appendix Table 3.1.

1.58 Results in the first nine months of 1984 were even more favorable for the balance of payments, as export growth accelerated and both oil and non-oil imports again declined. Exports reached US$20 billion by the end of September, and increase of 23% over the same period in 1983, and within this total manufactured exports grew by 31%. The 1984 trade surplus reached US$9.6 billion in September, exceeding the target of US$9.1 billion for 1984 as a whole. Under the 1984 financing package arrangement, commercial banks are providing US$6.5 billion in new loans, on terms better than those for 1983, in addition to rescheduling payments of principal of US$5.3 billion. Official bilateral credits amounting to US$2.5 billion in export guarantees were made available, along with almost US$4.0 billion in rescheduling through the Paris Club.

1.59 From 1980 to the end of 1983, external debt increased by an estimated US$27.4 billion to US$93.6 billion (Table 1.12) There was an increase estimated at US$11.1 billion in medium- and long-term debt, mainly because of the postponement of payments of principal in 1983 under rescheduling arrangements, as the new inflows of medium- and long-term funds amounted to only US$4.4 billion, under half the 1981 and 1982 figures. Table 1.13 shows the exceptionally large pressure exerted by the costs of debt service and oil imports on the balance of payments in 1980-82. The ratio of debt to GDP increased in 1983 to an estimated 34%, and to over 300% of exports of goods and non-factor services.

1.60 About 70% of Brazil's debt is public or publicly guaranteed. Commercial bank lending, at variable interest rates, increased as a share in the debt and accounted for 76% in 1982 and about the same in 1983. Debt held by multilateral lenders and by bilateral lenders each accounted for less than 6% of the total in 1982 and 1983. Approximately 80% of the debt is subject to variable interest rates, about 70% linked to the LIBOR and the rest to the New York prime rate. Brazil therefore remains highly vulnerable to increases in international interest rates; by the same token, it would be a major beneficiary of any reduction in rates.

1.61 In 1984, the international reserve position was rapidly recovering from the drastic decline in 1982 and the further deterioration in the net reserve position that occurred in 1983. At the end of 1982 gross reserves had declined to less than the equivalent of 2 months imports of goods and services, and this position had only moderately improved the end of 1983 (Appendix Table 3.11). Reserve accumulation was, however, rapid in the first half of 1984 on the basis of the large and growing trade surplus and improved financing arrangements.

1.62 Brazil is therefore emerging from its external payments crisis, primarily through its own strenuous efforts to generate increased exports and to contain its already low volume of imports, both through short-term demand management measures and the substitution of domestic energy for imported oil, the latter representing a structural improvement in the balance of payments. In this process, it is likely in 1984 to establish a new and larger export base which, with sustained export growth, should be able to support the recovery now starting to gather momentum within the economy. The other main factor enabling Brazil to overcome the external accounts crisis has been the collective international response, which in 1983 provided the essential complement to the resources Brazil could

Table 1.12: BRAZIL - EXTERNAL DEBT, 1975-83

(US$ Billions)

	1975	1980	1981	1982	1983	Annual Growth Rate (%) 1975-80	1981-83
Medium- and Long-Term Debt/a	23.4	55.8	63.7	70.2	81.3	19.0	13.0
Public and publicly Guaranteed	13.8	39.2	44.5	49.5	n.a.	23.2	n.a.
Private Non-Guaranteed	9.6	16.6	19.2	20.7	n.a.	11.6	n.a.
Short-Term Debt/b	5.0	10.4	12.6	14.6	12.2/c	16.1	-1.6
TOTAL EXTERNAL DEBT	28.4	66.2	76.3	84.8	93.6	18.4	10.8

/a Registered debt disbursed and outstanding as of the end of period and as compiled by the Bank's Debt Reporting Service based on Central Bank data. The 1983 data are from the Central Bank.

/b Estimates based upon Central Bank information. There is no short-term debt information available prior to 1980; the 1975 short-term debt was estimated as approximately 25% of total 1975 trade flows.

/c The 1983 short-term debt estimate includes $2.3 billion of payments arrears.

Source: Banco Central do Brasil.

Table 1.13: BRAZIL - RELATION OF OIL IMPORTS AND DEBT SERVICE TO EXPORT EARNINGS, 1972-83

(Percent)

	1972	1977	1980	1981	1982	1983/a
Ratio to Goods and NFS Exports:						
Oil imports	11	31	47	46	47	36
Net interest payments	8	16	29	31	42	36
M&LT debt amortization	27	31	31	29	33	40 (15/b
Total	46	78	107	106	122	118 (87)

/a Preliminary.

/b Adjusted for 1983 rescheduling.

Source: Statistical Appendix Tables 3.1 and 3.4.

generate on its own, and which in 1984 is contributing to the rapid recovery of the balance of payments.

Export Composition and Performance

1.63 Brazil's trade structure changed radically during the 1970s, as its manufacturing and processing base expanded and diversified. Coffee's share of export earnings declined from 36% in 1970 to less than 11% in 1983. In 1970, manufactured exports accounted for only 13% of merchandise export earnings. By 1980, this had increased to 42%, and by 1983 to almost 50% of the value of exports (Table 1.14). Broad import substitution in manufacturing, fostered by import controls, also limited the growth of non-oil imports. The share of oil in merchandise imports increased from 11% in 1970 to 44% in 1980 and 56% in 1983.

1.64 Agricultural export earnings were 4.4 times greater in 1980 than in 1970. Inasmuch as agricultural commodity prices were less than 15% higher in 1980 than in 1970, nearly all of this growth was attributable to export volume, which rose at an average rate of 14.5% a year. Part of this came from the dramatic rise in soybean exports. Even without this boost, however, and with a diversion of sugar production to the alcohol fuel program, the volume of agricultural exports nearly tripled with average annual increases of about 11% a year. A further 25% rise in agricultural export volumes is estimated for 1980-83. Mineral exports increased 10 times in volume between 1970 and 1980, although only 6.5 times in value, and have remained at the higher level although domestic processing has expanded.

1.65 Overall, this constitutes a noteworthy export performance. However, because of the parallel growth in GDP over the decade, and unfavorable trends in prices for primary products other than oil, volume growth in exports was not translated into significant growth in export earnings relative to GDP. Merchandise exports receipts averaged 6.7% of GDP in 1970-72 and 7.9% in 1980-82, while exports of non-factor services declined as a proportion of GDP. Brazil remained a relatively closed economy, although much more diversified and developed than a decade earlier.[22/]

1.66 The small size of Brazil's two-way trade, relative to GDP, is shown in Table 1.15. The compression of imports, and especially non-oil imports, is clearly shown. Imports of goods and non-factor services averaged 9.6% of GDP in 1970-80, and there was a resource gap averaging 2.3%, with both ratios increased by high import costs in 1974-75. The pattern of imports was increasingly distorted after 1973 by higher payments

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22/ The growth in the ratio of exports to GDP observed during 1983-84, as witnessed in Table 1.14, is due not only to the export growth during that period but also very importantly to exchange rate movements on which the comparison is based. Because of those exchange rate movements, coupled with the recession, GDP measured in current US$ has dropped considerably, thereby increasing the export to GDP ratios. The same phenomenon is also observed with imports. Nevertheless, the export-GDP ratio will increase significantly in 1984.

Table 1.14: BRAZIL - COMPOSITION OF EXPORT AND IMPORT TRADE, 1970-83

(US$ Millions)

	1970	1975	1980	1981	1982	1983
Exports	2,739	8,670	20,226	23,293	20,175	21,899
Coffee	979	933	2,772	1,761	2,113	2,347
Sugar	126	1,100	1,288	1,062	580	517
Soybean (incl. oil)	71	1,303	2,254	3,085	1,964	2,102
Other agriculture	660	1,232	1,813	2,302	2,337	2,330
Minerals	264	1,022	1,722	1,982	2,001	1,675
Semi-processed goods	249	493	1,620	1,484	1,134	1,601
Manufactured	366	2,379	8,394	11,244	9,754	10,856
Others	24	208	361	374	251	461
Imports (total)	2,507	12,210	22,955	22,091	19,395	15,429
Consumer goods	376	1,198	2,557	2,066	1,850	1,700
Fuels and lubricants	281	3,100	10,200	11,340	10,457	8,607
Other intermediate goods	942	3,978	5,817	4,662	3,816	2,617
Capital goods	908	3,934	4,381	4,023	3,272	2,505

Source: Appendix Tables 3.3 and 3.4.

Table 1.15: BRAZIL - RATIOS OF TRADE TO GDP, SELECTED YEARS, 1970-84

(Percent)

	1970	1975	1980	1981	1982	1983/a	1984/b
Exports	6.0	6.9	8.0	8.5	7.3	10.6	12.5
Non-Oil Imports	5.1	7.3	5.1	3.9	3.3	3.5	4.1
Total Imports	5.5	9.4	9.2	8.1	7.0	7.5	7.3

/a Preliminary

/b Forecast

Source: Appendix Table 3.5.

for imported oil, which were 36 times higher in 1980 than 1970 (accounting in the later year for 44% compared to 11% of the value of merchandise imports), although the volume increase was less than 60%. In 1980-83, with reduced demand and higher domestic production of petroleum and of alcohol fuels, the volume of oil imports fell 11%. Imports of cereals were four times greater in 1980 than in 1970, in volume terms. Adjusted for price changes, the rise in all other imports was only about 75%. They were subject to increasing restrictions and resource limitations and, from 1981, by the onset of the recession. By 1983, after a sharp reduction (47%) in current US dollars from 1980, the volume of imports excluding oil and cereals was no higher than in 1970. Imports of capital goods fell from 36% to 19% of total merchandise imports between 1970 and 1980, and declined further to 16% in 1983. Intermediate goods imports, as a group, excluding oil, went down from 36% to 25%, then to 17% of total imports, in the same periods.

1.67 Export performance in 1983 and in the first part of 1984, combined with the drop in imports, has gone far in transforming the trade account. In the short run, the growing surplus provides increased resources for servicing Brazil's accumulated external debt. For the longer term, it establishes a new and higher base for further export expansion and increased imports, as the economy recovers and imports are liberalized. Since part of the 1983-84 manufactured export growth can be attributed to depressed domestic market conditions and high levels of excess productive capacity, export growth is likely to slow somewhat once a recovery in the domestic market begins but can, nevertheless, be maintained at rates sufficient to support this domestic growth if appropriate trade and exchange rate policies are pursued.

1.68 In addition, the latest boost in exports has raised several questions for medium-term strategy. Table 1.16 summarizes the changes in the direction of trade in 1981-83 and shows a substantial shift in exports towards the United States and away from the developing countries, which, until then, had been rapidly expanding markets for Brazil. Exports to the rest of Latin America contracted from US$4.1 billion in 1981 to US$2.0 billion in 1983. Those to the United States rose by US$1.0 billion, and accounted for 60% of the rise in exports from 1982 to 1983. While exports to Asia, including Japan, to Iran and Iraq, and to some European countries and the USSR also increased significantly during 1983, export performance depends heavily at present on the growth of US markets and continued access to them.

1.69 This dependence on the United States has become especially evident for some products, including footwear exports, which increased 50% in 1983, with 80% of the total going to the US; machinery and equipment, and orange juice, with 40-50% of exports to the same country; and coffee, iron and steel, cocoa and tobacco with 20-30%. The growth continued into 1984, when total exports increased by 21% in the first half, compared with the same period in 1983, with those to the US accounting for some 70% of the increment. For Brazil, this may be seen as a short-term benefit derived from the US recovery, the high value of the US dollar and the relatively open nature of the US economy. Further efforts to diversify export trade, and to preserve the gains made in trade with the US, will be required to maintain good export growth.

Table 1.16: BRAZIL - DIRECTIONS OF TRADE, 1981-83

(Percent)

Country Group	Exports			Imports		
	1981	1982	1983	1981	1982	1983
Industrial	53.7	56.1	58.7	41.8	37.3	37.1
of which U.S.	(17.6)	(20.0)	(23.1)	(16.3)	(14.8)	(15.6)
Oil Exporting	10.1	9.4	8.8	41.1	43.5	41.6
Non-Oil Developing	28.4	26.6	23.9	15.8	16.7	17.7
of which Latin America	(17.6)	(13.4)	(9.2)	(10.2)	(12.7)	(10.7)
Eastern Europe	6.1	5.9	6.6	1.0	2.4	3.3
Other, Unspecified	1.7	2.0	2.0	—	0.1	0.3
	100.0	100.0	100.0	100.0	100.0	100.0
Total (US$ billion)	23.3	20.2	21.9	22.1	19.4	15.4

Source: Developed from CACEX materials. See Appendix Table 3.5.

1.70 Efforts to diversify export markets, combining government initiatives and private enterprise, have been relatively successful, notably in the Pacific Basin and the Middle East. Exchange rate policy during the last two years has strengthened Brazil's competitive position, although linking the cruzeiro to a strengthening US dollar has, in the short run, limited opportunities in Japanese and European markets. Consolidating the recent export gains will require the maintenance of appropriate exchange rate policies and further marketing efforts. Export growth will also depend increasingly on the capacity to produce and market manufactured goods of a standard and style fully attuned to international demand. In this respect, Brazil's restrictions on imports have imposed some penalties, insulating its own large domestic markets from the direct benefits of changes in taste and technology. The liberalization of imports, as external constraints ease, to allow more consumer goods into the country as well as intermediate and capital goods, could be a sound investment in export development.

1.71 Another challenge for Brazil is to maintain export competitiveness, and growth, while at the same time reducing export subsidies. The fiscal subsidy for manufactured exports, the crédito premio, is currently in the process of being phased out, with final elimination scheduled for April 1985. At the same time, credit subsidies for manufactured exports have been eliminated. To avoid the risk of retaliatory action by major trading partners, Brazil should, especially at this stage of its recovery, seek to minimize distortions in its external trade. In order to maintain export competitiveness in the midst of the reduction and curtailment of export incentives, particularly for manufacturing exports, compensatory policy actions should be considered. For example, the elimination of the crédito premio by itself will mean an 11% reduction in the real domestic currency remuneration for affected exports. In addition, through reducing the incentives for export sales vis-a-vis domestic sales, the phase-out of the crédito premio implies an increase in the anti-export biases in economic policies. Consequently, compensatory policy actions are desirable in: (a) exchange rate policy (which affects the relative prices between tradable and nontradable goods but not between exportable tradable and import substitute tradables) and in (b) redressing the balance between export and domestic market sales incentives. The latter could be served through the elimination of the financial operations tax (IOF) on import transactions.

Exchange Rate Management

1.72 The current Government clearly recognizes the importance of maintaining a competitive exchange rate in order to sustain and promote the expansion of exports.[23/] Since the maxi-devaluation in February 1983, the

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23/ There is now substantial econometric evidence demonstrating a high degree of Brazilian export supply responsiveness to changes in the real exchange rate. This work also provides evidence of the capacity utilization effect on export performance. See, among others, Helson C. Braga and Ricardo A. Markwald, "Funçoes de Oferta e de Demanda das Exportaçoes de Manufaturados no Brasil: Estimação de Um Modêlo Simultâneo," Pesquisa e Planejamento Econômico, Vol. 13, No. 3 (December 1983), pp. 707-744 and William G. Tyler, Manufactured Export Expansion and Industrialization in Brazil (Tubingen: J.C.B. Mohr, 1976).

policy has been to depreciate the currency pari passu with domestic inflation, as measured by the General Price Index, on a monthly basis.[24] The Government has repeatedly stated its intention to continue this practice. Accordingly, the mini-devaluations, taking place at irregular intervals, roughly every 5-6 days, have prevented an increase in the cruzeiro's real rate of exchange, notwithstanding the offsetting effects of dollar inflation and changes in the value of the US dollar in relation to third-country currencies. This exchange rate policy constitutes an essential component of the Brazilian system of indexation. As such, it has come under increasing attack, even within the Government, as a propagating factor of inflation. There is a risk, if a de-indexation strategy is pursued in an attempt to reduce inflation, that exchange rate adjustment will be allowed to lag behind domestic inflation discounted for foreign inflation and cross-currency movements. If so, the real exchange rate will appreciate, Brazil's crucial export expansion will be retarded, and its longer-term future clouded.

1.73 Along with the interest rate, the exchange rate is the single most important price in the economy.[25] Despite the favorable balance-of-payments experience in 1984, the Government should not become complacent about exchange rate policy. Figure 1.2 shows movements over time of a purchasing power parity exchange rate, estimated both with and

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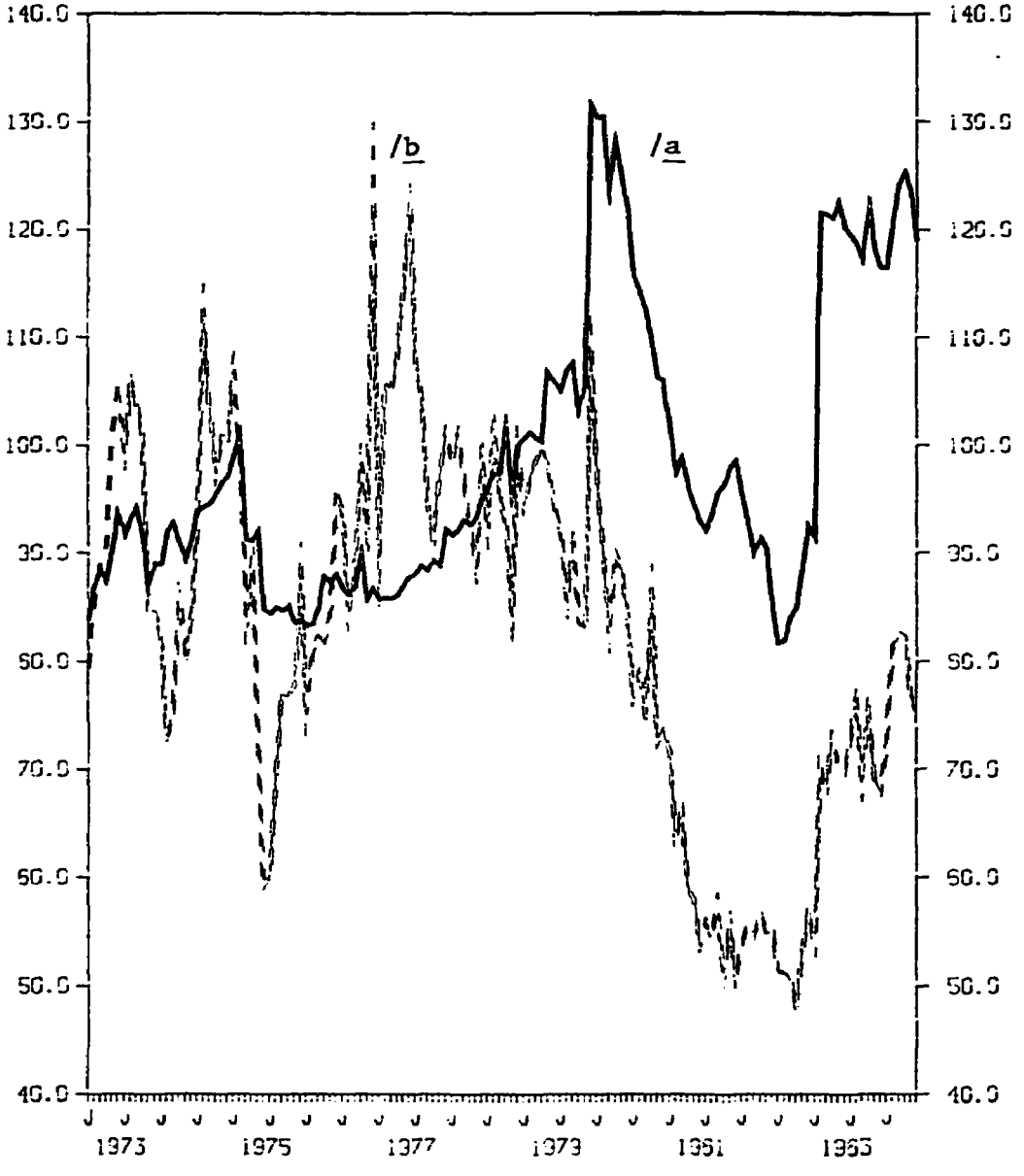
24/ Contrary to expectations the rule of devaluing in keeping with domestic inflation, as measured by the IGP-DI, and not discounting international, or dollar, inflation has not resulted in a real depreciation vis-a-vis the US dollar in the period since the maxi-devaluation in February 1983. This is shown in Appendix Table 8.9. First, inflation in the US has been very low, especially if measured by the wholesale price index instead of the cost of living index. Second, the relevant concept for the comparisons is parity as measured through the relative price movements of tradable products. Wholesale price indices capture these movements better than cost-of-living indices, which contain many nontradables. For Brazil, the wholesale industrial price index was used on the grounds that the competitiveness of Brazil's industrial exports is the major question at issue. If the general wholesale price index for Brazil were used instead, a real appreciation of the cruzeiro vis-a-vis the dollar would be demonstrated.

25/ The exchange rate can be viewed as the relative price of tradable goods vis-a-vis nontradables. A real currency depreciation, therefore, has the purpose of increasing the relative price of tradable goods, thereby inducing expenditure-switching in favor of tradable goods production. The effect on the trade balance is positive through the stimulation of export and import substitute production. Balance-of-payments adjustment achieved through expenditure-switching policies is far less onerous than that achieved through generalized absorption-reduction. The maxi-devaluation of February 1983 resulted in an increase in the price of tradables relative to nontradables. Statistical Appendix Table 3.8 presents evidence of this in the form of rudimentary estimates of indices for the domestic prices of tradables and nontradables.

Figure 1.2: BRAZIL - TRADE WEIGHTED PURCHASING POWER PARITY EXCHANGE RATE, WITH AND WITHOUT TERMS OF TRADE ADJUSTMENT, 1973-84 - MONTHLY ESTIMATES

(DECEMBER 1978=100)



/a Unadjusted for terms of trade changes. An increase in the rate is shown to represent a real depreciation.

/b Adjusted for terms of trade changes, as estimated from the Central Bank's export and import price indices.

Source: Mission estimates.

without adjustments for terms of trade changes.[26/] Without such adjustments it is evident that the maxi-devaluation of February 1983 and subsequent exchange rate policy have restored export competitiveness to levels unsurpassed since early 1980. In such a construct, the current levels for the real exchange rate are seen to be higher than those existing in the early or mid-1970s. On the presumption, however, that appropriate exchange rate policy should take terms of trade movements into account, the picture appears quite different. The terms of trade adjusted purchasing power parity exchange rate, while showing some recovery as a result of the February 1983 maxi-devaluation, has shown considerable real appreciation relative to most earlier periods. To reestablish the average 1973 parity, i.e., prior to the first petroleum price shock, for June 1984, for instance, would have required a real devaluation of 20%. While estimates such as these can only be viewed as indicative in very general terms, it is clear that the Government should watch the situation closely and compensate through exchange policy, as needed, for the removal of fiscal and credit incentives.

1.74 The present crawling peg exchange rate regime, and the associated rule of thumb to depreciate the currency roughly in line with inflation, have been in effect since 1968 with three notable, and relatively recent, divergences. These exceptions — the two maxi-devaluations of December 1979 and February 1983 and the pre-fixation episode of 1980 -- have had the effect of increasing the perception of the risk of future rule-of-the-game changes. Uncertainty also exists concerning what the new Government's position will be, and, as noted above, there are pressures building in favor of some sort of deindexation course, which might delink the exchange rate from price movements. Also contributing to exchange rate uncertainty are the continuing hesitancy of international commercial banks to resume lending and the commitment made by the Government under the GATT to eliminate the fiscal subsidy (the credito premio) for manufactured exports by April 1985 (see para. 1.70). This exchange rate uncertainty raises domestic interest rates, inhibits new investment and has an adverse impact on export performance. A statement by the new Government outlining its exchange rate policy intentions might serve to diminish this uncertainty.

1.75 The cruzeiro's par value is defined and quoted in terms of US dollars, and it is the dollar value of the cruzeiro that is indexed to domestic inflation. Thus, considerations related to cross currency changes in value are not incorporated. In particular, the appreciation of the US dollar relative to European currencies and the Japanese yen since 1980 has carried the cruzeiro with it. Accordingly, it has been frequently suggested that the adjustment be pegged to a basket of currencies representing Brazil's trading partners. Although conceptually this would appear to be a better procedure, the present time does not seem appropriate to move towards such a system. Some of the recent appreciation of the cruzeiro vis-a-vis the basket of currencies of its trading partners stems

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26/ Such an exchange rate was estimated on a trade weighted basis, reflecting Brazil's export market structure and accounting for cross currency exchange rate movements and relative country inflations. See also Appendix Tables 8.7 and 8.8.

from having pegged only to the U.S. dollar. When the dollar depreciates vis-a-vis other currencies, as it is likely to do eventually, this will provide Brazil with a real depreciation ceteris paribus, offsetting the previous appreciation. To now peg to a currency basket would preclude this relatively painless depreciation.

H. Public Finance

1.76 In the absence of fully consolidated revenue and expenditure accounts, imbalances in public sector finances are measured here by the borrowing requirements of the sector as a whole and its main component parts, the central administration, the states and municipalities, the federal state enterprises and the remaining agencies. Table 1.17 shows these borrowing requirements for the years from 1979 to 1983. Much of the borrowing, and the bulk of it in 1983, has been required to cover the monetary correction (indexation) of the already outstanding domestic public debt. The debt is indexed to changes in domestic price levels or, for a proportion of the debt, to the exchange rate. Inflation (or exchange rate devaluation) thus increases the charge against the budget for monetary correction. Largely for this reason, the overall borrowing requirement increased from 7.1% of GDP in 1980 to an estimated 17.7% in 1983.27/

1.77 The overall borrowing requirement measures the pressure exerted by the public sector on domestic and available foreign financial resources, i.e. it represents the total public sector deficit. In 1982, about 60% of this deficit was financed by the banking system through direct lending and the purchase of government debt instruments, over 20% by the non-financial private sector including the accumulation of arrears, and another 15% by foreign financing. In 1983, the financing was almost wholly from domestic sources, primarily the banking system (77%) and the non-financial private sector (19%). Some Cr$5 trillion, or about 22% of the total domestic borrowing requirement, was financed through the monetary budget. State enterprises account for the largest share of the overall deficit, and their share increased sharply in 1983, partly because much of their outstanding debt is foreign and subject to exchange correction (which amounted to a total of 290% in 1983) rather than monetary adjustment made in that year (160%). Because of these adjustments, overall borrowing requirements have continued to rise and present major financing problems likely to continue so long as inflation remains high.

1.78 The two components of the deficit are thus the part representing the monetary correction, via indexation, of existing Government debt, and the "operational" deficit which includes all other causes of excess

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27/ During a period of accelerating inflation, the ratio of overall borrowing requirement to GDP will rise even with no additional government borrowing, simply because the monetary correction applied to the outstanding indexed debt at the end of the year will reflect a higher inflation rate than the annual average rate incorporated into the GDP. If inflation rates were to decline, however, the trend would reverse.

Table 1.17: BRAZIL - PUBLIC SECTOR BORROWING REQUIREMENTS, 1979-83

(As Percent of GDP)

	1979	1980	1981	1982	1983
Total Financing	8.1	7.1	12.5	15.8	17.7
Operational	3.0	3.6	6.0	6.6	2.6
Monetary correction/a	5.1	3.5	6.5	9.2	15.1
Central Administration	2.3	3.7	3.7	5.4	4.1
Operational	0.3	2.2	1.6	2.0	-0.2
Monetary correction	2.0	1.5	2.1	3.4	4.3
States and Municipalities	1.6	1.3	3.3	4.0	5.3
Operational	0.3	0.3	1.3	1.3	0.8
Monetary correction	1.3	1.0	2.0	2.7	4.5
State Enterprises	4.5	3.0	5.6	6.8	8.8
Operational	3.3	2.7	3.0	3.5	2.5
Monetary correction	1.2	0.3	2.6	3.3	6.3
Other Institutions	-0.9	-0.9	-0.1	-0.4	-0.5
Operational	-0.8	-0.7	0.1	-0.2	-0.5
Monetary correction	-0.1	-0.2	-0.2	-0.2	—

/a In addition to the adjustments on indexed domestic currency debt, this also includes exchange rate correction on foreign debt, held principally by state enterprises.

Source: Banco Central.

expenditure. It would be feasible to modify or eliminate monetary correction only in the context of wider monetary reform. Pending this (or a reduction in inflation by other means), the only way to limit the costs of monetary correction is to reduce the size of the operational deficit and thus its contribution to the growth of public debt. Operational surpluses, if achieved, will allow part of this debt to be retired.

1.79 Because of the monetary character of the rest of the deficit, the operational deficit (borrowing requirements less the increase in debt caused by monetary or exchange correction) is a more direct measure of current fiscal performance. Table 1.17 shows the deterioration in the operational balances in 1980, 1981, and 1982, with the deficit rising from 3.6 to 6.6% of GDP. Within this total, the deficit of the central administration declined fractionally, that of the states and municipalities rose by 1% of GDP, and that of the state enterprises by nearly that amount, while the surplus derived from other institutions declined.

1.80 A major domestic objective for 1983 was to secure a significant reduction in the operational deficit of the public sector, with a view to its elimination in 1984. Given the difficulties in a recessionary environment of obtaining real growth in tax revenues and other government receipts, this improvement has had to be secured through reductions wherever possible in public sector expenditures.

1.81 In 1983, as is shown in Table 1.18, total revenues available to the Treasury declined as a proportion of (a reduced) GDP, from 8.9%, the average maintained in 1979-82, to an estimated 8.3%, or a real reduction of around 10%. Income tax revenues would have increased substantially in real terms, on the basis of measures taken in 1983 to make both corporate and personal tax liabilities subject to full monetary correction and to shorten collection periods, had not the reduction in real activity and incomes occurred.

1.82 Wage legislation, limiting increases particularly at the higher salary levels, reduced the collection of taxes withheld at the source, although other income tax revenues increased. Revenue measures taken late in 1983 are expected to raise the equivalent of an extra 0.5% of GDP in 1984, however. These included increases in some rates, changes in the assessment values for indexed bonds, changes in exemptions and tighter administrative procedures, which affect capital gains, interest and dividends as well as other income.

1.83 The recession also reduced revenues from the value-added tax on industrial products (IPI), and tax restitutions on growing industrial goods exports further eroded this tax base. Without the FINSOCIAL gross receipts tax, adopted in 1982 and earmarked for social expenditures, the incorporation of the coffee quota into the Treasury accounts (a transfer which does not increase consolidated revenues), and the temporary imposition of new export taxes, Treasury revenues would have declined by over 20% in real terms, to an estimated 7.3% of GDP.

1.84 State government revenues also declined in 1983 with real collections of the ICM, the main tax source, especially for industrial

Table 1.18: BRAZIL - FEDERAL TREASURY REVENUES, 1979-83

(As percent of GDP)

	1979	1980	1981	1982	Prel. 1983
Total revenues/a	8.7	9.3	8.7	8.9	8.3
Income taxes	3.0	2.7	2.8	3.0	3.0
Of which: withholdings at the source	(1.8)	(1.7)	(1.6)	(1.7)	(1.4)
Industrial products tax	2.2	2.1	2.0	2.0	1.5
Tobacco products	(0.9)	(0.8)	(0.9)	(1.0)	(0.8)
Other	(1.3)	(1.3)	(1.1)	(1.0)	(0.7)
Taxes on energy sources	1.1	0.9	0.7	0.8	0.5
Fuel tax	(0.9)	(0.7)	(0.5)	(0.5)	(0.3)
Electricity tax	(0.2)	(0.2)	(0.2)	(0.3)	(0.2)
Automobile licenses	0.2	0.3	0.2	0.2	0.2
Tax on financial operations	0.4	0.9	1.0	1.0	0.6
FINSOCIAL	—	—	—	—	0.5
Import duties	0.6	0.7	0.5	0.4	0.4
Surcharges on telecommunication services	0.2	0.2	0.2	0.2	0.2
Social security surcharges	0.2	0.2	0.1	0.1	0.1
Coffee contribution quota	—	0.3	0.1	—	0.3
Other export taxes	—	0.2	—	—	0.2
Other taxes	0.5	0.5	0.7	0.5	0.4
Nontax revenue	0.3	0.3	0.4	0.4	0.4
Total revenue in Cr$bn	544	1,220	2,334	4,728	11,122

/a Accrual basis.

Source: Banco Central.

states like Sao Paulo, down by 10.9% in 1983 to about 4.8% of GDP. Lower employment and incomes similarly influenced the level of contributions to the social security funds, which fell from 7.9% to an estimated 6.4% of GDP. Altogether, tax revenues, including the social security component, declined in real terms by over 12%, from 22.6% to about 20.5% of GDP.

1.85 The burden of adjustment in public sector finances therefore fell heavily on the expenditure side of the accounts. Treasury expenditures were reduced primarily through cuts in wage and salary payments, the result of wage rate adjustments below the inflation rate and a freeze on hiring and promotions, as well as reduced purchases of goods and services, investment outlays, and transfers to state and local governments. Interest payments and subsidies increased slightly in real terms.

1.86 Enough savings were made to translate an operational deficit of 2.0% of GDP in 1982 to a small surplus in 1983, achieving one of the key objectives of the internal adjustment program. Savings were also obtained through tightened administration of the various funds and programs. Tight limits were imposed on the domestic and foreign borrowings of the state and municipal governments, resulting in a reduction of their deficits by about 0.5% of GDP. All this contributed to a reduction in public sector outlays, not including those of the state enterprises, equivalent to some 3.0% of GDP.

1.87 The monetary authorities (Banco Central and Banco do Brasil) continued to make, on behalf of the Treasury, expenditures that in most countries are normally included in the fiscal budget. These include direct subsidies for wheat, sugar, alcohol fuel and, ending in 1983, petroleum; agricultural minimum price supports; interest, monetary correction and other costs of government securities; payments on behalf of the social security system; and some other advances. In 1981-83 these expenditures averaged about 2.5% of GDP although the composition changed considerably, with commodity subsidies increasing and other agriculture-related expenditures and debt servicing showing a decline. Treasury transfers covered an increasing proportion of these expenditures, increasing to the equivalent of about 2% of GDP in 1983 (Cr$2,700 billion), up from about 1.3% in 1982. Measures to transfer these essentially fiscal operations from the monetary authorities back to the Treasury budget are now in preparation, following decisions by the National Monetary Council in August 1984 as part of a wider fiscal and financial reform. This will contribute to the objectives of improved fiscal management being pursued by the Government.

State Enterprises

1.88 Efforts to control the expenditures, operations and investments of Brazil's large state enterprise sector have been progressively strengthened since 1979, when the Secretariat for the Control of State Enterprises (SEST) was established as an organ of SEPLAN. SEST operates through the formulation of annual budgets for the state enterprise sector, supplemented by import, foreign exchange and fuel budgeting for the public sector as a whole. The 1983 SEST budget covered 353 enterprises, including the 7 entities making up the national social security system (SINPAS)

funded by employer-employee contributions, and the 14 federal government banks subject to the authority of the National Monetary Council.[28/] Among the most important enterprises are the 109 which form part of the 10 major enterprise groups, including PETROBRAS, SIDERBRAS, ELETROBRAS, TELEBRAS and CVRD. These account for the bulk of earned revenues, expenditures and borrowings and nearly all investment of the state enterprise system.

1.89 In 1980-82 the operational deficits of the system increased, as revenues declined in real terms from an estimated 16.1% to 14.1% of GDP, while current expenditures and most capital expenditures were broadly maintained. Treasury transfers increased by about 17% in real terms in 1981, to the equivalent of 3.1% of GDP, and declined by only 5% in 1982. The operational deficit, after transfers, increased from the equivalent of 2.7% of GDP in 1980 to 3.5% in 1982. The overall financing needs of the enterprises, including provision for monetary correction, rose from 3.0% to 6.8% of GDP. It was therefore only during 1983 that there was a major improvement in the operational balances of the state enterprises.

1.90 Table 1.19 summarizes the receipts and expenditures of the state enterprise complex in 1982 and 1983, showing both total receipts and expenditures for the 318 enterprises and those for the state production sector, involving 179 of the enterprises and accounting in 1983 for 85% of total outlays and nearly 90% of fixed investment of the enterprises as a whole. Operational receipts declined substantially in real terms in 1983, but there was also a reduction in real payroll expenditures (12%) secured through wage restraints and a small reduction in the number of employees. In addition, state enterprise real investment, which had been broadly maintained in 1980-82, declined by 30% in 1983.

1.91 In part this reduction in public investment was facilitated by the fact that some of the largest projects initiated in the 1970s were nearing completion, and because no new large projects are being undertaken, but it also represents the slowing down or suspension of spending on others, in the effort to contain state enterprise expenditures. Appendix Table 5.5 shows the trends in 1980-83 in real investment outlays of the ten largest enterprises. Apart from the sharp fall in total investment in 1983, there has also been a major reallocation of investment priorities, with the share of petroleum investment increasing to one-third of the total while investment in steel, ports and railways declined.

1.92 The overall effect of tighter controls over state enterprise finances and operations was to reduce the sector's operational deficit from 3.5% of GDP in 1982 to an estimated 2.5% in 1983. Treasury transfers to the enterprises were reduced from 2.9% of GDP in 1982 to about 2.3% in 1983, so that the overall improvement in operating performance was equivalent to about 1.6% of GDP. The financing requirements were increased

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28/ There are also 26 state electricity enterprises and 92 other entities of minor budgetary significance indirectly monitored by SEST, to make a 1983 total of 471 enterprises on SEST's register. This represented a significant reduction, obtained through transfers to the private sector, liquidations, etc., from the 530 listed as recently as 1981.

Table 1.19: BRAZIL - STATE ENTERPRISE RECEIPTS AND EXPENDITURES, 1982-83/a

(CR$ Billions in Current Prices)

	1982/b	(1982)/c	1983/b	(1983)/c	% Increase	
Receipts						
Operational Receipts	6,176	(6,056)	15,609	(15,303)	153	(153)
Nonoperational Receipts	443	(425)	1,564	(1,470)	253	(246)
Treasury Transfers	1,487	(521)	3,157	(976)	112	(87)
Credit Operations	1,929	(1,845)	2,934	(2,666)	53	(44)
Other Resources	1,281	(634)	3,761	(2,174)	194	(243)
Subtotal	11,311	(9,481)	27,025	(22,589)	139	(138)
Misc. Asset Adjustments	275	(-189)	375	(730)	36	(-)
TOTAL RECEIPTS	11,036	(9,292)	27,400	(23,319)	148	(151)
Expenditures						
Personnel	1,598	(1,130)	3,297	(2,314)	106	(105)
Financial Charges	1,003	(949)	2,778	(2,666)	177	(181)
Other Current/d	4,443	(4,146)	12,450	(11,816)	180	(185)
Total Current	7,044	(6,225)	18,525	(16,794)	163	(170)
Investment	2,697	(2,431)	4,966	(4,343)	84	(79)
Amortization	493	(454)	1,821	(1,733)	270	(282)
Other Capital Costs/d	308	(182)	901	(449)	193	(147)
Total Capital	3,498	(3,067)	7,688	(6,525)	120	(113)
TOTAL SEST EXPENDITURE	10,542	(9,292)	26,213	(23,319)	149	(151)
Transfers Authorized by CMN	494	(-)	1,187	(-)	140	(-)
TOTAL EXPENDITURE	11,036	(9,292)	27,400	(23,319)	148	(151)

/a Excludes SINPAS and the Government financial institutions.

/b For 318 state enterprise.

/c From the 179 state production enterprises.

/d Net of transfers.

Source: SEST, Relatório Anual, 1983.

by exchange rate correction of the debt to a total of 8.8% of GDP, about half of the overall public sector's borrowing requirements. Changes in pricing policies, particularly for petroleum products, power and telecommunications, are now generating increasing revenues.

1.93 Growth in public sector borrowing requirements has placed increasing strains on Brazil's financial system. External financing provided 10% of the financing in 1981, 15% in 1982 and a negligible amount in 1983 when the bulk of foreign loans was directed to the Central Bank. As shown in Table 1.20, the contribution of sales of government debt instruments to the nonfinancial private sector, at federal, state and local levels, declined from 53% to 26% of total financing requirements. The banking system financed the rest through purchases of bonds and bills and direct lending, and through an increase in Central Bank financing of Treasury and state enterprise expenditures.

1.94 In 1981-83, domestic debt outstanding rose pari passu with the size of the overall nominal deficit and amounted in 1983 to about 18% of GDP. While this stock of debt is relatively small, monetary correction creates an intractable financing problem because of the rate at which the debt expands under inflationary conditions. While financial indexation is maintained, this can be eased only through surpluses generated in the operational budgets and with the reduction of inflationary pressures.

Table 1.20: BRAZIL - FINANCING OF THE PUBLIC SECTOR DEFICIT, 1981-84

(CR$ Billions)

	1981	1982	1983	1984/a
TOTAL FINANCING	3,350	8,385	23,605	44,190
Internal	2,993	7,107	23,339	41,227
State Enterprises	1,120	2,360	11,486	14,805
Monetary Authorities	(201)	(173)	(4,231)	(2,949)
Commercial Banks	(390)	(891)	(3,921)	(7,336)
Other	(529)	(1,296)	(3,334)	(4,520)
Central Government	992	2,831	5,649	12,583
Debt	(1,534)	(2,591)	(4,406)	(22,348)
Monetary Authorities	(-507)	(294)	(862)	(-4,043)
Commercial Banks	(-57)	(-106)	(52)	(-5,795)
Other Financial Institutions	(22)	(52)	(329)	(-28)
State and Local Governments	883	2,129	6,902	14,721
Debt	(263)	(620)	(1,641)	(3,342)
Financial System	(620)	(1,509)	(5,261)	(11,379)
Autonomous Agencies	17	249	651	1,229
Funds and Programs	94	-263	-929	-2,941
Social Security	-113	-199	-420	830
External Finance	357	1,278	266	2,963
MONETARY AND EXCHANGE RATE CORRECTION	1,755	4,854	20,290	43,639
OPERATIONAL FINANCING	1,595	3,531	3,315	551
Internal	1,238	2,253	3,049	-2,412
State Enterprises	426	585	2,833	-242
Central Government	422	1,080	-95	-1,727
State and Local Governments	342	678	991	610
Decentralized Agencies	-15	162	118	15
Funds and Programs	94	-264	-929	-1,898
Social Security	-31	12	131	830
External Finance	357	1,278	266	2,963

/a January-September

Source: Central Bank of Brazil.

Chapter 2

THE ECONOMIC OUTLOOK AND PROSPECTS

A. Short-Term Outlook

2.1 The short-term economic outlook for Brazil, as of September 1984, appears much more encouraging than that of a year before. The balance-of-payments situation is much stronger, some signs of recovery from the domestic recession are apparent, and the inflation is no longer accelerating. In addition, the international economic situation appears more encouraging, despite continuing high international interest rates and a slowing in the economic recovery in the U.S. The international institutional environment also appears more accommodating than a year ago. As exemplified by the recent Mexican debt rescheduling agreement, the international commercial banks have shown themselves more responsive to the difficulties of the Third World debtor countries.

2.2 The immediate prospects for the balance of payments appear quite favorable. As indicated in Chapter 1 and Table 1.3, a trade surplus of at least US$12 billion is expected for 1984. Although total imports have continued to fall,[1/] much of this surplus, especially for the latter part of 1984, can be attributed to a promising expansion of exports. Total exports, as measured in current US dollars, for the first eleven months were 23% greater than those for the same period in 1983; the comparable increase for industrial exports was an encouraging 35%. As such, exports for 1984 through November exceeded the previous yearly high during 1981. Reflecting the favorable trade performance, Brazil's international reserve position has improved markedly, providing a greater cushion and increasing the Government's latitude in dealing with the country's international creditors as a part of the ongoing discussions regarding the 1985 international financial program.

2.3 Export growth is essential to Brazil's ability to resume satisfactory growth over the medium-term, while continuing to meet its debt service obligations. That export growth could be threatened, however, if the OECD economic recovery were to weaken, or if protection was raised in those markets. The increased dependence of Brazilian exports on the US market in the past two years, as indicated above, underlines the importance of continued US recovery and the keeping of US markets relatively open. Brazilian export growth will also depend on its own domestic policies, including most importantly, the maintenance of a reasonable exchange rate. With the sharp cutback of credit directed to exporters and of the subsidy element in that credit and the scheduled phase-out of the *credito premio*, the impact on export performance can be expected to be adverse unless compensating policy measures are taken.

1/ During 1984, reductions of oil imports have led the observed decline. Total imports for 1984 through November were 9% below those of the year before.

2.4 Sparked by the export ressurgence, GDP for 1984 is expected to grow in the 3% range, or about 1% per capita. The increase in manufacturing exports has been the driving force behind the as yet very fragile industrial recovery. For the first six months of 1984 total manufacturing and mining output was 5% greater than for the same period in 1983. If manufacturing exports continue growing by 30% through the end of the year, manufacturing output for the year will increase by about 4%.[2/] Those manufacturing industries with the most marked recent success in increasing exports, e.g., steel, shoes, chemicals, paper and capital goods, have been those showing the greatest recovery and output increases during 1984. This has occurred despite the fact that for most sectors the proportion of total output which is exported remains relatively small. Few industries export more than 15% of output. Overall expansion is being inhibited by continuing depressed domestic market conditions. For the latter conditions to be turned around, and for economic recovery to extend itself to other sectors, some relaxation in the present austere demand management policies appears necessary. In particular, recovery is not likely to become generalized, until real interest rates fall from their present levels of 30-40%. Unless significant progress is made against inflation, the outlook is for domestic market conditions to improve only slowly.

2.5 The outlook for reducing inflation quickly does not appear bright. It is important, however, that inflation is no longer accelerating. As discussed above, reducing inflation under the current system of indexation and in the context of very resilient inflationary expectations is exceedingly difficult. Although the aggregate demand origins of the inflation are no longer existent, as a result of the measures taken to eliminate the real consolidated public sector deficit, indexation and inflationary expectations continue to propagate the inflation. In the absence of further supply shocks, such as were experienced in 1983 via devaluation and crop shortfalls, inflation is expected to continue roughly at present rates. The end of the year annual inflation is projected to be about 220%. Indexation, while making it difficult to reduce inflation, does of course mitigate some of the ill economic and social effects commonly associated with inflation. A major challenge for the new Government, taking office in March 1985, will be to restore confidence and, in doing so, dampen inflationary expectations. To accomplish this, a consistent medium-term strategy and a clearly stated and credible economic program are essential.

D. Medium-Term Prospects

2.6 Beyond 1984, the economic prospects for Brazil are more encouraging, with a projected continuation in the presently observed incipient recovery. This recovery depends, however, both upon the economic policies pursued by the Government and a number of external economic

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2/ These estimates are based on ongoing work at IPEA/INPES, using the observed export composition and the input-output table coefficients for 1975.

conditions outside of the control of Brazilian policy-makers. Projections of the economy's performance, particularly for the balance of payments, are obviously highly sensitive to assumptions regarding future developments in international product and financial markets. The level of international interest rates, oil prices, continued recovery in the OECD, the avoidance of additional trade barriers for Brazil's exports, and the willingness of the international commercial banks to increase their nominal exposures are all critical for Brazil. At the same time, much also depends upon the conduct of national economic policies. The present situation requires an integrated, medium-term, strategy for structural adjustment and economic recovery. This strategy should focus on greater production efficiency, an improved allocation of economic resources, increased investment and savings, export promotion, and a reduced reliance on external borrowing.

2.7 The projections for the economy and the balance of payments assume progress in implementing such a medium-term strategy. General monetary and fiscal policies would consist of: (a) monetary, credit, and fiscal policies consistent with reduced real interest rates, as a means of stimulating private sector investment and economic activity; (b) further reductions in the consolidated public sector deficit, to be achieved through better federal budgetary control, more realistic pricing policies for products of public enterprises, the elimination of the remaining consumption subsidies such as for wheat, reduced operating losses for publicly controlled firms, revenue-increasing tax reform measures, and improved public sector operating efficiency; and (c) accompanying reductions in public sector short-term borrowing requirements. Trade policies under the assumed medium-term strategy would concentrate on expanding exports and would include, inter alia, (i) the continuation of the crawling peg exchange rate regime with nominal depreciation roughly coinciding with domestic inflation, (ii) consolidation and extension of the gains under the reformed drawback system, permitting free access to imported inputs for direct and indirect export production, (iii) reductions in anti-export biases in commercial policies through removal of existing restrictions and de facto taxes on exports, particularly for agricultural products, and by gradual reductions in import restrictions, (iv) the adequate provision of credit for export production and sales, and (v) improved government export marketing and promotion efforts. The strategy underlying the base-case projections also assumes the continued cost-effective development of domestic energy sources, including increases in domestic oil production (currently targeted to reach 600,000 bpd in 1988) and energy conservation through pricing policies and the economic substitution of petroleum derivatives by hydroelectricity, natural gas, coal and alcohol. Because of the constraints on future borrowing in the international financial markets, both the generation of large trade surpluses and a substantial increase in internal savings are required.

2.8 Two sets of base-case projections are presented, both of which embody the medium-term policy strategy outlined above. The central difference between the two sets of projections -- Base Case A and Base Case B -- is that the latter assumes a more vigorous export promotion effort and concurrently higher rates of GDP growth. In addition to a more aggressive pursuit of the export promotion measures indicated, Base Case B assumes that the Government will compensate the removal of the export subsidy program for manufactured exports, in particular the crédito premio, with an accelerated crawling peg exchange rate adjustment and other trade policies

to offset the associated increase in anti-export policy biases. As will be discussed below, the medium-term prospects for the economy are much more favorable with a policy strategy embodying more aggressive export promotion.

2.9 The central question posed is whether or not such constraints and considerations are consistent both with reasonable rates of growth for the Brazilian economy and a gradual reduction in the relative burden of external debt service. The general conclusion from the projection exercises, for both cases, is that, under reasonable assumptions, they are. It should be noted that these projections (presented in Tables 2.2, 2.3 and 2.4) are predicated upon international commercial bank borrowings being available in the amounts indicated, including the rollover of existing short-term debt. In most cases this also presumes a complete rollover of the medium and long-term amortization. The projections reflect the economic policy program for 1984 and emphasize the key role to be played by export growth, and hence the policies that affect such growth, in escaping from the present severe resource constraints.

2.10 With a few exceptions, noted below, the assumptions for both base cases are the same. The assumptions for Base Case A are presented in Table 2.1. The international interest rate, defined here as the LIBOR, is projected to peak at 12.5% in 1985, and then gradually fall to 10% for 1988-90. It is also assumed that Brazil will continue to pay about a 2% spread over LIBOR on its floating rate debt. If negotiations with the commercial banks result in a reduction of this spread, the projected creditworthiness ratios would improve more rapidly. The real rate of growth of manufactured exports is posited to taper off from the rates observed in 1983-84, falling to 6% annually by 1986, but then increasing to 7% for 1989-90. While dependent in part upon OECD growth, these growth rates are considered conservative, being substantially below the pre-1982 experience. Petroleum prices are projected to be constant in real terms through 1990, resulting in a nominal price of US$43 per barrel for crude oil in the latter year. Domestic petroleum production is projected to increase, as noted above, to 600,000 bpd in 1988 and then to level off pending the development of new reserves. Domestic petroleum consumption is projected as a function of GDP, and oil imports are estimated as a residual.

2.11 The component sectors of GDP are projected on the basis of assumed economic policies and individual sectoral prospects. The resultant GDP projections for Base Case A show a gradual recovery from 1985 on, with GDP growth increasing from a projected 4.3% in 1985 to 6.6% in 1989. If such growth rates are realized, it will still take until 1989 to restore the 1980 levels of per capita income.

Base Case A

2.12 On the basis of these assumptions and the projected economic recovery, Brazil would achieve substantial improvements in its balance of payments situation, external debt outlook, and creditworthiness indicators. The resource balance, which turned positive in 1983 with the large trade surplus of that year, would continue to grow, resulting in a further reduction of the current account deficit. This deficit, which

Table 2.1: BRAZIL - PROJECTION ASSUMPTIONS (BASE CASE A), 1983-90

	1983	1984	1985	1986	1987	1988	1989	1990
LIBOR	.10	.11	.125	.115	.11	.10	.10	.10
Oil Prices (US$/bbl)	29	28.5	29	32	34.5	38	40	43
National Accounts Growth Rates (%)								
GDP	-3.2	3.0	4.3	5.4	6.2	6.3	6.7	6.7
Agriculture	2.2	3.0	3.0	4.0	4.0	4.0	4.5	4.5
Industry	-6.8	5.0	5.0	7.0	8.0	8.0	8.0	8.0
Others	-1.5	1.6	4.0	4.5	5.2	5.5	6.0	6.0
Import Elasticities								
Food (w.r.t. Private Consumption)	*	*	1.0	1.0	1.0	1.0	1.0	1.0
Metal (w.r.t. GDP)	*	*	*	1.3	1.3	1.3	1.2	1.2
Capital Goods (w.r.t. Investment)	*	*	*	1.5	1.2	1.2	1.2	1.2
Fertilizer (w.r.t. Agric. Value Added)	*	*	*	1.5	1.2	1.2	1.2	1.2
Intermediate Goods (w.r.t. Indust. Value Added)	*	*	*	1.5	1.0	1.0	1.0	1.0
Petroleum (% Growth Rates for Imports)*	-10.6	-16.8	-7.3	1.6	0.9	3.8	5.3	7.6
Total Imports,/a (w.r.t. GDP)	4.7	0.6	5.9	2.4	1.4	1.2	1.2	1.2
Reserves	2.2	4.7	4.4	4.1	4.0	3.8	3.7	3.6
(Months of Imports GNFS)								

* Volume required to reach target import level for non-oil imports.
/a Growth of imports of goods and non-factor services relative to GDP growth.

Source: Mission estimates.

Table 2.2: BRAZIL - BALANCE OF PAYMENTS PROJECTIONS (BASE CASE A), 1984-90

(US$ Billions)

	-Actual-	-Projected-						
	1983	1984	1985	1986	1987	1988	1989	1990
Balance of Payments								
Exports (Goods)	21.9	26.5	30.3	35.0	40.0	45.8	52.2	58.9
Imports (Goods)	15.4	14.3	17.0	20.4	23.7	27.5	31.7	36.3
Trade Surplus	6.5	12.2	13.3	14.6	16.3	18.3	20.5	22.7
Non-Factor Services (Net)	-2.4	-2.5	-3.8	-4.8	-5.8	-6.9	-8.1	-9.3
Factor Services (Net)/a	-10.4	-12.3	-13.7	-13.3	-13.6	-13.7	-14.6	-15.8
(of which interest)								
(M&LT)	(-8.6)	(-9.9)	(-11.7)	(-11.2)	(-11.3)	(-11.4)	(-12.1)	(-13.0)
(Short Term)	(-1.8)	(-1.2)	(-1.2)	(-1.1)	(-1.0)	(-1.0)	(-1.0)	(-1.0)
Current Balance	-6.3	-2.6	-4.2	-3.5	-3.2	-2.3	-2.1	-2.4
Direct Foreign Investment (Net)	0.7	0.7	0.7	0.8	0.9	0.9	1.0	1.0
Disbursements, M&LT Debt (Net)	7.4	8.1	3.9	5.3	7.3	7.2	7.5	6.7
Gross Disbursements	(16.6)	(17.0)	(14.0)	(19.4)	(21.8)	(22.0)	(23.4)	(21.9)
Amortization	(-9.2)	(-8.9)	(-10.1)	(-14.1)	(-14.5)	(-14.8)	(-15.9)	(-15.2)
Disbursements, S-T Debt (Net)	-5.5	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF (Net)	2.2	1.8	1.6	0.0	-2.0	-2.0	-1.9	0.0
Brazilian Lending Abroad (Net)	0.1	-0.6	-1.0	-1.4	-1.8	-2.4	-3.0	-3.7
Change in Reserves (- denotes increase)	0.0	-3.8	-1.1	-1.2	-1.2	-1.3	-1.5	-1.6
Net M&LT Tranfers /b	-1.2	-1.8	-7.9	-5.9	-4.0	-4.2	-4.6	-6.4

/a Includes net transfers.

/b Gross disbursements less amortization less interest.

Source: Bank estimates.

Table 2.3: BRAZIL - PROJECTIONS OF EXTERNAL DEBT & DEBT SERVICING (BASE CASE A), 1984-90

(US$ Billions)

	-Actual-	-Projected-						
	1983	1984	1985	1986	1987	1988	1989	1990
External Debt								
Total Debt	102.4	108.5	110.5	114.2	120.5	127.6	135.2	142.0
M&LT debt Outstanding & Disbursed (DOD)	79.5	87.7	91.5	96.8	104.1	111.3	118.8	125.5
Official	10.8	14.0	16.1	17.8	19.3	20.0	19.8	19.3
Private	68.8	73.7	75.4	79.0	84.8	91.3	99.0	106.2
Undisbursed M&LT Debt	13.8	12.7	10.9	9.3	8.3	8.2	8.3	8.4
Short Term	9.1	8.1	8.1	8.1	8.1	8.1	8.1	8.1
Rate of Growth of Debt								
Total Debt	1.1	6.0	1.8	3.4	5.5	5.9	6.0	5.0
M&LT Debt (DOD)	10.2	10.2	4.4	5.8	7.5	6.9	6.8	5.6
Official	22.1	29.6	14.9	11.1	7.9	3.9	-1.1	-2.7
Private	8.6	7.2	2.4	4.7	7.5	7.5	8.5	7.3
Short Term	-37.9	-11.0	0.0	0.0	0.0	0.0	0.0	0.0
Credit Worthiness Indicators								
Debt Service/Exports GNFS (%)/a	82.7	69.8	70.1	69.7	62.0	54.8	51.3	45.9
Amortization (M&LT) (%)	39.1	31.1	30.9	37.2	33.4	29.9	28.2	23.9
Interest Payments (%)	43.6	38.7	39.2	32.5	28.6	24.9	23.2	22.0
M&LT	36.2	34.5	35.7	29.6	26.2	22.9	21.4	20.4
Short Term	7.4	4.1	3.6	2.9	2.4	2.0	1.7	1.5
Debt Outstanding & Disbursed/ Exports GNFS (%)	3.7	3.3	3.0	2.8	2.6	2.4	2.2	2.1
M&LT	3.3	3.1	2.8	2.6	2.4	2.2	2.0	1.9
Short Term	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.1
Debt Outstanding & Disbursed/GDP (%)	34.4	34.9	32.2	29.6	27.4	25.1	23.3	21.6
M&LT	30.9	32.0	29.6	27.3	25.4	23.4	21.8	20.3
Short Term	3.5	2.9	2.6	2.3	2.0	1.7	1.5	1.3

/a Amortization of M&LT debt plus interest payments on short-term debt and M&LT debt. GNFS = goods and non-factor services.

Source: Mission estimates.

Table 2.4: BRAZIL - PROJECTIONS FOR BASE CASE B: GREATER EXPORT PROMOTION AND ECONOMIC RECOVERY, 1984-90

(US$ Billions)

	-Actual-	Projected						
	1983	1984	1985	1986	1987	1988	1989	1990
Balance of Payments								
Exports (Goods)	21.9	26.5	30.9	36.5	42.9	50.4	58.6	67.5
Imports (Goods)	15.4	14.3	17.0	20.4	23.9	27.9	32.2	37.1
Trade Surplus	6.5	12.2	13.9	16.0	19.0	22.5	26.4	30.4
Interest Payments	-10.3	-11.1	-12.9	-12.2	-12.1	-11.7	-11.9	-11.9
(M&LT)	(-8.5)	(-9.9)	(-11.7)	(-11.1)	(-11.1)	(-10.7)	(-10.9)	(-10.9)
(Short Term)	(-1.8)	(-1.2)	(-1.2)	(-1.1)	(-1.0)	(-1.0)	(-1.0)	(-1.0)
Current Account Deficit	-6.3	-2.6	-3.6	-1.9	0.0	2.7	5.2	7.7
Disbursements, M&LT (Net)	7.4	8.1	3.3	3.7	4.3	2.1	-0.3	-2.6
Gross Disbursements	(16.6)	(17.0)	(13.4)	(17.8)	(18.7)	(16.9)	(16.2)	(12.5)
Amortization	(-9.2)	(-8.9)	(-10.1)	(-14.1)	(-14.4)	(-14.8)	(-15.9)	(-15.1)
External Debt								
Total Debt	102.4	108.5	110.0	112.0	115.5	117.5	117.8	115.2
M&LT Debt Outstanding & Disbursed (DOD)	79.5	87.7	91.0	94.6	98.9	101.1	101.3	98.7
Official	10.8	14.0	16.1	17.8	19.2	20.0	19.8	19.3
Private	68.5	73.7	74.9	76.8	79.7	81.1	81.5	79.4
Undisbursed M&LT Debt	13.8	12.7	10.9	9.3	8.4	8.3	8.4	8.4
Short-term Debt	9.1	8.1	8.1	8.1	8.1	8.1	8.1	8.1
Rate of Growth of Debt								
Total Debt	1.1	6.0	1.4	1.8	3.1	1.7	0.3	-2.2
M&LT Debt	10.2	10.2	3.7	4.1	.5	2.2	0.3	-2.6
Official	22.1	29.6	14.9	11.1	7.9	3.9	-1.1	-2.7
Private	8.6	7.2	1.6	2.6	3.7	1.8	0.6	-2.6
Credit Worthiness Indicators								
Debt Service/Exports GNFS (%)/a	82.7	69.8	68.9	66.5	57.3	48.7	43.8	37.0
DOD/Exports GNFS (%)	3.7	3.4	3.0	2.6	2.3	2.0	1.7	1.5
M&LT	3.3	3.1	2.7	2.4	2.1	1.9	1.6	1.4
Short Term	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1
DOD/GDP (%)	34.4	35.0	32.1	28.9	25.9	22.7	19.8	17.0
M&LT	30.9	32.0	29.5	26.6	23.9	21.0	18.3	15.7
Short Term	3.5	3.0	2.6	2.3	2.0	1.7	1.5	1.3

/a Amortization of M&LT debt plus interest on short-term debt and M&LT debt. GNFS = goods and non-factor services.

Source: Mission estimates.

amounted to US$6.2 billion in 1983 (equal to about 3% of GDP), is projected to fall gradually to US$2.4 billion in 1990 (Table 2.2). The debt would grow at much more modest rates than in the past (Table 2.3). Total medium and long-term debt is projected to grow, in nominal terms, at an annual rate of 4.8% from 1983 to 1990, below the projected rate of international inflation. The 1984 commercial bank disbursements have been annualized as agreed in Brazil's international financial program; for 1985 the program is still under discussion. For private M&LT debt the projections are consistent with reductions of total real commercial bank exposure in Brazil and a reduced share of Brazilian loans in total commercial bank lending portfolios. Nevertheless, continued new lending will be required for the foreseeable future.

2.13 Creditworthiness indicators for Brazil improve dramatically over the projection period. As seen in Table 2.3, the total debt service ratio is projected to fall from 82% in 1983 to a plateau of 69-70% for 1984-86, and then decline gradually to about 46% in 1990. In the absence of any further rescheduling, there would be an amortization bulge in 1986. The total external debt as a multiple of total goods and non-factor service exports is projected to decline continually, after having reached a high of 3.9 in 1982. By 1990 the ratio is projected to have fallen to 2.0.

2.14 One striking feature of the balance-of-payments projections is the magnitude of the projected net financial medium- and long-term resource transfers (excess of interest over net new borrowing) from Brazil to its creditors. This transfer would amount to US$7.9 billion in 1985. The net resource transfer over the entire projection period would average 3% of GDP annually. These resources are Brazilian savings transferred abroad to meet international financial obligations. Even with these transfers, economic growth of a reasonable magnitude can occur. Throughout the 1984-90 period an increase in real per capita consumption of 3.0% annually is projected.

2.15 Despite the projected increase in average per capita consumption, a slow growth of employment opportunities could continue to constitute a serious social problem. In the past, the relationship between output and employment growth has been that a GDP growth rate of about 6% annually was required to absorb the new entrants into the labor force. Unless this relationship can be changed, perhaps as a result of relative price changes either favoring more labor-intensive activities or a more labor-intensive technology choice, the employment prospects for the economy do not appear encouraging. Even with GDP growth of the magnitude projected, a large overhang of unemployment and underemployment is likely to persist, perhaps most visibly manifested as a downward occupational shifts. Unless more directly dealt with, only towards the end of the projection period is any substantial alleviation in this potentially explosive social problem likely to occur.

2.16 If the projected improvements in the balance of payments are realized, it is possible that the current attitudes of international commercial banks could change. With continued good balance-of-payments performance, voluntary lending may be restored. Also, if the projected improvements in the balance of payments are realized, the opportunity could be taken to further reform trade policies. Over the longer term, such

policy reforms would be consistent with faster export expansion, higher rates of economic growth, greater employment generation, and an improved distribution of income.

Base Case B: Increased Export Promotion and Economic Recovery

2.17 A more vigorous pursuit of export promotion policies and other elements in a medium term strategy for structural adjustment and economic recovery, could produce more favorable results. Table 2.4 presents the results of an alternative base case involving greater export promotion and faster economic recovery. Manufactured exports are assumed to grow at 10% annually in real terms for 1986-90, as opposed to 6-7% in Base Case A. As a result of this greater export expansion, and the easing of foreign exchange constraints, GDP growth is also projected to be higher, reaching more than 7% by 1990. Under this projection scenario, the external debt would grow less rapidly than in the base case, and the creditworthiness indicators show more rapid improvement. It is unlikely that the large projected trade surpluses and the growing current account surpluses in the outer years of the projection period would come to pass. What these projections indicate is that there is ample opportunity for more accelerated growth and a substantial relaxation of import restrictions under the circumstances projected. In any event, it is clear that a successful export expansion strategy is consistent with higher rates of economic growth, improved balance-of-payments prospects, and a more modest growth of the external debt. Accordingly, setting a nominal growth rate target of 15-20% annually for manufactured exports could serve as an important point of departure for defining policies.

Alternative External Scenarios

2.18 In view of the importance of the external resource constraint and the uncertainties of the world economic environment, balance-of-payments projections were carried out under a variety of assumptions regarding LIBOR, petroleum prices and OECD growth. In these exercises, as in the base cases, the results are not intended as predictions of the future. Rather, they are intended to show consistency in the balance of payments under different circumstances and the external financing requirements of various scenarios. The greater the projected financing needs, presumably, the less feasible the scenarios would appear.

2.19 Four major alternative scenarios were tested (see Appendix Table 2.11), including changes in the LIBOR, larger increases in the crude oil price, and reduced export growth (resulting from either adverse international market conditions and/or inappropriate domestic economic policies). The outcomes generated by these exercises clearly emphasize the importance of export growth. In the scenarios involving retarded export growth and very poor world economic recovery, the amounts of international financing required, and the resultant increase of debt, are so large that such outcomes are unlikely. As such, these scenarios appear to be nonviable.

2.20 Any projection results must be viewed cautiously because of the enormous uncertainties regarding future international market conditions.

Nevertheless, some conclusions may be drawn. First, the success of Brazilian development strategy over the foreseeable future will depend upon the country's success in expanding exports. Second, given the seriousness of the external constraint, Brazil's economic growth over the period 1984-90 will be more modest than during the 1970s. Third, to sustain that more modest rate of growth will require both a continued net inflow of external financing, at least in nominal terms, and a greatly improved savings effort from the domestic economy. Finally, despite the clear difficulties and risks inherent in the current situation, Brazil has the economic strength, with the support of its lenders, to work its way out of the present liquidity bind and resume a satisfactory rate of growth while continuing to meet its international obligations. The consistency of those two objectives could be broken, however, if the world's goods and financial markets do not provide the needed access and support.

Chapter 3

PERSPECTIVES ON MEDIUM-TERM STRATEGIES FOR ECONOMIC RECOVERY AND DEVELOPMENT

A. General Considerations

3.1 A typical characteristic of economic policy in most countries is a tendency to focus on the short term. Brazil is no exception. Pressing problems requiring immediate attention have occupied the time, attention, and energy of the country's top policy-makers. Thus, little effort has been devoted to developing and articulating an overall and consistent medium-term policy framework or strategy. Since the eruption of the debt crisis in September 1982, there has been, quite understandably, an even greater concentration of high-level policy-maker attention on short-term adjustment and stabilization problems. The preoccupation with short-term problems and considerations has resulted in frequent policy reversals and changes of course, which have served to create confusion, increase uncertainty, and make stabilization and recovery more difficult.

3.2 The articulation and adoption of a coherent medium-term strategy for economic recovery and development would be important in several respects.[1/] First, such a medium term strategy would define the context of short-term, and particularly stabilization, policy rather than vice versa. Second, a medium-term strategy, if properly formulated, would help enforce consistency among policy objectives and between objectives and resource availability. In doing so, it would provide a framework for the clear establishment of priorities. Third, through the articulation of general policy directions, a medium-term strategy would provide a better basis for long-term production and investment decisions by the producing sectors of the economy. Finally, and related to the indicative dimension of such a strategy, a better perspective for dealing with recurring economic policy problems would be available. For example, a medium-term perspective of the country's external debt, and how to cope with it, would better enable the Government to deal with Brazil's creditors on a multi-year basis.

3.3 A number of groups, both inside and outside the Government, are currently analyzing medium-term economic problems and policy directions. Within the Government, the work being undertaken by IPEA is especially noteworthy. Even though this ongoing work and study is being carried out by very diverse groups with very different political and ideological perspectives, the degree of consensus on many issues is striking, perhaps in part because of the reduction in the margin of maneuver in economic policy. For instance, there appears to be wide agreement on the necessity to reinitiate economic growth, lower real interest rates, and expand exports. There is also a general consensus

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1/ This chapter summarizes existing and ongoing work by Bank staff, and others, on questions related to Brazil's medium term prospects and policy choices. As the ongoing Bank work is completed, such work will be included in subsequent economic reports.

on the importance of stimulating employment generation, increasing the domestic savings rate, reforming the banking system, establishing a consolidated and more transparent federal government budget, delineating the scope for public sector economic activity so as to avoid the crowding out of needed private sector investment, and reforming the fiscal system, particularly to provide a greater share of the total revenues to the states and municipalities and to increase interpersonal and interregional equity. There is less consensus on how to deal with other aspects of tax reform, external debt rescheduling, the management of the domestic public debt, reform of the indexation system, agricultural policy, and industrial policy, and incomes policy. Even when there is agreement on an objective, such as stimulating employment creation, there may be no consensus on the means to be used. The challenge, of course, for any new government will be to move beyond the level of generalities and to specify, and implement, concrete policy measures in these areas.

3.4 The new Government will have a unique opportunity to develop a cohesive development strategy for the country. The economic stabilization burden borne by the population over the past four years has been very heavy, and a new Government seeking to alleviate the recession and restore growth will enjoy a honeymoon period of popular support. While the legally mandated National Development Program (Programa Nacional de Desenvolvimento, or PND) could serve as a suitable vehicle to put forth a medium-term strategy, the overall direction of economic policies should be clearly articulated early on. The new Government will have the opportunity to consolidate the gains made under the stabilization program, such as the pruning of government expenditures, improved control of the consolidated public sector, and the increased recognition of the importance of export expansion.

3.5 The new Government, whatever its composition, will have to deal with three general areas of economic policy concern: (a) the external deficit as reflected by the balance of payments and the external debt; (b) the public sector deficit, involving issues of public sector management, financial policies, and administration of the internal public sector debt; and (c) the social deficit, including in most general terms poverty alleviation and encompassing problems of employment generation, nutrition, public health, basic education, and shelter. These three policy areas, have both macro- and microeconomic policy dimensions. Policy actions to deal with these deficits cut across industrial, agricultural, energy, employment and public sector management. What is required is consistency in policy, which a medium-term framework can provide.

3.6 While there exist many alternative policy strategies, two general, but not necessarily mutually exclusive, directions are most apparent. One option would be to pursue a course of inward-directed development. Import substitution would be emphasized through policy incentives, as was done in Brazil between 1946 and 1964 and to a lesser extent, during the 1974-80 period. As in the past this strategy, while temporarily bringing growth, would discriminate against agriculture, lead to inefficient resource allocation, impede labor absorption, and probably exacerbate the uneven distribution of income. The second option would be a more outward-looking development strategy focusing on export expansion.

To a limited extent, the beginnings of such an outward-looking strategy were present in Brazil during the 1968-74 period. A greater emphasis on export expansion, in addition to being essential to service the external debt, could result in accelerated rates of economic growth, high employment generation, more rapid real wage growth, and presumably a more even distribution of income. While one can make an analytical distinction between inward-directed and outward-looking development strategies, in practice a policy strategy can contain elements of both. Export promotion under Brazil's current economic circumstances appears absolutely essential. Yet, at the same time, there are efficient import substitution opportunities, such as in energy, that should be pursued. The important thing is to adopt policies that make both export expansion and efficient import substitution attractive to producers and investors.

3.7 While trade and incentive policies provide a focus for development strategies, the choice does not necessarily predetermine other policies, especially pricing policies. Market-oriented pricing could be employed with either overall strategy. Whichever approach is followed, there are additional policies and policy areas that merit attention. The next few pages briefly discuss medium-term issues in trade and industrial policies, agricultural policies, energy policies, public sector management, financial sector policies, and employment. The presupposition is that a consistent medium-term strategy for economic recovery and development can be fashioned based, in part, upon policies undertaken in these areas.

3.8 Reinitiating economic growth and development in Brazil appears to be contingent upon, at a very minimum, stabilizing the inflation. Another acceleration in inflation from the present very high rates would clearly introduce additional instability and distortions and jeopardize the sustainability of the present incipient recovery. Clearly, dealing with inflation will be a primary item on the new Government's agenda. Bringing down inflation will require an increased credibility in government policy actions, a break in inflationary expectations, and possibly some change in the existing indexation arrangements. A sharp reduction in inflation may be served by a currency reform as well, perhaps along the lines currently being discussed in Brazil, assuming that the operational public sector deficit is eliminated and wage demands can be kept within the bounds of productivity increases.[2/]

3.9 If inflation in Brazil expresses, as an outward manifestation, conflicts among different social and economic groups, any progress in reducing inflation would seemingly be conditional upon the appearance of an equitable sharing of any short-run costs of reducing inflation. This

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2/ Discussions of these questions are included in André Lara Resende, "A Moeda Indexada: Uma Proposta para Eliminar a Inflação Inercial," PUC/RJ, Texto para Discussão no. 75 (September 1984) and Pérsio Arida, and André Lara Resende, "Inercial Inflation and Indexation," paper presented at the conference" Inflation and Indexation," Institute of International Economics, Washington, December 8, 1984, forthcoming in the conference volume.

implies some sort of "social pact" (to use the current term in Brazil) negotiated politically. This approach should be viewed in the context of a medium term strategy and would involve inter alia: (a) increasing capacity utilization; (b) decreasing real interest rates from their present very high levels; (c) a possible limited use of domestic price controls for a transition period with a view towards holding price increases in the mark-up, i.e., oligopolistic corporate, sector below the rate of inflation; (d) wage restraint; and (e) restricting any expansion of the public sector.

B. Trade and Industrial Policies

3.10 The essence of a country's industrial policy is to be found in its overall incentive system which encompasses, inter alia, exchange rate policy, export subsidies and taxes, other export restrictions, import restrictions, credit and fiscal incentives, domestic price controls, and production licensing. These varied policy instruments are frequently pursued by different government agencies for different reasons. Inconsistencies frequently arise, and the net effects of the various policy instruments are sometimes not immediately apparent. Yet it is the net effects which are relevant in determining the composition of production and trade. Importantly, policies comprising the incentive system affect (a) the relative prices between tradable goods and nontradables, as determined principally by exchange rate and other trade policies, (b) the structure of incentives across different tradable goods sectors, including agriculture, and (c) the relative magnitudes for individual producing firms, of the incentives for domestic market versus export sales.

3.11 The complex Brazilian incentive system possesses a number of important characteristics.[3]/ First, there are very high levels of protection, i.e., net incentives, for domestic market sales. In addition to imposing high static welfare costs on Brazilian society as a whole, these domestic market incentive levels generally outweigh those for export sales. The result is an anti-export bias in economic policies, thereby impeding export expansion. This is frequently further exacerbated by direct impediments imposed on export activity through government actions.

3.12 A second characteristic of the overall incentive system relates to the structure of incentives among sectors. Agriculture is discriminated against through the overall constellation of economic policies. The incentive system in general appears to favor those sectors which are

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3/ See IBRD, Brazil - Industrial Policies and Manufactured Exports (Washington: IBRD, 1983) and William G. Tyler, "Incentivos às Exportações e as Vendas no Mercado Interno: Análise da Política Commercial a da Discriminação contra as Exportações - 1980/81," Pesquisa e Planejamento Econômico, Vol. 13, No. 2 (August 1983), pp. 543-574.

capital intensive (for both, physical, i.e., machinery and equipment, and human capital). Accordingly, the absorption of unskilled labor is impeded, with resulting adverse implications for the distribution of income. In addition, the inter-sectoral structure of nonspacial incentive policies benefits activities situated in the Center-South, discriminating against the Northeast and South. The extent to which the effects of these general incentives are offset by explicitly regional incentives, such as the FINOR fiscal incentives program for the Northeast, is an open question.

3.13 A third feature of the Brazilian incentives system is the wide discretionary latitude allowed its administrators. Various government institutions and organs apply differing and sometimes varying criteria for the application of policy measures both among sectors and among firms within a sector. Rules which are frequently imprecise and poorly specified are sometimes arbitrarily applied. This lack of automaticity generates uncertainty, results in disproportionately high administrative expenses for producing firms, and is especially disadvantageous for small- and medium-sized firms.

3.14 Fourth, because of the frequently conflicting nature of policy instruments, the incentive system overall, as viewed through its net effects, appears to lack a clearly defined economic rationale.The choice of sectors to benefit (and implicitly, others to be discriminated against) is not systematically related to maximizing either present welfare, growth, or the benefits to the country over time. Institutional arrangements also sometimes prevent the country from maximizing the benefits to be derived from technological progress or the transfer of technology from abroad, thereby undermining Brazil's competitiveness in international goods markets.

3.15 In awarding protection from import competition and in promoting economic activities, economic questions, involving the benefits and costs to the country as a whole, have frequently not been adequately posed. A prime illustration of this is the present effort to develop a national computer industry with domestically developed technology. Current government measures to promote development in the information areas involve government intervention through import restrictions and industrial production licensing. For informatics, the pursuit of an import substitution strategy, which brought success earlier in other sectors, possesses four very crucial differences from the past experience: (a) world-wide technology is growing very rapidly for informatics; (b) informatics has important applications in industry as an input, as opposed to being destined to final users only; (c) the use of international technology is restricted through impediments imposed on multinational firm production, joint venture activities and international licensing agreements; and (d) domestic entry, i.e., production even by fully owned domestic firms, is regulated and impeded. These and other considerations illustrate the need for an objective economic assessment of the present policies in terms of their benefits and costs to Brazilian society as a whole. There is a risk of imposing technological obsolesence, perhaps even of an increasing nature, on the other producing sectors of the economy, thereby adversely affecting the country's ability to compete abroad.

3.16 Over the past several years the Government has increasingly recognized some of the deleterious effects of the incentive system, and important steps have been taken in the direction of reform. The incoming Government will have the opportunity to broaden some of these initial measures and to undertake major reforms of lasting significance. Present international circumstances and Brazil's balance-of-payments conditions favor the adoption of a development strategy that emphasizes export expansion and economic efficiency. Such a strategy would imply a gradual opening up of Brazil's goods markets in order to promote exports, and would stress the importance of producing at internationally competitive prices. The overall goals of such a medium-term strategy would be (a) first and foremost, the increase of exports, especially of manufactured products, (b) the promotion of technological progress, and (c) dynamic efficiency in the allocation of economic resources as in part reflected in employment generation. Policies to achieve these goals would include, inter alia, an export-oriented exchange rate policy, reduction in anti-export biases in economic policies, guaranteeing full and unimpeded access for direct and indirect exporters to intermediate inputs at international prices, and assuring access to imported technology for industrial firms. Regarding technological transfer, it may be possible to take better advantage of foreign enterprises to achieve national objectives.

3.17 If the policy objectives suggested above are to be pursued, their instrumentation would include: (a) extension of the recently reformed drawback system to indirect exporters on an automatic basis; (b) measures to ensure the availability of adequate amounts of credit at competitive costs to exporting firms; (c) the reduction and eventual elimination of de facto export taxes (except as justified on terms-of-trade grounds) and other export restrictions; (d) further simplification of CACEX export procedures, including greater autonomy for field offices in processing exports; (e) reduction of the discretionary nature of industrial incentives with the establishment of more clearly defined and consistent criteria; (f) improvements in government-sponsored export marketing and promotion efforts; and (g) a generalized multi-phase reform in the system of import restrictions entailing simultaneous reductions in preferential tariff schemes, nontariff barriers, and tariff levels and dispersion. The underlying purpose of all of these suggested measures would be to expand exports, increase economic efficiency, and accelerate the country's economic development.

C. Agricultural Policies

3.18 Measured in terms of aggregate real growth, Brazilian agriculture has performed well, expanding at an average annual rate of 4.7% since 1970, almost twice as fast as population.[4/] This progress was accompanied by

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4/ The analysis in this section draws on several published World Bank reports, including Brazil: A Review of Agricultural Policies (Washington: IBRD, 1982), Brazil: Financial Systems Review (Washington: IBRD, 1984) and Brazil: Human Resources Special Report (Washington: IBRD, 1979), as well as ongoing work by World Bank Staff and Brazilian researchers.

an absolute decline in the rural population over the 1970's. The principal sources of growth in agriculture have been the expansion of crop production into new areas, encouraged by subsidized investment credit, and the expansion of capital-intensive agriculture, principally in the South and Center-South.

3.19 But this strong overall performance masks the disparate rates of growth of the principal crops. By far the most dynamic performance has been that of products oriented primarily toward the export market (particularly soybeans and citrus fruits) or domestic fuel production (sugarcane). On the other hand, much poorer performance has characterized such basic food crops as rice, corn, wheat, beans, manioc and potatoes.

3.20 The Government's concern with inflation in recent years has led to frequent intervention to hold food prices down in real terms. This has been accomplished by direct price controls, quantitative restrictions on trade, and the sale of subsidized imports. Together with exchange rate changes, the fall in international prices, and the rise in the price of petroleum products, it has been a factor in depressing the terms of trade for agricultural producers since their peak in 1977.[5/] Agricultural production has been taxed explicitly through the value added tax (ICM), which for agriculture falls on the gross value of output rather than value added and is not rebated on exports, and through export taxes, particularly on coffee and cocoa. On the other hand, farmers pay virtually no income or property taxes. To compensate farmers for the acknowledged discrimination of other policies against agriculture, the Government has provided substantial flows of subsidized seasonal credit. Deeply negative real interest rates, which prevailed until 1984, helped induce a strong bias towards capital-intensive crop production. The tax structure, coupled with interest rate subsidies, also encouraged land speculation and the diversion of resources to financial and other non-agricultural applications. The distortions implicit in the incentive policies outlined above have been highly regressive. Apart from its negative employment effects, subsidized credit benefits those with the easiest access to it, usually favoring large over small farmers.

3.21 In summary, the incentive system for agriculture has been characterized by: (a) taxation (including implicit taxation of exports via an overvalued exchange rate and of production for the domestic market

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5/ The movements for different crops and animal products have varied, affffecting different states and different regions to different degrees. For example, the coffee boom of 1977/78 had a particularly strong positive impact on the terms of trade in Parana, Sao Paulo and Minas Gerais. Though there has been some recovery since the maxidevaluation of 1983, over the first six months of 1984 the unweighted average domestic terms of trade in the eight key agricultural states for which data are collected stood at 79.8% of the peak level of 1977, compared with a 15-year low of 63.3% in 1982, or almost exactly the average value of 79.3 for the period 1970-83.

through interventions aimed at holding down food prices) heavily concentrated on production rather than income (including capital gains) or assets; (b) relatively harsher taxation of traditional low-input agriculture; (c) the promotion of capital-intensive cropping and processing; and (d) the encouragement of expansion into frontier areas at a pace faster than would be economic without heavy use of interest rate subsidies. Such a system is unlikely to be a viable basis for future growth in agricultural output and employment, not merely because it fails to reflect comparative advantage, but also because of its fiscal implications.

3.22 Agriculture and agro-industry have the potential to contribute importantly to Brazil's economic recovery. Agriculture has a low import coefficient, strong backward linkages to the industrial and service sectors, and is directly or indirectly responsible for almost half of exports. In addition, it is an almost exclusively private sector activity with millions of farm enterprises operating in an environment of near perfect competition.

3.23 Agriculture is intensive in the application of precisely the factors which are abundant in Brazil -- land and labor. While modern mechanized agriculture also requires considerable capital, needed machinery can be produced economically in Brazil and much intensification of labor-intensive family farming is possible using scale-neutral inputs such as chemical fertilizer, chemical and biological pest controls, green manure and improved seeds. Border price comparisons indicate that Brazil is capable of producing virtually all of its food and fiber needs economically, the major exception under current technology being wheat.

3.24 International markets for Brazilian agriculture should continue to expand, though protectionist tendencies in major actual and potential markets pose a threat to as rapid increases as might otherwise be possible. Brazil should exploit all export possibilities. But a primary task of Brazilian agriculture will remain that of feeding the nation. Substantial parts of the Brazilian population have unmet nutritional needs. In 1975, 21% of children under 18 suffered from second or third degree malnutrition and 17% of the population had calorie intakes more than 400 calories below their needs. Stagnation or decline in output per capita of major domestic food crops has characterized Brazilian agriculture in recent years, contributing to inflation and leading to intermittent imports of products such as beans, rice and maize.

3.25 The problem is complex and its solution will require an improved incentive system for producers, a more efficient marketing system, improved access to land for those with an ability and desire to farm, an incentive structure in all sectors of the economy which promotes employment creation, and carefully targeted food subsidies for the truly needy. Small farmers producing primarily foodstuffs for the domestic market are themselves frequently among the poor and undernourished, and policies which have attempted to hold down producer prices in order to favor urban consumers have contributed importantly to the relatively poor performance of this sector of the agricultural economy, and to the excessively rapid rural exodus which has aggravated the urban poverty problem.

Accelerating Agricultural Growth

3.26 While the overall growth of Brazil's agricultural sector has been impressive when compared to that of most other countries, there is ample evidence that Brazilian agriculture is operating below its potential given its resource base and rapidly evolving agricultural technology. Grain output (including soybeans, which has been the fastest growing crop over the past two decades) has stagnated at roughly 50 million tons for the past five years, while population has continued to grow at about 2.3% per year.

3.27 With the proper policy environment, agricultural output could be increased rapidly 6/ permitting improved nutrition for a growing population, expanded exports, and increases in alcohol production. Production can be intensified on large areas of underutilized land in some of Brazil's most productive agricultural regions, such as Sao Paulo and Parana. Such land is frequently retained in less than socially optimal productive use (e.g. for extensive livestock operations) by owners who retain it principally for speculative purposes. These regions are already relatively well-served by roads, railways, storage facilities and telecommunications. They also have relatively healthy and well-educated populations. At the same time, investments in economic and social infrastructure will be needed. For example, investments in irrigation, agricultural machinery, additional storage facilities and on-farm infrastructure improvements will be necessary to expand production even in the agricultural heartlands of Minas Gerais, Sao Paulo, Parana, Santa Catarina and Rio Grande do Sul. Improvements in education and health services will also be required to provide more attractive rural living conditions as well as to improve the quality of the labor force, thereby contributing to productivity increases.

3.28 While these measures are important, the key to achieving a major acceleration of agricultural production is to establish a policy framework which will make agriculture profitable without subsidies. If this can be accomplished, market forces will do far more to stimulate efficient and rapid agricultural growth than the combination of credit subsidies, interventionist trade policies that discriminate against exports, and production-based taxation. Together they resulted in net resource transfers from agriculture to industry. While this is quite normal during the industrialization process in most countries, a strong case can be made that this process should be halted or reversed over a medium-term horizon. The price system (which is essentially scale-neutral and rewards actual production, not declared intentions to produce or speculative activity) should be the principal source of incentives.

6/ Work by the Government Work Group on Agricultural Policies has suggested that a target for annual increases in agricultural output of 6.5% is attainable. This is discussed in Guilherme Leite da Silva Dias, "Politica Econômica e Tendências da Agricultura Brasileira," paper prepared for IPEA, December 1983.

3.29 In order to provide agricultural incentives primarily through the price system, an aggressive exchange rate policy will be necessary. The second major element is to allow free export and import of agricultural products, as recently declared by the National Monetary Council establishing stable "rules of the game" for whatever Government intervention may be deemed necessary to reduce the impact of extreme swings in international prices on domestic markets. Third, the phaseout of rural credit subsidies should be completed. Fourth, the ICM should be drastically reduced or eliminated for agriculture. It could be replaced by a combination of a more effective land tax, based on the productive potential of land and shared by the state and municipal governments; and a broadened federal income tax, which would eliminate fiscal incentives and tax agricultural income like that originating in any other sector.

D. Energy Policies

3.30 Brazil has been following an energy strategy that emphasizes the development of domestic resources.7/ With imported oil comprising almost 50% of total imports, the country has been giving top priority to the exploration and development of domestic oil. Simultaneously, attention has been given to the development of domestic energy substitutes for petroleum products, especially hydroelectricity and alcohol, and conservation of petroleum products. Natural gas is emerging as a potentially important fuel in the medium-term, with the prospects of large natural gas deposits in Jurua; in the short-run, Brazil is taking steps to use its associated gas, primarily from the Campos basin.

3.31 This strategy has not been without costs. Brazil has tolerated high production costs for domestic fuels, such as alcohol and coal, and has been willing to borrow extensively in the case of hydroelectric power generation. At the same time, in order to build up the market for these domestic fuels, the Government has tended to keep consumer prices of oil substitutes relatively low, even subsidizing them on occasion while raising the price, or reducing the quotas, for competing oil derivatives. Following the oil price shock of 1979 and the February 1983 maxi-devaluation, the Government also attempted to shield the consumer from the resulting large, sudden increases in imported oil prices. Consequently, subsidies to consumers of oil were generated which contributed to the public sector deficit until May 1983, when the subsidy was eliminated. Although total revenues now cover total costs, cross-subsidies between products allow the government to adjust consumer prices of individual petroleum products and their substitutes, alcohol and coal, according to energy objectives.

7/ See IBRD, Brazil: Energy Issues and Prospects, Report No. 3424a-BR (Washington: IBRD, 1982).

3.32 With Brazil's continuing macroeconomic and external borrowing constraints, Brazil must seek to conserve both domestic resources and foreign exchange. Two general principles are suggested, related separately to production and to consumption. First, in terms of production -- especially of relatively new activities -- emphasis should be given to reducing costs in existing plants, wherever possible; new plants or development of new domestic fuels should only be undertaken when economically justified. With severe resource constraints on its investment program, investments should also be carefully synchronized with demand in order to minimize excess capacity in the early years.

3.33 This point is particularly relevant for the alcohol and electricity programs. In international terms, the alcohol industry is a low-cost producer. However, alcohol production costs are still relatively high, compared to the import price of gasoline. In the most efficient areas, such as Sao Paulo, alcohol costs are only slightly below the c.i.f. import price of gasoline, while in other areas, costs tend to exceed the import price. As the alcohol program moves into its "mature" phase, the emphasis of the program should be on consolidating production and reducing costs, entering only into new locations which minimize production-plus-transportation costs. Brazil is a low-cost producer of hydroelectricity. Since the sector is currently operating under severe financial constraints, inclusion of new coal-fired or nuclear power plants in the sectoral investment program should be strongly discouraged, since these plants have substantially higher investment and operating costs than new hydroelectric plants. At the same time, existing oil-fired thermal plants, which have been withdrawn from operation because of high fuel costs, should be used to increase the reliability of the system, when to do so is less costly than to build new hydro-plants or risk widespread blackouts in the system.

3.34 A second guiding principle for energy policies, should be that efficient energy use -- reducing the energy input per unit of output or service provided -- is essential. Conservation is typically more cost-effective than installing new production capacity, and appropriate pricing is the most effective way to encourage conservation. Users of all fuels, even those which are domestic substitutes for petroleum fuels, should be encouraged to conserve. There is room, for instance, for higher price increases over the medium-term for both alcohol and electricity. The retail alcohol to gasoline price ratio (64%) is well below the fuel efficiency ratio of alcohol-to-gasoline (close to 80%). Electricity tariffs are still substantially below the long-run marginal cost of installing new capacity. Increasing tariffs gradually over a 4-5 year period would restrain the growth of consumption, which historically has been increasing 10-11% per year, and reduce the future investments needed to satisfy demand. Finally, the retail diesel price is already above the c.i.f. import price for diesel plus local distribution costs. However, as long as the Government wishes to have refinery capacity to meet domestic consumption of diesel, diesel conservation would need to have a high priority, since diesel represents the bottleneck in the current refinery configuration.

3.35 In influencing both production and consumption, market signals should be given a more prominent role. At the moment, both producer and consumer prices for the major fuels, including alcohol, are controlled by the government. Even if the government continues to set prices, it no

longer has the budgetary flexibility to allow prices to deviate substantially from the costs of importing or producing and distributing the fuels in question. Subsidies may still be justified, insofar as the economic benefits to the country of developing and using a domestic fuel may well be greater than the financial benefits to the user. Social considerations, such as the ability of the users to pay the market price, may also be important. However, in a resource-constrained environment such as Brazil's, even cross-subsidies would have to be used judiciously.

3.36 The Government should also reassess the policy of maintaining a uniform price for the major fuels (oil products, electricity, and alcohol) throughout the country, even though production and distribution costs differ by area. A major reason for this policy is to maintain equal (price) access to energy, without penalizing consumers in the interior or in poor areas. An elaborate administrative system has developed to transfer revenues from large consuming areas, where sales revenues exceed costs, to high cost areas. Consumers close to the production source (or to the ports of entry, in the case of imported oil) tend to subsidize those who are in more distant locations. The present system works satisfactorily with oil and alcohol, but less well in recent years with electricity, where the "surplus" states have sought to use the resources for their own investments, rather than transferring them elsewhere. Even where it works satisfactorily, it is extremely cumbersome and is prone to unplanned subsidies, since retail prices in a given area are not automatically derived from production and distribution costs. In addition, production must be closely regulated, in order not to have excessive expansion in high-cost areas. On the consumption side, the regional benefits are achieved at the cost of stimulating economic activity which are in part dependent on unduly low energy prices. Even if the country is not willing to leave pricing entirely to the market, basing consumer prices on costs would simplify the system and allocate investment resources where consumers are willing to pay for them.

3.37 Because the energy sector is so heavily regulated, Brazil needs a comprehensive long-term energy plan and institutional mechanisms to implement that plan in a coordinated manner. As the energy picture becomes more complex, such a plan is needed to relate the country's overall energy objectives with development within the sub-sectors, recognizing the interrelationships and tradeoffs between fuels; to synchronize the increase in production with the growth in demand; and to coordinate the range of policies and incentives for the various energy sub-sectors and the actions of the various institutions which now implement policy. Many of the domestic fuels are competing with each other -- for example, natural gas and electricity or coal -- as well as with petroleum derivatives, and coordination is critical. At the moment, planning is done by the various ministries and public enterprises for fuels under their jurisdiction, with little systematic coordination across agencies. Formal coordination by the Ministry of Planning is focused on investment and borrowing ceilings for each state enterprise and setting of producer and consumer prices for each fuel. Both control mechanisms are currently oriented toward short-term macroeconomic targets, although in principle they could be used for medium-term objective as well.

3.38 Brazil is well into an inward-looking phase of energy development. The ambitious hydroelectric program, initiated in the late 1970s under optimistic projections of the future, will be completed in a more somber environment. An accelerated oil exploration program is needed in order to continue or increase oil production beyond 500,000 bpd for more than a few years. The possibility of large natural gas reserves in Jurua, coupled with major gas discoveries in other parts of Latin America, make natural gas a potentially important fuel for the future but one whose development should be coordinated with other large domestic energy programs, especially electricity. Finally, alcohol has been accepted as an automotive fuel. The challenge now is to use these domestic energy resources more efficiently.

E. Issues in Public Sector Management

3.39 During the 1970s, the public sector expanded rapidly both in absolute terms and in relation to the economy as a whole. Its operations became increasingly complex, diverse and distortionary as the government sought to maintain investment and growth in a difficult external environment, counter inflationary trends for which growing public sector deficits were themselves largely responsible and meet a variety of competing and sometimes conflicting social objectives.[8/]

3.40 Total expenditures expanded primarily via the monetary budget, administered by the Central Bank. Initially intended as a tool of monetary restraint, the monetary budget was used increasingly to channel development and welfare expenditures through a number of subsidized credit programs and through producer and consumer subsidy arrangements for basic commodities such as wheat and petroleum. Heavy external borrowing was undertaken by major state enterprises to finance ambitious investment plans. The requirements for improved public sector management stem, essentially, from these distortions, which developed mainly in the 1970s, and which, because of the changed circumstances facing Brazil, will have to be largely or wholly corrected in the 1980s.

3.41 The main thrust of measures taken to date has been to bring public sector expenditures, however financed, under better control. The successes achieved, reflected in the efforts to reduce the size of the public sector's operational deficit and borrowing requirements, are described in Chapter 1. The agreed aim for 1984 is to secure a surplus equivalent to 0.5% of GDP in the operational balance of the combined public sector, including state enterprises. With this obtained, it will be timely to devote more attention to the broader questions of public sector resource mobilization and allocation.

8/ See IBRD, Brazil - Economic Memorandum (Washington: IBRD, 1984). Chapter 2 presents an analysis of the flow of funds and the financing of the federal public sector.

Resource Mobilization

3.42 Brazil's performance in generating resources for development deteriorated in the 1970s. In 1970-72, gross national savings averaged 24.4% of GDP, but in 1980-82, only 17.2%. There was also a decline in tax revenues, especially on a net basis, after the deduction of subsidies and transfers. Total taxation peaked at 26.5% of GDP in 1973 and averaged 24.0% in 1980-82. Net taxation amounted to 17.0% of GDP in 1973 and 10.8% in 1980-82, and would be much lower still if the transfers and subsidies from the monetary authorities, for basically fiscal purposes, were also subtracted.

3.43 Increased domestic resource mobilization requires positive action in at least three main areas. First, increases in individual and corporate savings are needed to finance growth in private as well as public sector investment; these increases will depend largely on economic recovery and the reduction of inflation. Second, the large state enterprise sector must be expected to generate internally more of its own investment resources. Its capacity to do so was for several years undermined by public pricing policies intended to hold inflation down, as mentioned above. The financial charges associated with past borrowing at variable interest rates have mounted and currently exert heavy pressure on many of the enterprise groups. In this sector, therefore, improving the financial situation of the state enterprises, as well as improved planning for current and proposed operations, is urgent.

3.44 Third, the tax system is no longer adequately providing the resources required for the stable management of public finance and investment. Progress made towards the restoration of fiscal balance, primarily through cuts in public investment, now needs supplementing through the recovery of revenues in addition to the reduction, where feasible, of public current expenditures. This applies to state and municipal finances, to transfers between different levels of government, and to the social security system as well as the relatively small proportion of revenues (less than 9% of GDP in recent years, about 3% coming from taxes on income) accruing directly to the Federal Treasury.

Tax Reform

3.45 The need for major reform of the Brazilian tax and transfer system is now widely recognized. Political support exists for some types of reform, especially of the revenue-sharing arrangements between federal, state and municipal governments. Substantial changes in the system occurred in 1982-83, but constitute less than the wider reform on which a degree of consensus is emerging. Tax reform would therefore seem to be high on the agenda for 1985.9/

9/ A solid base for tax reform is available from much of the ongoing work done by various groups and commissions in Brazil.

3.46 Tax reforms might best be considered in the context of a broader medium-term strategy for economic and social development. The objectives of tax reform should include growth in revenues and progress towards agreed distributional objectives. This would include modifying existing tax measures with a view towards increasing employment generation, reducing individual and regional income disparities, and providing adequate revenues for state and municipal governments to carry out their economic and social support programs. Efficiency criteria must also be met, if the growth and equity aims of reform are to be attained.

3.47 A broad review should take full account of the potential for broad-based and more progressive income taxation; the fiscal costs of business tax concessions and allowances, as well as their impact on resource allocation; the appropriate role for the para-fiscal social funds as well as the conventional sources of revenue; the elimination of the financial transactions tax (IOF) which has the effect of raising domestic interest rates; the rationalization of the mechanisms for taxing goods and services; the establishment of adequate tax bases for states and municipalities, keeping in mind their widely differing circumstances and the consequent need for transfers to lower-income regions and communities; the role of taxes and tax benefits for goods traded internationally; the administrative capacities for revenue collection; and the equity requirements, as perceived in Brazil, of a good tax system.

Efficiency in Public Sector Resource Allocation

3.48 The necessary short-term emphasis on crisis management and expenditure control has limited the Government's opportunities for broader planning and public sector budgetary and administrative reforms. SEPLAN is now engaged in a review with the main objective of preparing proposals, for consideration by the incoming Government, to strengthen public sector management capabilities. Six management areas appear to merit special attention:

(a) the development of an improved system of project and program evaluation, especially for large projects, as the orientation shifts from financial control over existing activities to the definition of a new public sector investment program;

(b) multi-year investment programming, building on earlier initiatives submerged by short-term management needs;

(c) the establishment within SEPLAN of more comprehensive project and program reporting;

(d) budget reform, to reduce further, and eventually eliminate, the financing of fiscal operations through the monetary budget, and to introduce needed flexibility into Treasury budget procedures and systems of financial management;

(e) further development of mechanisms for the supervision of federal and state enterprises, with more emphasis on improved resource

allocation and investment decisions, and much less on direct budgetary controls; and,

(f) more systematic development and application of macro and sectoral modelling and economic analysis in order to improve economic policy decision-making.

3.49 In addition, there is the need to review the overall approach to public administration including personnel management, financial management and audit systems to ensure that these meet the requirements of flexibility and efficiency for a new phase of development.

3.50 Finally, although much has been done to develop information systems for specific areas of public sector management, the Government still (and not withstanding the efforts of the organizations most directly involved) lacks the comprehensive, integrated and up-to-date statistical information which a better national accounts system could provide. A comprehensive program has now been proposed, and is under consideration, to bring the national accounts up to the level needed for better policy analysis and formulation. Special efforts will be needed to achieve this in a reasonable period of time.

3.51 The initiatives already taken, including measures to strengthen control over the state enterprises, rationalize pricing policies and reduce reliance on credit operations by the monetary authorities to support essentially fiscal programs, promise substantial improvements in the allocation of public sector resources in the future. Consequently, there are improving prospects for a more balanced and sustained process of development in the medium term.

F. Financial Sector Policies

3.52 Over the past decade, financial policies, in particular selective credit programs, have performed three main functions.[10/] First, with a balanced federal Government budget, an expansionary stimulus was effected through financing the deficit spending of the borrowing of public enterprises and through the credit and other expenditures of the Monetary Authorities, whose responsibilities extend far beyond those conventionally assigned to central banks. Second, the financial system was used to compensate certain sectors, notably agriculture and export industry, for the adverse consequences of price controls and exchange overvaluation. This increased the system's complexity and led to greater segmentation; interest rates vary widely depending upon the sector, purpose, region, and nature of the borrower and the source of funds. Third, until recently the system was increasingly managed to attract foreign funds to support the current account deficit in the balance of payments.

10/ An analysis of the development of Brazil's financial system since 1964 can be found in the World Bank, Brazil - Financial Systems Review (Washington: IBRD, 1984).

3.53 Credit subsidies and financial market fragmentation became a major source of renewed inflationary pressure, policy-induced distortions and allocative efficiency losses. Financial arbitrage and the search for favorable credit terms absorbed entrepreneurial and managerial resources with a high opportunity cost in terms of output. The structure of the overall system and the difficulty of controlling numerous, highly selective credit lines have been responsible for many of the problems experienced in controlling levels of economic activity and inflation over the past decade. Powerful financial feedbacks amplified the effect of exogenous disturbances and accelerated inflation, which then became institutionalized in Brazil's highly indexed economy.

Suggested Principles for Financial System Reform

3.54 Events since 1974 have made an overhaul of financial structure and policies necessary. Reform, if combined with appropriate changes in trade and fiscal policies, offers Brazil the least painful way of reducing inflation while avoiding undue decreases in growth and adverse distributional effects during the stabilization process. Significant progress in the direction suggested below has already been achieved under the current stabilization program.

3.55 At the broadest level, the main objective of changes in financial structure should be to widen financial markets and render them responsive to generalized macroeconomic (as opposed to selective sectoral) policies. Abrupt policy changes affect financial markets strongly, increasing uncertainty and inhibiting planning. The "firefighting" attitude of much of financial policy in the past has both resulted from and contributed to financial segmentation, which encourages sequential focussing on sectoral priorities rather than on a sufficiently broad macroeconomic view.

3.56 A constructive basis for all further financial reform was the decision by the National Monetary Council in August 1984 to establish working groups to propose specific measures to establish the Central Bank of Brazil as the sole monetary authority, transfer its development banking functions to the BNDES and/or the Bank of Brazil, transfer to the Treasury (Ministry of Finance) the responsibility for issuing federal government securities, and provide for the remuneration (through a unified Federal fiscal budget) of the Bank of Brazil for its services as an agent of the Treasury, the Central Bank, or other official institutions. Any remaining subsidies channeled through Bank of Brazil lending would be financed explicitly in the fiscal budget.

3.57 Mobilization and allocation of financial resources should be guided more by market forces and less by administrative controls. This implies that the phasing out of credit subsidies should be continued, the earmarking of commercial bank demand deposits for specific purposes sharply reduced and eventually eliminated, compulsory reserve requirements generally reduced and used in the future only as a mechanism of monetary policy (and not as a mechanism for funding Central Bank funds and programs), and that a greater reliance be placed on the private sector.

3.58 The principle purpose of monetary correcton should be recognized as the avoidance of unexpected real capital gains or losses and the maintenance of planned real values on payments on medium- and long-term loans (those of more than one year maturity, except for passbook savings accounts). Formal indexation should therefore not be used for financial instruments of a short-term nature. The interest rate on the remaining indexed instruments should be determined by the play of market forces rather than fixed by administrative means.

3.59 A greater use of equity as opposed to loan finance should be encouraged. BNDES, for example, should consider using a greater proportion of PIS/PASEP resources for equity investments subject to strict legal guidelines designed to assure that investments are made only in economically sound firms. In line with maintaining balance between the assets and liabilities of the BNDES system, remuneration of PIS/PASEP balances would reflect portfolio performance, rather than earn a fixed return of monetary correction plus three percent as now required. Management of portfolios of equities purchased with PIS/PASEP resources might be decentralized and perhaps contracted with private sector financial institutions.

G. Employment Issues and Policies

3.60 As was discussed in Chapter 1, Brazil has witnessed a decline in industrial employment of more than 20% since 1980. While economic recovery will raise employment levels, it will not by itself, other things being equal, eliminate the country's unemployment and underemployment problems. Balance-of-payments constraints, coupled with a restrictive stabilization program, are apt to limit GDP growth for the rest of the decade, especially if international interest rates remain high, world economic recovery is sluggish, and domestic inflation continues at present high levels. Even with a 5-6% GDP growth rate, employment growth is not apt to exceed 2.0-2.5% per year if labor absorption follows historical trends. In contrast, the projected increase in the labor force is estimated to be at least 3% per year. Expansion of employment, therefore, should be an important part of the country's strategy for economic recovery and future growth.

3.61 There are several ways to improve employment opportunities in the medium term, and there are some encouraging indications that the country already is moving in those directions. First, the pattern of economic growth could well affect the growth in employment. Promotion of sectors with a large potential for growth, without special emphasis on labor intensity per se, is one possible strategy. In today's context, this would include emphasizing export expansion and export-oriented industries. Directly stimulating the growth of more labor-intensive industries, such as construction, is a related possibility. Since agriculture is also relatively labor-intensive, current Government plans to free agricultural prices are likely to also have positive employment effects by stimulating production. Other associated policy changes, such as reducing the taxes on agricultural exports, would also be beneficial. In general, a reform of

the incentive system, which currently discriminates against agriculture, exports, and other more labor intensive activities, would be consistent with more rapidly expanding employment opportunities.

3.62 Second, relative factor prices have historically favored capital. Investment credit was subsidized, and capital goods could be imported without restrictions, while labor costs exceeded wage costs by a large margin because of social security and other contributions. Relative prices now appear to be moving more in favor of labor, as government-sponsored interest rate subsidies have been reduced, market interest rates have risen sharply, and real wages have fallen. If this change were to continue, the medium-term employment implications would be positive; however, it has not generated more use of labor yet, because of the large drop in aggregate demand in the past several years. Since "social contributions" and other charges on labor currently raise labor costs about 40% above wages, reducing these charges, within the context of a generalized fiscal reform, would be a more desirable way to reduce real labor costs than cutting the real wage rate. It may be difficult to maintain the present package of benefits with such a reform; however, the likely expansion in employment would be expected to offset the reduction in non-wage benefits.