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TARIFFS AND TRADE

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Committee on Balance-of-Payments Restrictions

REPORT ON THE 1987 CONSULTATION WITH BRAZIL

Annex I

Statement by the Representative of the International Monetary Fund

For about a decade and a half through 1980, Brazil experienced a rapid export-led growth process that relied increasingly on foreign borrowing to supplement domestic savings. By 1982, however, Brazil's economic situation had weakened markedly and the widespread external debt servicing difficulties that emerged in that year underscored the need for a major revision in economic strategy.

In 1983 Brazil undertook a stabilization program that was supported by an extended arrangement from the Fund. The program was preceded by a major devaluation, and contemplated a substantial improvement in the public finances, cutbacks in credit subsidies to agriculture, a substantial liberalization of domestic pricing policies (particularly with respect to prices of fuel products), a tightening of income policies, the pursuit of an active exchange rate policy, and the liberalization of restrictions on trade and payments. Brazil's performance during the first two years of the extended arrangement resulted in a remarkable improvement in the country's external position which surpassed by wide margins the targets established for the entire 1983-85 period. The strengthening of the balance of payments and the restoration of foreign exchange reserves permitted the elimination of comprehensive foreign exchange controls and the liberalization and

simplification of the trade system in 1984. Progress on the domestic front during 1983-84 was not commensurate, however, with that achieved in the external accounts as economic policies were unable to deal effectively with the problems of inflation in the context of an extensively indexed economy. Inflation accelerated from about 100 percent in 1980-82 to 220 percent in 1984.

Brazil's domestic imbalances were aggravated during 1985 as the authorities sought to stimulate demand through a relaxation of fiscal and wage policies. Inflation accelerated to an annual rate of 450 percent in the first two months of 1986, and on February 28, 1986 the authorities introduced the cruzado plan, a set of measures that included a price and exchange rate freeze, a temporary deindexation of financial assets, and a modification of wage indexation arrangements.

Despite its initial success in reducing the rate of price increase, the cruzado plan came under pressure owing to lack of sufficient support from fiscal, monetary, and wage policies. As a result there emerged widespread distortions in relative prices and growing instances of scarcities and illegal premia, while there was a large deterioration in the external sector. On the fiscal side, the overall public sector borrowing requirement, which includes payments due to the indexation of public debt (monetary correction), was sharply reduced as a result of the drop in such payments brought about by the lowering of inflation. However, the operational deficit (the difference between the overall borrowing requirement and monetary correction expenditures) amounted to 3.7 percent of GDP in 1986, a level that was not entirely consistent with price stability. Monetary policy sought initially to avoid an increase in real interest rates and resulted in a

rapid expansion of monetary aggregates; the financial system's credit to the private sector increased by 48 percent from end-February to end-November 1986. Over the same period the recorded rise in prices was 14 percent. Buoyed by domestic demand policies, real GDP in 1986 grew by more than 8 percent and real wages rose by about 10 percent.

The upsurge in the rate of price increase that followed the abandonment of the price freeze in December 1986 resulted in the reintroduction of indexation arrangements in virtually all sectors of the economy. Officially recorded prices, which had risen by some 1.5 percent a month on average in the nine months ended November 1986, increased by an average of 15 percent a month during the first quarter of 1987 and by an average of 23 percent a month during the second quarter. The acceleration of inflation was accompanied by a reduction in real wages and a slowdown in economic activity.

The rapid rise in prices prompted the authorities to introduce a new price and wage freeze in June 1987. In contrast with the cruzado plan, the freeze was to be maintained for a maximum of 90 days (during which price adjustments were to be allowed to prevent the emergence of price distortions), the system of daily minidevaluations reintroduced in November 1986 was preserved, financial indexation was maintained, and rules governing price and wage arrangements after the freeze were announced. The freeze was preceded by the adjustment of key administered prices and by a 8.5 percent devaluation of the cruzado vis-à-vis the U.S. dollar. In line with the stated intentions, the price freeze was administered in a flexible manner and was de facto lifted at the end of August 1987. At that time, measures also were taken to contain public sector expenditure and to reduce the rapid growth of the

monetary aggregates that took place during July-August. The official rate of increase in consumer prices declined to 3.1 percent in July from 26.1 percent in June but rose to 6.4 percent in August and to 5.7 percent in September.

The overheating of the economy during the cruzado plan and the fixed exchange rate policy followed from February to November 1986 had a negative impact on Brazil's external current account. The trade balance, which averaged a surplus of more than US\$1 billion a month in the 2 1/2 year period ending August 1986 moved to a deficit during the last quarter of the year. The current account shifted from balance in 1984-85 to a deficit equivalent to 1.8 percent of GDP in 1986, and foreign reserves dropped by US\$4.0 billion. The worsening of the balance of payments position prompted the authorities to shift during 1986 from indicative to binding annual exchange budgets for imports, which was followed by the transfer in January 1987 of a wide-ranging list of items to the prohibited import list and by the declaration in February 1987 of a moratorium on interest payments to foreign commercial banks.

The external performance recovered after April 1987 in response to a more active exchange rate policy, including a step devaluation of 6.8 percent on May 4, and a dampening of demand pressures, and the trade balance moved to a US\$1.4 billion average monthly surplus during June-September 1987. The authorities project a US\$9.7 billion trade surplus in 1987 and a current account deficit (including all scheduled interest payments) equivalent to about 1 percent of GDP. The authorities expect to limit the loss in gross reserves in 1987 to US\$0.3 billion, which would bring their reserve

position by end-year to four months of merchandise imports, or about one half the end-1984 level. The latter projection assumes that financing agreements are reached with Paris Club creditors and commercial banks. Debt service (before rescheduling) in 1987 would amount to just under 100 percent of exports of goods and services, and total external debt would reach US\$113 billion, equivalent to about 40 percent of GDP.

The June 1987 stabilization effort was part of a medium-term plan, which provided a framework for the authorities' domestic and external objectives through 1993. These included an annual rate of real GDP growth of 7 percent from 1989 to 1993 (6 percent for 1988), based on a sharp rise in investment to be financed largely by a substantial increase in domestic savings and by recourse to foreign savings in the range of 1-1 1/2 percent of GDP throughout the period. A major strengthening of fiscal policy would be needed to achieve these saving goals. However, partly because of the negative effects on fiscal performance of the acceleration of inflation during the first part of this year, the authorities have targeted an operational deficit of 3.5 percent of GDP in 1987, which would imply little improvement over the outcome in 1986. For 1988, the authorities envisage a reduction in the operational deficit to 2 percent of GDP.

The Fund notes that the authorities have set ambitious goals in regard to the growth of output and investment in the medium term and welcomes their intentions to base such growth on a substantial increase in domestic savings. These intentions highlight the importance of policy measures commensurate with the savings objectives and emphasize the need to seek a decisive fiscal adjustment from now through 1988 to

help ensure a lasting reduction of inflation and to help lay the basis for sustained growth.

With respect to the external objectives, the Fund welcomes the renewed emphasis given by the authorities to the strengthening of Brazil's external position and in particular, their commitment to exchange rate flexibility. Economic growth based on a strong expansion of exports would facilitate the orderly management of Brazil's external debt and the normalization of Brazil's relations with official and private creditors. The balance of payments outlook for the coming years is predicated on a continued expansion of exports, thus highlighting the importance of preserving competitiveness and of reducing protectionist practices in other countries that hinder the access of Brazilian exports to international markets. In this regard, Brazil is affected by quantitative restraints on certain exports and has had to adopt product-specific taxes to avoid the implementation of countervailing duties. 1/

Brazil's import system is complex and relies on a number of quantitative controls. 2/ The increased difficulties encountered in the external area since 1986 prompted the reversal of some of the progress made during 1984 in the liberalization of the restrictive system. The authorities have indicated that a marked expansion in the volume of imports will be necessary to permit the efficient realization of the

1/ Detailed information is provided in "Brazil--Recent Economic Developments" (EBS/87/184, 8/26/87), section VII.

2/ Op. cit. EBS/87/184, section VII.

economic growth objectives envisaged in their development plan, and in this connection have stressed their intention to work toward a liberalization of the exchange and trade system. However, there is no assurance that Brazil's restrictions will be removed at an early stage and at the conclusion of the 1987 Article IV consultation in September of this year the Fund was not in a position to approve the exchange measures subject to its jurisdiction.