Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (4 pages)	09/08/99	P5
002. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (5 pages)	11/09/00	P5
003. memo	Karin Lissakers (IMF) to Larry Summers & Wes McGrew re: Brazil (LOI) (1 page)	11/12/98	P1/b(1) Unclass.
004. report	re: Brazil - LOI (Letter of Intent) (11 pages)	11/12/98	P1/b(1) (C)

COLLECTION:
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OA/Box Number: 24126

FOLDER TITLE:
[History of the Department of the Treasury - Supplementary Documents] [23]

jp3

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
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1999-se-009707

DEPARTMENT OF THE TREASURY 009707
WASHINGTON, D.C.

SEP 03 1999

UNDER SECRETARY

ACTION

MEMORANDUM FOR SECRETARY SUMMERS

FROM: Timothy Geithner
Under Secretary (International Affairs)

SUBJECT: APEC Leaders Meeting: Memo to the President

Attached is a memorandum for the President which outlines the overall economic setting for this year's APEC Leaders meeting, recommended economic themes the President should emphasize and points the President should raise during his trilateral and bilateral meetings.

RECOMMENDATION: That you sign the attached memorandum.

Agree __________ Disagree __________ Lets Discuss __________

Attachment

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (4 pages)	09/08/99	P5

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EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Friday, September 03, 1999

PROFILE #: 1999-SE-009707

DATE CREATED: 09/03/1999

ADDRESSEE: Lawrence H. Summers
Secretary

AUTHOR: Geithner, Timothy
International Affairs

SUBJECT: APEC Leaders Meeting Memo To The President

ABSTRACT: APEC Leaders Meeting Memo to the President.

RM 3419

TO REVIEWERS

IN:

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

DISTRIBUTION: AS, INTERNATIONAL AFFAIRS

NCC revised
and to LS
(signature)
9/3/99

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LS ok to autopen 9/7/99 -NCC
NCC/BD autopenned
LS original to WH
NCC to SE (reading)
NCC cc to TS, SS, CK, AK/PA

09/03/1999 12:29:54 PM

9/8/99 Please file

2000-se-002941

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence H. Summers

SUBJECT: Your Trip to South Asia

As you prepare for your upcoming trip to South Asia, allow me to share with you some thoughts on each of the countries you will visit.

India

India has enormous economic potential that will remain unrealized until the government addresses some difficult economic issues. There are four particular issues that the government must address if it hopes to meet its goal of 7-8% annual GDP growth and $100 billion in foreign direct investment over the coming decade. In recent years GDP growth has been only 5-6%, and foreign direct investment only $1.5 billion per year.

First, the government needs to lower the federal and state fiscal deficits that together amount to nearly 10% of GDP. To do so requires a serious effort to privatize state-owned enterprises and reduce India's extensive subsidy regime. Second, the government needs to reform the financial system, which is dominated by the public sector. Third, they must open further to trade and foreign investment in order to take full advantage of the benefits of global economic integration. Fourth, they need to deepen their investment in the health, education, and development of India's enormous population. There are other important economic concerns detailed in your briefing book, but these four issues form the core of our economic agenda with India.

Unfortunately, India's most recent budget fails to address these core issues. While it imposes some mild spending cuts and tax increases that will lower the federal budget deficit slightly, it falls short of introducing significant new revenue sources, ending India's extensive subsidy regime, or closing failed government banks. Furthermore, the 28% increase in defense spending will draw resources away from human and infrastructure development. With this status quo budget, India has deferred important and necessary reforms for another year.

Given India's size, its prominence in world affairs, and its enormous potential, the U.S. has a strong interest in developing closer economic relations with India. On your trip, you will introduce a process to begin that broader coordination. You will want to emphasize our commitment to more active engagement, and encourage the Indian authorities to move forward on issues of interest to the international community, such as WTO.

You should also be aware that the Indian officials are likely to focus their attention on the economic sanctions imposed after the nuclear tests in 1998. These sanctions direct us to oppose non-basic human needs lending from the international financial institutions to any country that tests a nuclear device. We still support the sanctions policy and continue to implement it. However, the sanctions have become increasingly ineffective since some G7 partners no longer vote to oppose the loans on these grounds, which has allowed some of the loans to proceed.

Pakistan

Pakistan's economic position is extremely weak. Years of corruption and mismanagement have undermined the economy at a fundamental level. Political instability and commercial disputes keep foreign investment in Pakistan low, and foreign reserves are only $1.2 billion, enough to cover just four weeks of imports. Three-quarters of all public expenditure is devoted to debt servicing and the military budget. Despite bilateral and commercial debt rescheduling and a successful Eurobond exchange last year, Pakistan has failed to improve its financial position. There has been little substantive economic reform under the Musharraf government, and none is expected at least until the new budget is released in June. Our greatest economic priority in Pakistan, therefore, is to convince Musharraf that he must move quickly to establish a credible economic record and attract investment. Otherwise, Pakistan's economic situation can only continue to deteriorate and there will be little the international community can do to help.

In your meetings, Pakistani officials are likely to focus on the economic sanctions that have been in place since the nuclear tests (the same sanctions that apply to India). In December 1998, you signed a waiver that allowed us to vote for international financial institution loans in support of Pakistan's IMF program. However, by June 1999 Pakistan had already failed to meet the IMF program's economic reform criteria and we therefore did not renew the waiver when it expired in October 1999. Pakistan still has not met those economic targets, nor has it made progress on the other economic and political issues that might justify a waiver. Furthermore, Fund staff believe that the previous government falsified economic data in order to receive some loan disbursements from the IMF, in which case Pakistan may be forced to pay back the loans early.

Bangladesh

Bangladesh will be the first country to benefit from programs under the Tropical Forest Conservation Act (TFCA). As such, Bangladesh will be a showcase as Congress considers the Administration's FY 2001 request of $37 million for this program. The TFCA is an environmental program that leverages a country's concessional debt obligations to the United States in conserving and restoring tropical forests. However, you should be aware that the program only provides very modest debt reduction overall. For example, under one possible scenario, Bangladesh could reduce its debt to the United States by $3 million, keep $8 million of its debt service within the Bangladesh economy in support of a tropical forest fund, and reduce debt service requirements by $4 million over the next 20 years. Its main effect is to free financial resources to endow the fund for tropical forest preservation in Bangladesh. Though Bangladesh is very poor, it is not considered a heavily indebted poor country (HIPC). Bangladesh has benefited from large levels of grants from the international community. Its level of debt is much lower than that of the HIPCs and not considered a constraint on development.

We have received a formal letter from the government of Bangladesh accepting our invitation to participate in the program. Treasury has begun negotiating with Bangladeshi officials on a possible debt agreement in support of its participation in the TFCA. For the current fiscal year, Congress appropriated $13 million for the TFCA, of which we would plan to use $6 million to support Bangladesh's participation. As of the end of 1999, Bangladesh had $467 million total outstanding concessional debt to the U.S. government (all PL-480 debt).

2000-SE-002941

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

March 17, 2000

ACTION

MEMORANDUM TO SECRETARY SUMMERS

FROM Under Secretary Geithner TFG

SUBJECT Memo to the President about his Trip to South Asia

ACTION-FORCING EVENT

The President departs on Saturday for a week-long trip to South Asia. The attached memo from you to him highlights Treasury's main issues in each of the countries he will visit.

RECOMMENDATION

That you sign the attached memorandum to the President

__✓__ Agree _____ Disagree ______ Let's Discuss

BACKGROUND

The President will visit India, Pakistan, and Bangladesh next week (March 20-24), departing from Washington this Saturday. The attached memo highlights for the President the most important Treasury issues in each country. We have also provided more detailed background and talking points (where appropriate) on these issues for the President's briefing book.

ATTACHMENT

TAB A: Memorandum to the President for your signature

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Friday, March 17, 2000

PROFILE #: 2000-SE-002941

DATE CREATED: 03/17/2000

ADDRESSEE: Lawrence H. Summers
Secretary

AUTHOR: Geithner, Timothy F.
US, International Affairs

SUBJECT: Memo to the President About His Trip to South Asia

ABSTRACT: Memo to the President about his trip to South Asia

RM 3419

TO REVIEWERS

IN:

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

DISTRIBUTION: AS, INTERNATIONAL AFFAIRS

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LS signed
NCC/TR original to WH
NCC cc to SE (reading)
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TS
3/20/00 ck
NC/PH/AK/TR
Please file as CLOSE HOLD

2000-se-010853

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

NOV 8 2000

ACTION

MEMORANDUM FOR SECRETARY SUMMERS

FROM: Edwin M. Truman EMT
Assistant Secretary
International Affairs

SUBJECT: APEC Leaders Meeting: Memo to the President

Attached is a memorandum for the President that covers the economic outlook for the APEC region, economic and financial themes that the President should emphasize, and points the President should raise in his bilateral meetings with China, Japan, Korea, Indonesia, Russia, and his subsequent trip to Vietnam.

RECOMMENDATION:

That you sign the attached memorandum.

11/9/00

NCC ok to autopen per LS

_______ Agree _______ Disagree _______ Let's Discuss

ATTACHMENT:

Tab A: Memorandum for Your Signature

EXECUTIVE SECRETARIAT

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (5 pages)	11/09/00	P5

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EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Thursday, November 09, 2000

PROFILE #: 2000-SE-010853

DATE CREATED: 11/09/2000

ADDRESSEE: Lawrence H. Summers
Secretary

AUTHOR: Truman, Edwin M.
International Affairs

SUBJECT: APEC Leaders Meeting: Memo To The President

ABSTRACT: APEC Leaders Meeting: Memo to the President.

RM 3419

TO REVIEWERS

IN:

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

DISTRIBUTION: AS, INTERNATIONAL AFFAIRS

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11/9/00 TS

TR autopenned +
original to WH 11/9/00

11/09/2000 08:58:15 AM

TREASURY CLEARANCE SHEET NO.

Date 11/07/00

MEMORANDUM FOR: ■ SECRETARY ☐ ASSISTANT SECRETARY
☐ EXECUTIVE SECRETARY

■ ACTION ☐ BRIEFING ☐ INFORMATION
☐ LEGISLATION ☐ PRESS RELEASE ☐ PUBLICATION
☐ REGULATION ☐ SPEECH ☐ TESTIMONY

FROM: Edwin M. Truman
Assistant Secretary (International Affairs)

SUBJECT: APEC Leaders Meeting: Memo to the President

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance	☐ Enforcement	☐ Policy Management
☐ Domestic Finance	☐ ATF	☐ Scheduling
☐ Economic Policy	☐ Customs	☐ Public Affairs/Liaison
☐ Fiscal	☐ FLETC	☐ Tax Policy
☐ FMS	☐ Secret Service	☐ Treasurer
☐ Public Debt	☐ General Counsel	☐ E & P
☐ Inspector General	☐ Mint	☐ Under Secretary (International)
☐ IRS	☐ Savings Bonds	☐ Legislative Affairs
☐ Management	☐ Other	☐ OCC

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
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CMcCoy	CM/lm	11/7	INA	622-0337
REVIEWERS				
RJohnston	RJ/lm	11/8	IMI	622-1539
ABaukol	AB/lm	11/8	ICN	622-0603
DLoevinger	DL	11/8	INA	622-0138
ABerg	[illegible]	11/8	IN	622-0070

BRAZIL

1997-SE-011062

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 18, 1997

INFORMATION

MEMORANDUM FOR Deputy Secretary Summers

FROM: David Lipton

SUBJECT: Risks to Brazil's Financial Stability

Summary

Brazil's recent taming of inflation has come at the cost of high external imbalances, but the Brazilian government will probably be able to maintain financial stability through its November 1998 elections.

In just three years, Brazil has gone from 800 percent annual inflation to an expected rate of 5.8 percent in 1997. Monetary policy has borne the brunt of the stabilization effort, as the central government has so far been unwilling to clamp down on the local and state spending responsible for a fiscal deficit of 3.5 percent of GDP (operational). High interest rates resulting from the government's macroeconomic policy mix, together with extensive privatization offerings, have attracted strong foreign exchange inflows that have supported a significant real appreciation of the currency and financed both a current account deficit of 4.5 percent of GDP and a buildup of foreign reserves from $60 to $64 billion this year. Constrained by the high and rising real interest rates (currently about 14 percent), GDP growth will probably be less than 4 percent in 1997.

The current policy mix seems likely to continue through the November 1998 elections, as the government remains committed to attacking inflation, a goal that has thus far enjoyed strong popular support. In the meantime, however, Brazil's high current account deficits raise the question of the country's financial vulnerability. A tightening in world liquidity conditions could significantly raise the cost of financing the current account deficit, reducing foreign exchange inflows, raising domestic interest rates, and prompting a rapid depreciation of the currency.

Our judgment is that the risk of financial disruption over the next year is fairly low. Brazil's external financing requirement this year is composed of its $35 billion expected current account deficit plus $22 billion in amortization payments on a net external debt of about $190 billion. Next year looks similar as the current account deficit may rise slightly while required amortization payments will fall. With the exception of state financial institutions, financial sector reform has left the banking sector looking relatively healthy. Moreover, confidence in the Real Plan seems to have been strengthened by the relative ease with which Brazil survived this summer's Asian currency crisis. Marcel Carvalho of J.P. Morgan and Paolo Leme of Goldman Sachs both rate the chances of a maxi-devaluation (15-20 percent) next year at less than 20 percent

Although the Real Plan looks sustainable through next year's presidential elections, high real interest rates will continue to constrain growth. Following the elections, the government will be obliged to conduct a serious fiscal reform to increase net savings to help close the current account gap, and to allow the central bank to relax interest rates without renewing inflationary pressure.

Brazil Focus

Selling Assets to Postpone Fiscal Adjustment

Paulo Leme (902-9711)
August 19

Introduction

The currency turmoil in Asia has heightened investor concerns about the sustainability of exchange rate regimes in countries running large current account deficits. In this context, investors are wondering if the current account and fiscal deficits in Brazil will eventually force the central bank (BACEN) to devalue the exchange rate. In our opinion, BACEN is likely to maintain its exchange rate system unchanged in 1997 and possibly 1998.

The stabilization program implemented by the Cardoso Administration has been remarkably successful in reducing inflation. However, tangible progress regarding fiscal adjustment has been disappointing. Deprived of fiscal adjustment, the government has allocated the exchange rate to achieve its internal policy objective (reduce inflation), overburdening monetary policy with the task of achieving external objectives (balance of payments).

This uneven policy mix to lower inflation has high costs: Real GDP growth will have to remain subdued, while Brazil is becoming increasingly dependent on external financing. In addition, the economic team has lost degrees of freedom regarding its ability to defend the currency against external shocks that would reduce global liquidity or domestic shocks. The first line of defense against a speculative attack is likely to be the immediate use of up to 20% of its US\$63 billion in international reserves because BACEN's ability to raise interest rates has diminished; higher interest rates worsen the operational fiscal deficit because the stock of gross domestic public debt has soared since 1994. Higher interest rates would also reduce growth and disturb an otherwise successful consolidation of the banking system.

Cognizant of the constraints noted above, the economic team has wisely launched the largest privatization program in the emerging market world, adding credibility to the Real plan and raising unprecedentedly large amounts of external financing. This allows the government to buy time until it is able politically to implement the long-overdue fiscal adjustment in 1999. Therefore, despite large fiscal and external imbalances, it is unlikely that a speculative attack would succeed against the real in 1997. Nonetheless, such a risk could rise somewhat into 1998 if G3 tighten global liquidity conditions or if weaker financial policies widen the Brazilian current account deficit and erode the credibility of the Real plan.

Developments in 1997

Political Developments

In our opinion, the premature focus on the 1998 presidential elections diverted valuable political capital from the hard task of restructuring the Brazilian public sector. The main government priority was to secure the constitutional amendment enabling President Cardoso to run for a second term on October 3, 1998. Congress approved the amendment in June. Without a clear contender, President Cardoso likely will be re-elected, ensuring policy continuity in 1999.

Focus on the re-election and internal disputes within the ruling coalition delayed administrative and social security reforms. More recently, Congress has focused to the reform of the election code, a task that will consume significant time and draw attention away from economic reforms. In all, there is only a small chance that Congress will approve the administrative and social security reforms before it enters a prolonged recess that will begin February 1998. Therefore, the government will not have the required tools to deal with the structural components of the fiscal deficit until 1999. On a more positive note, following approval of the laws regulating and enabling privatization in the telecommunications and oil sectors (excluding state oil company Petrobras), we expect Congress to approve the fiscal stabilization fund (FSE) before November and extend the financial transactions tax (CPMF) for another year. The FSE limits the fiscal deficit by effectively excusing the federal government until year 2000 from making some R\$28.0 billion (3.5% of GDP) in constitutionally-mandated transfers to state and municipal governments. Congress is also likely to approve an important bill establishing the framework to stimulate private financing to construction (SFI).

Fiscal Policy

Since the beginning of the Real plan in July 1994, fiscal policy weakened continuously until the third quarter of 1996. Since then, there has been a modest improvement in the primary position of the consolidated public sector (Chart 1). According to BACEN data, in the 12-month period ended May 1997, the primary fiscal balance shifted to a marginal surplus of 0.1% of GDP from a deficit of 0.8% a year earlier. The federal and state governments contributed, improving about 0.4% of GDP each. Notwithstanding increases in their operating surpluses resulting from large increases in public utility tariffs, the primary position of state enterprises improved only the equivalent of 0.2% of GDP, reflecting the investment of operating surpluses in preparation for privatization.

Within the federal government, Treasury finances improved, while better administrative efforts by the social security (INSS) reduced its primary deficit by the equivalent of 0.1% of GDP. Regarding the Treasury, total real revenue increased 5.5% in the year through June 1997 from a year ago. This primarily reflects the introduction of the CPMF since January 1997; excluding the CPMF, real tax revenue fell 0.3%. Real non-interest outlays fell 2.6% from a year ago. Freezing public sector wages for the last two years accounts for the 7.7% decline in the Treasury's nominal wage bill. However, earmarking CPMF revenue for investments in health accounts for the 34.7% surge in investment outlays (a drop of 3.5% excluding investments financed by CPMF).

There are statistical problems related to the assessment of the federal government's performance. Measured from above the line (the difference between revenue and non-interest expenditure), the federal government's primary surplus improved the equivalent of 0.6% of GDP in the first half of 1997 from a year ago. However, the primary balance of the federal government worsened by the equivalent of 0.3% of GDP measured below the line (on the financing side). The statistical discrepancy amounts to 0.9% of GDP. The closer reality is from measured data from above the line, the closer the government will be from achieving its target of doubling the federal government's to primary balance 0.8% of GDP in 1997. In all, we believe that the federal government will keep its primary surplus unchanged at 0.4% of GDP in 1997. Regarding the INSS, we expect an increase in pension benefits to worsen its primary deficit to R$3.0 billion (0.4% of GDP), compared with a deficit target of R$2.0 billion.

Turning to state governments, their primary deficit was cut the equivalent of 0.4% of GDP to a deficit of 0.2% of GDP in the 12 months ended May 1997. This improvement is attributable to the adjustment program negotiated between the Ministry of Finance and state governments. Following decades of mismanagement, most state governments have become either bankrupt (Alagoas) or unable to meet their payroll or debt service obligations. As a result, the adjustment program includes a debt-restructuring module (the equivalent of an internal Brady debt-restructuring plan) and a cash-flow adjustment

Chart 1: Primary Fiscal Balance

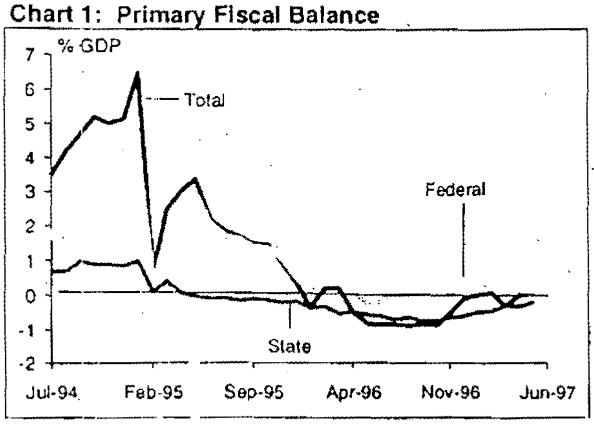
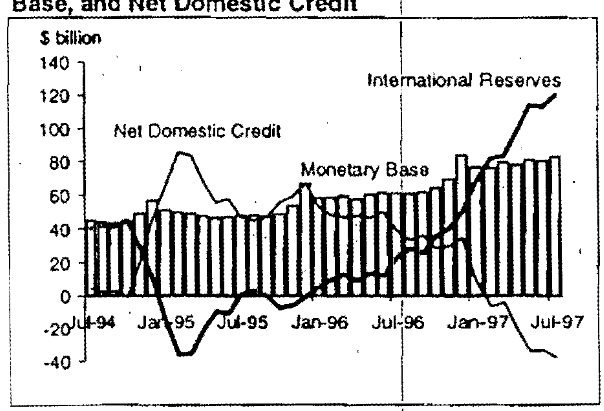


Chart 2: Mexico - Reserves, Monetary Base, and Net Domestic Credit



component (the equivalent of an internal IMF adjustment program). Of the 27 state governments, 19 have signed a preliminary agreement for the adjustment and debt-restructuring programs with the federal government, but only São Paulo signed a final agreement on May 22. We expect Minas Gerais, Rio Grande do Sul, and Rio de Janeiro to finalize their agreements by the deadline of September 30.

The debt module aims at restructuring some R$130.0 billion (16.3% of GDP) in state government debts to the federal government, BACEN, and commercial creditors. The state governments agree to pay 20% of their debts in cash, while the R$103.3 billion balance will be paid to the Treasury in the form of a 30-year bond paying IGP-DI plus a spread of 600 basis points (bp). In exchange, the federal government will take over the debt obligations of state governments and their state banks. Since state governments have no cash, they will have to surrender to the federal government ownership or shares of state-owned public utility companies. The largest debt restructuring program is for the state of São Paulo, amounting to R$50.4 billion. It must be noted that the restructuring program will raise the stock of federal government debt some R$102 billion to R$222.8 billion (27.9% of GDP). In theory, such an exchange of debt instruments will keep the federal government's net worth unchanged. However, the program will have a recursive fiscal cost for the federal government resulting from the fact that the Treasury will have to issue debt at the SELIC interest rate and get paid only IGP-DI plus 6.0%. In addition, the Treasury will have to take one-time costs at the close of each state restructuring program. In all, we estimate that the annual fiscal cost for the Treasury will amount to just under 1.0% of GDP.

To be eligible for the debt restructuring program, state governments must meet two conditions imposed by the adjustment module. First, they must achieve primary fiscal surpluses that are large enough to service their restructured debt. The new bonds have been structured in a way so that total debt service corresponds to at least 11.0% of the state's net revenue (13.0% for São Paulo). It will be extremely difficult for state governments to improve their primary balances without congressional approval of the administrative reform; it will be only with this reform that states will be able to fire public employees whenever their payroll exceeds 60% of revenue (Lei Camata). Over two-thirds of state governments would be eligible to fire civil servants under the Lei Camata.

Second, the federal government has completely eliminated state governments' abilities to obtain financing. They have placed binding ceilings on commercial bank borrowing pledging state revenues (AROs) as well as on promissory notes (precatorios). As part of the agreement, state governments cannot borrow from their state banks; the state banks must either be privatized (BANAERJ, Credireal) or closed (Produban). We expect the government to privatize the largest state bank (BANESPA) by early 1998. Finally, the states cannot borrow against the balance sheet of their state electricity companies (as they are being privatized). The Constitution prohibits state governments from borrowing abroad.

Chart 3: Thailand - Reserves, Monetary Base, and Net Domestic Credit

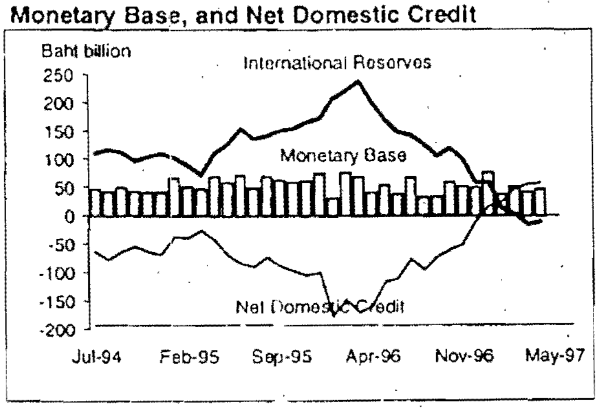
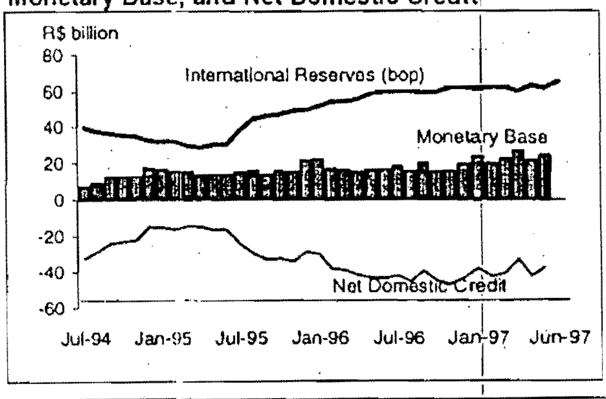


Chart 4: Brazil - Reserves, Monetary Base, and Net Domestic Credit



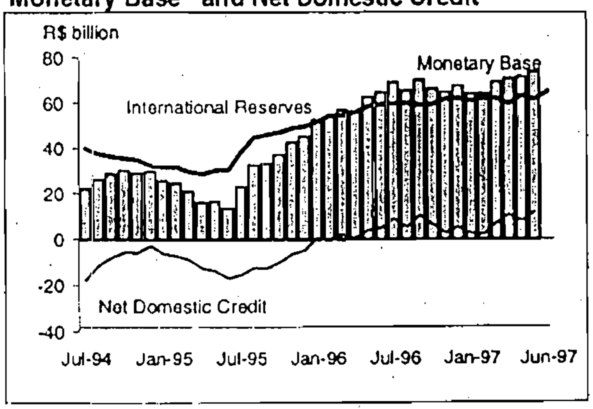
Three factors could worsen fiscal performance ahead of the 1998 elections: (1) wage increases for civil servants; (2) minimum wage increases (which impacts the INSS); and (3) higher investment spending by the federal and state governments. While the economic team is braced to resist such pressures, history shows that this will be a vulnerable flank for the Real plan in 1998. For example, in the 1998 budget proposal, the government assumes a 10% wage increase to civil servants at the cost of 0.5% of GDP. We are particularly concerned about the likelihood that the São Paulo government will use the proceeds of its privatization program to invest in public works. An additional risk worth monitoring is the likely supreme court ruling for a 28% increase in wages for the entire civil service. At this point, the only uncertainty regarding this ruling is when and by how much it will increase wages. The Treasury believes that the final ruling will not be effective until 1998, and it will not have to pay the full 28% increase because some worker categories have already received pay raises. In any event, under the new budget system, there is some room for higher spending resulting from a 15% underexecution of the budget.

Monetary Policy and Banking System
The stance in monetary policy will be critical in deciding whether Brazil will be at risk of experiencing a balance of payments crisis like Mexico or Thailand. While credit policy in Brazil has been mildly expansionary, it neither exhibits the pattern nor the strength of the virulent credit expansion that contributed to the drop in the Mexican peso in 1994 and the Thai baht in 1997. Charts 2 and 3 show that the Mexican and Thai central banks sterilized the drop in the demand for monetary base and outflows of net international reserves (NIR) by expanding net domestic credit (NDC) This is characterized by an X pattern in Charts 2 and 3 that plot NDC versus NIR. While credit has been expansionary in 1997 in Brazil, we do not see the X pattern yet that precedes speculative attacks against a currency (Chart 4). The expansion of NDC in Brazil is more visible if we define this aggregate as the difference between NIR and a broader base money that includes the stock of BACEN bonds (Chart 5).

In Brazil, in June 1997, the monetary base and narrow money (M1) expanded 46.7% and 59.4% year on year, respectively from a 3.1% contraction and a 4.6% expansion in December 1996. The sharp increase in such aggregates simply reflects a portfolio shift toward narrow money (resulting from the transactions costs in holding broad money from the imposition of the CPMF tax on financial transactions). Consistent with this shift, the growth rate of broad money (M4) slowed to 25.4% year on year in June 1997 from 28.5% in December 1996.

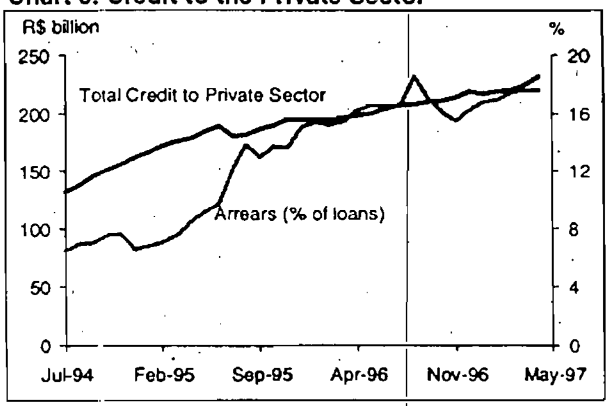
The main source of monetary base expansion has been BACEN's assistance to banks under the restructuring program, PROER. With the restructuring of three large private banks and actual/prospective privatization of state banks, the Brazilian banking crisis is almost over. If we include the capitalization costs of Banco do Brasil and BANESPA, the restructuring of the Brazilian

Chart 5: Brazil - Reserves, Extended Monetary Base[1/] and Net Domestic Credit



1/ Monetary base plus Central Bank debt.

Chart 6: Credit to the Private Sector



banking system will cost the government about 5.0% of GDP, compared with 17.0% of GDP in Venezuela, and 12.0% in Mexico. In addition, Brazil is likely to recover at least 2.0% of GDP with the sale of the collateral posted by banks to PROER.

Financial system credit to the private sector abated to 16.6% year on year in May 1997 from 17.4% in December 1996 (Chart 6). However, financial system credit to households more than doubled since December 1996 to 106.6% year on year in May 1997. This largely accounts for the strength in domestic demand and imports of consumer durables. It must be noted that credit expansion has abated somewhat since May, as loan delinquencies have increased to almost 18.7% of total bank loans. Also, the ratio of financial system credit to private sector total credit is less than half that observed in Argentina in 1994. In addition, the ratio of financial system credit to GDP is more than five times smaller in Brazil than in Thailand or Malaysia (Chart 7).

The pursuit of a slightly expansionary credit policy, combined with the sharp drop in spreads in U.S dollar-denominated Brazilian sovereign debt, has been reflected in a sharp drop in the dollar coupon. The dollar coupon is the local interest rate on SELIC-CDI adjusted for expected devaluation and taxes. Since January 1995, the dollar coupon has dropped 4910 bp to about 10.9% in June. As a result, since mid-1996, there has been a net cumulative outflow of US$3.3 billion in fixed income investments out of Brazil (Chart 8) through the floating exchange rate market. This shows that BACEN has exhausted its room to reduce domestic interest rates. This suggests that in order to protect its reserves and support the exchange rate, BACEN likely will be more prone to raise (rather than reduce) domestic interest rates beyond September 1997.

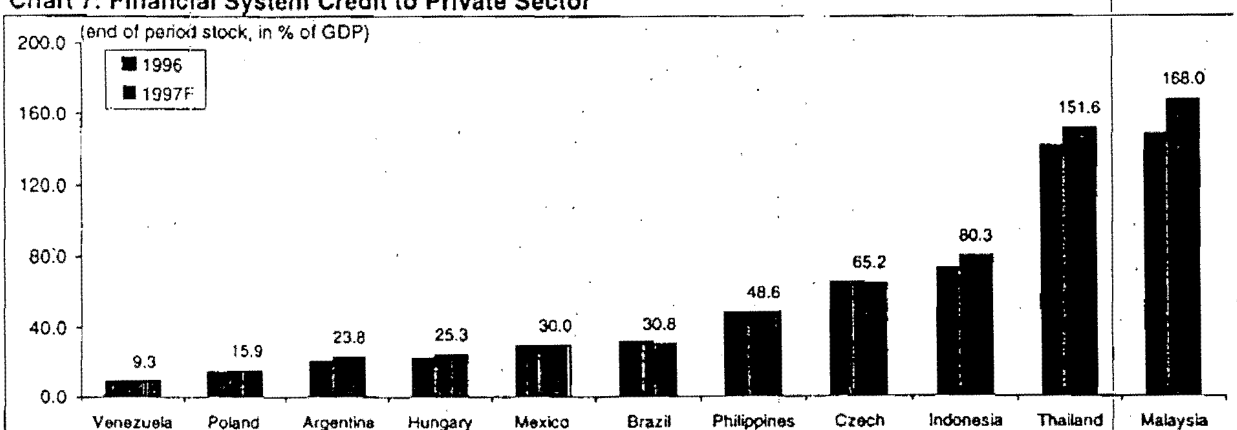
Economic Activity and Prices

Low and volatile growth has been one of the main adverse consequences of the uneven Brazilian policy mix, with economic activity remaining quite erratic in 1997. Following a seasonally adjusted contraction of 0.6% of GDP in the first quarter of 1997 (from the fourth quarter of 1996), real GDP expanded 3.3% in the second quarter. In the first half of 1997, economic activity was quite robust in the agricultural, construction and industrial sectors, while the most dynamic component of aggregate demand was private consumption, financed by credit and stable real wages. Strong imports were unmatched by modest export growth, thus representing an important drag on real GDP.

However, there are signs that economic activity will remain more subdued in the second half of 1997; consumer demand and industrial output already show signs of abating, while inventory accumulation is reducing the pace of auto production, the main engine behind industrial activity. Sales of electronic goods have also decelerated since June. Nonetheless, these decelerating forces will be somewhat offset by a pickup in construction and investments and production of capital goods.

Following the de-indexation of the economy, the partial use of the exchange rate as an anchor, and the switch from monetary to debt financing of fiscal

Chart 7: Financial System Credit to Private Sector



deficits have been the main reasons for the spectacular drop in the annual rate of consumer price inflation (CPI-FIPE) to 5.8% in July. An additional factor that has reduced inflation is the higher degree of openness in the economy; this has allowed lower external prices to influence domestic price formation. More recently, prices of nontradables (services) have been rapidly converging on the prices of tradable goods. This should help limit the appreciation of the real exchange rate and the government reduce the annual inflation rate to 5.0% in 1998. Another factor that precluded an even faster drop in the rate of inflation was the large increases in public utility prices in preparation for privatization of state enterprises. Given that the government has concluded the realignment of public utility tariffs, this increases the likelihood that from here on the monthly rate of inflation will be extremely low or even negative. In fact, in July, the monthly rates of inflation measured by the IPC-FIPE and IGP-M were -0.2% and 0.1%, respectively.

Balance of Payments

The sharp deterioration in the external current account has been the other adverse consequence of the uneven policy mix. Since 1992, the current account balance has worsened almost 5.0% percentage points of GDP to a deficit of 3.3% of GDP in 1996. About two-thirds of this deterioration is explained by fiscal dissavings, while the rest is attributable to a drop in private savings resulting from a 35% increase in real wages and the surge in consumer credit. What is worrisome about this deficit is not its level, but the fact that it has been accompanied by low growth without a pickup in investment.

The deficit in the current account almost doubled to US$18.9 billion in the year through July 1997 from a year ago because public and private savings continued to fall. This implies that year on year, the current account deficit increased to 4.4% of GDP. About half of this deterioration is attributable to a nine-fold increase in the trade deficit to US$5.5 billion, while one-third of the deterioration is explained by increased outflows of profits and dividends. The latter reflects the fact that over the last three years there has been a six-fold increase in inflows of long-term direct foreign investment (DFI) to US$13.3 billion in July, thus allowing DFI to finance almost half of the current account deficit. However, it is also true that such a reliance on DFI has increased the sum of interest payments and dividends to over one-third of exports, thus making it structurally hard for the government to quickly reduce the deficit if there is a future drop in external financing.

Regarding the composition of the trade deficit in the year through June, it is worth highlighting that export growth has recovered somewhat, to 8.2% from a year ago and only 2.7% in 1996. This is mostly attributed to a 34.8% increase in commodity exports, reflecting a bumper crop and strong international commodity prices. This also shows how elastic Brazilian exports are to changes in relative prices, as commodity exports are responding to elimination of the ICMS tax levied on primary exports. In contrast, manufactured exports have dropped 1.2% in volume terms in the period, which reflects an overvalued exchange rate and the 35% increase in the wage bill in manufacturing. Data through July indicates that total export growth accelerated to 9.7%, while the volume of manufacturing exports increased somewhat. In the year through June, import growth accelerated to 26.9% from 6.9% a year ago. During this period, the fastest growing imports were consumer goods (40.0%), of which durable goods and automobiles increased 60.3% and 110.0%, respectively; capital goods increased 38.3%; and intermediate inputs rose 21.1%.

Propelled by sharp increase in DFI and bond issuance by private and public issuers in international capital markets, net capital inflows increased US$2.4 billion to US$19.8 billion in the year through July 1997 from a year ago. Strong gross inflows more than offset the US$7.8 billion increase in scheduled amortization payments to US$22.3 billion in 1997, of which US$14.5 billion corresponds to private maturities. The bulk of net capital inflows corresponded to DFI (US$8.8 billion), followed by bond issuance by both the private and public sectors, and some US$4.0 billion in net equity inflows through the Annex IV facility. The drop in the dollar coupon led to net capital outflows of fixed income investments on the order of US$1.7 billion in 1997.

Chart 8: Net Capital Outflows (floating) and Interest Rates (Cupon Cambial on CDI)

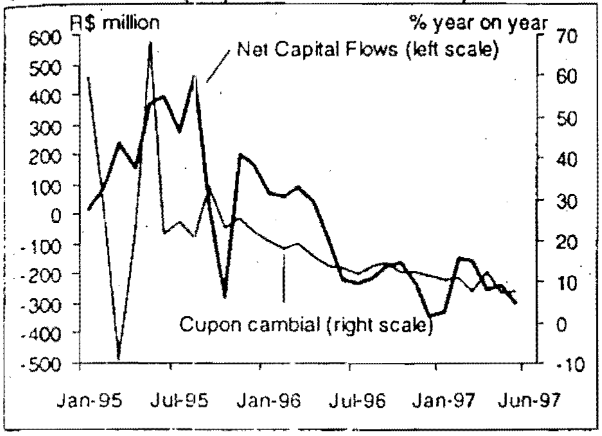
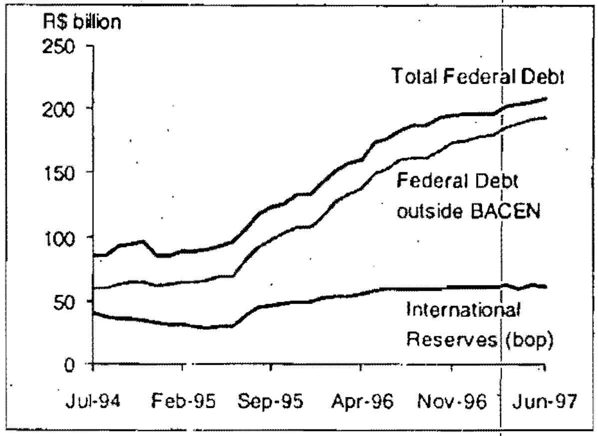


Chart 9: Brazil - Total Federal Debt Debt Outside BACEN vs. Reserves



In all, net international reserves (balance of payments concept) increased US$201 million in the year through July. However, in view of a pickup in privatization revenue, international reserves recovered to US$63.0 billion as of August 15. At 9.2 months of cover of imports of goods and nonfactor services, such a reserve level is quite high to allow BACEN to defeat speculative attacks against the exchange rate.

While impressive, such a reserve cover level is only adequate inasmuch as the Real plan remains credible and investors believe that there is only a small probability of a large devaluation. BACEN's reserves are not large as they seem on first inspection to cover the stock of R$194.9 billion (24.4% of GDP) in domestic public debt outside BACEN (Chart 9). The stock of federal debt is highly liquid, posting an average maturity of 6.9 months, with about 10% of it corresponding to Treasury bills indexed to the exchange rate (NTN-Ds), resembling in many respects the Mexican Tesobonos. In addition, over the last five years, the Brazilian private sector has borrowed some US$40 billion abroad to invest in federal debt instruments. Given that the private sector is long reais and short U.S. dollars, they are the most likely investors that would initiate an attack against the currency. In case investors perceive an increase in the probability of a devaluation, another potentially destabilizing factor is US$37.2 billion in foreign equity investments through the Annex IV facility.

Exchange Rate Policy

According to our GSDEEMER methodology, as of June 1997, the real exchange rate was 12.8% overvalued relative to its long-term equilibrium level. According to the research institute IPEA, since the introduction of the Real plan (1) the trade-weighted real exchange rate has appreciated 18.4%; and (2) competitiveness measured by the ratio between the real effective exchange rate and wages in manufacturing fell 42.0%.

BACEN's strategy to recover competitiveness without a discreet devaluation is to maintain its exchange rate policy to gradually depreciate the exchange rate 60 bp a month. Under such a strategy, BACEN could bring the real to fair value in just over three years if (1) the annual rates of inflation amount to 6.0% in Brazil and 2.5% in industrialized countries; and (2) the exchange rate remains stable between the U.S. dollar and the German mark and the Japanese yen. If we consider that over the last three years, labor productivity has averaged about 4.5% annually in Brazil, such a strategy could bring the real exchange rate back to fair value in just over two years. More recently, the real exchange rate has appreciated 4.0 percentage points because of the strength of the U.S. dollar against the German mark and the Japanese yen. However, we believe that BACEN will automatically recover such a loss because we expect that until June 1998 the U.S. dollar will depreciate to DM1.60 per U.S. dollar and ¥110 per U.S. dollar.

Privatization Program[1]

Once the government jumped the political hurdle of privatizing state mining company CVRD, the privatization program gained an impressive momentum. More recently, the economic team obtained President Cardoso's pledge to strictly use privatization revenue to retire domestic public debt. In May, the government used about half of the proceeds from the privatization of CVRD (US$1.8 billion) to retire domestic federal debt.

As of early August, privatization revenue in 1997 and since the beginning of the program in 1990 amounted to US$18.0 billion and US$35.0 billion, respectively. According to Minister of Finance Malan, privatization revenue could reach US$25 billion for full-year 1997. This would include completion of the privatization of the cellular phone business (B-band), the sale of Petrobrás shares for the equivalent of US$6.0 billion, and the sale of the remaining government shares in Light, Ecelsa, and CVRD. For the fourth quarter, we also expect the privatization of four state-owned electricity companies: Energipe, CEMAT, Enersul, and COSERNE.

For 1998, the government expects to privatize the A-band of telecommunications, including the entire Telebrás system (27 state telephone companies and Embratel), in the second quarter. In addition, the government plans to make significant progress regarding privatization of the electricity sector. For example, state development bank BNDES expects to privatize Furnas, ELETROSUL, ELETRONORTE, CHESF, CESP, CPFL, and Eletropaulo. In all, forthcoming revenue from privatization could exceed US$25 billion in 1998, totaling US$85 billion by the year 2000.

Outlook for the Rest of 1997 and 1998

We believe that the government will continue to make spectacular progress in privatization. However, constrained by the presidential elections, the government will only be able to muddle through regarding fiscal policy until the end of 1998. In light of recent currency developments in Asia, we believe that the economic team is keenly aware that it cannot ease monetary policy and lower interest rates, otherwise this would widen the current account deficit and encourage capital flight. As a result, it is unlikely that the government will ease monetary policy beginning in the fourth quarter of 1997 to increase real GDP ahead of the 1998 elections.

In light of developments through August, we believe that the primary fiscal surplus will close at 0.6% of GDP, or slightly below our initial forecast of 0.8% of GDP. We have also lowered our forecast for real GDP growth to 3.4% from 4.0%, while we have reduced our end-of-period inflation forecast to 5.8% for 1997 from 7.5%. This will allow Brazil to post one of the lowest annual rates of inflation in Latin America (after Argentina, Panama, and Chile). However, fiscal adjustment is a necessary condition for Brazil to keep such a low rate of inflation in coming years.

In line with lower inflation, we reduced our forecast for the benchmark interest rate (CDI-Over) to 18.6%. We kept our forecast for the current account deficit at 4.5% of GDP, but we lowered the trade deficit forecast to US$11.5 billion from US$12.0 billion. In view of the accelerated privatization program, we have increased the stock of international reserves forecast for the end of December 1997 to US$65 billion from US$56 billion. Given that we believe BACEN will successfully defend its exchange rate policy, our exchange rate forecast remains R$1.11 per U.S. dollar for yearend 1997.

In 1998, we believe that the economic team will have a difficult task to avoid deterioration in the fiscal and external accounts. As a result, we forecast that the primary fiscal surplus will drop to 0.3% of GDP in 1998, while the marginal fiscal stimulus will accelerate real GDP growth 4.0%. However, a prudent stance in monetary policy is likely to result in an additional drop in the annual rate of inflation to 5.0% in 1998.

Consistent with the drop in the primary fiscal surplus, we forecast an increase in the current account deficit to 4.8% of GDP in 1998; the trade deficit is projected to increase to US$16.0 billion. In light of the scale of the privatization program,

[1] For a full description of the privatization program, see the June 24th *Emerging Markets Biweekly*, "Brazil – Privatization: Necessary But Not Sufficient".

such a current account deficit should be financeable in 1998, particularly if G3 countries only moderately tighten monetary policy. To this end, the Brazilian government must keep its privatization program on the fast track to attract the large amounts of external financing required and maintain credibility.

Under these assumptions, Brazil should be able to obtain US$53 billion in gross external financing it will need in 1998, or US$10.0 billion less than 1997. Notwithstanding the increase in the current account deficit, the drop in external financing needs simply reflects a US$10 billion drop in scheduled amortization payments in 1998. Brazil should be able to (1) obtain US$27.5 billion from the combination of direct foreign investment and privatization revenue; (2) tap international capital markets for some US$20.0 billion (from a projected US$25 billion in 1997); (3) attract US$2.5 billion in portfolio inflows (mostly equity); and (4) increase trade credit lines US$3.0 billion. Under this scenario, BACEN would keep its stock of international reserves unchanged at US$65 billion. In addition, BACEN would keep its current exchange rate policy, allowing the nominal exchange rate to close 1998 at R$1.19 per U.S. dollar. Such a policy will allow Brazil to recover at least 5.0 percentage points of external competitiveness.

Taking a longer-term perspective, it is evident from the fiscal and external imbalances[2] discussed above that the government cannot continue to rely on external financing to postpone the adjustment effort that it has not made under the Real plan. Quite simply, the government cannot allow the current account deficit and the stocks of external domestic public debt to rise indefinitely; otherwise, it risks a balance of payments crisis once its external and fiscal liquidity and solvency positions become unsustainable.

[2] This paragraph draws in part from an interesting study by Fabio Giambiagi entitled " A condição de estabilidade do coeficiente de endividamento externo: cálculo do requisito de aumento das exportações no Brasil", BNDES, July 4, 1997. However, we are responsible for the policy conclusions expressed herein.

Without fiscal adjustment, a discreet devaluation would be extremely counterproductive, leading to higher inflation and no change in the real exchange rate. In our opinion, in order to secure fiscal and external solvency, Brazil must start by implementing a primary fiscal adjustment effort equivalent to 3.5% of GDP and use all the projected proceeds from privatization (some US$85 billion) to reduce the stock of federal public debt by 10.5% of GDP. The primary fiscal surplus and lower debt ratios would reduce the Brazilian risk premium and crowd in private investment. Such a fiscal adjustment would allow Brazil to grow 5.0% annually while reducing its current account deficit to a sustainable 2.0%-2.5% of GDP. In order to complete such an adjustment within five years, the government has to boost export growth to at least 13.5% a year from the current 9.7% (in July). This implies that within the next five years, the government must depreciate the real effective exchange rate some 20%. In the absence of large external financial shocks, the current strategy of gradually depreciating the exchange rate, combined with a weaker U.S. dollar, should be sufficient. However, this will require that the government's economic program strengthens credibility through implementation of the fiscal adjustment and debt-reduction programs suggested earlier.

Investment Considerations and Risks

Based on our muddling-through scenario, we believe that for the rest of 1997, Brazilian fixed-income securities will perform at best in tandem with the broad emerging market debt index (EMBI+). Until the central bank decides to raise the dollar coupon, we believe that investments in real-denominated debt will remain unattractive. At the same time, we continue to suggest keeping outright flat currency positions.

We believe that our scenario for 1998 is more tilted toward a downside risk than an upside risk, at least until the October elections. The central scenario assumes that the government will keep prudent monetary and fiscal policies for the rest of 1997 and 1998. At the same time, we assume that there will be no major liquidity crunch in international capital markets. Under these assumptions, BACEN likely will avoid or fend off speculative attacks against the real.

The downside risk is that external or domestic policy shocks would lead to a loss of investors' confidence, triggering a market-induced devaluation in Brazil. The risk of a successful speculative attack against the real would increase if the government bends to pressures to: (1) increase public sector wages and investment, leading to a primary fiscal deficit in 1998; (2) ease monetary policies to accelerate real GDP growth in 1998; and (3) reduce the speed of privatization and use proceeds for current spending instead of debt reduction. The other risk is that Brazil may face increasing difficulties to raise US$53 billion in gross external financing in case G3 countries unexpectedly tighten monetary policy in 1998. Under these assumptions, local and foreign investors may buy foreign exchange to protect themselves against an expected devaluation. We think that the probability of this scenario materializing in 1997 is insignificant, but it will rise mildly as we enter 1998. However, once polls show by the end of the third quarter of 1998 that President Cardoso likely will be re-elected, the probability of the downside scenario should vanish. In fact, once the re-election is secured, the best strategy the government could follow is to announce and implements a bold and coherent fiscal adjustment program, including the structural reforms of the civil service and of the social security system. In such case, the upside for Brazilian securities would be enormous.

Table 1: Brazil - Selected Economic Indicators

	1991	1992	1993	1994	1995	1996P	1997P	1998 P [1/]
I. Activity and Prices (changes in %)								
Real GDP growth	0.3	-0.8	4.2	6.0	4.2	2.9	3.4	4.0
Domestic Demand	0.3	-4.6	5.8	6.8	11.7	3.6	4.5	5.0
Private Consumption	1.4	-4.0	5.5	5.7	11.2	3.9	4.3	4.5
Investment	-5.5	-7.7	7.5	12.9	14.5	10.8	9.0	8.0
GDP (in billions of U.S. dollars)	386.2	374.3	430.3	561.3	718.5	749.1	793.9	846.3
Industrial Production (IBGE)	-2.6	-3.7	7.5	7.6	1.8	1.4	4.1	4.3
Population (million)	147.1	149.4	151.6	153.7	155.8	157.1	159.2	161.4
II. Inflation (Changes in %)								
Inflation (IGP-M), end of period[1]	458.0	1174.0	2567.3	869.8	15.2	9.2	5.8	5.0
Inflation (IGP-M), period average [1]	410.1	986.8	2006.8	2036.3	58.8	12.1	7.5	5.4
III. Monetary Sector (12-month, % change)								
Monetary base	280.5	987.2	2358.9	210.0	22.6	-8.7	40.0	14.7
Broad Money (M4)	600.0	1821.7	2834.6	41.2	43.1	28.9	25.0	16.8
Interest rate (on CDI-Over, annual)	536.9	1549.2	3059.8	57.1	38.1	23.7	18.6	16.0
Financial System Credit to the Private Sector (% GDP)	35.0	56.1	82.1	44.4	32.0	30.8	31.0	31.5
IV. External Sector (in billions of U.S. dollars)								
Current account balance	-1.4	6.1	-0.6	-1.7	-18.0	-24.4	-36.0	-41.0
Trade Balance	10.6	15.2	13.3	10.5	-3.4	-5.5	-11.5	-16.0
Exports, f.o.b.	31.6	35.8	38.6	43.5	46.5	47.7	53.5	58.7
Imports, f.o.b.	21.0	20.6	25.3	33.1	49.9	53.3	65.0	74.8
International reserves incl gold (b.o.p. concept)	9.4	23.8	32.2	38.8	51.8	60.1	65.0	65.0
Import coverage coefficient (months of MGNFS)	4.0	10.2	11.3	10.7	9.7	10.4	9.2	8.0
Exchange rate (Real/US$, end of period)	1068.8	12387.5	326.1	0.846	0.973	1.039	1.110	1.190
Real Exchange Rate (Index, 1990=100)	83.0	73.7	74.1	85.3	102.1	108.1	104.9	99.9
V. Public Sector Cash Flows (% of GDP)								
Nominal budget balance	-24.5	-44.3	-58.4	-43.5	-7.1	-6.1	-5.0	-4.8
Operational budget balance	1.4	-2.2	0.2	1.1	-4.8	-3.9	-3.5	-3.5
Primary budget balance	3.0	2.4	2.6	4.8	0.4	0.1	0.6	0.3
VI. Debt Indicators								
Total External Debt (US$ billion)	120.7	135.9	145.7	148.3	159.3	176.3	186.0	200.0
Total external debt, % of GDP	31.3	36.3	33.9	26.4	22.2	23.5	23.4	23.6
Total external debt, % of Xs	382.0	379.6	377.5	340.9	342.6	369.3	347.8	340.6
Total public sector debt (% of GDP)	38.4	44.8	43.1	46.3	50.2	58.0	60.0	60.0
External debt service ratio, % of XGFS	47.2	35.4	45.4	35.6	41.2	49.7	57.3	39.2
VII. Investment and Savings (% of GDP)								
External current account balance	-0.3	1.4	-0.1	-0.3	-2.6	-3.3	-4.5	-4.8
Gross domestic savings	18.5	20.3	19.1	19.3	16.6	15.7	15.0	15.0
Gross domestic investment	18.8	18.9	19.2	19.6	19.2	19.0	19.5	19.8

Source: Banco Central do Brasil, International Financial Statistics (IMF), and GS forecasts

1/ The IPC-FIPE closed at 23.2% in 1995.

Background

External Sector

Exchange rate: With a focus on defeating inflationary expectations once and for all, Brazil has an announced policy of maintaining a narrow sliding band for the *real* that depreciates seven percent a year against the dollar. Reflecting continuing strong capital inflows, the real is now trading on the high side of the band. Factoring in inflation rates of 26 percent in 1995 and 10 percent in 1996, the result of the *real*'s slow nominal depreciation has been a real appreciation, and consequent decline in trade competitiveness. In recent months, however, this trend to real appreciation reversed as year-on-year inflation dropped to five percent.

For the past year, most observers of the Brazilian economy have asserted that the *real* is above its long-run equilibrium level, and even Finance Minister Malan has conceded that the currency may be 15 to 20 percent overvalued. The government hopes that its continued policy of seven percent per annum nominal depreciation, when coupled with low inflation, will bring the *real* into line with its long-run equilibrium value within two to three years.

External debt: Total external debt is slightly less than one-fourth of GDP, at an estimated $190 billion[1] for 1997. This ratio is on the low side of average for an emerging economy, and a good deal lower, for example, than Thailand's 50 percent or Mexico's 37 percent. External debt as a share of GDP fell from a high of 36 percent in 1992 to 22 percent in 1995, reflecting roughly balanced current accounts and currency appreciation during this period, along with the effects of the Brady plan and some other debt restructuring. Since the inflation-fighting commitment to a strong *real* was adopted in 1994, however, external accounts have deteriorated, with the debt/output ratio increasing slightly as a result.

Current Account: The most recent consensus forecast has this year's trade deficit rising to $11.3 billion, and the current account deficit at $34.6 billion, in an $800 billion economy. Still responding to the currency's real appreciation over the past two years, imports are expected to grow 15 percent in 1997 while exports should expand at five percent. The rapid import expansion has predictably set off alarms within the government, which has responded with measures that include restricting the use of credit cards for making overseas purchases, and raising tariffs on the import of capital goods from zero to 17 percent.

Taking into account expected amortization payments of $22 billion on its net external debt, Brazil's gross external financing requirements this year will total $57 billion, a sum that the nation appears to be having little trouble in financing (see below). Although the current account deficit is expected to rise next year to $38 billion, scheduled amortization payments will fall to $17 billion, resulting in a slight drop in the gross external financing requirement.

Financing external obligations: Enthusiastic investors simplified the task of financing Brazil's external obligations in 1997 by snapping up a variety of privatizing state-owned firms. Together with about $4 billion in equity investment flows, the strong FDI contributed to a year-to-date rise of 58 percent in the Bovespa stock index. Net foreign direct investment for this year has

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[1]Source: Federal Reserve; Goldman Sachs estimates $186 billion.

amounted to $8.8 billion, with a total of about $15 billion expected by the end of 1997. About half of the country's current account deficit is now financed by foreign direct investment. With privatization expected to continue at the same rate in 1998, the present balance between foreign direct investment and net portfolio investment will likely be maintained as well.

Foreign reserves: Starting in January at $60 billion, reserves reached the impressive level of $64 billion at the end of August, without any major dips along the way. Central Bank Governor Franco and Finance Minister Malan both regard the stock of reserves as a war chest of considerable use in intimidating potential speculators against the *real*.

Monetary base: Brazil's monetary base (M0) has expanded by 47 percent on a year-on-year basis to 25 billion *reais* ($23 billion at the present exchange rate) at the end of June, equal to about 40 percent of foreign exchange reserves. Growth in the monetary base indicates substantial remonetization, and reflects growth in both domestic credit and international reserves. Net domestic credit is still substantially negative at -$37 billion, though, due to sterilization of foreign exchange inflows.

Creditworthiness and cost of funds: Along with a host of other sovereign borrowers, Brazil has benefited tremendously from large reductions in risk premiums on its dollar obligations over the last two years. Brazil's thirty year uncollateralized fixed-rate dollar bonds now yield 370 basis points over Treasuries, down from over 1400 basis points in 1995. Yields for comparable Mexican and Argentine debt are about 80 basis points lower, however.

Domestic Sector

Fiscal balance: The fiscal situation remains a major weak point. Although central government spending is under control, President Cardoso has so far shied away from bringing individual state governments to heel. The government's program to take over states' outstanding loans in exchange for commitments to fiscal discipline has met with little success so far. In some states, such as Minas Gerais, the government has provided refinancing before receiving credible commitments to reform.

The consolidated operational fiscal deficit this year is forecast at 3.4 percent of GDP, with a similar level foreseen for next year. The operational figure corresponds to a public sector borrowing requirement of 5.0 percent. This fiscal borrowing has forced the government to rely heavily on monetary policy to keep inflation under control, with predictably adverse consequences for domestic interest rates. It has become clear that, while the central government will continue to cajole state governments to get their spending under control, little will be done about aggregate fiscal imbalances until after the presidential elections in October 1998.

Banking sector: Given the austerities of the Real Plan, Brazil's banking sector is in surprisingly good shape. A restructuring program (PROER) to adapt the banking sector to life in a low inflationary economy is entering its final stages, with the overall cost of the program estimated at about 5 percent of GDP. Since 1994, 37 banks have been liquidated, and a number of mergers and acquisitions have taken place. Financial system credit to the private sector is now relatively low at 30 percent of GDP.

Privatization: Privatization of state-owned assets has been one of the brightest spots of the Cardoso Administration's economic program. Revenues from various privatizations, including parts of Telebras and Petrobras and a number of small electric utilities, may total $25 billion for 1997, with receipts expected to continue at the same rate into 1998. Other areas in need of reform include banking sector regulation, the inefficient pension system, and labor laws and practices. Having emerged only recently from a long period of economic interventionism, the Brazilian government still has a penchant for administrative control of many aspects of the economy.

Drafted by: Chris Walker CS

Reviewed by: Dan Zelikow DZ
Wes McGrew WMG
Bruce Juba BJ

Attachment: Paolo Leme/Goldman Sachs Brazil Analysis

Watch Office: Please fax to the Secretary, with copy to Mike Froman
Fr. Dan Zelikow

Sunday, 11.00am

Attached you will find:

1) "High case" scenario, which would entail bilateral funding from U.S./G7 and announced commitments of money to coincide w/Cardoso speech.

2) "Low case" scenario: where we are now, though we currently have not communicated w/Brazil on steps we all take "to prepare for failure".

3) Russ Munk + team are preparing today a legal framework for bilateral support — as far as can be done w/o discussing w/Brazil.

4) There are also a number of private sector deals in a fairly advanced stage, some of which could require our backstop. More on this should clarity emerge.

5) Debt stock summary — IMF owes us more detail Mon.

I will be in tonight should you wish to discuss.

Dan.

2/8

Brazil "Low Case" Scenario

Plan A:

Variant 1: "Muddles through the election" ($36b package goes forward after election, o/w $28.5b "firm money", nothing firm announced in advance of election.)

Pre-election period of temporizing:

-- Brazilian policy announcements are positive but not specific. Even so, these, along with ongoing expectations of financial support, succeed in carrying them through the election;

-- IMF program prepared for adoption shortly after election; ($18b)

-- IFIs make positive noises about willingness "to be supportive", but no clear statements of commitment of money are announced until after election, when Brazilians themselves request financial support. (IDB: $3.5b, o/w $1.5b in CY98; IBRD: $4.5b, o/w $1.5b in CY98). No explicit commitment to exchange rate.

"Welcome Brazil's policy commitments, which should go a long way to consolidating progress already being made. We've worked closely with Brazilians in past, and we stand ready to support them with financing should they wish to develop programs with us".

-- US/G7 make supportive noises about Brazilian policy commitments and urge implementation. No mention of money. No explicit commitment to the exchange rate.

"Brazil very important. Pleased that President Cardoso plans to make fiscal adjustment the centerpiece of his second term's economic policy. Urge aggressive implementation to consolidate the important progress Brazil has made in recent years.

-- Private sector: Brazilians extract favorable noises from financial statesmen about their willingness to financing options. Work goes forward on finance backed by privatization proceeds of assets already sold. ($10b) Statesmen say:

"Brazil very important for global economy and has made tremendous progress in recent years. Pleased at recent policy announcements and, in context of improved policy conditions, we'd be prepared to provide additional financing. Working on options now."

Preparations for failure:

-- Brazilians are told that IMF/G7 willingness to make supportive announcements (as above) contingent on Brazilian assurances that they would not impose administrative controls on capital outflows.
-- Reserve floor would be agreed that would trigger a move to Plan B.
-- Incentives for Brazil's compliance with agreements: a) In the event that reassurances are

violated, G7/IFIs distance ourselves from Brazil's actions. b) Brazilians could be threatened (perhaps not very credibly) that IFIs would be less forthcoming on a large package if they were to violate reserve floor or impose cap controls.

-- Private sector: We don't do meaningful prep for a workout or even make soft warnings to private sector that they will be expected to contribute if Plans B or C are activated because of concern that this would accelerate flight.

Variant 2: Same as Variant 1 but fail to temporize through the election. Depending on whether failure is virtuous or malevolent determines which plan we move to:

Plan B: If "virtuous failure" occurs (continued reserve outflows but no obnoxious policies):

-- Fund negotiates a program based on a maxi-devaluation and a flexible exchage rate system that has already occured (capital controls, if any, are minimal).

-- Large IFI programs go forward.

-- Brazil restates commitment to keep markets for goods and capital open.

-- Private sector workout (external/internal?) convened, if necessary. We agree to facilitate the effort with G10-based creditors using mild moral suasion.

-- US adopts soft "blame the victim" strategy. Indicates that Brazil warrants IFI support in order to restore stability following "regrettable" devaluation. We didn't provide finance before because "the key was Brazil having policies that the markets would find credible, and they obviously didn't".

Plan C: If "malevolent failure" occurs: (Brazil tries to tough it out but fails; has violated our reserve floor and attempted use of capital controls to stave off devaluation):

-- Removal of some capital controls (those not required to make a debt restructuring work) is a prior action for Fund program

-- Fund program is not generously financed but rather requires deeper Brazilian policy adjustments to stabilize external finances.

-- Debt restructuring and mandatory Club deal are presumed to be necessary for program to work and, if so, would be requisite for IFI disbursements. Presumption is that capital controls would be imposed at least until the debt restructuring and Club deals could be arranged. We facilitate work with G-10 based creditors, but we don't muscle them.

-- US adopts more harsh "blame the victim" posture. We indicate that Brazil has misbehaved and hurt its neighbors. We're willing to support Brazil but only if it does the right things and the private sector bears its fair share of burden. We turn our intention to other Latins.

Notes: a) "capital controls" are assumed to be the worst option, which may not be so. The true worst option can be substituted wherever the capital controls moniker is mentioned.

b) "flexible exchange system" also assumes a major devaluation. How the devaluation is actually brought about is an issue that requires deeper thought.

c) "Statesmen commitment" means a select group of bankers and investors who, on their own or Brazil's initiative, agree to retain exposures and commit new funds to bridge to the privatization proceeds. G7 financial authorities are not involved in any way.

10

Brazil High Option

Plan A

Before Elections

- Brazil announces fiscal commitments for 1999 (3%/GDP primary surplus) and 2000 (4%), with maximum concreteness.
- IMF publicly endorses fiscal plan as adequate basis for a program, should Brazil need one, and signals availability of $20 billion.
- MDB's announce willingness to provide $10 billion.
- Brazil announces it has secured $10 billion in external funds from private sources, backed by receivables from Telebras ($7.5 billion) and from its shares in privatized companies.
- Foreign banks announce confidence in Brazil ~~and~~ intention to maintain their exposure, + ~~expand~~ lend la do Clyb
- G-7 announce swap facility for emerging market countries facing financial contagion. Announce Brazil can draw up to $30 billion (half from the U.S.) from facility, with $15 billion available prior to elections. Swap line eligibility requires IMF endorsement but no public commitment to go the IMF.

Total Available: $70 billion.

Conditions

- Brazil agrees privately to us that it will go to IMF immediately after elections.
- Brazil agrees it will not impose controls on capital outflows.
- Brazil will be eligible to draw $15 billion in swaps if its forex reserves fall to a pre-determined level ($40 billion). Any actual drawings will be approved on a case-by-case basis and will be contingent on adequate policy.
- Brazil agrees it must maintain reserves net of swap drawings at a pre-determined level ($25 billion). If reserves fall below that level that would activate Plan B.

After Elections

- Brazil concludes program with IMF, with large ($5 billion) initial disbursement.
- MDB's make initial disbursements ($3 billion).
- G-7 swap line is still open, but is only available after IMF money, subject to case-by-case approval of G-7.
- Brazil commits to move to Plan B if pre-determined reserve floor ($25 billion, excluding IFI and G-7 resources) is breached.

Plans B and C

Identical to low case scenario except:

(1) If "valiant failure" occurs (either before or after the elections), we would be more reluctant to activate any further swaps. But we would not exclude that possibility, given that they could still be useful to contain the degree of instability.

(2) In valiant failure case we would not take critical stance toward Brazil.

(3) In the case of malevolent failure, we would halt swap disbursements. Swap facility would still be open for others.

Key Issues:

1. ESF Resources:

-- The EFS has $15+ billion in readily available dollar holdings.

– Treasury has the legal authority to activate the ESF to provide swaps to Brazil since the financial situation in Brazil and world financial markets is sufficiently grave to trigger the basic requirements of the ESF statute.

-- A key policy feature of all past ESF programs has been the existence of some form of backing. There are two options in the case of Brazil:

  - Korean model could be used with requirements that GOB must maintain a certain level of gross usable reserves and that G7+ creditors can impose additional economic/financial conditions on Brazil.

  - Mexico model, whereby proceeds of certain Brazilian exports would have to flow through a NY bank account which flow could be diverted to repay G-7+ swap line. Possible alternative is GOB pledge of future proceeds from planned privatizations. But that could (a) raise negative pledge clause and/or pari passu clause problems and (b) be conditioned on future GOB and Brazilian parliamentary actions out of GOB's current control.

– Swaps would be for 90-days, with up to three roll-overs for a maximum term of one year. Interest charges would be at market rates, either tied to U.S. Credit Reform Act standards, or to IMF/SRF type margin (Korea is 350 basis points over rate for 90 day Treasuries).

-- Under ESF statute, the President would have to furnish written statement to Congress where unique or emergency circumstances require the loan or credit be for more than 6 months.

Congressional Relations:

-- We would need to notify the bipartisan leadership in both Houses (4) and the Chair and Ranking Members of each of the appropriating and authorizing committees.

– A key issue would be timing of congressional notification. Current House IMF legislation requires 36 hour advance notification when ESF funds are disbursed in conjunction with IFI stabilization funds led by the IMF. Commitment and/or disbursement constitutes a package for purposes of the legislation. If there is any kind of commitment in a statement, it would certainly be argued that this requirement would apply as a precedent as we go into negotiations on the IMF bill.

– There would likely be a gap between announcing the swap facility and its activation, which would affect timing considerations.

Strategy for getting G-7 support:

- G7 support for and participation in the financing will require strong lobbying, in particular if we plan disbursements in the absence of an IMF agreement (or Brazilian commitment to go the IMF), the envisaged private sector elements could win some support.

- We will have to explain our concerns about contagion; our expectations on Brazilian policy commitments; and our intention to make any disbursements conditional on understandings about policies, including on reserves levels.

- So far the rest of the G7 has unanimously opposed (Germans, Japanese and French most forcefully) moving without IMF linkage. We could probably move them if the IMF itself supports the financing. On the private sector, the Germans have been most forceful. We would have to explain how our plan includes a significant private sector element, and that moving to a more coercive approach would be highly dangerous in today's world.

- For Japan, we should lobby in the context of the Obuchi-POTUS bilateral on Tuesday (Sakakibara will be here on Monday), and the Japanese desire to announce a big "plan" to reduce attention on their own domestic problems. Larry Summers should separately lobby some of his other G7 Deputy colleagues (David Lipton/Tim Geithner could do Germany and France, maybe the others as well).

- We would need the Fed on board, with Ted Truman/Alice Rivlin making the case to their counterparts. Eventually, calls from RER and Greenspan may well be needed, at least to Germany (Tietmeyer).

- More broadly, we will then want to make sure to involve other countries that may well contribute, including the rest of the G10 (Belgium, Netherlands, Sweden, Switzerland) and others with Latin American interests, notably Spain and Portugal.

- If most others refused to disburse before an IMF program (thus before the elections), one possible solution would be for pre-election disbursements by a subset that would include us and any others we could bring on board.

8/8

BRAZIL'S DOMESTIC AND EXTERNAL DEBT
(Latest Data)

	$ bn
I. PUBLIC SECTOR DOMESTIC DEBT	
Total Net Debt - Federal & Local Govt., Central Bank, SOEs	283.7 (36.9%/GDP)
Gross Securitized Debt of Federal Govt. & Central Bank	251.7
Indexed to Overnight Rate	166.1
Indexed to the Dollar/1	41.5
Other -- Non-indexed fixed-rate debt	44.1
II. EXTERNAL DEBT	
Total Debt - Gross	226.4 (29.5%/GDP)
Of which, to Commercial Bank Creditors/2	76.3
Gross External Debt of the Public Sector	85.8
Gross External Debt of the Private Sector - Total	140.6
Short-Term/3	32.1
Medium & Long-Term	108.5
Total Debt - Net	177.4
Net Public Sector External Debt	36.8 (4.8%/GDP)
III 1999 M&LT EXTERNAL DEBT AMORTIZATION	
Total/4	20-25
Public Sector	4
Private Sector/4	16-21

1/ Reflects latest estimate that 66% of domestic debt now indexed to overnight rate.
2/ Bank lending of BIS countries as of December 1997.
3/ IMF still working on classification of private external debt. Some indication this may raise S-T debt by $25 billion and reduce M&LT debt by the same amount.
4/ IMF is re-examining its estimate of private sector amortizations. The original estimate was $12.9 billion, but Fund staff now believe the correct figure could be as high as $20-25 billion.

Source: IMF

9/18/98

1998-SE-011851

1998-SE-011851

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

October 15, 1998

ASSISTANT SECRETARY

ACTION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner
Assistant Secretary, International Affairs

SUBJECT: U.S. Financial Support for Brazil

Issue: Whether to provide Exchange Stabilization Fund (ESF) financing to Brazil in the context of a prospective international support program and strong policy adjustments by Brazil supported by the IMF.

RECOMMENDATION

That you authorize us, based on the conditions set forth below, to: (1) begin negotiations with other G-10 countries on terms for bilateral support for Brazil; and (2) once we have reached consensus with other bilateral lenders, begin negotiations with Brazil on an agreement to lend up to $10 billion through an ESF facility. We would seek your approval for the final terms of any agreement with Brazil.

Agree ✓ Disagree _____ Let's Discuss ✓

I have a feeling that the Camdessus view on exchange rate is well worth pursuing

BACKGROUND

We would enter into negotiations with other G-10 countries (and possibly other countries) on terms for bilateral support for Brazil. After we reach consensus with other bilateral lenders, we would begin negotiations with Brazil on an agreement under which we would be prepared to make up to $10 billion through ESF swaps available to Brazil as part of an international package that includes the IMF, World Bank and IDB, other bilateral lenders, and an appropriate role for commercial bank creditors.

Conditions for conclusion of the agreement with Brazil

- Brazil enters into an IMF program; or Brazil reaches agreement with the IMF on the main elements of a program and we have full expectation that such a program will be concluded soon.
- Commitment by the World Bank and IDB to provide a combined total of [$8 billion] in support for Brazil, at least [$4 billion] of which would be disbursed this calendar year.
- Agreement by other bilateral lenders (G-10 and possibly other Latin American countries) to provide $10-15 billion to match $10 billion from the U.S., on *pari pasu* terms.
- A standstill agreement with commercial banks, i.e., they would agree to roll over their existing exposure to Brazil. [Issue: should we require new money?]
- Brazil agrees that it will not impose any controls on capital outflows.

EXECUTIVE SECRETARIAT

- Brazil agrees to a floor level on foreign reserves.
- We and Brazil establish in advance an economic and financial monitoring program that specifies reporting requirements. Brazil's failure to meet conditions of our monitoring program would be grounds for an acceleration of repayment of outstanding ESF funds.
- Failure by Brazil to meet any of its IMF program reviews would trigger accelerated repayment of outstanding ESF funds.

<u>Timing of announcement</u> We would be prepared to announce our conditional willingness to use ESF resources prior to conclusion of an ESF agreement with Brazil, provided we have reasonable expectations that conditions relating to IMF, World Bank and IDB, bilateral, and commercial bank support would be satisfied.

<u>Terms</u> The ESF swaps would be for six months, with an option for renewal, at an interest rate equal to the six-month Treasury bills rate plus an appropriate spread [350 basis points?]. We would approve each disbursement of ESF funds on a case-by-case basis. We would be prepared to approve and disburse the first ESF tranche (notional size of $2 billion) alongside the initial IMF disbursement.

As was the case in the 1995 Mexican program, before the first disbursement we would request, and provide factual support for, a Presidential statement to Congress that he had authorized this support and that unique or emergency circumstances required this loan or credit to be outstanding for more than 6 months if necessary. This would satisfy the requirements of the ESF statute.

<u>Backing</u> As in the proposed Korea agreement, the conditions related to international reserve floors and implementation by Brazil of economic and financial policy measures would provide backing for repayment to the U.S. We would require Brazil to establish a facility to back bilateral lenders with future privatization proceeds. good

<u>Risks</u> Use of our ESF would send a powerful signal of official support for Brazil that could improve the prospects that Brazil will be able to maintain financial stability. There are also serious risks.

- Negative sentiment in global financial markets may prove too strong to resist, even with a strong program that would succeed in a more normal environment. In that case, capital outflows from Brazil could overwhelm international support.
- Brazilian policy adjustment could fall short of its commitments. Adequate fiscal adjustment will require <u>strong political will</u> on the part of President Cardoso's Administration and cooperation of legislators and sub-national politicians.
- Use of ESF funds to support Brazil may prove to be controversial within the United States and could lead to efforts to impose new congressional restrictions on use of the ESF.
- If our support fails and Brazil succumbs to financial instability, we will have <u>lost credibility</u> and will be in a weaker position to support other possible victims of contagion (although we fully expect to be repaid even in the case the program does not succeed in its objectives).

At Sunday see note on exchange rate

1998-SE-012810

From: Wes McGrew
To: watchoffice
Date: 11/11/98 7:13pm
Subject: draft Rubin statement on Brazil

Please fax the attached paper to Secretary Rubin, Deputy Secretary Summers and Assistant Secretary Geithner. Please also print out and fax this email along with the attachment. thanks.

NOTE:

Ted Truman and Dan Zelikow have cleared the attached draft statement on Brazil support.

CC: israeld, kurapkad, shahs, loweryc

Secretary Rubin Brazil Statement

We welcome today's agreement between the International Monetary Fund and Brazil and the announcement of support by the management of the World Bank and Inter-American Bank. Brazil's strong economic program, if fully implemented, will help put Brazil's public finances on a sustainable path, safeguard the commendable progress Brazil has made in achieving financial stability, and lay the basis for a future of healthy economic growth that will benefit all Brazilians.

Today the United States and [nineteen] other countries announced a program of bilateral support to augment resources from the IMF and the multilateral development banks. Bilateral lenders will provide approximately $14.5 billion in short-term financing for Brazil, in most cases through guarantees of lending by the Bank for International Settlements. The United States' portion of this support will be to guarantee, through the Exchange Stabilization Fund, up to $5 billion. We anticipate that the first disbursement of the bilateral support will take place once Brazil's program is approved by the IMF Executive Board and will be in parallel with the first IMF disbursement.

Our decision to provide bilateral support reflects our commitment to strengthen the international financial system, guard against financial market contagion, and preserve economic growth in the United States. The success of Brazil's program is very much in the interest of the United States and the international community.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
003. memo	Karin Lissakers (IMF) to Larry Summers & Wes McGrew re: Brazil (LOI) (1 page)	11/12/98	P1/b(1)

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P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
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RR. Document will be reviewed upon request.

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b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
004. report	re: Brazil - LOI (Letter of Intent) (11 pages)	11/12/98	P1/b(1)

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OASIA (Sonal Shah) to LS

NCC cc to MF

NC/DC/PA/AK

SS

11/12/98

Please Log IN

November 7, 1998

TO: SECRETARY RUBIN

FROM: Ted Truman

SUBJECT: Draft Public Statement on Brazil

As we discussed, I am attaching a draft of a statement on Brazil by the 15 countries that will be participating in bilateral financing to supplement the IMF arrangement with Brazil.

I would appreciate your comments/clearance so we can send the text to the other countries over the weekend.

cc Larry Summers, Mike Froman, Neal Comstock

DRAFT: 7 November 1998 5:30 p.m.

Statement of Finance Ministers and Central Bank Governors[1]

We welcome today's announcement by Brazil and IMF management of the completion of negotiations on IMF financial support for Brazil's economic program. We also welcome the announcements by managements of the World Bank and Inter-American Development Bank that they will recommend that their institutions participate in this international effort as well. It is important that Brazil carry forward the implementation of its three-year program of economic and financial policies so as to establish a strong foundation for stability and growth.

Because of the importance we attach to Brazil's success with its program and to the contribution of that program to international financial stability, we have chosen to supplement the substantial resources that are expected to be made available by the international financial instiutions to Brazil. In line with recent steps toward a strengthened international capacity to help countries ward off financial market contagion, we will support the provision of additional financing to Brazil, expected to total $15 billion, alongside financing from the IMF. This financing is being arranged under the aegis of the Bank for International Settlements, in most cases through guarantees of BIS lending. We expect that these arrangements will be completed shortly and that the BIS will make a disbursement alongside the IMF's initial disbursement following approval of Brazil's program by the IMF Executive Board.

The financial community shares a common interest in the success of Brazil's program. So as to achieve this, the Brazilian authorities will be presenting their program to their domestic financial community and to the private international financial community over the course of the next few days.

---

[1] [Austria], Belgium, Canada, [Denmark], France, Germany, Italy, Japan, Netherlands, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States

US Support for Brazil

Support for Brazil is in the United States' core national interest

- A stable, growing Brazil is very much in our economic interest. Brazil is the ninth largest economy in the world -- behind the G-7 and China -- and the eleventh largest trading partner of the U.S. U.S. merchandise exports to Brazil increased 25 percent to $16 billion in 1997. In 1997 the U.S. ran a $6.3 billion trade surplus with Brazil.

- Brazil is the largest economy in Latin America and the economic lynchpin of the region. Stability in Brazil is critical for the continued health of Latin America -- the U.S.'s fastest growing export market. Latin America currently accounts for one-fifth of all U.S. exports.

- Stability in Brazil is important to limiting contagion around the world. Throughout the recent global financial crisis, we have seen problems in one part of the world quickly spread to other regions. For example, when Russia devalued in mid-August, borrowing costs increased across emerging markets.

Brazil's economic program -- fully implemented and along with international support -- holds the best prospect for restoring investor confidence and providing a strong foundation for renewed growth.

- Financial assistance from the international community should provide Brazil critical breathing space it needs to implement its adjustment program.

- In the past four years, Brazil has proved its willingness to take the hard steps of economic and structural reforms. As a result of the Real plan adopted in 1994, Brazil:

  - lowered inflation from over 2,000 percent in 1994 to 2 percent today,

  - opened its economy,

  - worked to reform and strengthen its domestic financial sector, and

  - launched an ambitious program of privatizations – the largest such program underway in the world today.

- The government has taken stock of remaining policy weaknesses and is implementing a tough adjustment program to address them.

  - The government announced a program to sharply reduce the deficit, stabilizing debt as a share of GDP in two years. The government has also committed to pressing forward with its current policies of: a strong monetary policy, privatization, and market opening.

- Brazil has already taken tough actions to help preserve stability, raising interest rates to over 40 percent.

- While there are no certainties in life, this is the right program. What's crucial is that it be implemented as effectively as possible.

In September, President Clinton outlined a plan to address the challenge of working with countries affected by contagion. This program is consistent with the priorities the President set.

- One of the key elements of the President's plan is helping countries with sound or improving economic policies ward off contagion. In this case:

  - the international community is acting to provide early support for Brazil based on a strong adjustment program,

  - Most of the IMF money and the bilateral support will be provided on a short-term basis at higher than regular interest rates in order to encourage Brazil to access the international capital markets as soon as possible.

- Efforts are being made to lessen the effects of the Brazilian adjustment program on the poor.

  - We have asked the World Bank and the IDB to design a program that would cushion the effect of the adjustment on Brazil's poor.

  - The Brazilian government -- in cooperation with the IMF -- is working to help ensure that social spending does not bear the brunt of fiscal adjustment efforts.

Why should we use U.S. taxpayer dollars to support Brazil?

- Support for Brazil is in the United States' core national interest

  - A stable, growing Brazil is very much in our economic interest. Brazil is the ninth largest economy in the world -- behind the G-7 and China -- and the eleventh largest trading partner of the U.S. U.S. merchandise exports to Brazil increased 25 percent to $16 billion in 1997. In 1997 the U.S. ran a $6.3 billion trade surplus with Brazil.

  - Brazil is the largest economy in Latin America and the economic lynchpin of the region. Stability in Brazil is critical for the continued health of Latin America -- the U.S.'s fastest growing export market. Latin America currently accounts for one-fifth of all U.S. exports.

  - Stability in Brazil is important to limiting contagion around the world. Throughout the recent global financial crisis, we have seen problems in one part of the world quickly spread to other regions. For example, when Russia devalued in mid-August, borrowing costs increased across emerging markets.

- As in the case of Mexico, we fully expect that Brazil will repay all loans and that there will not be any cost to the United States taxpayer.

- The U.S. will not be loaning money directly to Brazil. Rather, we are offering to guarantee loans provided by the BIS to Brazil.

- The BIS is charging a premium interest rate (450 basis points over its cost of funds) to Brazil in keeping with short-term nature of the loan. This fee structure is designed to encourage Brazil to repay the loan as soon as normal access to international capital markets resumes.

Isn't the *real* overvalued?

- We don't comment on the value of another nation's currency.
- However, we note the intentions of the Brazilian authorities to maintain their exchange rate regime (the Real plan) which has been tremendously successful in taming inflation that was more than 2000 percent four years ago.

Is the United States committed to a fixed exchange rate regime in Brazil?

- Brazil has been tremendously successful in reducing inflation from over 2000 percent in 1994 to 2 percent or less today, and the *real* plan has been critical to that success.

- Brazil's adjustment program preserves the present exchange rate regime. Successfully implemented, we believe that the government's plan offers the best prospects for maintaining stability and laying the foundation for sustained growth.

Brazil is going to have a recession next year anyway, so what good is official support?

- Global market pressures and the Brazilian authorities' strong efforts to contain them will have a negative impact on the domestic economy in the short run but financial instability and high inflation in the absence of Brazil's efforts would carry a much larger cost -- not merely for Brazil but for its neighbors.

- Brazil's economic adjustment program, backed by official support, aims to preserve financial stability. A failure to respond would risk a far more severe downturn in Brazil and have a major negative impact on the stability of other Latin American economies and global financial system as a whole.

- Implementing Brazil's strong adjustment program today will reduce the threat of instability today and lay the foundation for more rapid and sustained growth in the future.

Many economic experts believe Brazil should devalue to restore growth. Are they wrong?

- Everyone is agreed that the goal of Brazilian policy should be to lay the foundation for reduced interest rates and the fastest possible return to growth. The question is how best to achieve that goal. In this regard we believe that Brazil's economic adjustment program offers the best way forward.

    - Fiscal adjustment that puts public finances on a solid and sustainable basis will help to achieve a reduction in interest rates.

    - Continued low inflation, together with gradual depreciation of the *real* under the present exchange rate system, provides for steady gains in competitiveness.

Why should we use official funds to bail out private investors and facilitate capital flight?

- The Brazilian authorities are counting on the support of this program by the private sector. AS we indicated in our joint statement with the finance ministers and central bank governors of 19 other countries, the private financial community shows a common interest in the success of Brazil's program.

- In the wake of recent pressures, private investors, both foreign and local, have already taken sharp losses on Brazilian assets – Brazil's stock market has fallen 26 percent in dollar terms year to date, and the price of its 30-year bond fell by 40 through early September, though it has partially recovered since then.

- Brazil's adjustment program is designed to deal with these pressures. If implemented fully and backed by official support, it should restore confidence and help the Brazilian people and their neighbors.

- The success of Brazil's program ultimately requires the support of the private sector. Official support is on a temporary and emergency basis and is not a substitute for private sector investment.

Why will this program succeed where Indonesia's and Russia's programs failed?

- Every situation is different and must be looked at on its own terms.
- That said, Brazil is moving forward with its adjustment program with important advantages which other countries have often lacked. These include:
  - A stable political situation and strong commitment to undertake needed adjustments.
  - A relatively strong banking sector, not burdened by excessive amounts of short-term external debt.
  - Deep and liquid domestic debt markets.
  - A high level of foreign exchange reserves.
  - And a relatively modest current account deficit -- over half of which has been covered in recent years by foreign direct investment.

How are you complying with new legislative mandates on IMF programs, including social protection, labor rights, and openness of foreign trade?

- The U.S. Executive Director at the IMF has conveyed to IMF management our policy guidelines regarding the legislative mandates. We have also conveyed similar guidance to the World Bank and Inter-American Development Bank.

- We have also communicated to Brazilian Government officials the importance we place on meeting legislative mandates and will continue to consult closely with them to monitor consistency of Brazil's IMF-backed economic adjustment program with those mandates.

- Consistent with our legislative mandates, Brazil's economic program supported by the IMF includes the following features:

  - Brazil has agreed to publish the LOI.
  - The bulk of IMF support will be at penalty interest rates (300-500 bps above regular IMF lending rates).
  - Brazil's IMF program contains a commitment to maintain an open international trade regime.
  - Spending cuts will fall disproportionately on the investment budget so as to protect social programs that meet basic human needs. Other important savings will come from pension system reform that will raise the minimum retirement age to 60 for men and 55 for women -- designed to curb the growing deficit in the public pension system.
  - Labor reforms will ensure continued protection of workers' rights.
  - Brazil will approach private sector investors to discuss their support of the program.

- We are also consulting with Brazil to ensure adequate protection of the environment and the rights of indigenous peoples.

Background: At least 70 percent of the IMF program will be on SRF terms (420 percent of quota, vs. 180 percent of quota on standby terms at normal IMF lending rates). That means interest rates 300 basis points above normal IMF rates for the first year after the program is approved, with the rate increasing 50 basis points after one year and 50 basis points every six months thereafter to a maximum of 500 basis points over normal IMF lending rates.

How can you say Brazil is a victim of contagion when their fiscal deficit is nearly 8 percent of GDP?

- Brazil has made impressive strides toward reforming its economy in recent years but the high level of the fiscal deficit remains a serious weakness that it needs urgently now to address. That is why substantial fiscal adjustment is the centerpiece of the Brazilian adjustment program.

- While the high level of public borrowing made Brazil more vulnerable to financial pressures, it was not the immediate cause of the financial pressure on Brazil. Emerging markets around Latin America and across the world have been affected by a general pulling back from emerging markets the wake of the financial crises in Asia and Russia.

- It is also worth keeping in mind that:

    - the level of Brazil's public debt is relatively modest by international standards. It will stabilize at less than 45 percent of GDP in the year 2000 under the government's new fiscal program, significantly below the level in many industrial countries.

    - the deficits are due in large part to the high interest rates Brazil is presently having to pay to service its public debt. With the restoration of confidence and continued success in achieving low and falling inflation, we would expect interest rates to fall and the fiscal deficit to decline accordingly. For example, if interest rates were even reduced to 10 percent, the annual deficit would be halved.

What role will the private sector play in supporting Brazil?

- We expect Brazil to present its program to the private financial community in the coming days and we believe that these investors have a common interest in the success of Brazil's program.

- Ultimately, the confidence of private investors will be necessary for Brazil's program to succeed.

Why is Brazil asking the support of commercial banks but not of bondholders or other investors?

- The private investment community as a whole has a shared stake in the success of Brazil's efforts and we expect that Brazil will meet with a broad class of investors to explain its program, not just commercial banks.

- We believe that Brazil's adjustment program represents the best way forward, if it is successfully implemented, and that investors of all types will find it in their interest to support it on a voluntary basis including current bondholders.

Is the official money real? Will Brazil actually spend it?

- The commitments by the IMF, the World Bank, the IDB, the United States and other nations underlines that the international community is prepared to provide real resources on a temporary basis to Brazil in support of a strong Brazilian adjustment program aimed at maintaining financial stability.

- Brazil's economic program aims to restore the confidence of international investors as quickly as possible. The sooner that happens, the less likely that Brazil will actually need to use official support.

If needed:

- Official support gives Brazil a breathing space while it implements its adjustment program.

Why are you helping a country with massive poverty and inequality?

- Brazil's development has been hampered by high rates of poverty and unequal distribution of income. Addressing these problems is a high priority for Brazil. But financial instability would only aggravate poverty and inequality.

- Inflation hurts the poor disproportionately. The poor would be the first to suffer if inflation and instability returned to Brazil.

Won't Brazil's austerity program hurt the poor?

- Fiscal adjustment is essential for preserving financial stability, reducing interest rates, and creating a basis for increased prosperity for all Brazilians. The poor would be the first to suffer from the return of high inflation and financial instability.

- The Brazilian government -- in cooperation with the IMF -- is working to help ensure that social spending does not bear the brunt of fiscal adjustment efforts.

What if Brazil keeps losing reserves -- will you keep lending it more money?

- The official sector should not and cannot seek to replace private capital or finance capital flight. In supporting the Brazilian program the international community is expressing its desire to give Brazil the breathing space needed to take steps to restore confidence to attract adequate private financing as soon as possible.

- We believe that Brazil's economic program offers the best way forward for preserving stability, and that our support program will significantly improve the prospects for success.

Why do you need to provide bilateral financing now that the IMF has received $90 billion from the quota increase?

- The IMF is on course to provide a very large program of temporary conditioned financial support for Brazil. The IMF resources will be the centerpiece of the international community's support for Brazil.

- Bilateral support is an important supplement to IMF assistance -- which is constrained by the IMF's need to retain adequate resources to meet future needs.

- The quota increase is in fact not in place. Ratification will take another month or two.

- Bilateral support is indicative of the importance that we attach to Brazil's success at a time of intensified international financial contagion.

Is the ESF the Administration's new tool for foreign assistance?

- The ESF is not American foreign aid nor should it be considered as such. The purpose of the ESF is to provide the United States with a flexible tool that can be used quickly for financial support consistent with U.S. obligations in the IMF on orderly exchange arrangements and a stable system of exchange rates.

Background:

The ESF's enabling legislation, the Gold Reserve Act (as amended), states that "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary [of the Treasury] ..., with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary."

The ESF

- The Exchange Stabilization Fund (ESF) is a fund under the control of the Secretary of the Treasury, acting with the approval of the President. The ESF was established pursuant to section 10 of the Gold Reserve Act of 1934. As amended, that legislation authorizes the Secretary of the Treasury, with the approval of the President, to deal in gold, foreign exchange, and other instruments of credit and securities "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates[.]" 31 U.S.C. 5302(b).

- In addition, the ESF statute provides that a loan or credit to a foreign entity or government of a foreign country may be made for more than six months in a twelve month period only if the President gives Congress a written statement that "unique or emergency circumstances" require the loan or credit be for more than six months.

- When originating this provision, the Senate Banking Committee recognized a number of "unique or emergency circumstances" affecting either a borrower or the international creditor community that might justify such loans or credits:

  -- A country might be hampered by natural disasters, embargoes, unforeseen economic developments, political assassinations, or other catastrophic events;

  -- Adequate funds from the IMF or other international financial resources might be unavailable for the purposes of assisting a country so affected.

- In the case of Brazil, a number of these factors are present:

  -- The rapid loss of foreign investor confidence caused by financial events outside of Brazil are "unforeseen economic developments" of significant magnitude.

  -- However, it is clear that IMF resources can be usefully supplemented by other IFI and bilateral loans.

- In the past, the ESF has been used on numerous occasions to provide short term swaps of less than six months to other countries. In a few instances, the ESF has been used to provide guarantees for sovereign loans. On two occasions (1982 and 1995), the ESF was used to provide longer term loans to Mexico. The United States also offered, as part of the 1995 Mexico Support program, to guarantee Mexican borrowing from the private capital markets, but Mexico never activated the guarantee program.

1998-SE-013131

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

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November 20, 1998

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner
Assistant Secretary - International Affairs

SUBJECT: Brazil -- fiscal program implementation update

Summary: Brazil's Congress has approved tax and spending measures expected to generate 1% of GDP in deficit reduction next year, out of 3.4% of GDP in planned fiscal cuts at the federal level. The government is somewhat ahead of the expected schedule in gaining Congressional approval of the program and has accomplished all the prior actions for first tranche IMF disbursement. The toughest challenges to completing the fiscal adjustment and meeting conditions for second tranche disbursement will be Congressional approval of the increase in the Financial Transactions tax (constitutional amendment - 0.8% of GDP) and imposing social security taxes on government retirees (ordinary law - 0.2% of GDP). The market perception is that the government has done a good job so far on the fiscal adjustment package.

Congressional and Government Actions to Date: *Measures Passed* -- On November 18, Congress approved a measure raising the "COFINS" corporate social security tax from 2% to 3% and extending its coverage to include financial firms (0.5% of GDP revenue yield in 1999). Congress also approved, with ample margins, a controversial measure allowing the government to impose social security taxes on government retirees -- though Congress must still approve the specific tax rate and other implementing measures before the tax takes effect. Congress also approved two other implementing laws for social security reform.

On November 11, Congress approved a measure transferring judicial deposits in tax disputes to government coffers (one-time 1999 revenue yield of 0.2% of GDP). On November 4, the Government overcame the last obstacle to final approval of the Social Security Reform constitutional amendment (1999 savings of 0.3% of GDP, rising to 0.6% in 2000 and 0.9% in 2001), defeating opposition amendments that would have diluted much of the savings.

Measures Submitted -- The government submitted the 1999 budget to Congress on November 9, and the Financial Transaction tax constitutional amendment on November 18. Those are prior actions, together with passage of social security reform, for first tranche disbursement by the IMF.

Next Steps:

1. On November 25, Congress is expected to vote on the remaining social reform implementing measures, including a 9% surcharge on public employees earning more than $1,000 per month (0.1% of GDP revenue impact in 1999).

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2. The 1999 budget, including 1% of GDP in discretionary spending cuts, will likely be approved without difficulty by end-December.

3. Congress will likely vote in January on implementing legislation for the Administrative Reform constitutional amendment allowing dismissal of government employees (0.1% of GDP in expected 1999 savings). The legislation (in the form of a Complementary Law) must be approved by a majority of total members in both chambers.

4. The two laws subjecting government retirees to the 11% Social Security tax and the 9% surcharge will come up for a vote in January (0.2% of GDP revenue impact). This is viewed as the most politically contentious issue in the government's fiscal program, but Congressional approval of the measure may not be as difficult as expected. Congress approved with ample margins the measure subjecting retirees to the tax in principle, and the government needs just a simple majority of members present to approve the implementing laws.

5. Final approval of the constitutional amendment increasing the financial transaction tax from 0.2% to 0.38% (0.8% of GDP revenue impact) is expected by January. But the cumbersome procedural requirements for constitutional amendments -- a 3/5 majority of total members in two separate votes in each chamber -- may delay approval after until the new Congress takes office on February 1, 1999. The government may be forced to accept a rate increase to 0.3% instead of 0.38%.

6. Brazil has told the Fund, but not yet announced publicly, 5 additional measures with an expected yield of 0.4% of GDP: a tax on insurance operations, gasoline tax increases, oil sector deregulation, social security contributions from employees of charitable organizations, and cuts in transfers to states and municipalities. The timing of those measures is not yet clear.

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TIME LINE FOR IMPLEMENTING BRAZIL'S FISCAL PROGRAM

(updated November 20, 1998)

Description of Measure	1999 Fiscal Impact (%GDP)	Legal Form[1]	Expected Final Congressional Approval[2]	Congressional Actions & Linkage to Fund Program	Other comments
FEDERAL GOVERNMENT FISCAL MEASURES	**3.4%**				
Social Security Reform: includes measures to set minimum retirement ages and cap benefits for public employees.	0.3%	Constitutional amendment	**Approved 11/4/98**	Approval is a prior action	Final promul-gation by 12/15
Judicial deposits transferred to federal government: Deposits made in tax disputes incorporated into tax revenue	0.2%	Provisional Decree[3]	**Approved 11/11/98**	N.A.	Accelerates govt. access to the funds
COFINS "social tax" -- imposed mainly on large firms: Rate increased from 2% to 3%, and coverage broadened to banks.	0.5%	Provisional Decree[3]	**Approved 11/18/98**	Approval a condition for 2nd tranche disbursement	Thought contentious, but approved w/ ease
Social Security tax 9% surcharge on public employees earning more than 1,200 *reais* ($1,000) per month	0.1%	Provisional Decree[3]	Expected 11/25/98	Approval a condition for 2nd tranche disbursement	Procedurally easy but a contentious issue
Cuts in discretionary spending: primarily investment and health & education; these items account for just 20% of non-interest spending; cuts to fall primarily on investment spending.	1.0%	Annual budget	By end-December, 98	Govt submission to Congress a prior action (11/9); approval a 2nd tranche condition	Not hard politically, but complicated in procedural terms.
Administrative Reform implementing legislation: Laws to set guidelines for implementing Administrative Reform -- a constitutional amendment approved in June allowing dismissal of civil servants for poor performance or for budgetary reasons.	0.1%	Complementary Law	By end-January, 1999	Approval a condition for 2nd tranche disbursement	Fiscal impact grows over time. Lengthy procedural process, but not contentious
Social Security tax -- imposed on public sector retirees: Two laws subjecting them to current 11% tax and 9% surcharge.	0.2%	Ordinary Laws[3]	By end-January, 1999	Approval a condition for 2nd tranche disbursement	Very contentious; **1st step approved 11/18**
Financial Transactions Tax increase: Rate to rise from 0.2% to 0.38% in 1999, falling to 0.3% in 2000 and 2001.	0.8%	Constitutional Amendment	By end-January, 1999	Govt submission to Congress a prior action (**11/18**); approval a 2nd tranche condition	Procedurally difficult; medium contentious; rate may be reduced

[1]Constitutional amendments require two separate votes with a 3/5 majority of total seats in both houses of Congress. Complementary laws require two separate votes with majorities of 50% + 1 of total seats in both houses of Congress. Ordinary laws, some of which can be implemented initially by provisional decree (see note 3), require one vote with a simple majority of members present in each house of Congress. Tax increases take effect after 90 days.

[2]Estimates, based on procedural issues and expected degree of political contentiousness.

[3]The government may implement some ordinary laws by provisional decree, which have the force of law for 30 days (extendable) until/unless Congress rejects the measure.

BRAZIL FISCAL PROGRAM TIME LINE (continued)

Description of Measure	1999 Fiscal Impact (%GDP)	Legal Form	Expected Final Congressional Approval	Congressional Actions & Linkage to Fund Program	Other comments
FEDERAL GOVERNMENT MEASURES (cont.)					
Fiscal Stabilization Fund extended through 2006: Effectively reduces revenue sharing with state & local governments	0.0%	Constitutional Amendment	By end-1999	Approval a condition for 2nd tranche disbursement	Fiscal impact by 2000 if lower revenues for states –> spending cuts
Measures not yet announced	0.3%				
Tax on Insurance Operations	0.04%	Prov. Decree	Not yet known		
Gasoline Tax Increases	0.1%	Ministerial Decree	Not yet known		
Oil Sector Deregulation	0.1%	Ministerial Decree	Not yet known		
SS Contributions on Charitable Organization Employees	0.1%	Ordinary Law	Not yet known		
STATE AND LOCAL GOVERNMENT MEASURES	0.5%				
Legal & institutional changes to enhance fiscal discipline:					
Fiscal Responsibility Law -- sets spending and borrowing ceilings on state & local governments; allows federal government to impose sanctions on violators		Not yet known	Early 1999	Fund staff in intensive discussions w/ Brazilians on these issues	
Administrative Reform implementing legislation -- limits state & local government payrolls to 60% of expenditures (some currently exceed 80%), with transition arrangement		See Previous Page			
STATE-OWNED ENTERPRISES	0.3%	Administrative Action	N.A.	N.A.	Implementation by Federal govt. is the key to fiscal impact
TOTAL MEASURES	4.2%				