

# WORLD TRADE ORGANIZATION

RESTRICTED

**WT/BOP/W/7**

27 September 1995

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## **Committee on Balance-of-Payments Restrictions**

### 1995 CONSULTATION WITH BRAZIL UNDER ARTICLE XVIII:12(a) OF THE GATT 1994 AND THE RELATED UNDERSTANDING

#### Background Paper by the Secretariat

1. This paper has been prepared in accordance with paragraph 12 of the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994.

#### I. Introduction

2. Brazil disinvoked Article XVIII:B of GATT 1947 on 9 July 1991 (L/6885 and BOP/R/194). Prior to that date Brazil had held six full consultations with the GATT 1947 Committee in 1971, 1976, 1978, 1981, 1983 and 1987 and four simplified consultations in 1978, 1980, 1985 and 1989.

3. On 27 June 1995 Brazil communicated, under the general WTO notification procedures, Provisional Measure No. 1024 of 13 June 1995 which prescribed a set of rules "reducing the tariff rate on specified products and containing other provisions" on imports of motor vehicles and parts, including the establishment of a quantitative limitation for the second half of 1995 (WT/L/73). In a further communication dated 13 July 1995 Brazil notified, under paragraph 9 of the Understanding on the Balance-of-Payments Provisions of the GATT 1994, that the Provisional Measure had been adopted for balance-of-payments reasons as provided in Article XVIII:B, paragraph 9 of GATT 1994 (WT/BOP/N/4).

#### II. The measures introduced in June 1995

4. Provisional Measure No. 1024 of 13 June 1995 provides a range of measures:

(i) Tariffs are lowered to 2 per cent on machines and equipment for assembling and manufacturing motor vehicles and their parts, and on raw materials and other inputs, including sets and sub-sets (Article 1);

ii) A trade-balancing framework is established, linking imports to export performance (Articles 2 to 6). Local content requirements are also introduced (Article 7). Imports of motor vehicles and their inputs are linked to export performance per company and per year: a proportion may be established by the Executive Power between: (a) imports of raw materials, parts, components, sets and subsets, and net exports of passenger vehicles, goods vehicles and buses by each company; (b) imports by each company of each item of raw materials, parts, components, sets and subsets and the total imports of such imports; (c) domestic purchases and imports by each company of machinery and equipment used in the manufacturing process,

their parts, and moulds; and (d) imports and net exports by each company of passenger motor vehicles, goods vehicles and buses (Article 2). Net exports are defined in Paragraphs 2 and 3 of Article 2 and in Articles 3 and 4. Companies manufacturing parts, components and tyres in Brazil may use the net export value as a transfer price in selling such parts to associated manufacturers of vehicles (Article 6).

(iii) Quantitative limitations and related rules for bidding for import quotas and issuance of import licences are established (Articles 9, 10 and 14). Import quotas apply to companies that do not manufacture the restricted items domestically (Article 9). Imports for the second half of 1995 are limited to 50 per cent of the value of vehicle imports that had been cleared through customs between 1 January and 12 June 1995. The quotas cover vehicles for passengers and mixed use, and jeeps; vans, station wagons, pick-ups and similar vehicles; vehicles for transportation of merchandise and for the collective transportation of passengers. Bidding for the import quantity will be made through public offers, as to be established in regulations, and the bid winners shall be, in decreasing order, the proponents that present the largest tariff increases, taking as basis the rates in force at the date of the public offer (Sole Paragraph to Article 9).

(iv) Specific rules applicable to motor vehicle trade within MERCOSUL are to be established, with a view to establishing the Common Automotive Régime (Article 8). According to the Brazilian authorities, motor vehicle exports from Argentina are not exempted from the quantitative limitations of 13 June 1995.<sup>1</sup>

### III. The Trade and Exchange Policy Framework

5. Brazil's foreign trade policy is formulated by the Ministry of Industry, Trade, and Tourism, implemented by the Secretariat of Foreign Trade (SECEX), and carried out by the Technical Department of Commercial Interchange (DTIC). The Ministry of Finance coordinates public sector import policy.

6. The process of trade liberalization which began in 1990, with lower tariffs and reduced non-tariff barriers and foreign exchange controls, produced significant changes in Brazil's trade régime. As a result, tariffs have become the primary instrument of border protection of domestic activities.

#### Tariffs

7. The Technical Department of Tariffs (DTT) under the Ministry of Industry, Trade and Tourism is responsible for formulating tariff policy and decides on changes in customs duties.

8. As a result of annual duty reductions between January 1991 and July 1993, the simple average m.f.n. tariff rate on non-oil imports was reduced to 11.3 per cent as of end-1994 from 32.2 per cent in 1990. The tariff structure included: (i) zero tariff rates, applying to products in which Brazil had a clear comparative advantage (such as orange juice, iron ore, and cellulose), products with high transport

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<sup>1</sup>The motor vehicle industry represents 28 per cent of internal trade among MERCOSUL countries. Under the Ouro Preto Agreement of December 1994 motor vehicles were granted special treatment; arrival at a common policy on intra-trade in this sector was postponed until 1999, and Argentina was granted freer access to the Brazilian market than it was required to grant Brazilian exports in the meantime. (Handelsblatt of 14-15 July 1995 and Latin American Regional Reports -Brazil 1995)

costs (such as live animals and cement) products that are not produced domestically and products with small value added (such as copper and zinc); (ii) 5 per cent applying to products that had such tariff rate in 1990; (iii) rates between 10 and 15 per cent applying to products that used imported inputs with zero tariffs (such as paper and cotton); (iv) a rate of 20 per cent applying to most imported manufactured products; and (v) rates of 30, 35 and 40 per cent applying to certain manufactured products, such as fine chemistry items, televisions, stereo sound systems and informatics products.

9. By Decree 1427, published on 29 March 1995, Brazil raised tariff rates on about 109 items, including automobiles and other durable consumer goods (some electronics and domestic appliances including answering machines, water heaters, interphones, earphones, walkmans, CD sound equipment, video-lasers, parabolic antennae, amplifiers and washing machines) for the period 15 May 1995 - 28 April 1996. On 27 April 1995, under Decree 1471, Brazil reduced tariffs from these increased levels on a number of items which would have otherwise breached Brazil's tariff bindings in Brazil's schedule of concessions annexed to the Marrakesh Protocol on these items (WT/L/66 and Add.1).

10. Brazil has adopted the Common External Tariff (CET) of the Southern Common Market (MERCOSUL) which went into effect on 1 January 1995. CET rates range between zero and 20 per cent in steps of two percentage points. Brazil may identify up to 300 national exceptions to the CET. Initially Brazil applied 175 national exceptions, 123 above CET rates and 52 below. There are also 150 items included in the list of exceptions for reasons of price-control and domestic provisioning which include the 109 items on which tariffs were increased by Decree 1427. The list of exceptions to the CET was increased to 450 items in Decree 1471 on 27 April 1995. Fifty of these items can be changed every three months while the remainder can be removed but not replaced. Approximately 85 per cent of Brazilian tariff lines are covered by the CET; all automobile items are national exceptions. There is also the list of convergence that include 1,236 tariff items; capital goods will converge to the CET in the year 2000 and informatics and telecommunications goods in 2006.

11. Intra-regional trade between Brazil and its MERCOSUL partners has been duty-free since 1 January 1995, except for 29 tariff headings subject to the procedure for adaptation to the trade liberalization programme until the year 1999.

12. Varying tariff preferences are also granted by Brazil under LAIA to other Latin American countries in the context of a variety of complex product-specific and country-specific agreements. Brazil grants concessions under the Global System of Trade Preferences Among Developing Countries, covering 98 items and under the Protocol Relating to Trade Negotiations Among Developing Countries covering only 12 tariff lines.

#### Tariff bindings

13. Brazil bound its entire tariff schedule in the Uruguay Round negotiations: 86 per cent of industrial products were bound at existing applied levels and 14 per cent at ceiling duties (Table 1). Bound rates are set at 35 per cent, with the exception of chemicals at 20 per cent and agricultural products (milk products, cheeses, wheat and meat) at 55 per cent. 66.7 per cent of tariff lines, accounting for 50.6 per cent of 1989 imports, are bound at 35 per cent. Another 17.5 per cent, accounting for 20 per cent of 1989 imports, are bound at 20 per cent (Table 2). The simple average of bound rates has decreased from 54.1 per cent to 30.0 per cent in the new schedule. (Table 3)

**Table 1****Overview of tariff bindings in Brazil**

(US\$ million and per cent)

	Pre-Uruguay Round				Post- Uruguay Round			
	1989 imports		Tariff Lines		1989 Imports		Tariff lines	
	Value	Per cent	Value	Per cent	Value	Per cent	Value	Per cent
All products (excluding petroleum products)								
Total	12,415	100	12,381	100	12,415	100	12,381	100
Bound	3,022	24	785	6	12,415	100	12,381	100
Fully Bound	2,024	16	432	3	12,415	100	12,381	100
At existing levels	2,024	16	432	3	9,780	79	10,571	85
At ceiling duties	0	0	0	0	2,634	21	1,810	15
Partially bound	998	8	353	3	0	0	0	0
At existing levels	998	8	353	3	0	0	0	0
At ceiling duties	998	0	0	0	0	0	0	0
Unbound	9,392	76	11,596	94	0	0	0	0
All agricultural products								
Total	888	100	1,520	100	888	100	1,520	100
Bound	320	36	81	5	888	100	1,520	100
Fully Bound	309	35	63	4	888	100	1,520	100
At existing levels	309	35	63	4	575	65	1,236	81
At ceiling duties	0	0	0	0	313	35	284	19
Partially bound	11	1	18	1	0	0	0	0
At existing levels	11	1	18	1	0	0	0	0
At ceiling duties	0	0	0	0	0	0	0	0
Unbound	568	64	1,439	95	0	0	0	0
Industrial products (excluding petroleum products)								
Total	11,526	100	10,861	100	11,526	100	10,861	100
Bound	2,702	23	704	6	11,526	100	10,861	100
Fully bound	1,716	15	369	3	11,526	100	10,861	100
At existing levels	1,716	15	369	3	9,205	80	9,335	86
At ceiling duties	0	0	0	0	2,321	20	1,526	14
Partially bound	988	9	335	3	0	0	0	0
At existing levels	988	9	335	3	0	0	0	0
At ceiling duties	0	0	0	0	0	0	0	0
Unbound	8,824	77	10,157	94	0	0	0	0

Source: WTO Secretariat.

**Table 2**

**Frequency distribution of bound rates on industrial products, excluding petroleum**  
(US\$ million and per cent)

M.f.n. duty range	Number of lines	Per cent	Imports 1989	Per cent
Total	10,851	100.0	11,409	100.0
Free	54	0.5	520	4.5
0.1 - 1.0	2	0.0	2	0.0
1.1 - 2.0	1	0.0	0	0.0
2.1 - 3.0	0	0.0	0	0.0
3.1 - 4.0	2	0.0	2	0.0
4.1 - 5.0	2	0.0	37	0.3
5.1 - 6.0	0	0.0	0	0.0
6.1 - 7.0	1	0.0	0	0.0
7.1 - 8.0	4	0.0	1	0.0
8.1 - 9.0	0	0.0	0	0.0
9.1 - 10.0	38	0.4	113	1.0
10.1 - 11.0	0	0.0	0	0.0
11.1 - 12.0	41	0.4	6	0.0
12.1 - 13.0	1	0.0	2	0.5
13.1 - 14.0	3	0.0	62	0.5
14.1 - 15.0	131	1.2	758	6.6
15.1 - 16.0	0	0.0	0	0.0
16.1 - 17.0	4	0.0	14	0.1
17.1 - 18.0	554	5.1	467	4.1
18.1 - 19.0	0	0.0	0	0.0
19.1 - 20.0	1,903	17.5	1,604	14.1
20.1 - 21.0	0	0.0	0	0.0
21.1 - 22.0	6	0.1	8	0.1
22.1 - 23.0	70	0.6	46	0.4
23.1 - 24.0	5	0.0	35	0.3
24.1 - 25.0	676	6.2	1,703	14.9
25.1 - 30.0	116	1.1	257	2.2
30.1 - 35.0	7,236	66.7	5,772	50.6
35.1 - 40.0	0	0.0	0	0.0
40.1 - 45.0	0	0.0	0	0.0
45.1 - 50.0	0	0.0	0	0.0
50.1 - 60.0	1	0.0	74	0.0

Source: WTO Secretariat.

**Table 3**

**Structure of bound tariffs, industrial products (excluding petroleum products)**

	Pre-Uruguay Round	Post-Uruguay Round
Number of tariff lines:		
Total	11,180	11,180
With unspecified duty rate	0	0
Simple tariff average	54.1	30.0
Standard deviation	28.3	7.6
Weighted tariff average based on 1989 imports	40.6	27.0

Source: WTO Secretariat.

#### Other measures affecting imports

14. Most imports are subject to automatic import licensing in the form of prior approval by Bank of Brazil, essentially for statistical and price-control purposes. Bank of Brazil is authorized to levy a processing fee R\$ 66.70 per licence. Import prohibitions apply to used consumer goods such as second-hand cars and motorcycles.

#### Exchange arrangements affecting imports

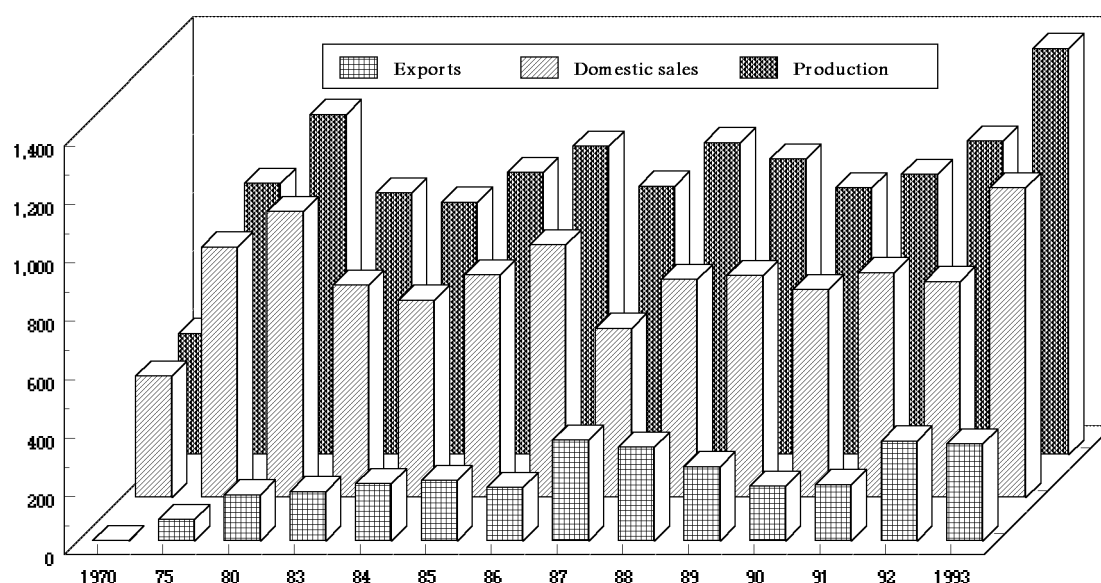
15. The National Monetary Council (CMN) is responsible for formulating overall foreign exchange policy. As from July 1994 importers are permitted to purchase foreign exchange in the exchange market within 180 days of settlement date. SECEX may approve applications for payment for imports of any goods at terms of up to 720 days from the date of shipment without prior authorization from the Central Bank. External financing at terms in excess of 720 days for imports must be authorized by the Central Bank, which will evaluate them in the light of foreign debt policy. Payment of the amount financed and accrued interest may be made only upon presentation of a certificate of authorization and a payment schedule issued by the Department of Foreign Capital (FIRCE) of the Central Bank.

#### IV. Motor vehicles and parts

16. Brazil, with 3 per cent of world motor vehicle production in 1993 was ninth among world producers. The vehicle industry plays a significant role in the Brazilian economy, accounting for around 2 per cent of GDP; exports of motor vehicles and parts were 8.6 per cent of the total exports in 1994. Established in the late 1950s under heavy protection, including stringent local content requirements, fiscal benefits, foreign exchange advantages and market reserve rules, the motor vehicle industry was set up initially to cater for the domestic market. However, as a result of fluctuations in domestic demand over the years, external markets gained significance from the mid-1970s: in 1974 the Industrial Development Council lifted all incentives previously granted, with the exception of those available under the Commission for the Concession of Fiscal Benefits for Special Export Programmes (BEFIEEX). During the following two years, all car producers then operating in Brazil signed export commitments under these programmes. The share of exports of motor vehicles in domestic production grew from 8 per cent in 1975 to 13 per cent in 1980, 21 per cent in 1985 and 38 per cent in 1987, declining to 24 per cent in 1993. Exports of engines and parts also increased. Exports supported production in years of sluggish domestic demand: at the onset of the debt crisis in the 1980s, domestic sales dropped by more than 40 per cent in 1981, while exports increased by 35 per cent.

**Chart 1****Motor vehicles and parts exports, domestic sales and production, 1970-93**

Thousand units



Source: American Automobile Manufacturers Association, 1995.

17. In recent years, significant increases in vehicle output have occurred in 1988 (16 per cent), 1993 (30 per cent) and 1994, when output rose by 14 per cent to over 1.5 million vehicles.

18. Currently vehicle manufacturing is divided among nine producers. Passenger cars, which account for nearly 80 per cent of all motor vehicles produced in 1993, are produced by four multinational companies (Volkswagen, Fiat, General Motors and Ford). Parts and components are produced by nearly 1,600 firms, producing around 5,000 different items. The four major companies have announced plans involving US\$10 billion of investment in the coming years for increasing capacity and productivity and upgrading factories.<sup>2</sup>

19. Brazil is a net exporter of motor vehicles, with US\$1.5 billion of earnings in 1994 from passenger motor vehicles, lorries and trucks, buses and tractors, and US\$1.4 billion from parts. Import payments for motor vehicles in 1993 amounted to US\$920 million (US\$707.1 million for passenger transport vehicles) and US\$828.2 million for parts; imports of motor vehicles increased by nearly 80 per cent to US\$1.6 billion in 1994 and by US\$757 million in the first two months of 1995<sup>3</sup> (Chart 2). Imported vehicles were 12.2 of local production in 1994 and 37.2 per cent in the first half of 1995.

<sup>2</sup>Financial Times of 11 August 1995

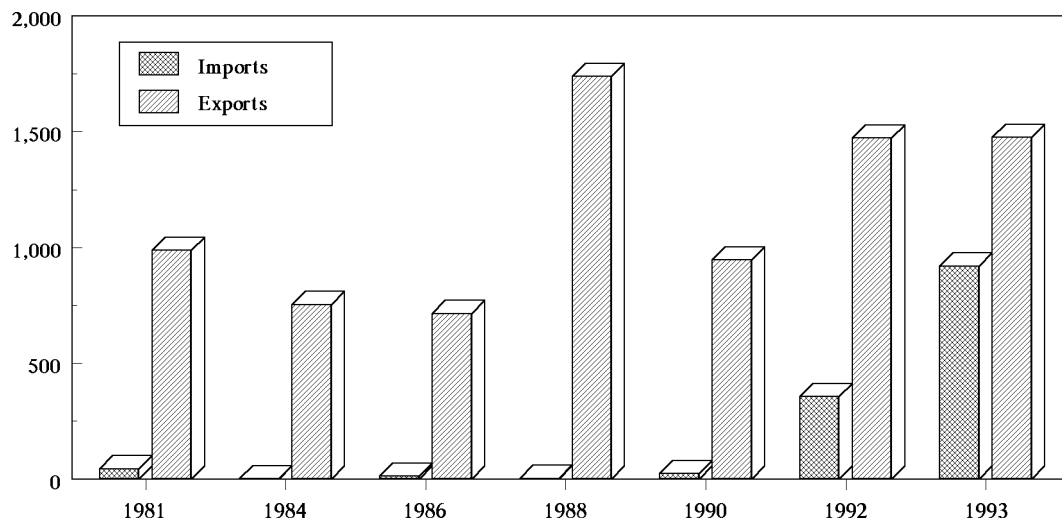
<sup>3</sup>Economist Intelligence Unit, London: Brazil: Country Report, 2nd Quarter, 1995.

Chart 2

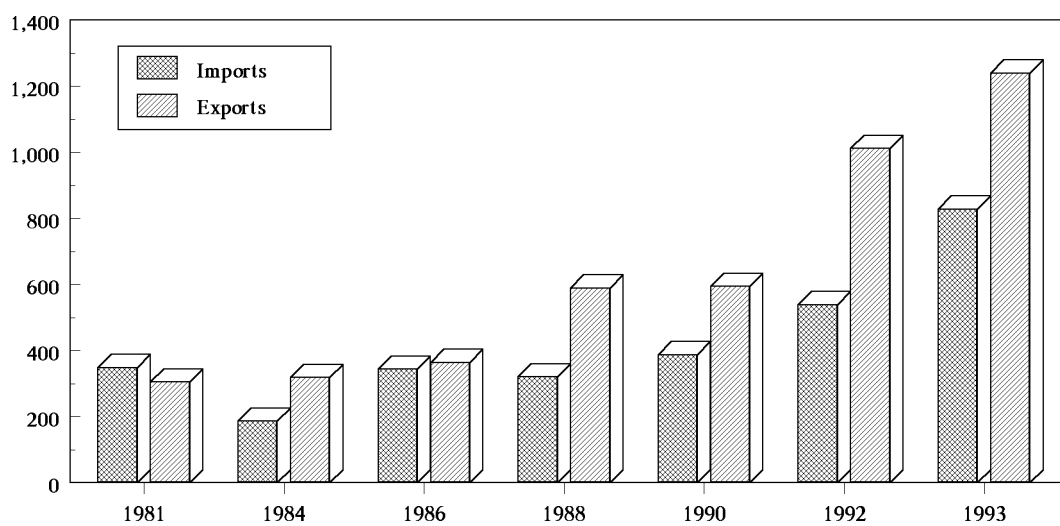
## Motor vehicles and parts imports and exports, 1981-93

US\$ million

## (a) Motor vehicles



## (b) Motor vehicle parts



Source: UNSTAT, Comtrade database.



20. Main export destinations of passenger transport vehicles, goods vehicles and public transport passenger vehicles in 1994 were Argentina (32 per cent), Italy (15 per cent), Chile 9 per cent), Mexico (9 per cent), Uruguay (7 per cent). Argentina (31 per cent) and the United States (23 per cent) were the main markets for Brazilian exports of parts in 1994.

21. Main sources of imports of passenger vehicles in 1993 were Japan (29 per cent), Argentina (22 per cent), United States (17 per cent), Italy (12 per cent), Germany (11 per cent), France (2 per cent), Russian Federation (2 per cent) and Republic of Korea (2 per cent). Argentina (30 per cent), Germany (19 per cent), United States (13 per cent) and Japan (13 per cent) were the main suppliers of parts in 1993.

22. The average nominal tariff protection for the motor vehicles sector has been traditionally the highest in the economy. From the tariff reduction programme of 1991 onwards, the rate applied on imports in this sector was successively reduced from 105 per cent to 20 per cent by 1994. The rate was again raised to 32 per cent in February 1995 and to 70 per cent in March 1995. In the Uruguay Round the tariff in this sector will be consolidated at 35 per cent.

23. Tariffs on fully assembled automobiles (HS 8703.21-8703.90) and light trucks (8704.21.10, 90; 8704.31.10, 90) currently stand at 70 per cent; tariffs on other classes of assembled vehicles are generally 32 per cent. Duties on parts are generally 14 per cent and 18 per cent. Under the current tariff reduction schedule, rates of 70 per cent will be reduced to 62 per cent in January 1996 and to 30 per cent in March 1996, while the 32 per cent rate will be cut to 30 per cent in January 1996 (WT/L/66/Add.1).

24. In addition to tariffs, a series of federal and state taxes are charged on imports. The federal taxes are: Importation Tax and Tax on Industrialized Products. State Taxes are charged on circulation of certain merchandises and services. Following an agreement with manufacturers, unions and dealers in April 1992, the Government lowered state and federal taxes by 12 percentage points in return for a 7.5 per cent cut in profit margins by manufacturers and a 2.5 per cent by dealers as part of efforts to increase competition and price stability.

## V. Macroeconomic and Trade Developments<sup>4</sup>

### Introduction

25. Despite its many achievements, the performance of the Brazilian economy has been historically marred by strong inflationary pressures. Inflation control has been one of the central problems of economic policy. Following a sharp reduction of external capital inflows and an increase in factor payments abroad in the early 1980s, inflation accelerated, leading to a slowdown in the growth of investment and domestic output. The successive Brazilian governments have made several attempts to contain the inflationary pressures. They have adopted stabilization programs that have heavily relied on price and wage freezes and on unilateral modifications in the terms of financial contracts. However, these measures were not supported by a sufficient tightening of financial policies and resulted, therefore, in only brief periods of reduced inflation. Throughout the second half of the 1980s and the early 1990s, *monthly* inflation remained mostly above 10 per cent, with several periods during which the inflation

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<sup>4</sup>The present analysis is based on provisional data for 1994 and 1995. In contrast to the standard practice, the analysis draws on different statistical sources that may not be strictly comparable.

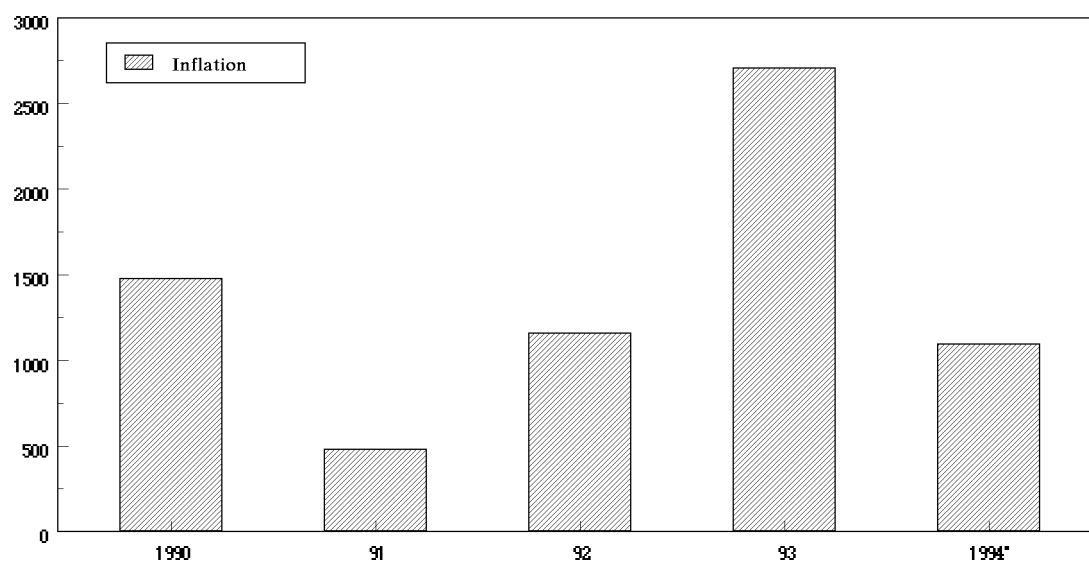
reached a rate as high as 80 per cent per month (e.g., late 1989). Following each attempt to stabilize the currency, inflation rebounded with greater intensity as controls were relaxed and indexation was intensified, and the credibility of these programmes dwindled.

26. The latest stabilization programme was introduced in 1994. The programme was built on measures adopted in 1990 that included tight credit targets, the strengthening of public finance, price liberalization measures, privatization, trade liberalization, various adjustments to the exchange rate policies and modifications to wage indexing. The main objective of the 1994 program was the reduction of inflation from about 42 per cent per month in the first semester of 1994 to the level at par with international inflation rates. The program's main components included strict financial policies combined with measures that would reduce what is known in Brazil as the "inertial" element of inflation. That includes measures that do not resort to price freezes or to unilateral modifications of contractual arrangements. The operational balance of the public sector was targeted at 0.6 per cent of GDP, and the program assumed a further reform of public finances, an expansion of the privatization program and reductions in import tariffs. Furthermore, a new currency - the *real* - was introduced in three stages between March 1 and July 1 1994.

#### Output, Prices and Employment

27. The stabilization measures adopted in the course of 1994 led to a significant reduction of inflation, even though the rate still remains high. Annual inflation dropped from about 2,700 per cent at the end of 1993 to 1,094 per cent at the end of 1994 (Chart 3). This reduction reflected successful stabilization measures in the second half of the year, when monthly inflation rates dropped dramatically. The estimates vary among different sources but they show a clear trend of lower inflation between October 1994 and March 1995 in the range of 1-3 per cent per month, compared to about 48 per cent in July 1994. However, starting in March 1995, the inflationary pressures began again to accelerate as a result of demand pressures, adjustment of prices in the public sector and exchange rate adjustments (Chart 4). Even though estimates vary for 1995, it is evident that the inflationary pressures have not been fully subdued; inflation accelerated in June and July but, according to the most recent information, it slowed down in August.

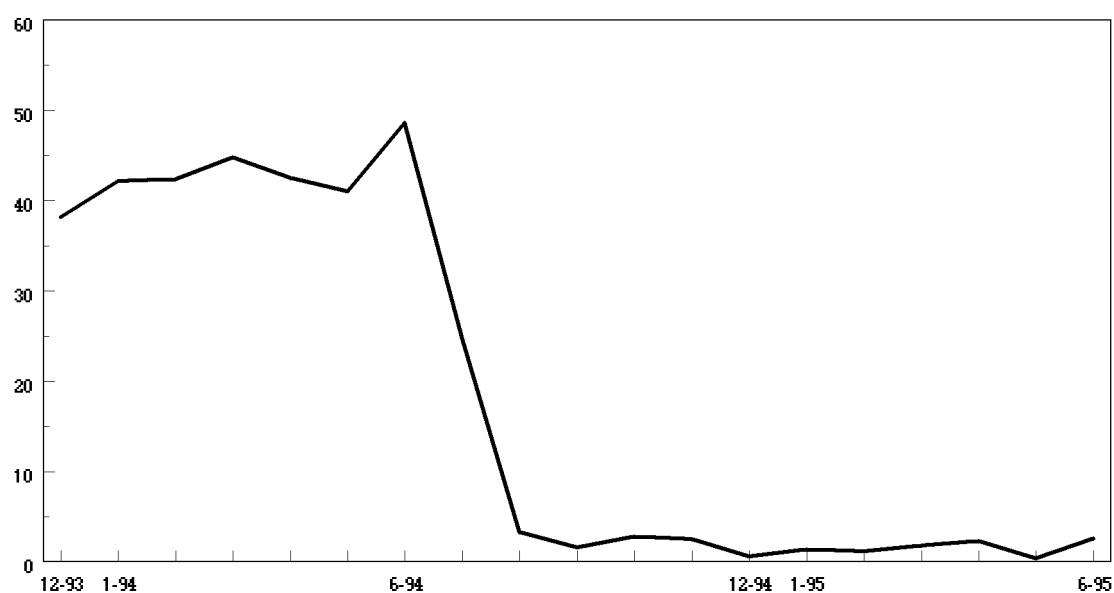
**Chart 3**  
**Brazil - Consumer prices, 1990-94**  
Annual percentage change



\* End of period.

Source: IMF, *International Financial Statistics*.

**Chart 4**  
**Brazil - Monthly inflation rates, 1993-95**  
Per cent



Source: World Bank.

28. Following stagnation and recession in 1991 and 1992, the economy began to recover in 1993 when it registered a growth of GDP of 4.1 per cent (Chart 5). The recovery was stimulated by an extremely rapid growth of domestic demand, induced by strong growth of real wages and by the low level of real interest rates in the first three quarters of the year; real interest rates in the overnight market for government securities dropped to 4 per cent from about 30 per cent in 1992, while real wages in the manufacturing sector, for example, have increased in 1993, according to official sources, by 11.4 per cent (Sao Paulo region). The growth was generated by a strong recovery in the manufacturing sector, brought about by radical restructuring in the sector, in construction, commerce and in transportation activities. In 1994, GDP growth further accelerated to an estimated 5.8 per cent, stimulated by a further strong growth of real wages and by a sharp drop of inflation.<sup>5</sup> According to Central Bank estimates, the December-to-December increase in real wages in the Sao Paulo region was 11.4 per cent in 1994. There are clear indications that the strong growth of domestic demand continued in the early part of 1995. The World Bank reports that GDP increased by 10.5 per cent in the first quarter of 1995 compared to the first quarter of 1994, with industrial sales growing at 28 per cent. Most recent estimates of the Brazilian statistical institute (IBGE) suggest a slowdown in the second quarter of 1995. Nevertheless, growth in the first half of 1995 was estimated by the same source at 7.8 per cent.

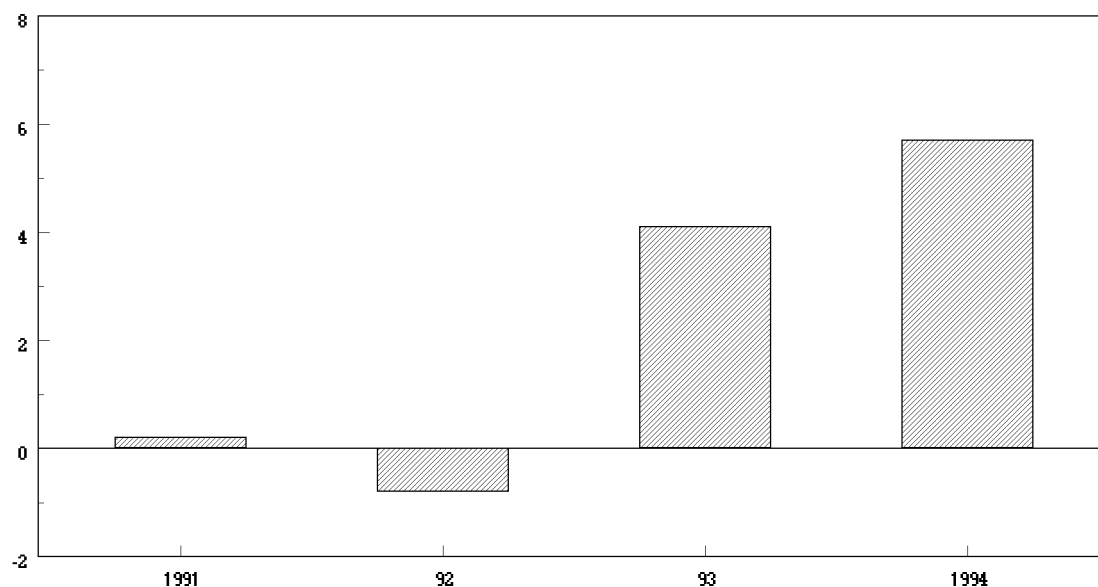
29. The domestic recovery has brought about some improvement in the labour market. The recession of the early 1990's resulted in substantial displacement of labour and in rising unemployment. The official rate of unemployment rose more or less steadily between December 1989 and April 1993 when it reached the level of 6.1 per cent compared to 2.4 per cent registered in December 1989. The manufacturing sector was particularly seriously affected. For example, measured employment in the manufacturing sector of the Sao Paulo region, where a large part of the sector is located, declined by 21.3 per cent between 1989 and 1993. The recovery of production increased demand for labour and, as a result, the unemployment rate started to fall in the middle of 1993 and the unemployment rate continued to fall in 1994. By the end of 1994, the rate was down to 3.4 per cent. According to the World Bank, the rate of unemployment stabilized throughout the first half of 1995 in all major regions of the country.

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<sup>5</sup>The contribution of wages to inflation is not entirely clear. There are some indications that manufacturing productivity also increased quite rapidly. If true, the productivity-adjusted growth of real wages would have been substantially lower and so would be, therefore, its inflationary impact.

**Chart 5**  
**Brazil - Growth of real GDP, 1991-94**

Annual percentage change



Source: IMF, *International Financial Statistics*.

## VI. Balance of Payments

30. The balance of payments position of Brazil has been crucially dependent in recent years on the development of the external debt burden. Brazil has contracted over the years a very large external debt which stood at the end of 1990 at US\$148.3 billion, or about 26 per cent of GDP. This makes Brazil one of the most heavily indebted nations in the world. The high external debt has put a heavy burden on the country's ability to service its debt obligations, which became particularly evident between 1989 and 1991 when external arrears increased from about US\$4 billion to US\$19.6 billion. Following a comprehensive debt rescheduling package with the Paris Club and a restructuring agreement with commercial bank creditors, together with a significant increase in the trade surplus and in foreign capital inflows, the balance of payments situation strengthened and the value of arrears was reduced considerably in 1992 - to US\$5.3 billion. The relatively strong trade performance combined with renewed access to foreign capital markets and a relatively high level of real interest rates have been instrumental in attracting foreign capital.

31. Despite the highly unstable monetary situation and the heavy external debt burden, the balance of payments continued to be relatively strong in 1993 and in 1994. This reflected partly the continuation of favourable trends in the trade balance. It also reflected a further increase in capital inflows and the completion of the agreement on April 15, 1994 with commercial bank creditors that provided for a significant debt and debt service reduction. The agreement, which involved the restructuring of some US\$47.2 billion of debt (including all existing payments arrears to bank creditors),

resulted in reductions of US\$ 4.3 billion in the stock of debt and of nearly US\$10 billion in the present value of total debt-service obligations over the 30 year period.

32. The following section will describe separately and in greater detail the developments in the current and capital accounts. In addition, the analysis will be concluded with an assessment of the adjustment process over the last four years as reflected in the changes of the main macroeconomic balances - the savings-investment balances. Since changes in the savings-investment balances have a direct counterpart in the corresponding changes in the current account balances, they are included here to identify the main forces and instruments of the domestic adjustment process and its impact on the evolution of the balance of payments.

#### Current account

33. The current account of Brazil has been more or less in balance over the last two years. Following a large surplus, amounting to US\$6 billion in 1992, or about 1.5 per cent of GDP, the current account turned into relatively small deficits in 1993 and 1994, amounting to US\$0.6 billion in 1993 and US\$1.5 billion in 1994, or 0.1 and 0.2 per cent of GDP respectively (Table 4).<sup>6</sup> The changes in the current account in recent years have been dependent on the developments of three variables - the changes in the surplus on merchandise trade, in the deficit in trade in services and in interest payments on outstanding debt.

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<sup>6</sup>The current account position of Brazil is even stronger if it is expressed in constant prices, that is after allowing for changes in terms of trade that improved considerably in 1993 and in 1994. The improvement in the terms of trade has been estimated by the IMF to be 1.8 and 6.1 per cent respectively.

**Table 4 - Brazil - Selected Indicators of Balance of Payments, 1991-94**

(In billions of U.S. dollars)

	1991	1992	1993	Prelim. 1994
Trade balance	10.6	15.2	13.3	10.4
Exports (f.o.b.)	31.6	35.8	38.6	43.6
Imports (f.o.b.)	-21.0	-20.6	-25.3	-33.2
Services and transfers (net)	-12.0	-9.2	-14.2	-11.8
of which: interest	-8.6	-7.3	-8.4	-6.4
<b>Current account balance<sup>1</sup></b>	<b>-1.4</b>	<b>6.0</b>	<b>-0.9</b>	<b>-1.5</b>
<b>Capital account</b>	<b>-3.3</b>	<b>23.9</b>	<b>9.3</b>	<b>14.4</b>
Foreign direct investment	0.9	1.3	0.6	1.8
Portfolio investment	-0.4	1.6	5.7	6.4
Long-term capital (net)	-1.5	19.6	3.8	7.3
Multilateral	-0.3	-0.6	-0.7	-0.1
Banks	-2.2	5.1	-3.4	5.0
Other	1.0	15.1	8.0	2.4
Misc. <sup>2</sup>	-2.2	1.4	-0.8	-1.1
<b>Overall balance</b>	<b>-4.7</b>	<b>29.9</b>	<b>8.4</b>	<b>12.9</b>
Change in reserves (- indicates an increase)	0.4	-14.5	-8.7	-7.2
Liabilities	4.3	-15.4	-0.3	-5.7
Arrears	5.6	-14.3	1.1	-5.6
Other	-0.7	-0.7	-0.3	0.1
<u>Memorandum items</u>				
Current account in percent of GDP	-0.3	1.5	-0.2	-0.2
Interest payments in percent of GDP	-2.3	-2.1	-2.0	-1.3
Debt service in percent of exports of GNFS <sup>3</sup>	52.1	45.8	52.8	30.2
Import volumes (percent change)	9.5	-4.0	21.5	33.1
Export volumes (percent change)	3.5	13.8	12.6	5.5
Terms of trade (percent change)	4.6	-0.8	1.8	6.1
Gross reserves (end of period in US\$ billions)	8.8	23.3	31.7	38.5
Gross reserves (months of imports of goods and nonfactor services)	4.0	11.0	11.9	11.3
Trade balance in percent of GDP	2.6	3.8	2.8	1.7

1 Includes reinvested profits.

2 Includes Brazilian lending abroad, flows related to DDSR transactions, short-term capital, gold monetization, valuation adjustments, and errors and omissions.

3 Goods and Non-Factor Services.

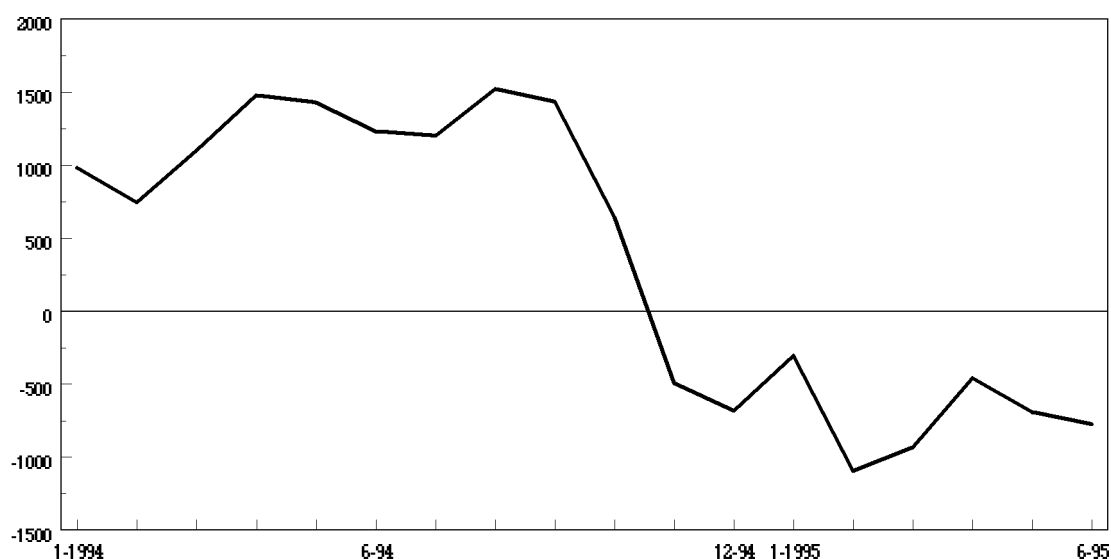
Source: IMF

34. Brazil has a fairly long history of large surpluses in merchandise trade (since 1982). Even though the trade surpluses have been falling both in absolute terms and as a percentage of GDP since 1992, they continued to be large until the second half of 1994. The surplus on merchandise trade amounted to US\$15.2 billion in 1992, or 3.8 per cent of GDP. Even though the surpluses declined in 1993 and in 1994, they continued to be sufficiently large to cover deficits in trade in services including foreign transfers and interest payments. As a result, the current account remained roughly in balance

in 1993 and 1994, and the large net capital inflows that have taken place over the last three years (see further below) have resulted in the increase of international reserves.

35. The deterioration in the current account in 1993 and 1994 relative to 1992 entirely reflected the reduction in trade surpluses. The latter was due to the considerable slowdown in the rate of growth of exports and a sharp acceleration of imports between 1992 and 1994 as the economic recovery progressed and domestic demand strongly expanded. In contrast, interest payments declined in 1994, amounting to US\$6.4 billion, a fall of about 24 per cent from 1993. The deficit in the service account also declined from US\$15.4 billion in 1993 to US\$14.4 billion in 1994, mainly reflecting a reduction in interest payments. By the end of 1994 and the beginning of 1995, however, the pattern began to change. The monthly merchandise trade surpluses disappeared in the latter part of 1994, fuelled by the rapid growth of domestic demand (Chart 6). The deficits in services and in financial contracts increased considerably. According to government sources, the trade deficits persisted until July 1995, when a small surplus of US\$2 million was registered. Preliminary figures for August 1995 indicate that the trade surplus increased to US\$300-350 million.

**Chart 6**  
**Brazil - Monthly trade balance, 1994-95**  
US\$ million



Source: World Bank.

36. The reduction of trade surpluses reflected both the significant upturn of the economy and the liberalization of import measures. These factors led to a sharp increase of demand for imports stimulated by the fast growth of real wages, the nominal appreciation of the currency in the second half of 1994 and, mainly, by credit and monetary expansion. Imports expanded by about 23 per cent in 1993 in real terms and even faster in 1994 - by 32 per cent. The expansion of import demand continued in the beginning of 1995 as imports are reported to have almost doubled between January and March



of 1995 compared to the same period in 1994.<sup>7</sup> The slowdown in exports also had its origins in the domestic recovery, which diverted resources to the domestic market. Another short-term factor affecting the performance of exports and imports at the end of 1994 and in the beginning of 1995 was the anticipation by traders of a devaluation, as well as their expectations about new trade restrictions; these expectations delayed some export decisions and accelerated imports.

37. The strength of domestic recovery and the growth of import demand resulted in a rapid growth of imports of capital goods. Total imports of capital goods expanded by 45 per cent between 1990 and 1993 in current dollar terms, considerably faster than total imports (Table 5). According to government sources, strong growth of imports of capital equipment continued in 1994. The most dynamic capital import items included transport equipment, which more than tripled since 1990, and imports of electrical equipment. In contrast, imports of consumer goods, other than passenger cars, and imports of fuels grew modestly, the latter benefitting from a favourable development in fuel prices in world markets. Imports of "other raw materials" expanded but also at a more modest pace (38 per cent).

38. In 1994 and 1995, however, the most dramatic increase was in the growth of imports of passenger cars. (See Section IV above).

**Table 5 - Brazil: Commodity composition of merchandise imports by end-use, 1991-1995**

(In millions of US dollars and percentage shares)

	1991		1994		1994		January-June 1995	
	Value	% Share	Value	% Share	Value	% Share	Value	% Share
<b>Total Imports</b>	21,042	100.0	33,105	100.0	13,331	100.0	25,716	100.0
Nondurable consumer goods	1,501	7.1	1,435	7.4	797	4.0	2,316	9.0
Foodstuff	880	4.2	1,286	3.9	398	3.0	1,242	4.8
Clothing	66	0.3	109	0.3	38	0.3	194	0.8
Durable consumer goods	827	3.9	2,714	4.2	1,033	7.8	3,186	12.4
Machine and apparatus for domestic use	163	0.8	329	1.0	107	4.8	335	1.2
Vehicles	121	0.6	1,233	3.7	435	3.3	2,360	9.2
Parts, spares and accessories	325	1.5	623	1.9	294	2.2	470	1.9
Fuel and lubricants	4,894	23.3	4,351	13.1	1,822	13.7	2,699	30.5
Oil and derivatives	4,073	19.4	4,044	12.2	1,799	13.5	2,641	10.2
Crude oil	3,371	16.0	2,342	7.1	879	6.6	1,423	5.5
Derivatives	702	3.3	1,702	5.1	920	6.9	1,152	4.7
Raw materials	8,624	40.9	13,715	41.4	6,553	49.2	11,920	46.4
Cereals	1,080	5.1	1,408	4.2	570	4.3	917	3.4
Fertilizer	374	1.8	636	1.9	219	1.6	336	1.2
Chemical products	2,833	13.5	4,573	13.8	1,805	34.1	3,451	13.4
Iron and steel	342	1.6	433	1.3	191	1.4	332	1.3

Table Cont'd

<sup>7</sup>See Brazil: Country Report, 2nd Quarter, London: The Economist Intelligence Unit, 1995, p.22.

	January-June							
	1991		1994		1994		1995	
	Value	% Share	Value	% Share	Value	% Share	Value	% Share
Other metals	433	2.1	571	1.7	285	2.1	615	2.4
Paper products	443	2.1	559	1.7	232	1.7	629	2.4
Plastic products	741	3.5	1,334	4.0	566	4.2	1,234	4.8
Capital goods	5,205	24.7	5,886	29.1	3,126	23.4	5,593	21.7
Machines and apparatus for office	903	4.3	1,537	4.6				
Tools	49	0.2	100	0.3				
Accessories to industrial machines	486	2.2	514	1.6				
Industrial machines	1,611	7.7	2,349	7.7				
Other fixed equipment	335	1.6	1,046	3.2				
Spare parts for industrial capital goods	471	2.2	1,161	3.5				
Accessories for transportation equipment	868	4.1	1,813	5.5				
Moving transportation equipment	336	1.6	964	2.9				
Fixed transportation equipment	39	0.2	41	0.1				
Spare parts for transportation equipment	79	0.4	65	0.2				
(Annual percentage change)								
	1992		1993		1994		1995 (Jan-June)	
Memorandum items								
Total imports	-2.3		23.0		31.1		93.0	
Nondurable consumer goods	23.5		24.1		68.2		190.8	
Durable consumer goods	4.6		83.5		71.0		208.0	
Fuels and lubricants	-8.1		-9.0		6.3		48.8	
Raw materials	-1.7		35.1		19.6		81.8	
Capital goods	6.8		19.5		48.5		29.0	

Source: IMF

39. In addition to the influence of domestic demand and domestic policies, the trade performance has also been affected by external factors. All these forces have stimulated an adjustment process in the tradeables sector, especially in the export producing segment. The recession in the OECD area in the early 1990s primarily affected exporters of primary and semi-manufactured products. The result was stagnation of virtually all primary exports such as coffee, cocoa, tobacco, soybeans, sugar and iron ore (Table 6) between 1990 and 1993. Semi-manufactured products of agricultural origin also stagnated or even declined. In contrast, the manufacturing sector responded well to structural policies and other incentives, and the recovery of output noted above was partly stimulated by fast growth of exports, which increased by 39 per cent between 1990 and 1993. The most dynamic exports included electric and non-electric machinery, transport equipment, footwear and steel products. The improvement in export performance in 1994 was mainly due to a strong recovery of primary exports (coffee and soybeans) and semi-manufactured products; manufactured exports also increased, albeit at a slower pace.

**Table 6 - Brazil: Commodity composition of merchandise exports by principal commodity groups, 1991-1993**

(In millions of US dollars and percentage shares)

	US dollars			Shares		
	1991	1994	1995 (Jan-June)	1991	1994	1995 (Jan-June)
<b>Total exports (f.o.b.)</b>	31,620	43,545	21,449	100.0	100.0	100.0
<b>Primary products</b>	8,743	11,058	5,257	27.7	25.4	24.5
Coffee beans	1,382	2,219	1,085	4.4	5.1	5.1
Raw sugar	209	173	236	0.7	0.4	1.1
Soybeans and soybran	1,817	3,296	501	5.7	7.6	2.3
Cocoa beans	88	106	13	0.3	0.2	0.1
Tobacco leaf	681	694	182	2.2	1.5	0.8
Iron Ore	2,600	2,294	1,297	8.2	5.3	6.0
Other	1,966	2,274	1,937	6.2	5.2	9.0
<b>Semi manufactures</b>	5,364	6,893	3,804	17.0	15.8	17.7
Crystal sugar	47	614	233	0.1	1.4	1.1
Cocoa products	178	173	45	0.6	0.4	0.2
Tin	100	38	24	0.3	0.2	0.1
Soybean oil	209	828	434	0.7	1.9	2.0
Paper paste	578	840	663	1.8	1.9	3.1
Iron products	672	734	383	2.1	1.7	1.8
Steel products	952	1,072	606	3.0	2.5	2.8
Leather hides	308	459	271	1.0	1.1	1.3
Other	2,320	2,085	1,145	7.3	4.6	5.3
<b>Manufactures</b>	17,085	24,959	11,942	54.0	57.3	55.7
Soluble coffee	97	340	207	0.3	0.8	1.0
Refined sugar	142	185	140	0.4	0.4	0.7
Electric machinery	1,015	1,395	715	3.2	3.2	3.3
Non-electric machinery	2,597	3,660	1,904	8.2	8.4	8.9
Transport equipment	2,217	3,727	1,507	7.0	8.6	7.0
Footwear	1,245	1,625	757	3.9	3.7	3.5
Fruit juices	910	992	508	2.9	2.3	2.4
Steel products	2,648	2,660	1,012	6.4	6.1	4.7
Processed beef	219	287	162	0.7	0.7	0.8
Cotton fabrics and yarn	269	291	127	0.9	0.7	0.6
Other textiles	624	722	356	2.0	1.7	1.7
Petroleum derivatives	722	1,131	454	2.3	2.6	2.1
Other	4,380	7,944	4,093	13.9	18.2	19.1
Other exports	428	635	446	1.4	1.5	2.1
<b>(Annual percentage change)</b>						
	<b>1992</b>	<b>1993</b>	<b>1994</b>		<b>1995 (Jan-June)</b>	
<b>Memorandum items</b>						
Total exports	13.2	7.8	12.8			6.7
Primary products	0.9	6.2	18.1			7.4
Semi-manufactured	-2.8	5.6	26.6			25.9
Manufactured	25.0	9.8	6.3			0.4

Source: IMF

40. The second important feature of the adjustment process was the geographical reorientation of foreign trade. In the past, the traditional partners of Brazil were the developed markets of the European Union, the United States and the markets of the oil-exporting countries and Latin America (Table 7). The trade orientation began to change dramatically in the beginning of the 1990's with the recession in the OECD countries and with the creation of MERCOSUL. The recession and depressed prices in the OECD area in the early 1990's were instrumental in generating stagnation of Brazil's exports to these countries and a significant decline in their share in total exports of Brazil. In contrast, the Latin American market began to play an increasingly more important role as particularly exports to the MERCOSUL countries began to rapidly expand. Exports to these countries almost quadrupled in only three years - between 1990 and 1993. The Latin American market now takes about a quarter of Brazil's exports compared to 11 per cent in 1990 and together with the European Union, it is the most important export market for the country.

**Table 7 - Brazil - Direction of Trade, 1990, 1994**

(In million US dollars and percent)

	US Dollars		Shares <sup>1</sup>	
	1990	1994	1990	1994
<b>Total exports</b>	31414	43545	100.0	100.0
Latin America	3469	10163	11.0	23.3
MERCOSUR	1313	5922	4.2	13.6
Argentina	639	4136	2.0	9.5
Paraguay	379	1054	1.2	2.4
Uruguay	295	732	0.9	1.7
Other	2156	4241	6.9	9.7
EC	9852	11812	31.4	27.1
United States <sup>1</sup>	7675	8951	24.4	20.6
Japan	2350	2574	7.5	5.9
Oil exporters <sup>2</sup>	1166	847	3.7	1.9
CMEA	704	534	2.2	1.2
Other	6198	8664	19.7	19.9
<b>Total imports</b>	20661	33105	100.0	100.0
Latin America	3776	6663	18.3	20.1
MERCOSUR	2327	4656	11.3	14.1
Argentina	1412	3612	6.8	10.9
Paraguay	330	366	1.6	1.1
Uruguay	585	678	2.8	2.0
Other	1449	2007	7.0	6.1
EC	4232	8590	20.5	25.9
United States <sup>2</sup>	4412	7674	21.4	23.2
Japan	1247	1798	6.0	5.4
Oil exporters <sup>3</sup>	3990	2382	19.3	7.2
CMEA	359	448	1.7	1.4
Other	2645	5550	12.8	16.8

1 Sums may not add up due to rounding.

2 Including Puerto Rico.

3 Algeria, Iran, Iraq, Kuwait, Lybia, Nigeria, Qatar and Saudi Arabia.

Source: Brazilian Authorities

## Capital account

41. The capital account remained relatively strong in recent years despite the large and growing external debt and some weakening of the current account as noted above. This primarily reflected the rescheduling agreements with the Paris Club and commercial bank creditors, the access to external capital markets and relatively high interest rates combined with improving business prospects throughout the period of 1993 until the beginning of 1995. Even though the total outstanding external debt has been rising for a number of years, the burden of debt servicing has been consolidated and even somewhat reduced since 1990. While the total external debt outstanding increased from US\$115.5 billion in 1989 to US\$145.7 billion in 1993 (Table 8), its share in GDP has remained essentially constant. The external debt exposure in terms of earnings from exports of goods and non-factor services declined more significantly - from 361 per cent in 1991 to 349 per cent in 1993. More importantly, the debt service ratio - the ratio of interest payments and amortization and of exports of goods and non-factor services - was significantly reduced in 1994 - from about 52.8 per cent in 1993 to 30.4 per cent in 1994.

Table 8 - Brazil - External Debt, 1991-1994

	1991	1992	1993	1994
<b>External Debt</b> (In billions of US dollars)				
Total	123.9	133.8	139.3	148.3
of which:				
Medium- and Long-Term	110.3	114.0	116.5	...
Short-Term	13.6	19.9	22.8	...
<i>Memorandum items</i>				
Total External Debt				
In percent of GDP	29.6	31.5	30.7	...
In percent of exports GNFS <sup>1</sup>	360.6	341.7	331.6	...
of which:				
Short-term external debt				
In percent of exports GNFS <sup>1</sup>	39.5	50.7	54.3	...
In percent of gross international reserves	155.0	85.4	71.9	...
Interest Payments				
In percent of GDP	2.3	2.1	2.0	1.3
Debt Service				
In percent of exports of GNFS <sup>1</sup>	52.1	45.8	52.8	30.2
External Payment Arrears				
In billions of US\$	19.6	5.3	6.5	0.8

1 Goods and Non-Factor Services.

Source: IMF

42. The second positive feature of recent developments in the capital account was the relative reduction in the role of short-term capital. Exposure to the short-term debt was sharply decreased, and this considerably reduced the vulnerability of Brazil's external position to speculative fluctuations of short-term money. The short-term debt as a percentage of gross international reserves dropped from 152 per cent at the end of 1990 to 72 per cent at the end of 1993. Even though the exposure to short-term debt remains high, the term-structure of external debt was much improved by the end of 1994.

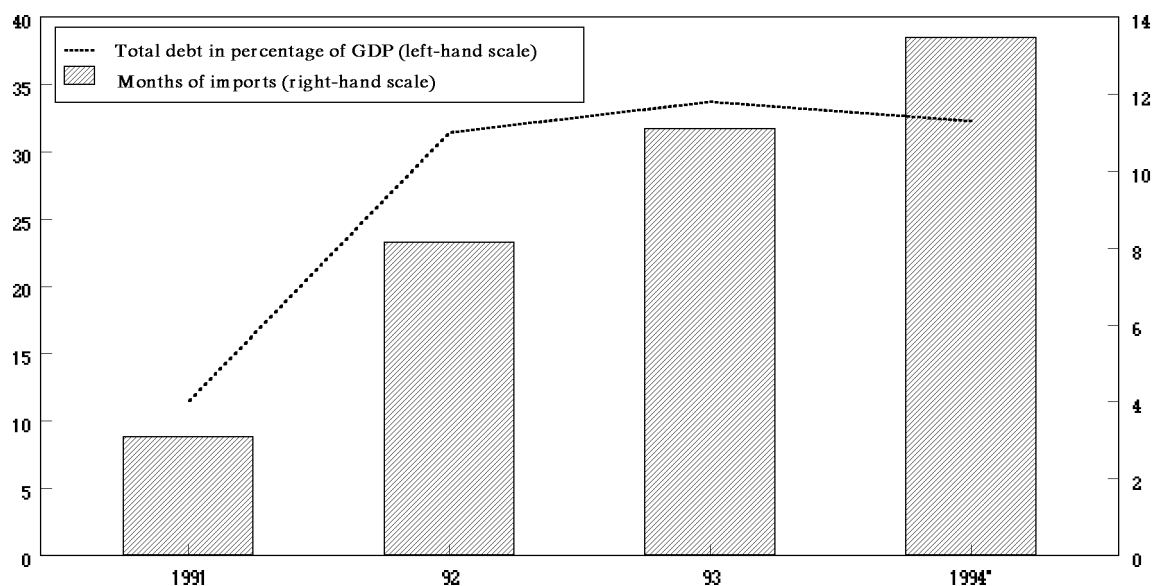
43. The third positive symptom of a strong capital account has been the inflow of foreign capital. Brazil has benefited in recent years from a large inflow of foreign capital which substantially exceeded the repayment of foreign loans mainly to multilateral institutions. Initially, the bulk of the net capital inflow came from foreign direct investment. In 1991, for example, foreign direct investment amounted to 0.9 billion and the amount had doubled by 1994 (Table 1). Starting in 1992, however, the structure of foreign capital inflow shifted towards indirect foreign investments-portfolio investments, long-term lending by commercial banks and towards financing new debt issues. By 1994 total portfolio investment and net long-term capital amounted to more than 13 billion. What is perhaps equally important is that virtually all of this "new money" came from private sources even though the country has also received a considerable support from multilateral financial institutions.

44. In view of the large capital inflows and the relatively mild current account deficit, the level of international reserves has dramatically increased. Gross international reserves more than quadrupled between the end of 1991 and the end of 1994 as they increased from just under 9 billion to 38.5 billion (Chart 7). While the level of international reserves represented about 4 months of imports of goods and non-factor services at the end of 1991, the corresponding ratio increased to about 11.3 months of imports by the end of 1994. International reserves continued to rise in the first seven months of 1995.

### Chart 7

#### Brazil - Gross official reserves, 1991-94

US\$ billion; and months of imports GNFS\*



\* GNFS refers to goods and non-factor services.

Source: IMF, *International Financial Statistics*.

## VII. Macroeconomic Adjustment

### Saving-Investment Balances

45. On the basis of current annual data, there does not appear to have been major balance of payment pressures to adjust the main macroeconomic balances (to maintain the external equilibrium) during the period of 1992 and 1994. As noted above, the relatively easy access to foreign capital and the relatively balanced current account have maintained the balance of payments fairly strong. The growth of international reserves has been so significant that the reserves can currently provide a temporary cushion against short-term fluctuations in the balance of payments. The only compelling balance of payments reason in the past was the heavy burden of external debt, but this has been addressed through the successful negotiations with the external creditors, also as noted above. To the extent that domestic macroeconomic adjustment was necessary, the reasons for such an adjustment were, therefore, mainly inflationary pressures. Even though the domestic inflation has produced a considerable degree of currency and exchange rate instability, the impact on the balance of payments has been relatively mild as indicated by the strength of capital inflows and by the strength of the trade account through mid-1994.

46. Nevertheless, the situation may be changing at present. After the initial success in controlling inflation the inflationary pressures are rising again, as noted above. More importantly, the rapidly deteriorating trade balance, which has been sensitive to changes in domestic demand, has also raised serious concerns about the balance of payments. To the extent that the deterioration is temporary and will reverse itself, the existing level of international reserves appear to be sufficient to contain the pressures on the exchange rate. On the other hand, should the deterioration reflect more permanent forces, and the acceleration in domestic inflation may be indicative of such pressures, an adjustment directed towards a further restraint of domestic spending will be called for.

47. The nature of adjustment that would be required can be seen from the developments of savings-investment balances in the last four years (Table 9). A major adjustment of the savings-investment balance took place during the recession of 1990-1992, which led to a sharp increase in the investments rates relative to 1988. While in late 1980's the investment rates were about 17 per cent of GDP, the rate increased to 19.6 per cent in 1991 and it edged further upwards in 1992 - 1994 to about 20 per cent on average. A negative side-effect of the recession was a drop in savings rates - the national savings as a percentage of GDP dropped from 20.1 per cent in 1989 to 19.3 per cent in 1991. A major turnaround came in 1992 when the savings rate increased to 21.3 per cent.

**Table 9 - Brazil - Savings - Investment Balance, 1991-94**

(In percent of GDP in constant 1980 prices)

	1991	1992	1993	1994
Gross National Savings <sup>1</sup>	19.3	21.3	20.2	19.8
Gross Domestic Investments <sup>1</sup>	19.6	19.6	20.4	20.0
Current Account Balance	-0.3	1.6	-0.1	-0.2

1 Gross National Savings, Gross Domestic Investments and the current account balance are calculated in current prices. The figures are not consistent with the corresponding data in Table 4 and the small differences that exist are due to rounding.

Source: IMF

48. The adjustment process continued in 1993 and 1994 but with relatively less success than in 1992. Domestic investment spending continued to be relatively strong as the investment rate moved upwards and was well above the level of late 1980's. However, the high savings rate that was achieved in 1992 began to slide downwards thereafter. As result, the current account surplus that represented 1.6 per cent of GDP in 1992, turned into a small deficit of about 0.2 per cent in 1993 and 1994.

#### Public Finance

49. The principal factors of the strong inflationary pressures have been of domestic origin, and these, in turn, primarily reflected the financial pressures in the public sector. The pressures were not so much emanating from the operational activities of the government and the public sector enterprises but rather from an enormous debt burden that has been contracted by these entities in the past. The operational activities are normally represented by two indicators - operational and primary balances. The former includes and the latter excludes net interest payments on external and domestic debt. In addition, these entities have to amortize old debt that can be financed from operational surplus and from new borrowing. The total requirements for outside financing are typically represented by the public sector borrowing requirements (PSBR). These indicators are summarized in Table 10.

**Table 10 - Brazil - Public Sector Borrowing Requirements and Primary and Operational Balances of the Public Sector Operations, 1991-94**  
(In percent of GDP)

	1991	1992	1993	1994
Public Sector Borrowing Requirements (PSBR)	24.5	42.4	55.7	43.5
Federal government	6.5	14.3	19.2	16.6
State and municipal governments	8.8	15.8	23.6	18.6
Public sector enterprises	9.3	12.4	12.8	8.3
Primary Balance (Deficit -) <sup>1</sup>	3.0	2.3	2.7	3.9
Federal government	0.9	1.4	1.5	2.6
State and municipal governments	1.4	0.3	0.5	0.4
Public sector enterprises	0.7	0.6	0.7	0.9
<u>Memorandum item</u>				
Operational Balance (Deficit -) <sup>1</sup>	1.4	-2.1	0.4	0.2
Federal government	0.3	-0.7	0.1	1.3
State and municipal governments	1.2	-0.8	0.2	-1.0
Public sector enterprises	-0.1	-0.6	0.1	-0.1

1 Primary balance excludes and operational balance includes net interest payments. Both exclude proceeds from privatization.

Source: IMF

50. PSBR increased dramatically between 1991 and 1993. This mainly reflected rapidly rising borrowing requirements of the federal and state and municipal governments. The borrowing requirements of public sector enterprises also increased but relatively much less. The growth in PSBR was mainly due to the sharp acceleration of inflation in mid-1991 which led to a large increase in nominal interest



payments. The growth of borrowing requirements was considerably slowed down in 1994 in all three segments of the public sector, which was also reflected in the reduction in the share of the PSBR in GDP.

51. The enormous burden of debt financing has increased pressures on the authorities to improve their effort to mobilize their own resources. The primary balance of the public sector, measured in terms of the share in GDP, has been in surplus in recent years, and the surplus has been rising since 1992. This has been possible as a result of new revenue measures introduced in 1993, the expansion of economic activity and strengthening of tax administration. Various spending measures have also been introduced such as spending limits and cuts in federal budget spending. The operational budget of the public sector has also been recently in surplus except in 1992 when interest payments considerably increased following a sharp increase in interest rates. According to the most recent indicators, fiscal policy weakened in 1995. The primary surplus declined from 4.6 per cent of GDP in the first half of 1994 to 3.2 per cent in the corresponding period of 1995. The operational balance swung from a surplus of 0.3 per cent of GDP to a deficit of 1.5 per cent of GDP.

#### Monetary Developments

52. Monetary policy was tight during the first half of 1994 - during the first months of the stabilization programme. The growth of money supply was under tight control and the share of money stock in GDP declined in comparison to the end of 1993. For example, the share of base money in GDP declined from 1.1 per cent in December 1993 to 0.7 per cent in 1994. In July, however, the money stock increased dramatically and it continued to grow for the rest of the year. The share of base money in GDP increased from 0.7 per cent in June 1994 to 3.4 per cent in December of the same year. According to the World Bank, the total monetary base increased by 16 billion Real in the second half of 1994, a considerable increase in comparison to the first half of 1994 when the corresponding increase was 6.2 billion Real (Chart 8). Other definitions of money supply - M1, M2, M3 and M4 all registered similar changes.

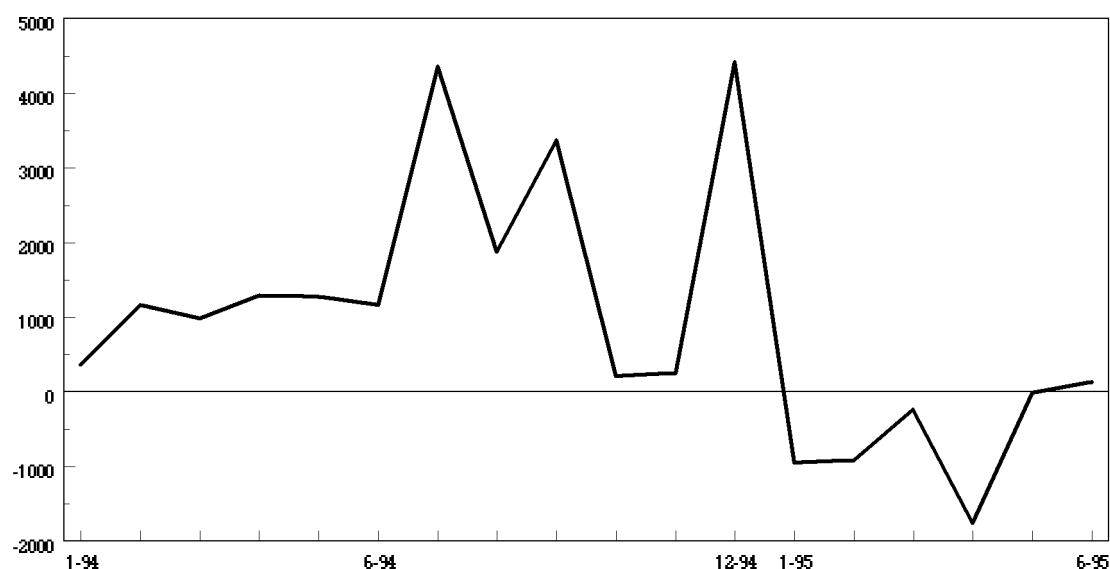
53. The expansion of money supply in the second half of 1994 reflected several factors. The sharp fall in inflation beginning in the second half of 1994 led to a strong *remonetization* process and significantly contributed to the growth of base money. Nevertheless, domestic demand was very strong, and this led to a strong demand for credit. Domestic demand increased by 9 per cent in real terms between July and December 1994, considerably fuelled by larger - than - expected growth of wages. Stimulated by the strong growth of demand, financial system credit to the private sector also increased rapidly - by 50 per cent compared with the cumulative inflation rate of 17 per cent. The substantial inflow of foreign capital continued and, in the absence of central bank purchases in the foreign exchange market, the nominal exchange rate of the *real* appreciated in terms of the US dollar and contributed to the expansion of credit and money supply.

54. The developments in the first half of 1995 were marked by further tightening of policies to restrict the growth of domestic demand. Reserve requirements were increased in April 1995 and additional restrictions on credit were introduced at the same time. Monthly overnight interest rate rose from the average 2.3 per cent in the second half of 1994 to 4 per cent in the first half of 1995. More recently, some of these measures were relaxed following signs that real GDP growth had started to slow down. As a result, the level of overnight interest rates began to fall in June and July. Nevertheless, the monetary authorities stepped up their recourse to wider use of open market operations in order to sterilized the inflow of foreign capital that has continued to be attracted by high level of interest rates. Despite these measures domestic demand and inflationary pressures continued to be strong.

### Chart 8

#### Brazil - Total changes in monetary base, 1994-95

CR\$ million



Source: World Bank.