PRESIDÊNCIA DA REPÚBLICA
Governo Fernando Henrique Cardoso

THE RESULTS OF THE *REAL* PLAN

BRASÍLIA, SEPTEMBER 1995

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THE REAL PLAN AND THE BRAZILIAN ECONOMY: PRESENT SITUATION AND PROSPECTS

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Brazilian Finance Minister
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The Real Plan, introduced on July 1st, 1994, is completing its fifteenth month of existence. There is no doubt that it is the most successful stabilization plan in Brazil's history. Previous attempts were overtaken by events within a few months of their implementation and failed to reach even a first anniversary.

At the end of June last year — just prior to the launching of the Real Plan —, inflation was running at the astonishing rate of 7000% per year. In the first half of 1994, it reached a monthly average of 43%. Now, inflation is around only 1 to 2% a month. Its level was of 31.3% in the first twelve months of the Real Plan and about 15% in the first eight months of 1995. These are the lowest figures in almost a quarter of a century. In fact, in the last 35 years (1961-1995), only in four of them (1969, 1970, 1972 and 1973), Brazil experienced lower rates of inflation.

Price stability fosters social development and improves income distribution. It removes the burden of the inflationary tax from those who are least able to protect themselves from it, namely the poor. It must be also recalled that the nominal price of the basic consumption basket now costs less than it did at the time of the launching of the Real Plan, and that, on the other hand, in nominal terms salaries and specially the minimum wage have risen significantly. This means that there has been a boost in the purchasing power of workers over the basic consumption basket.

It is important to stress that this sharp and continuous drop in inflation was attained without price or wage freezes, confiscations, breach of contracts or recession. It has been a direct consequence of a gradual process that began back in June 1993, when the so-called PAI (Program of Immediate Action), which paved the way for the introduction of the Real Plan, was announced. President Fernando Henrique was then Minister of Finance.

Behind this program is the idea that any serious effort in stabilizing the Brazilian economy must start by addressing the relative state of disarray of our public sector. And we have made substancial progress in this direction:

a) the debt of State Governments with the Federal Government was successfully refinanced;

b) State banks were forbidden to extend loans to their controlling shareholders, namely State Governments;

c) Congress aproved an ammendment to the Constitution, creating the Emergency Social Fund, which reduced the degree of earmarked tax revenues, allowing some tranquility in the fiscal front; and,

d) Government, in all levels, is promoting a fight against tax evasion and avoidance.

In this context, I would like to draw your attention to a point made by President Fernando Henrique in his speech, on July 1st, 1995, during the formal ceremony of celebration of the Real Plan's first anniversary. In reality, the Real Plan did not change the Brazilian society. The truth is that we, as a Nation, had already changed before the launching of the Real Plan making possible its success. Brazilian society was obviously tired of inflation and became eager for stabilization. And President Fernando Henrique, who received from the polls a clear mandate to carry on with the Real Plan, will not spare any effort to ensure price stability.

Tight policies in the field of money supply and credit are being followed, since the very inception of the Real Plan, to render the rate of growth in domestic consumption compatible with price stability and a satisfactory balance of payments situation. The growth rate increased sharply in the first quarter of 1995, when, in relation to the same period of 1994, GDP grew by 10.4% (14% in industry and 7.2% in agriculture); and sales increased by 28% in real terms.

This represented a threat to macro-economic stability. Hence, the need for additional restrictive measures adopted in the course of the first semester of 1995, which are becoming gradually more flexible in the light of a cooling off in domestic economic activity.

In the first half of 1995, the Brazilian economy experienced an 8% rate of growth. For the whole year, it will show a growth figure close to the one reached in 1994, when, in real terms, GDP increased by 5.7%. Growth of this order is even more satisfactory when it is realized that, according to recent estimates, the world economy should grow by 3% or less this year.

On the external front, Brazil put forward a major step by establishing a policy of exchange rate bands. The fact that Brazilian exports have continued to grow significantly, combined with the present low rate of inflation, is clear a proof that this exchange rate policy is well fitted for our stabilization program.

Brazil has, for some time, pursued a conservative policy with regard to its balance of payments. Current account showed a deficit of only 0.2% of GDP in 1994, 0.1% in 1993, 0.3% in 1991 and even a small surplus in 1992. The events of last December proved the correctness of our position.

It is in this constructive light that international observers should look at the temporary emergency provisions introduced earlier this year to reduce excessive imports of certain durable goods, such as automobiles. We are confident that our trade figures will continue to improve. Our balance of trade showed, last July, equilibrium after eight months of deficits and, in August, a US$ 328 million surplus.

The world has changed since the end of 1994, and Brazil will not hesitate to take the adequate measures to face the new realities in the fields of trade and finance.

The greatest challenge now facing Brazil, in the economic area, is to achieve stability on a permanent basis and to reach a one digit anual inflation rate in a gradual but firm manner. No other country in the world experienced a longer period of high and chronic inflation and went further than Brazil in promoting the indexation of its economy in a sort of vicious circle in which inflation and indexation feeded each other. The gradual de-indexation of our economy is essencial. Last June, important measures in this direction, for instance, were announced in the fields of salaries and interest rates.

It is also essencial, in order to consolidate stabilization and to attain self-sustained growth, a successful reform of our 1988 Constitution, which will enable, among others, the modernization of our public sector and the attainment of permanent fiscal equilibrium: the true anchor of any successful stabilization program.

Congress is giving majority vote in favor of the proposals of the Executive branch for the amendment of our Constitution and, indeed, has already approved most of those which were brought to its consideration in the first half of 1995, such as the ones that lifted previous restrictions against foreign capital and opened up for private investment, both Brazilian and foreign, several areas of economic activity.

The Executive branch has just sent to Congress two proposals: one for the reform of the fiscal and tax systems, with a view to simplification, clarity and the removal of burdens on investments and exports; and the other for the reform of public administration, aiming at streamlinig and cutting and controlling expenditure.

Government gives also high priority to the implementation of the privatization program, which will create the proper conditions for the lowering of the internal public debt, and to the reform of the social security system, in order, among others, to increase the domestic savings rate. There remains much to be done in regard to bureaucracy, red tape, deregulation and more efficient public management.

The achievement of the objectives on the present Administration's economic agenda will bring about the reduction of production costs in Brazil in relation to its international partners. By lowering the so-called "Brazil Cost", it will be possible to increase the inflow of direct investment and new technologies into the Brazilian economy, as well as to promote our exports of goods and services. This is what, in the final analisys, will bring about the continuing integration of Brazil into the Mercosul and into the world economy as a whole.

At present, we are witnessing in Brazil, within a full democratic system, the begining of an era of sustained economic growth and social justice. And our international partners may play an important role in this process.

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THE RESULTS OF THE REAL PLAN

I. Introduction

This paper evaluates the Real Plan and indicates Brazil's principal outstanding economic challenges. In doing so, it defines the peculiarities of the Brazilian stabilization process in order to discuss realistic targets for reducing inflation and for re-establishing the conditions of sustained growth.

Stabilization is a long process. Brazil's past experience illustrates the need for a relatively long time-frame to stabilize the economy. In fact, in the middle of the 1960s, three years were needed to reduce inflation from 100% to 30% per year. It fell from 92% in 1964 to 34% in 1965. It rose to 39% in 1966 and then remained at the rather high annual rate of 25% during the next two years This reduction in the inflation rate occurred when there were far fewer limitations on economic policy formation. The country was under an authoritarian regime, had no generalized indexation, enjoyed reasonable external support, and faced less critical fiscal and financial constraints than it does today. Even so, the stabilization plan faced serious difficulties in the 1960s and had to be adjusted on several occasions.

International experience is full of cases in which relatively long periods were needed to consolidate, and to adjust periodically, stabilization policies. Israel, Mexico, Argentina and Chile are examples. In countries like Brazil, the challenge can be even greater because inflation cannot be reduced simply by using conventional monetary and fiscal policy instruments. The Brazilian situation requires a complex combination of orthodox policies (monetary and fiscal) and structural reforms. These reforms frequently presume profound changes in the constitution and in the very culture of government organs. Further complicating the issue is the need to end the public's inflationary memory and to terminate an indexation system that, after four decades of double-digit inflation, permeates the economy.

Unlike in the 1960s, Brazil's current stabilization program is going forward within a democratic framework of independent power centers, a free press and a multi-party system. Therefore, the present reform agenda requires considerable political negotiation and greater maturity.

II. Inflation

Despite all the difficulties cited above, the Real stabilization program implemented in July 1994 generated a climate of euphoria and exaggerated optimism that carried over into the initial months of the Cardoso government. Several factors explain this phenomenon.

The inflationary trend has been extremely positive since the introduction of the real. Inflation during the first twelve months of the Real Plan was, according to the consumer price index, 35.3%. In the first six months of this year, the accumulated inflation was approximately 10%. This percentage equaled the inflation Brazil accumulated in the first six or seven days of June 1994. The fall in the inflation rate is even more impressive if one takes into consideration that, contrary to prior stabilization plans, the Real Plan did not freeze or prefix prices.

The success of the Real Plan's fight agaisnst inflation becomes obvious when one considers earlier stabilization programs. Table I traces the evolution of the consumer price index immediately following implementation of five stabilization plans, showing the average monthly rate in each quarter. The Real Plan shows the lowest average inflation during the first year. Moreover, under earlier plans, inflation began to rise strongly in the second quarter of the program, with average inflation exceeding 10% per month in the fourth quarter (remember that data for the fourth quarter of the Collor Plan I already incorporated the measures introduced by Collor Plan II).

Table 1 - Consumer Price Index (IPC/FIPE), Post-Stabilization Plans (monthly average)

	Cruzado	Bresser	Verão	Collor I	Real
Beginning	*March 1986*	*July 1987*	*January 1989*	*April 1990*	*July 1994*
1st-3rd month	2.02%	6.81%	10.16%	13.47%	3.24%
4th-6th month	1.30%	13.16%	23.31%	12.09%	2.48%
7th-9th month	2.98%	15.58%	34.69%	16.81%	1.35%
10th-12th month	11.78%	21.10%	56.44%	16.35%	2.42%
1st year average	4.44%	19.11%	30.07%	14.66%	2.36%

Graph 1 shows the month to month evolution of the consumer price index (IPC/Fipe) immediately after the initiation of the five stabilization plans mentioned above. The Summer Plan witnessed inflation of more than 30% per month after its seventh month of existence.

Graph 1 - Consumer Price Index (IPC/FIPE), Post-Stabilization Plans (monthly %)

Even though Brazil's present double-digit annual inflation is high by international standards, the following points should be highlighted:

- Average inflation fell from 43% per month in the first half of 1994 to 2.55% (IPC-R) per month in the first year of the Real Plan. If one discounts the inflation of the first two months of the Real Plan, which was a transition period (the carryover effect), the average inflation of the Plan has been 1.92% per month.
- Wholesale prices undergo less variation than do consumer prices. This difference indicates that a substantial part of the inflation during the first year of the Real Plan stemmed from price increases for non-traded goods. After one year of the Plan, prices of services may now start to decline, permitting smaller fluctuations in retail prices.
- Despite the existence of salary indexation, which tended to transform a seasonal rise in prices into a permanent increase, the variations in the price indices indicate a partial breakdown of the indexation mechanism. Graph 2 shows the rise and fall in monthly price indices, suggesting a behavior similar to that observed in countries without indexation.

Graph 2 - Monthly Inflation [General Price Index (IGP-M) and Consumer Price Index (IPC-R)]

- The cost of the basic food basket declined from R$106.95 at the beginning of the Real Plan to R$101.88 on August 28, 1995. Considering that minimum salaries during this period rose 42%, the purchasing power of workers obviously improved.

Although the redistribution of income may not have been a priority objective of the stabilization plan, the fall in inflation during the first year of the real was accompanied by substantial income redistribution. After all, a substantial part of the inflation tax had been falling on the lowest income sector that had no way to protect itself against inflationary affects.

III. The Level of Economic Activity

With the sharp reduction in the inflation tax, demand in the economy increased markedly after implementation of the Real Plan. This heightened demand strengthened significantly the economic recovery that had been occurring at a moderate pace since the last quarter of 1992. In fact, Brazil's GDP grew 7.4% in the second half of 1994, with manufacturing output rising 11%.

This growth stemmed mostly from increased consumption generated by: a) the drop in the inflation tax, b) the increase in total wages, and c) the strong expansion of consumer credit. Table 2 shows that sales in the São Paulo area during the first six months of the Real Plan were 15.3% above the same period of 1993. If July is not considered, this average rises to 22%.

Table 2
Variation in São Paulo — Commercial Sales
(Month/Month of Previous Year)

July 1994	7.1%
August	27.0%
September	26.0%
October	22.9%
November	13.6%
December	20.6%
Average	15.3%

Source: FCESP

The strong rise in demand led to a major expansion of industrial production and sales. According to the Industrial Federation of São Paulo (FIESP), industrial sales grew 25% in real terms during the second half of 1994 and 30% for the first year of the Real Plan compared to June 1994 (Graph 3).

Graph 3 - Industrial Sales - São Paulo (Base = Jan. 1994)

Labor market statistics also show that the economy grew substantially after the Real Plan's introduction. According to IBGE data, the unemployment rate in the six major metropolitan areas fell from 5.4% in June to 4.4% in March, and then to 3.4% in December. This unemployment level was the lowest registered since February 1990.

The rise in employment and in industrial production was accompanied by the growth of real wages and of the total wage bill. According to FIESP data, real wages in the industrial area of São Paulo grew 8.9% in the first six months and 8% in the first year of the Real Plan (Graph 4).

Graph 4 - Index of Real Industrial Salaries - São Paulo Deflator: Consumer Price Index (IPC-FIPE - Jan. 1994)

The increase in employment and in real wages caused the industrial wage bill to grow 10.5% during the first year of the Plan, according to FIESP data. This trend, combined with the renewal of consumer credits, led to a sharp growth in economic activity. The Indicator of Economic Activity (INA), calculated by FIESP, is composed of three elements: the utilization of installed capacity, the average number of hours worked per employee, and the value of sales. The INA was 25.7% greater in the second semester of 1994 than in the first semester of that year (Graph 5). Throughout the first year of the Plan, the INA grew 16.4%. Thus, economic activity and income levels rose greatly in the first year of the Plan despite the restrictive credit measures that were adopted beginning in October 1994.

Graph 5 - Indicator of Economic Activity (INA: Base - Jan. 1994)

The growth in industrial production and in employment was accompanied by a greater utilization of installed capacity and by a resumption of investments. As a percentage of GDP, investments in 1992 were the lowest since the 1970s, about 13.7%. As shown in Table 3, investment as a percent of GDP has since grown steadily, reaching 19% in 1995, according to data from the Institute of Economic and Applied Research (IPEA).

Table 3 - Investment Rates (% of PIB)

1989	16.6
1990	15.4
1991	15.0
1992	13.7
1993	14.4
1994	16.3
1995*	19.0

Source: IPEA
*Estimated

It is evident that the growth in investment is qualitatively different from that of the 1970s. Public sector investments are becoming less important at the same time that imports of capital goods are rising. These imports generate two distinct benefits: they update the industrial park by incorporating new technology and they permit increased industrial production without generating upward pressure on prices.

Graphs 6 and 7 show that the increase in investment was reflected in both domestic production of capital goods and in imports. It is obvious also that capital goods imports grew at a rate well above that of domestic production. In April 1995, such imports were double the level of April 1994 and almost 2.5 times those of April 1993.

Graph 6 - National Production of Capital Goods (Base: Jan. 1993=100)

Graph 7 - Imports of Capital Goods (Base: Jan. 1993=100)

Agricultural activity also has expanded during the Real Plan. The output of grains was 9.1% greater than that of 1993, significantly depressing prices. Another record harvest is estimated for 1994/95, with production at 80 million tons according to IBGE.

Despite the positive factors mentioned above, the excessive overheating of the economy towards the end of 1994 and during the first quarter of 1995 jeopardized the stabilization program. It threatened inflationary trends, promoted the trade deficits, and put pressure on the nation's productive capacity. In October 1994, some sectors were already working at 100% capacity. Graph 8 shows the growth in the rate of installed capacity utilization in the São Paulo industrial area since the Real Plan was introduced.

Graph 8 - Installed Capacity Utilization in the São Paulo Industrial Sector

IV. The Risks of Overheating and Measures to Constrain Demand

Given the excessive consumer demand during the initial months of the Real Plan, the government had no other choice but to constrain credit in order to avoid shortages and the return of high inflation rates. Of course, the best defense against excess consumption is to increase production, but this line of reasoning obscures a very serious problem. Namely, since two or three years are necessary to build a factory, short-term supply is limited by the availability of production capacity and imports. Over the short term, therefore, excess demand could definitely hurt the Plan. To avoid this threat, the following measures were adopted in October 1994:

- advances, loans and credits offered by the financial system could be granted for no more than three months, effectively reducing consumer credit;
- the financial system could no longer finance intermediaries and credit card companies;
- partial payments of credit cards were prohibited;
- consumer consortium purchases of appliances and electronic products were suspended;
- consumer consortium purchases of vehicles could not exceed 12 months; and
- a 15% compulsory, non-interest earning reserve requirement was established for bank loans and credits.

Despite these measures, economic activity in the first quarter of 1995 continued at a high level. The GDP that quarter rose 10.5% relative to the same period in 1994. Some industrial sectors, according to the Getúlio Vargas Foundation (Table 4), were already using 100% of their installed capacity in April 1995.

Table 4 - Sectors with the Highest Levels of Utilization, April 1995

Sector of Activity	Rate of Utilization (%)
Cellulose and mechanical paste	99
Automotive	98
Artificial and synthetic fibers	97
Metals for household use, non-ferrous metals, industrial equipment for hydraulic, thermal, ventilation and refrigeration installations, paper for printing, and natural fibers	96
Non-metallic material products for construction, paper, cardboard and products for packaging, tires, fuels and petroleum lubricants	95

Source: FGV Survey - April 1995

Thus, in the first quarter of 1995, the government adopted additional fiscal and monetary measures. In the fiscal area, it:

- eliminated some $3.2 billion in programmed government expenditures and some $3.4 billion in state company investments;
- delayed public-sector wage payments until the beginning of the month following that for which payment was being made;
- reduced by 10% and 15% the current expenditures of, respectively, state enterprises in the productive sector and government financial institutions, relative to those of 1994;

- re-negotiated existing contracts and bids of state companies;
- transferred a number of public services to the private sector, notably in the electrical and transport areas; and
- set quarterly limits for budgetary expenditures in order to balance outlays and revenues.

In the monetary area, it:

- prohibited financial institutions from granting credits guaranteed by various checking operations;
- forbade financial institutions and investment funds from acquiring or intermediating the sale of commercial paper;
- required compulsory reserves for guarantees offered by banks in support of loans or credits between individuals or non-financial companies;
- raised the tax on financial operations; and
- increased existing reserve requirements and mandated a 60% reserve for balances in excess of levels set by the Central Bank.

The measures adopted to control consumption were essential to ensure price stability and to secure the successes achieved since initiation of the Real Plan. Even with the restrictive measures, GDP grew close to 8% in the first 12 months of the Plan, which represents a per capita income growth on the order of 6.5%. This increase was the best result in the last 15 years.

V. Budget Results

The 1994 budget results, the best in the last four years, demonstrate the effective contribution of the tax adjustment to the success of the Real Plan. There was a marked reduction in the need for public sector financing compared to prior years (Table 5). The federal government contributed the most to this decline, producing an operational surplus equivalent to 1.14% of GDP. Several factors contributed to the 1994 results, but especially the 7.7% real growth in receipts compared to that of 1993.

Table 5 - Public Sector Financing Needs
(as a percentage of GDP)

Category	1991	1992	1993	1994
1. OPERATIONAL BALANCE	0.20	2.84	1.25	0.09
Central Government	0.08	1.20	0.95	-1.14
States and Municipalities	-0.72	0.70	0.12	0.78
State Companies	0.83	0.93	0.19	0.45
2. PRIMARY BALANCE	-2.88	-0.67	-1.75	-3.81
Central Government	-1.05	-0.61	-0.55	-2.66
States and Municipalities	-1.47	-0.04	-0.59	-0.74
State Companies	-0.35	-0.02	-0.61	-0.41

Source: SPE/MF

Since the initiation of the Real Plan, the federal government has adopted several measures designed to constrain public expenditures and to improve tax collection. These efforts are indispensable in order to achieve a balanced budget. In addition to the measures mentioned earlier, the following are the principal measures taken to constrain public outlays:

- extension of the Emergency Social Fund as a means of giving the government more flexibility in allocating expenditures;
- establishment of limits for budgetary contributions to sectoral activities;
- the requirement that the Council of Coordination and Control of State Enterprises approve the rules for the distribution of profits and for the annual reports of state enterprises;

- the decision that existing contracts and bids in progress by the federal government be re-negotiated in order to adapt them to current market conditions;
- the freeze until November 30, 1995, on the hiring of any new federal government personnel;
- the suspension of the re-hiring of employees who had been dismissed during the Collor government; and
- the prohibition against state enterprises adopting measures which would increase the transfer of resources to closed pension funds.

On the revenue side, the following measures stand out:

- the increase in employer and employee contributions to the social security system in order to offset part of the increase in the minimum salary, effective May 1995;
- the increase from 0.1% to 8.0% of the excise tax (IPI) that affects lower-priced automobiles, thereby, raising the average rate from 24% to 28.7%;
- the change in the legislation on corporate income tax;
- the adjustment in the tax on dividends from investments by individuals residing overseas; and
- the removal of imports of petroleum and its derivatives from the special drawback regime.

As a consequence of these measures, the federal government had a primary budget surplus of R$6.2 billion during January-July 1995, or 16.9% greater than that of the same period in the previous year. These figures can be seen in the following table.

Table 6: Public Sector Financing Needs
Primary Balance of the Federal Government

R$ million of April 1995, adjusted by IGP-DI

Category (A)	Until July 1994 (B)	Until July 1995 (C)	Variation (%) (C/B)
1 - Total Receipts	48,941	65,102	33.0
2 - State/Municipal Transfers	7,088	10,903	53.8
3 - Net Receipts	41,853	54,199	29.5
4 - Expenditures	36,547	47,997	31.3
4.1 - Personnel	15,245	19,353	26.9
4.2 - Welfare Benefits	12,333	13,114	6.3
4.3 - Other current and capital	8,969	15,530	73.1
5 - Primary Balance (*)	5,306	6,202	16.9

(*) Positive values equal surplus

Revenues were the major factor in the improvement of the budgetary performance this year. Through July 1995, they rose 33% relative to the same period of 1994. This increase stemmed essentially from the government's effort to augment collections and from the high level of economic activity. At the same time, expenditures also rose substantially (31.3%) as a result of more personnel and health expenditures.

The public-sector budget is still a major concern even though, with the stabilization measures, it has been in balance recently. The government's intention is to reach a budgetary equilibrium that eliminates the need for public sector borrowing, which was 1.4% of GDP in the first half of this year. Moreover, through the privatization of state companies and the improvement in receipts, the internal public debt will hopefully be reduced from the present 17% of GDP to 12% by 1998.

VI. The Foreing Trade Balance and the External Sector

Since the beginning of the Real Plan, there has been a profound change in exchange rate policy. Previously, the policy was to maintain a fixed real rate with the Central Bank buying exchange in order to ensure a monthly devaluation equal to the difference between domestic and foreign inflation. This policy caused: 1) excessive control of the exchange market by the monetary authorities, inhibiting the development of a market equilibrium, and 2) an increase in domestic debt in order to sterilize the monetary expansion generated by the Central Bank's purchase of foreign exchange.

At the start of the Plan, the Central Bank stopped intervening in the exchange market, letting the market set the rate each day. The rate was to fluctuate freely as long as it did not exceed the ceiling of US$1/R$1. During the first three months of the Real Plan, the Central Bank stayed out of the market, allowing an appreciation of the exchange rate (Graph 9).

Graph 9 - Exchange Rate (End of Period)
- offered -

Beginning in October 1994, the Central Bank began to intervene in order to avoid wide swings in the exchange rate. It should be noted that the Bank intervened both to buy and to sell in order to keep the rate within a band, but did not announce the upper and lower limits of the band.

Given the continuous appreciation of the exchange rate and its depressive effect on exports, the government decided as of October 1994 to adopt measures that would increase the demand for foreign currency and, thus, reduce the excess offering responsible for the appreciation of the exchange rate. The measures were designed to balance the exchange flow and to avoid the need for Central Bank intervention. Among the measures designed to stimulate the demand for dollars were:

- approval for the advanced payment of financial debts contracted abroad;
- introduction of a compulsory 30% reserve, later raised to 60%, on the stock of contracts held by financial institutions for import debts. This type of contract for financing imports effectively delays the purchase of foreign exchange to pay for imports;
- relaxation of import procedures, eliminating the need for prior import authorizations; and
- accelerated introduction of the 14% Common External Tariff established in the Mercosul agreement.

On the other hand, the principal measures taken to diminish the supply of dollars were:

- reduction in the term of forward exchange contracts and the creation of a 15% reserve requirement for this type of financing; and
- higher taxes on financial operations for foreign exchange inflows being applied to fixed income assets and to portfolio investments.

Meanwhile, two new developments toward the end of 1994 damaged Brazil's external position: 1) imports rose massively; and 2) the Mexican financial crisis sharply diminished foreign capital flows to Brazil.

Last December, because of the Mexican crisis, foreign investors became very cautious in dealing with all emerging markets. As regards Brazil, capital inflows fell and remittances rose. This sudden change in the international scene affected the first half of this year significantly. The Mexican crisis and Brazilian uncertainties sparked the outflow of some $3.7 billion from Brazil. At the same time, the current account deficit was about $5.4 billion in the first quarter of the year.

Beginning in March 1995, when there was a gradual recovery of the exchange rate (Graph 9), the limits of the band were expressly stated. Adoption of the exchange bands, by limiting the exchange rate fluctuations around the short-term equilibrium, diminished fluctuations due to changes in foreign exchange supply and demand. At the same time, as basic conditions change, modifying the long-term exchange equilibrium, the limits of the band are reviewed to avoid a misalignment of the exchange rate.

During the second quarter of 1995, a more favorable picture developed on the international scene, a change that was readily apparent from the strong flow of external resources to Brazil. These inflows reached a record peak in July and August (Graph 10). Thus, international reserves are already higher than they were prior to the Mexican crisis, rising from US$31.8 billion in April to US$41.8 at the end of July.

Graph 10 - Exchange Contracts - Free Market Segment - Overall Balance

As regards the massive expansion in imports, beginning in the second half of 1994, the demand for raw materials, intermediate goods and capital goods, whether domestic or imported, reached record highs. The demand for imported consumer goods rose even faster. Several factors, in addition to the increased level of economic activity, contributed to the rise in imports. During the second half of 1994, the exchange rate fell about 16% and the average import duty was reduced two percentage points. The tariff reduction was even larger for such items as automobiles, appliances and toys (11%), and for some chemical inputs (18%).

In July 1995, the trade balance (Graph 11) again showed a surplus, ending the series of deficits that had been occurring since the previous November. Exports in July totaled US$4.004 billion, an increase of 7.1% over July 1994. With imports at US$4.002 billion, the trade surplus was only US$2 million.

Graph 11 - Merchandise Trade Balance

During January-July 1995, exports totaled US$25.453 billion and imports were US$29.718 billion, producing a deficit of

US$4.265 billion. The total foreign trade during this period was US$55.171 billion, or 39.1% greater than that of the same period last year (US$39.677 billion).

Table 7 - Foreign Trade - July 1995

In US$ million FOB

	July			January/July		
	1995	1994	% Var. 95/94	1995	1994	% Var. 95/94
Export	4,004	3,738	7.1	25,453	23,839	6.8
Import	4,002	2,514	59.2	29,718	15,838	87.6
Balance	2	1,224	-99.8	-4,265	8,001	-153.3
Total Trade	8,006	6,252	28.1	55,171	39,677	39.1

Source: SECEX, SRF; Prepared by SPE/CAE

In the first seven months of the year, exports expanded only 6.8% whereas imports practically doubled, indicating that there might be a deficit for all of 1995. The July results were positive, but it would be premature to make a definitive comment on the government measures designed to produce a trade surplus.

Maintaining the trend of the first half of the year, exports of semi-manufactured goods in July rose 51.2% compared to that of July 1994. This increase represented an additional US$302 million in receipts (Table 8).

Table 8 - Exports by Category - July 1995

In US$ million FOB

	July					June	
	1995	1994	% Var. 95/94	% Part. 95		1995	% Var. July/June
1. Basic Products	1,026	1,047	-2.0	25.6	28.0	1,100	-6.7
2. Industrial Products	2,887	2,631	9.8	72.1	70.4	2,892	-0.2
2.1 Semi-manufactures	892	590	51.2	22.3	15.8	739	20.7
2.2 Manufactures	1,995	2,041	-2.3	49.8	54.6	2,153	-7.3
3. Special Products	91	60	51.7	2.3	1.6	128	-28.9
Total	4,004	3,738	7.1	100.0	100.0	4,120	-2.8

Source: SECEX

Table 9 shows that this year's results are related to the high growth of semi-manufactured exports (+ 30%), which reached a record high of US$4.696 billion.

Table 9 - Exports by Category - January-July

In US$ million FOB

	January-July				
	1995	1994	% Var. 95/94	% Part.	
				95	94
1. Basic Products	6,283	5,943	5.7	24.7	24.9
2. Industrialized Products	18,630	17,542	6.2	73.2	73.6
2.1 Semi-manufactures	4,696	3,612	30.0	18.5	15.2
2.2 Manufactures	13,394	13,930	0.03	54.7	58.4
3. Special Products	540	. 354	52.5	2.1	1.5
Total	25,453	23,839	6.8	100.0	100.0

Source: SECEX

Exports of commodities should continue to show excellent results until the end of the year because of favorable international prices. At the same time, sales of manufactured products, responsible for 50% of exports, have grown only slightly in 1995. This trend indicated the need for measures to promote manufactured exports. Such measures were adopted in April when taxes were reduced on manufactured exports.

Imports in July were US$4.002 billion, or 18.2% less than in June. Relative to July 1994, however, they were 57.9% higher. Table 10 shows imports during the first seven months of this year, highlighting the increase over 1994.

Table 10 - Imports by Category
January-July 1995/January-July 1994

In US$ million FOB

	January-July		Growth			Participation %	
Category	1995 1/	1994 1/	Absolute	Relative	Weight	Jan-Jul 1995	Jan-Jul 1994
1. Primary Materials/ Intermediate Goods	13,776	7,840	5,936	75.7	42.8	46.4	49.5
2. Fuels/Lubricants	3,144	2,136	1,008	47.2	7.3	10.6	13.5
3. Capital Goods	6,528	3,695	2,833	76.7	20.4	22.0	23.3
4. Consumer Goods	6,269	2,168	4,101	189.2	29.5	21.1	13.7
4.1 Non-durables	2,740	965	1,775	184.0	12.8	9.2	6.1
4.2 Durables	3,529	1,203	2,326	193.3	16.8	11.9	7.6
4.2.1 Passenger Autos	2,505	498	2,007	403.3	14.5	8.4	3.1
4.2.2 Others	1,024	706	319	45.2	2.3	3.4	4.5
Total	29,718	15,838	13,880	87.6	100.0	100.0	100.0

Source: SRF; Prepared by SPE

1/ Preliminary numbers or numbers under revision

Over the course of the year, imports of consumer goods grew the fastest (+189.2%). Durable consumer goods were up 193.1% while non-durable goods were up 184%.

Imports were rather high in July, indicating that this variable is neither under control nor at a desirable level. Although the government's restrictive measures have had some effect, it is too early to project that monthly imports will fall to a satisfactory level. At the same time, it is hoped that the measures taken to constrain demand and to achieve balance of payments equilibrium over the medium term will continue to affect the trade balance positively. The principal measures taken to reduce imports were:

- tariff increases on durable consumer goods considered to have a minimum impact on the inflation rate;
- an enlargement of the foreign exchange band;
- establishment of a limit on the prior payment of imports with a term of up to 300 days, reducing them from 100% to 20% of the imports; and
- the provisional measure defining the industrial and commercial policy for the automobile sector.

VII. The Interest Rate Question

Since the beginning of the Real Plan, the government has implemented a restrictive monetary policy characterized by:

- high compulsory reserve requirements for sight deposits, time deposits, savings accounts, and other forms of savings at, and loans by, the banking system; and
- a high interest rate policy designed to stimulate savings and to restrain consumer credit (Table 11).

Table 11 - Interest Rates per Month (%)

	SELIC	CDI
Jul. 1994	6.87	6.68
Aug.	4.17	4.16
Sept.	3.83	3.85
Oct.	3.62	3.65
Nov.	4.07	4.11
Dec.	3.80	3.84
Jan. 1995	3.37	3.48
Feb.	3.25	3.24
Mar.	4.26	4.41
Apr.	4.26	4.22
May	4.25	4.25
Jun.	4.04	4.05
Jul.	4.02	4.01
Aug.	3.83	3.81

Source: Bacen

The current debate over interest rates has not given enough emphasis to some considerations. First, it is wrong to speak of a recession. The available data show that there has been no more than a slowdown in the rate of growth. Second, the shortage of credit and the recent financial difficulties of private companies are related to the exaggerated expansion of credit since the introduction of the Real Plan, and not to interest rates. Third, with the re-appearance of consumer credit mechanisms, many new economic agents entered the market, some of whom were not prepared to evaluate risk and to select borrowers.

The above elements indicate that the high interest rates are being blamed for phenomena that occur independently of the interest rates. Despite the recognized high cost of disintermediation, the government's option for a restrictive monetary policy based on high reserve requirements has several advantages:

- the increase in reserve requirements reduced significantly the financial system's lending capacity; and
- the increase in reserve requirements broadened the spread between the interest rate to the saver and the interest rate to the buyer, thereby making it possible to have a restrictive monetary policy without increasing the basic interest rates in the economy.

Interest rate trends have been governed by the need to stimulate savings and the inflow of foreign capital, and, simultaneously, to control domestic credit and aggregate demand. The gradual reduction of interest rates, already begun, is conditioned on the continued decline in demand, the elimination of the trade deficit, and an achievement of a tax adjustment. As can be seen in Graphs 12 and 13, the increase in interest rates during March was caused by the need to:

- contain excessive demand; and
- avoid exchange market speculation that might be caused by the change in the exchange band and by the Mexican crisis.

Graph 12 - Effective Interest Rates (SELIC)

Graph 13 - Effective Interest Rates (CDI)

Despite pursuing a policy of relatively high interest rates and high reserve requirements, the Central Bank still has trouble controlling liquidity. The following three aspects of the problem stand out:

- the need to make adjustments in the state banks;
- the need to gain control of the classical liquidity instruments; and
- the need for adequate tax incentives to stimulate a shift from short-term to long-term savings instruments.

In regard to this third point, recent legislation introduces differentiated reserve requirements. As a result, new short-term savings instruments will require a 40% reserve while instruments of more than 60 days will have no reserve requirement. This change should stimulate longer-term savings.

VIII. Structural Reforms and Investment Prospects

The Brazilian government's limited investment capacity, combined with legislation that defined several activities as state monopolies, meant that the infrastructure for transportation, energy, communications, ports, storage and other areas has been deteriorating over the last 20 years. The defeat of inflation, combined with the passage of constitutional reforms terminating many public monopolies and ending market reservation for national companies, will permit private capital to invest in such infrastructure areas as telecommunications, the generation and distribution of electricity, cabotage shipping and piped gas.

The principal constitutional amendments already approved or sent to Congress will, moreover, help to promote exports by reducing the "Brazil Cost." Among the various positive points in the propose tax reform recently sent to the Congress are:

- the proposal to stimulate investment by permitting companies to deduct from their tax liabilities those taxes paid in the purchase of capital goods;
- the exemption of primary and semi-manufactured goods exports from the sales tax (only manufactured products are currently exempt);
- the exemption of agricultural inputs and machinery from the sales tax in order to stimulate investments in agriculture and agro-industry;
- repression of tax evasion, which is facilitated by the existence of different rates among and within the states; and
- termination of the "fiscal war" between the states.

IX. Privatization

The first phase of the Brazilian privatization program began in 1981 and was characterized by the re-privatization of companies that had been absorbed because of their bad financial situation. Between 1981 and 1989, 108 companies were included in the privatization program. During those years, the companies privatized were small and, therefore, the economic significance was modest.

The second phase of the program began in 1990 as a fundamental part of the Collor government's reforms. During 1990-1992, 32 state-owned companies in the productive sector and 32 minority participations were included in the privatization program. From 1991 to 1993, the program concentrated its efforts on selling the state-owned steel, petrochemical and fertilizer companies.

The third phase of the program began in the Itamar Franco administration. Several legislative changes were introduced. They included such items as the increased use of domestic debt for purchase payments, the sale of the federal government's minority participations, and the authorization for foreign investors to acquire 100% of a privatized firm's voting capital. The Itamar Franco government privatized 18 companies, receiving US$5.1 billion in payments. In 1994 the program receipts approximated US$2 billion -- 72% in cash equivalents. This procedure also was effective in reducing the public debt because part of the revenues were used to buy back short-term debt.

The fourth phase of the privatization program began in the government of Fernando Henrique Cardoso. The National Privatization Council (CND) was created. Since its members are Ministers of State, major decisions are taken at the highest level of the government. From January to August, the government sold Escelsa for US$385.7 million and COPENE for US$256.5 million, and transferred to the private sector debts totaling US$342.6 million.

The new structure of the privatization program extends its scope and gives it more authority to take significant decisions. The Council decided to maintain the existing privatization time schedule, which means that the 14 petrochemical companies will be privatized by December 1995, the privatization of Banco Meridional will occur in the first half of 1996, and the railway system (RFFSA) will also be privatized

The federal government still owns about 100 companies. Of these, some 29% belong to the Ministry of Telecommunications, 5% to the Eletrobrás system, 13% to Petrobrás, and the others are small firms such as Serpro, Dataprev, and Datamec. A working group has been created to determine what should be done with these small firms and with companies such as ENASA, FRANAVE, and LLOYD.

The passage of the Law of Concessions was an important benchmark for the privatization program. This law enables the government to include ports, highways and the electrical sector in the privatization program. The Council should soon present a proposal for including the ports. The Council has already included the Eletrobrás group in the program and appointed the Ministry of Mines and Energy to oversee the restructuring of the sector. The BNDES will lead in the privatization of Eletrobrás. The electrical sector poses challenges that have not been encountered previously. The earlier programs sold industrial companies without raising questions about regulatory issues or about competition. On the other hand, electrical service is a natural monopoly that must be regulated. Thus, the question of regulation becomes a crucial part of privatization. The challenge is to build a new regulatory framework for private companies providing public services.

X. The Need for Persistence

As was stressed initially, and has been amply illustrated by both Brazilian and international experience, the stabilization process requires time to bear fruit. It requires not only macroeconomic consistency in designing programs, but persistency in implementation. Any hesitation in introducing necessary adjustments will be extremely costly, endangering the success of the Real Plan and imposing greater sacrifices on future generations.

Obviously, the government must continue its tenacity and determination to maintain monetary stability, but it must also have the flexibility and capacity to identify the proper moment to ease its constraints on consumption. No matter how onerous the government's restrictive fiscal and monetary policies appear, their costs are small when compared to the impact of inflation, which falls predominantly on the poorest sectors of the Brazilian population. The popular demand and support for the fight against inflation is so large and overwhelming in Brazil that it is legitimate to say that the government was elected because of the Real Plan. This administration will, therefore, fulfill its essential mission of defending the Plan and of preparing the way for sustained economic growth.

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Secretaria de Comunicação Social
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