March 11 1999

Brazil: Speaking Notes for Meeting with Bankers, New York

1. The second phase of the Brazilian stabilization program began with the devaluation on January 13. By January 15 the exchange rate was floating, as it has been since. We started discussions with the Brazilian government on the revision of the economic program that weekend, and concluded them last weekend. The outcome of these discussions is contained in the Memorandum on Economic Policies (MEP), which the Brazilian government published on Monday, and which is available on the IMF website. The main elements of the accompanying Technical Memorandum of Understanding (TMU) have been released already, and the whole text will be available on the internet shortly.

2. You are probably all familiar with the changes in the economic program. They are:

- First, **monetary and exchange rate policy**. The prime goal of monetary policy is to prevent a return of the inflation that plagued Brazil for most of the post-War period, and that was so successfully defeated by the *Plan Real*. (Indeed, it was fear of the return of inflation that led the Brazilians to attempt to maintain the crawling peg exchange rate as the centerpiece of macroeconomic policy in the first phase of the program).

In the course of the next half year, a formal inflation targeting approach to monetary policy will be put in place. In the meantime, the approach will have to be less formal: there are target inflation rates, shown in Table 1, and the economic program specifies growth rates of monetary aggregates, particularly domestic credit creation by the central bank (NDA), that are consistent with these inflation goals. Since there is uncertainty about how the demand for money will behave in the next few months, these targets can be reset as the data come in—and the guiding principle will be the prospects for inflation.

Fortunately, the early data coming in now are encouraging about the prospects for containing inflation; the February CPI rose only 1.3 percent.

Of course, on a day to day basis, monetary policy still has to be run by setting interest rates, as in all countries. I will return to the interest rate issue shortly.

- **The exchange rate will float**, as it is now. Movements in the exchange rate will affect monetary policy, *but only to the extent they affect the inflation outlook.* Obviously, exchange rate depreciation tends to create inflation, and for that reason, the Banco Central would tend to tighten monetary policy if the exchange rate moved too much. But there is no explicit exchange rate target, though for purposes of the program, it is necessary to make assumptions about the exchange rate. We have assumed a real devaluation in the range of 20-25 percent by the end of the year.

- **Fiscal policy has been further tightened**. As you know, we are projecting an output decline of 3.5 - 4.0 percent this year. Nonetheless, the fiscal target if for a primary (i.e. non-interest) surplus of above 3 percent of GDP this year, and rising in the next two years. *The medium-term goal of fiscal policy is to reduce the debt-GDP ratio to below 46.5 percent,* the ratio targeted in the December program (Table 2). The Brazilian government believes it critical to reduce the debt-to-GDP ratio, to ensure that debt dynamics is stable, and that is why they are willing to tighten fiscal policy despite being in a recession.

  Fiscal problems were instrumental in the loss of confidence that led to January's devaluation. There were two main problems: (a) Congress's failure to pass certain measures -- however, as you can see from Table 3, there is now only one major pending measure, the second reading of CPMF, and that is well under way; and (b) the dispute with the states. The President is clearly winning in the latter dispute, and has now essentially isolated the opposition in Minas Gerais.

  We are confident that the fiscal adjustment envisaged in the program will be carried out.

- **Structural reforms**, in the financial sector, in center-state-municipal finances, in the social sectors, and particularly in privatization, will continue. On privatization, the government has requested a study of the future roles of the federal banks, in particular Banco do Brasil and Caixa Economica, with privatization among the options that are to be considered. It is reasonable to assume that that option will be taken very seriously. The report is expected towards the end of the year.

2. There are two key questions about the execution of the program:

- **Is the debt dynamics truly stable?** The behavior of the real interest rate is key in this regard, for the debt-GDP ratio is not particularly high. Our real interest rate assumptions can be seen in Table 1. They are conservative, in view of the elimination of the devaluation risk and of the depressed state of the economy. We assume the real interest rate will average 10.2 percent this year, and decline further in the coming two years.

- **Will the authorities deliver?** (a) There has been a remarkable change in the behavior of the Congress since the devaluation. (b) There is a completely new team in BCB. The authorities are well aware of the stakes. We believe they will deliver — indeed we see them as having delivered on both fiscal and monetary policy in the last two months.

3. **Balance of payments financing.**

- Table 4 presents our analysis of balance of payments financing. We see a sharp turnaround in the trade account — reflecting the impact of the devaluation and of the sharp decline in domestic demand — but of course less of a turnaround in the services component of the current account, because of higher interest payments. There is nonetheless a significant improvement in the current account, amounting to 1½ percent of GDP. In dollar terms the current account deficit is expected to be halved to $16.5 billion, about 3 percent of GDP.

- **Official financing** is expected to be large. The next IMF tranche, due at the end of March, will be approximately $4.6 billion. In parallel, the 20 countries supporting Brazil bilaterally through the BIS are expected to provide another $4 billion. Following that, if the program stays on track, the IMF is expected to provide two further tranches of $2.4 billion each, in June and September, and another $1.1 billion before the end of the year.

4. **The role of the private sector** As you have seen from the announcement of the program, the support of the private sector will be essential for the success of the program. Without the continued support of the private sector, the program simply will not work. The program is looking to two forms of private sector involvement: **new money**, and **rollovers**, particularly of interbank trade and credit lines.

[Governor Fraga] has already explained to you the current plans with respect to new borrowing and the request for rollovers. He has also explained the follow up the Brazilian authorities intend to make on commitments obtained by creditor banks.

5. This is an effort led by the Brazilians. We in the IMF strongly support this effort; indeed its success is essential to the overall success of the program. We will be playing a supporting role, particularly in the monitoring of the data, which we will be receiving and passing on to the relevant authorities. We stand ready to help in any other ways that would be useful, for instance by providing whatever information or assistance you need as this effort goes forward.

Thank you.