MEMORANDUM

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THE WHITE HOUSE

WASHINGTON

Orig back to Bowdler - for submission to Pres, w/new memo 12/5

~~CONFIDENTIAL~~ Wednesday - November 22, 1967

MEMORANDUM FOR THE PRESIDENT

SUBJECT: Brazilian Economic Performance and our Program Loan

I looked into the status of our $100 million program loan to Brazil for FY 1967 and believe it important that you have the whole picture. Following the disbursement of the first $25 million in June, there has been a hold-up on the remaining $75 million pending renegotiation of new self-help targets which is now nearing completion.

Poor performance on some of the original self-help commitments threatens the stabilization program which President Castello Branco and his Planning Minister Roberto Campos carried out with such success in 1964-66. Failure of the Costa e Silva Administration to take corrective measures could precipitate an economic crisis by mid-1968 comparable to what Peru is now undergoing. Since Brazil's performance sets the tone for our Alliance for Progress elsewhere in the hemisphere, the situation assumes added importance.

The Castello Branco Stabilization Program

Castello Branco's economic policies brought Brazil from the edge of collapse to a sound footing:

-- the cash deficit was reduced from 28% of total expenditures in 1964 to 10.5% in 1966.

-- the operating budget deficit which equalled 6% of expenditures in 1964 was turned into a surplus equivalent to 22.5% of expenditures in 1966.

-- a realistic exchange rate led to a 32% increase in non-coffee exports.

-- foreign exchange reserves went up $600 million and Brazil's credit standing was restored.

DECLASSIFIED
Authority NLJ 94-479
By clb NARA, Date 9-14-01

One trouble spot remained: price stability. Castello Branco had reduced the rate of increase of the cost-of-living index from 84% in 1964 to 41% in 1966. This rate of inflation was still too high, but steps were underway to bring it down to manageable proportions.

The 1967 program loan was designed to achieve stabilization which last January was well in sight. Its key features included:

-- further import liberalization to make Brazilian industry more competitive internationally.

-- continuance of a realistic exchange rate.

-- further reduction of the fiscal deficit.

-- monetary and credit policies to dampen excess demand pressures.

-- internal coffee prices which would discourage over-production and encourage diversification.

The program loan agreement was checked with then President-elect Costa e Silva and his economic team, who indicated their support.

The Costa e Silva Administration Performance

The Castello Branco stabilization program, while successful, had worked certain hardships on lower income groups and brought a mild recession which hit business interests. Sensitive to both of these sectors, and desiring to achieve political popularity, Costa e Silva has made a special effort to help them. The stabilization program he inherited and new price control measures he instituted have worked to:

-- hold the cost-of-living increase to the lowest level since 1962.

-- stimulate economic activity which is expected to bring a growth rate of 5% despite the first quarter recession.

Judged on these factors alone, there is ample basis for proceeding with disbursements. But Costa e Silva has taken steps which give us serious concern over the longer-range impact of his economic policy. By lowering interest rates, reducing or postponing taxes, increasing the coffee support price and maintaining levels of government expenditures far in excess of income, the government has brought about expansionary pressures which by mid-1968 could lead again to economic collapse. Danger signals are already clearly evident in the projected budget deficit of NCr$1.2 billion for CY 1967 and a net loss of US $220 million in its foreign reserves during the period June 30 -- November 4, 1967.

The Program Loan Negotiations

After it became clear in July that the Costa e Silva was not meeting important self-help aspects of the program loan agreement, we told the Brazilians that further disbursement would have to wait until mutually agreed new targets could be worked out. Also concerned over a resurgence of demand inflation, they accepted this decision in a cooperative spirit.

A new understanding covering performance during the second half of 1967 was promptly worked out. It centered on:

-- keeping the budget deficit within an established limit.

-- holding net domestic credit expansion over existing levels to roughly the same magnitude as originally programmed for the second half year, and

-- moving the exchange rate in the event of substantial reserve losses.

But before the new agreement was submitted to you for approval and a new disbursement made, the Brazilians were taking measures contrary to the new undertakings. So we went back to the negotiating table.

We fully recognize that many of the problems we have had with the Brazilians stem in the first place from the inexperience of the new team as well as their desire to get away from the hard political image of the Castello Branco Government. At the same time, our over-riding concern is to prevent serious reversal of the move toward stabilization in which we have invested so much money and effort during the past three years. Adjustment of the exchange rate is one of several measures which need to be taken. In the negotiations the Costa e Silva Government has recognized that it is necessary. The only remaining question is one of timing and on this we are flexible.

Because of our over-riding interest in preserving the momentum of stabilization we have kept pressing for a mutually acceptable program of self-help. We now think we are close to success. The Brazilian Minister of Finance is coming to Washington on December 6 for further talks. In preparation for these, Covey Oliver and Bill Gaud are preparing a memorandum defining the issues and presenting the alternatives for your decision.

The Congress has judged the success of our program lending in Brazil on the basis of progress toward decelerating inflation. The consequences to the whole Alliance for Progress budget would be serious if next year we had to tell the Congress that despite all our program lending the stabilization program has unravelled.

Walt Rostow