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ALL CONSULATES IN BRAZIL EXCEPT CURITIBA

FROM - RIO DE JANEIRO

SUBJECT - 1967 Program Loan

REFERENCE - Rio 005

I. First Semester Performance

1. The GOB's economic ~~and~~ performance during the first semester of 1967 deviated substantially from the program laid out in the Government's February letter to CIAP, which constituted an integral part of the 1967 program loan agreement with the GOB. These deviations were of such significance and magnitude as to ~~[illegible]~~ preclude further program loan tranche releases until agreement is reached with the GOB on a reformulated program. Deviations from the original program in the first semester were especially important with respect to fiscal and monetary performance. The GOB also failed to attain its foreign exchange target, and its coffee policy differed significantly from the commitments contained in its letter to CIAP.

OTHER AGENCY

A. Fiscal Policy

2. The cumulative cash fiscal deficit reached NCr\$1,143.3 million by the end of May, more than quadruple the CIAP letter target for the end of June and more than double the target for the entire year. Expenditures in the first five months exceeded programmed levels by NCr\$855.2 million or 34 percent, and revenues fell short of the target by NCr\$98.1, or 4 percent.

Enclosures:

1. Illustrative Draft Letter to CIAP
2. Brazil's Balance of Payments for 1966 and Projections for 1967
3. Program Assistance Approval Document

DRAFTED BY	OFFICE	PHONE NO.	DATE	APPROVED BY:
RBElwood; DESyvrud; JHKaufmann; RPHipskind; RCWilliams	ECON/FINATT ADDP		8/16/67	Minister Van Dyke

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3. Much of the deviation from the original fiscal program was the result of actions of the Castello Branco Government. Expenditure obligations carried over into 1967 exceeded the programmed amount by NCr$329 million. The malfunctioning (hopefully temporary) of the new local tax system instituted on January 1 resulted in unscheduled Federal advances to the states of NCr$90 million. Adoption on January 1 of a system of quarterly rather than monthly distribution of expenditure authorizations resulted in an acceleration of outlays as compared with the programmed rate.

4. Nevertheless, actions by the Costa e Silva Government also contributed to the poor fiscal performance. These included (a) postponement of application of state excise taxes to petroleum products and of transportation rate adjustments, which contributed to unscheduled transfers to the DNER and the autonomous transport entities, and (b) a 30-day extension of the deadline for remitting Federal excise tax collections which was a principal cause of the revenue shortfall.

B. Monetary Policy

5. The GOB's letter to CIAP projected no increase in net domestic credit in the first semester and an expansion of NCr$600 for the year, all of it to occur, for seasonal reasons, in the second semester. Actual expansion reached NCr$609 million by May 31, and preliminary data indicate that this figure reached NCr$750 million by mid-year. The dominating factor in this situation was the much larger than programmed fiscal deficit. Faced with the deficit and the need to fund a large amount of readjustable Treasury obligations maturing during this period, the Treasury borrowed (net) NCr$952 million from the Central Bank during the first five months of the year. All other accounts within the net domestic credit concept (taken together) were contractionary, and well within the program.

6. Despite this rapid expansion in primary credit, the GOB did not increase compulsory cash reserve requirements for commercial banks during the semester, choosing instead to utilize "open market" operations which were not very effective in reducing bank liquidity. As a result, commercial bank loans and the money supply expanded about 17 percent in the first five months, and on the basis of partial data, about 20 percent for the semester (this compares with an increase in the money supply of 15-17 percent for the entire year implicit in the original program). In spite of this high rate of expansion banks probably remained more liquid than usual at the end of the semester.

C. Foreign Exchange Policy

7. The net convertible foreign asset position of the Monetary Authorities improved by $24.1 million during the semester, $13.7 million less than the improvement

originally programmed. However, during the negotiation of the program loan the GOB was advised that the target figure would be adjusted for any decline in forward liabilities resulting from the elimination late in 1966 of the requirement that importers purchase exchange before obtaining an import license. Adjusting for a decline of $39.3 million in forward liabilities brings the end of June position to $53 million below target. However, a further adjustment needs to be made for the failure to transfer in the first semester as scheduled, owing to administrative delay in the GOB, the first $25 million tranche of the program loan. This adjustment brings the adjusted departure from the end of June net foreign asset target to $28 million. Gross foreign exchange reserves declined by $136 million during the semester, $82 million of the decline occurring in June, when the GOB had seasonally heavy repayments of principal and interest on foreign loans.

8. The exchange rate was devalued by 23 percent on February 13, 1967 following a period of heavy speculation and a sharp deterioration in the net foreign asset position. Since then, Brazil's foreign exchange position has improved, and from our analysis of the exchange market and the balance of payments the rate appears now to be realistic. A greater than anticipated decline in coffee exports (since the return to the exporter per bag is fixed in cruzeiros, coffee exports are not sensitive to the exchange rate) accounts for all of the shortfall in the net foreign asset performance during the semester. On the other hand, in the first five months of 1967 such cost sensitive exports as manufactures and iron ore increased by 40 percent and 10 percent, respectively, over 1966 levels. Therefore, while the CIAP letter statistical target for net foreign assets was not attained, the policy commitment contained therein--vis, "to maintain a realistic exchange rate"--appears to have been fulfilled.

D. Coffee Policy

9. In June the GOB fixed prices for the 1967/68 coffee crop which net the producer an increase in cruzeiros per bag, over the net return received in January-June 1967, of 21 percent during the remainder of 1967, and 35 percent in the first semester of 1968. The average increase for the entire crop is estimated at 28 percent.

10. During the negotiation of the program loan GOB negotiators stated orally that it was the intention of the GOB not to increase cruzeiro support prices for the 1967/68 coffee crop. However, immediately prior to the signing of the loan agreement the GOB refused to accept wording in a loan agreement implementation letter which would have made this commitment explicit. The GOB's commitment on the level of support prices is therefore somewhat indefinite, the letter to CIAP stating only that "it is the intention of the authorities as provided in the monetary budget for 1967, to set the

cruzeiro return paid to exporters and the price at which coffee is sold to the Brazilian Coffee Institute at levels which will discourage over-production and preserve the incentives and resources for diversification."

11. An evaluation of the GOB's coffee policy as related to its program as set forth in the CIAP letter must take account of (a) the much greater rate of increase in the general price level in the first half of 1967 than had been projected when the program was originally formulated, (b) the devaluation of the cruzeiro in February, and (c) the fact that the 1967/68 crop is smaller than was estimated when the original 1967 monetary budget was formulated (the Embassy's Agricultural Attaché now estimates slightly under 25 million bags as compared to the 28 million bag estimate used in the monetary budget). In the light of these changes, it became quite unrealistic to expect the GOB to maintain cruzeiro support prices unchanged. For the two crop years prior to 1967/68 the cruzeiro return per bag to growers increased by less than 10 percent while wholesale prices in general nearly doubled. The increase in 1967/68 is expected to increase the real return to producers by 5 to 10 percent over 1966/67. Owing to the decrease in the size of the crops, and the February devaluation, coffee operations for the 1967/68 crop year are expected to generate an offset of about NCr$140 million, or slightly more than was projected in the original 1967 monetary budget.

12. Nevertheless, a somewhat smaller price increase for the 1967/68 crop would have been desirable. The GOB would have been enabled thereby to take advantage of the smaller than anticipated crop, and the cruzeiro devaluation, to increase the contractionary monetary offset from coffee operations at a time when the economy remains under heavy inflationary pressure. Moreover, the price increase actually granted will have an unfavorable effect on the process of diversification out of coffee. Maintenance of price parity for such substitute crops as rice and corn may be impossible without raising the support prices of these crops above prices in the export market. Thus, substantially higher subsidy payments for pulling out coffee trees probably would be required this year to assure continued progress in the coffee eradication program.

E. Comment on GOB Economic Policy

13. As was noted above, in the fiscal area factors inherited from the Castello Branco Government were important in causing the deviation from the original program. However, especially in the monetary and coffee areas, and to a lesser degree in fiscal performance, the deviations were also related to the change of government which occurred in March, and to new policy emphases and initiatives of the Costa e Silva Government. Most important among these was the preoccupation of the new government with the recession which began about the middle of 1966 and reached its most serious proportions in the first quarter of this year. In its initial policy

statements the GOB made it clear that expanding production was its highest priority objective. Measures to increase the availability of credit and lower interest rates were viewed as necessary to achieve this objective. Such measures were not viewed as inflationary in the short run, since costs of production would be lowered through fuller use of existing capacity and reduced interest costs. Therefore, while the government did not act deliberately to greatly exceed the programmed fiscal deficit, the large deviation from the fiscal program which developed was not, in its view, incompatible with its approach to dealing with the cyclical situation which it faced on taking office. A number of the government's more important actions in the second quarter are wholly or largely explained by its determination to deal with the recession. These include its decision not to raise the compulsory reserves of commercial banks, the large increase in prices for the 1967/68 coffee crop (to stimulate demand from the coffee sector), and the decision to increase the working capital of business firms by permitting them to use for an additional 30 days their collections of excise taxes.

14. By June it was evident that the government's expansionist policies were having the desired effect. Business sources were almost unanimous in reporting an upturn in production and sales. Motor vehicle production had recovered to the levels of a year earlier, and state excise tax collections underwent an abrupt upturn. Price developments were also extremely favorable, the wholesale price index (excluding coffee) rising only 0.8 percent in the second quarter as compared with 9.0 percent in the first quarter and 24.0 percent in the first semester of 1966. While the GOB has been able to gain a public relations advantage from these developments, it is well aware of the fact that the favorable price trends have been largely due to the earlier stabilization efforts of the Castello Branco Government and to the unusually large crops harvested in the first half of 1967.

15. Some other factors have also played a role in the new government's economic performance. Thus far it has shown itself somewhat less willing than was its predecessor to make needed adjustments in administered prices and rates. This tendency has been revealed in its postponement of the collection of state excise taxes on petroleum products from April 1, as originally scheduled, until the beginning of 1968. It also has been reluctant to raise railway transport rates to keep pace with rising costs. Simple confusion, resulting from the replacement of experienced men in most of the top and second echelon positions, also played a role, especially in fiscal performance. In April and May members of the new economic team sometimes gave the impression that they were not completely on top of the fiscal situation. However, in June and July it became apparent that the GOB, including the President, was fully aware of the seriousness of the fiscal situation, and that the Minister of Finance had specific plans for holding the fiscal deficit within reasonable limits.

II. Revised Program for Second Semester 1967

A. The Program

16. The GOB has revised its economic program for the second half of 1967; it intends to submit these revisions to CIAP in a letter which will amend its letter of February 3, 1967. An illustrative draft of such a letter to CIAP is attached as enclosure 1. This draft is a slightly modified version of an earlier draft which was studied by GOB officials, and it includes minor modifications made in the Embassy to meet desires of the Minister of Finance. As revised, it is believed to represent what the GOB is prepared to submit to CIAP.

17. The cornerstone of the GOB's revised financial program for 1967 is a curtailment of NCr$715 million in Federal Government expenditures in the last seven months of the year as compared with the original program, and the generation of a fiscal surplus during this period of NCr$410 million. In making these expenditure cuts the GOB will endeavor to avoid reducing 1967 investments in the fields of Agriculture, Education, and Health, in conformity with Alliance for Progress objectives. Revenues are projected at almost the same level as in the original program, while the deficit for the year is projected at NCr$754 million, or NCr$200 million more than in the original projections. The revised program, as compared with the original projections is summarized as follows (data are in millions of new cruzeiros):

	January-May 1967	June-December 1967	1967 TOTAL
Revenues			
Original program	2,303.2	5,076.8	7,380.0
Revised program	2,251.6	5,135.4	7,387.0
Expenditures			
Original program	2,493.2	5,440.8	7,934.0
Revised program	3,415.6	4,725.4	8,141.0
Deficit			
Original program	190.0	364.0	554.0
Revised program	1,164.0	410.0(surplus)	754.0

18. The revised monetary program--approved in the form of a monetary budget by the Monetary Council--provides for limiting the expansion of net domestic credit to no more than NCr$253 million in the third quarter, and no more than NCr$651 million in the second semester. The programmed expansion is only slightly greater than was projected in the original program, which provided for an expansion of NCr$600 million. The program involves a very sharp reversal of the Treasury position with the Central Bank, so that a much larger proportion of credit expansion will go directly to the private sector than in the original program. The revised program--taking into account the necessity of financing an improvement in the net foreign reserve position--was designed to be consistent with an expansion of the money supply of no more than about 10 or 11 percent during the second semester of 1967. Although final data reflecting actual performance for the first half year are not yet available, on the basis of the partial data available the revised program will entail a total expansion of about NCr$1,350 million for the year, consistent with an increase in money supply of about 30 percent. This compares with an expansion in the original program of NCr$600 million for the year, consistent with an increase in the money supply of 15 to 17 percent. A summary of the monetary budget follows (data are in millions of new cruzeiros):

	Original Program	Revised Program	
	Second Semester 1967	Third quarter 1967	Second Semester 1967
I Net Domestic Credit	+ 600	+ 253	+ 651
Treasury	+ 209	- 175	- 435
Min. Price Program	+ 100	+ 25	+ 10
Rediscounts	- 80	+ 50	+ 30
Loans to Private Sector	+ 143	+ 152	+ 354
Coffee Operations	+ 176	- 33	- 36
All Others	+ 52	- 19	+ 475
Safety Margin	0	+ 253	+ 253
II Net Foreign Reserves	+ 155	+ 213	+ 189
III Monetary Liabilities (I & II)	+ 755	+ 466	+ 840

19. It should be noted that the usual individual components of net domestic credit (taken together) are projected to expand by only NCr$398 million during the second semester; there is NCr$253 million of the "permissable" expansion which has not

been allocated to any sector or activity, which the GOB considers to be a "safety margin" in the program. The Minister of Finance is well aware that despite this safety margin, it might become necessary to take special monetary measures during the semester to limit the expansion of the money supply to the projected amount. He has stated that he is prepared to increase compulsory cash reserves of the banks should the rate of monetary expansion at any point during the semester appear to be excessive in relation to the expansion limits established for the semester (see paragraph 6 of the enclosed illustrative letter to CIAP).

20. As regards foreign exchange policy, the revised program is substantially the same as the original program. The GOB intends to maintain a realistic exchange rate and its program calls for an improvement during the semester of $70 million in Brazil's net foreign asset position. This improvement has been supported by GOB balance of payments projections which show a surplus of $165 million, significantly higher than the surplus of $115 million included in the original program. The $165 million surplus is projected to retain reserves at the same level as at the end of 1966 while repaying short term liabilities totalling $165 million. This revised projection of the GOB compares with our original projection of a $119 million surplus, and our revised projection of a surplus of $61 million for 1967, both projections assuming no change in the reserve level. It should be noted that our earlier projection included a drawing from the IMF of $30 million, the amount of the 1967 Standby Agreement. The GOB has expressed no intent at the moment to draw from the IMF although, since it is in to its gold tranche to an amount of $12.5 million, Brazil could do so whenever necessary. The GOB and Embassy balance of payments projections for 1967, along with actuals for 1966, are presented as enclosure 2.§

21. The main lines of the government's coffee policy for the second semester of 1967 and the first semester of 1968 have already been fixed by the decision taken in June on prices for the new crop. No decision will be taken until all danger of frost damage has been passed regarding continuation of the coffee eradication program initiated in 1966, and the GOB in not willing to commit itself to more than doing its fair share to deal with the world-wide problem of over production of coffee. It intends, however, to fix 1967/68 support prices for crops which may be substituted for coffee with a view to at least maintaining the profitability of these crops relative to coffee (see paragraph 8 of enclosed draft letter to CIAP).

22. The new program calls for an increase of approximately NCr$100 million in the originally programmed transfers to the autonomous government transportation

§ A detailed analysis of the GOB and Embassy projections for 1967 has been submitted in the Embassy's A-136, dated August 11, 1967. Further analysis therefore is not presented here.

enterprises. Studies are now underway of the possibilities of raising rates. The Finance and Planning Ministers are in favor of raising rates now but are not certain that their views will prevail within the GOB; they therefore do not yet feel able to make a firm commitment that transport rates will be raised this year.

B. Evaluation of Revised Program

23. The revised program calls for a sharp reversal in the second half of 1967 of the expansionary trend of the first semester in the fiscal and credit areas. We believe that in terms of the global magnitudes involved, the program is consistent with the reabsorption of excess liquidity created during the first semester, and that if carried out successfully it will provide the basis for continued progress toward monetary stability in Brazil. The real foundation of the program is the large projected fiscal surplus and improved position of the Treasury with the Central Bank. This will allow a reasonable expansion of credit to the private sector within the limits of the projected overall rate of monetary expansion.

24. It is evident that fulfillment of the revised government expenditure program will require drastic cuts for certain agencies and activities. A large part of the excess expenditures early in the year, including advances to the States, DNER and BNDE, should be recovered later in the year. However, certain of the excess expenditures already made or planned will not be recoverable. These include, but are not limited to, an increase of NCr$110 million for the National Railways, a supplementary requirement of about NCr$200 million to finance military wages, and NCr$329 million of expenditures under expenditure authorizations carried over from 1966 in excess of the original program. To absorb these irrecoverable excesses above the original program the revised expenditure program will have to cut deeply in other areas in order to limit the increase in total expenditures to about NCr$200 million. Nevertheless, the Minister of Finance is confident that the program is a practicable one and that in carrying it out, he has the firm backing of the President.

25. In June and July actual expenditures as well as disbursement authorizations approved by the Minister of Finance were held below the reduced levels fixed by the revised program. The data are as follows (in millions of new cruzeiros):

Disbursement Authorizations	June	July
Original Program	706.0	720.9
Revised Program	600.0	630.0
Actual	593.0	570.0 (Estimate)

Expenditures	June	July
Original Program	706.0	720.9
Revised Program	600.0	630.0
Actual	516.4	608.2

26. The Ministers of Finance and Planning are aware of the danger that spending agencies may curtail expenditures during the remainder of 1967 without curtailing the real level of their programs, thereby greatly expanding the level of expenditure obligations carried over into 1968. The effect, of course, would be to ease the fiscal problem this year at the cost of an increased deficit in 1968. To cope with this possibility a decree has been drafted which will limit the carryover of expenditure obligations into 1968 to the approximate level of the NCr$600 million originally programmed. It will accomplish this by providing that any appropriation or portion thereof against which disbursement authorizations have not been issued by the end of calendar year 1967 shall be cancelled. This decree is to be issued not later than October.

27. The weakest element in the revised fiscal program is the estimate of revenues. New estimates of revenue from the two principal taxes, namely, the Federal excise tax and the income tax, were prepared during July. On the basis of these more up-to-date estimates, total revenues for the year have been estimated at NCr$7,272 million, or NCr$115 million less than the estimate contained in the revised program (see paragraph 17, above). Moreover, re-examination of the latest estimate by Embassy officers, technicians of the IBRD, and Ministry of Finance officials appears to have uncovered double counting of sufficient magnitude to bring the realistic expectation of total revenue collections for the year down to around NCr$7 billion. How the program is to be adjusted to take account of these more realistic revenue expectations--i.e., to what extent the deficit estimate is to be increased or compensating additional cuts are to be made in expenditures--has not yet been decided. If no further cuts are made in the expenditure program, it appears probable that the deficit for the year will exceed NCr$1.0 billion and the surplus for the last seven months will be reduced to NCr$150 million or less. In our view, this would still constitute very good fiscal performance. In fact, any fiscal surplus in the second semester would be without precedent for many years past. It should be noted that owing to the existence of a safety margin of $253 million in the monetary budget, a fiscal deficit of about NCr$1.0 billion would be consistent with the credit expansion budgeted, provided other elements of the monetary program (taken together) are fulfilled.

28. From the technical point of view, the parameters which determine the relationship between net domestic credit expansion and the money supply appear to be reasonable. It should be noted that the projected rates of expansion imply a tight monetary program for the period, a sharp reversal of the situation that developed during the first semester.

29. It appears that, except for rice, the GOB has failed to fully maintain price parity for food crops as compared with coffee over the past year. Before-planting levels of minimum prices in 1967/68 for a number of staple food crops were announced on August 8. These are shown below with comparable data for the preceding year together with the IBC support price for Santos type 5 coffee (data are in NCr$ per 60 kilo bag except as noted):1/

	Prices Announced August 5, 1966	Mar. 28, 1967 Pre-harvest Adjustment	Prices Announced Aug. 8, 1967	Percent Increase 8/66 to 8/67
Rice (rough)	10.00	11.75	14.50	45
Corn	6.00	7.00	7.50	25
Manioc flour 2/	3.70	4.50	4.80	30
Black beans	18.00	18.00	20.80	16
Colored beans	14.40	14.40	19.80	37
Soybeans	8.70	10.50	11.48	32
Sunflower seed 3/	10.00	11.30	11.80	12
Coffee	36.50	39.50 4/	51.10 5/	40

Nevertheless, since prices of food crops relative to coffee had improved greatly over the preceding three years, the recently announced support levels remain relatively quite high compared to the long-term norm, and the August 8 announcement has been well received in farm circles.

1/ Prices shown are gross of state excise taxes. In general, these taxes have increased more for food crops than for coffee during the past year, but there is a good possibility that the state excise taxes on food crops will be lowered before the end of 1967.

2/ Per 50 kilo bag.

3/ Per 40 kilo bag

4/ Support price for January-June, 1967.

5/ Price for June-December, 1967.

30. While the Mission's estimate of the 1967 balance of payments surplus for 1967 is substantially lower than the $165 million surplus projected by the GOB, even this low, $28 million, surplus is consistent with the revised financial program for the second semester, which includes a $70 million improvement in the net foreign asset position. To achieve a $28 million surplus for the year, following a first semester deficit of $46 million will require a surplus for the second semester of about $74 million. Owing to the seasonality of Brazilian exports and debt repayments, on the one hand, and the prospective release of the second tranche of the 1967 Program Loan for 37.5 million and a $35 million Title IV Agreement for wheat, on the other, the prospects for achieving this necessary surplus and the net foreign asset target appear good. Since the first tranche of the 1967 Program Loan has been included in our assessment of first semester performance, although not actually released until July, second semester data will likewise be adjusted in assessing net foreign asset performance. Although the prospects for the balance of payments for the second semester of 1967 appear good and the exchange rate appears realistic at the moment, the trend of net foreign assets and cost sensitive exports will be followed closely in the context of the GOB's general commitment to maintain a realistic exchange rate.

31. As is indicatdd above, the revised economic program of the GOB falls short of being an optimum program in various respects. Our concerns are centered on certain aspects of the fiscal program, and on the apparent reluctance of the GOB to adjust certain administered prices and public utility rates in order to minimize public subsidies. As noted above the fiscal program as presently formulated contains a gap of several hundred million new cruzeiros. The possibility that the Finance Minister will not be able to adhere completely to his expenditure program must also be recognized. Nevertheless, we have been very favorably impressed with the manner in which the new government--after an initial period in which it displayed an understandable lack of orientation--has reacted to its fiscal and monetary problems. It has reversed the expansionist tendencies of the first semester, and up to the present (mid-August) no slackening can be discerned in its determination to reduce the rate of monetary expansion to a level consistent with maintenance of progress toward stability. On balance, the Embassy/Mission believes that the GOB's revised program deserves renewed program loan support.

III. Recommendations

32. It is recommended:

a. That the GOB program for 1967, reformulated as described above and in a letter containing the substance of the illustrative letter attached as enclosure 1 which the GOB intends to submit to CIAP, be accepted as a reasonable and effective program which is consistent with the original GOB stabilization, development and reform objectives for 1967 upon which the program loan was predicated.

b. That upon further review of the reformulated program in Washington with the IBRD and IMF in conjunction with CIAP to determine that the Embassy findings are consistent with theirs, that the attached Program Assistance Approval Document (see enclosure 3) be signed to provide the USAID Mission authority to revise the original loan agreement and implementation letter signed with the Brazilian government on March 11, 1967 as follows:

(1) The remaining $75 million of the original loan as yet undisbursed will be divided into two tranches of $37.5 million each.

(2) The first of these tranches will be released to the GOB on condition that:

(a) The CIAP letter embodying the reformulated program (as indicated above) will have been received by CIAP.

(b) As of September 15, 1967 the evidence indicate that the GOB is making satisfactory progress in the achievement of the reformulated targets. Satisfactory progress shall not be deemed to have been made unless the GOB has made adequate provision to limit carryovers of expenditure authorizations into 1968 to approximately NCr$600 million, or unless the Mission is satisfied that the GOB will make such provision before the end of October 1967.

(3) Of the first tranche of $37.5 million, $15 million will be allocated to the import/investment stimulation fund and the remaining $22.5 million to finance general imports, subject, however, to results of the determination described in (4)(b) below.

(4) Not later than September 15, 1967 a review will be made by the Mission to determine (a) whether the overall assistance requirements are significantly less than those originally anticipated in the program loan document and whether disbursal of up to a maximum of $25.0 million accordingly should be deferred, and (b) whether performance and prospects for use of the import/investment stimulation fund requires any changes to be made in the level of funds allocated to it rather than to the financing of general imports and whether any changes should be made in the initial distribution of the fund between credit for the agricultural and the industrial sectors. The recommendations resulting from this review will be forwarded to the Coordinator of the Alliance for his approval.

(5) The size and distribution of the second tranche will be determined on the basis of the approved recommendations described in (4) above. The tranche

will be released if it is found that the GOB's performance under the reformulated CIAP letter targets has been satisfactory through the period ending December 31, 1967. It is anticipated that the data for this review will be available no later than February 15, 1967 and if the outcome of the review is favorable that the release would be made shortly thereafter.

TUTHILL

Enclosure 1

Illustrative Draft Letter to CIAP.

Dr. Carlos Sanz de Santamaria
Chairman, Inter-American Committee on the Alliance for Progress

Dear Mr. Chairman:

1. Under date of February 3 of this year the Government of Brazil addressed to the Inter-American Committee on the Alliance for Progress a letter outlining the Government's major economic policy and program objectives which had been established for 1967, and providing certain quarterly targets as set forth in the Monetary Council's approved monetary budget for the year. The purpose of this letter is to inform the Committee of certain changes which have been made in the program for the second half of 1967 in the light of the results actually achieved in the first semester. The revised quantitative fiscal and monetary targets for the third and fourth quarters of the year are presented in the annexed table.

2. Fiscal and monetary results actually achieved in the first semester deviated widely from the program set forth in the Government's February letter largely because of two factors which could not be adequately accounted for in late 1966, when the program was formulated. The first of these were the effects of the change-over to an entirely new system of State and Local taxation at the beginning of the year. Temporary revenue shortfalls which attended this change-over necessitated larger transfers from the Federal to the State Governments than had been programmed. The second factor was the recession in economic activity which necessitated certain monetary and fiscal measures to stimulate the economy.

3. As a consequence of the factors described above, the Government has substantially altered its original 1967 fiscal program. Instead of the NCr$554 cash deficit included in this program, the Government is now forecasting a deficit of NCr$754 million. To achieve this target the Government has put into effect a reduced expenditure program for the last 7 months of 1967. It also is taking steps to assure that the expenditure obligations carried over into 1968 will not substantially exceed the NCr$600 million included in the original program. The need for expenditure containment makes it likely that the capital expenditure and current account surplus goals included in the original program will not be achieved. The Government will, however, endeavor to avoid reducing 1967 investments in the fields of Agriculture, Education, and Health has been maintained in the 1968 budget proposal which has been submitted to the Congress.

4. An increase of approximately NCr$100 million in originally programmed subsidization of the autonomous federal transport entities will be necessary during 1967. Studies now underway concerning adjustment of the rates charged by these entities may lead to rate adjustments during the second semester which could reduce the amount of this additional subsidization.

5. Monetary Policy and fiscal measures taken during the second quarter of 1967 were oriented toward stimulating economic recovery. By mid-year, however, the economy was moving well toward recovery so that the rate of monetary and credit expansion during the second semester can be held to approximately the amount originally programmed for the period. The revised program calls for a maximum expansion of net domestic credit of NCr$651 million for the semester. The Government considers that this increase in net domestic credit will be consistent with an expansion of the money supply of no more than 10 to 11 percent for the semester. A sub-target has been established for the third quarter, during which period net domestic credit expansion will be limited to not more than NCr$253 million.

6. If, because of unforeseen circumstances, the rate of monetary expansion at any point during the semester appears to be excessive in relation to the expansion limits established for the semester, the Government will increase compulsory cash reserve requirements of the banking system.

7. During the first semester the government adhered to the basic exchange policy described in the December letter, but the net effect of an unexpected decline in coffee earnings and a delay in crediting a capital inflow item led to a smaller than planned improvement in the end of June net foreign asset position. The government intends, however, to continue to aim at an improvement in the net foreign asset position of $35 million during the quarter ending September 30, 1967, and an additional $35 million during the quarter ending December 31, 1967.

8. The Government has not yet reached a final decision as to whether the program to eradicate surplus coffee trees which was initiated last year, will be continued in 1967/68. A decision on this subject will be reached later this year after all danger of frost damage to the next coffee crop is past. If at that time there exist satisfactory international arrangements to deal with the problem of over-production in all of the major producing countries, Brazil will do its fair share in dealing with this world-wide problem. The 1967/68 support prices of crops which may be substituted for coffee culture will be fixed with a view to at least maintaining the profitability of these crops relative to coffee.

OPERATIONS OF THE MONETARY AUTHORITIES - SECOND SEMESTER 1967
(NCr$ millions)

		Change in Period (+ = monetary expansion)		
		Third Quarter	Fourth Quarter	Second Semester
I.	**Net Domestic Credit**	+253	+398	+651
1.	Treasury (net)	-175	-260	-435
2.	Minimum Price Program	+ 25	- 15	+ 10
3.	Autarquias	+ 18	- 24	+ 42
4.	State/Local Governments	0	0	0
5.	Rediscounts	+ 50	- 20	+ 30
6.	Private Sector Loans	+152	+202	+354
7.	Miscellaneous Assets	+142	+238	+380
8.	Coffee Operations	- 33	- 3	- 36
9.	Counterpart (AID & PL-480)	+ 7	+ 9	+ 16
10.	Exchange Burden	0	--	0
11.	Autarquia Deposits	- 98	+ 67	- 31
12.	"Safety Margin"	+253	--	+253
13.	Other Accounts (net)	- 88	+156	+ 68
	- exchange accounts	(+32)	(+204)	(+236)
	- capital, surplus & others	(-120)	(-48)	(-168)
II.	**Net Foreign Reserves**	+213	- 24	+189
III.	**Monetary Liabilities (I & II)**	+466	+374	+840

Enclosure 2

BRAZIL'S BALANCE OF PAYMENTS FOR 1966 AND PROJECTIONS FOR 1967

		Actuals 1966	GOB[1/] Projections 1967	Embassy Projections 1967
1.	EXPORTS	1741	1750	1700
	a. Coffee	777	696	680
	b. Other	964	1054	1020
2.	IMPORTS (FOB)	1303	-1500	-1500
	a. Petroleum, crude & derivatives	166	182	174
?	b. Wheat	142	127	125
	c. Mach., Vehicles and Parts	345	--	428
	d. Other	650	1191	773
3.	TRADE BALANCE	438	250	-200
4.	NET INVISIBLE	-492	-566	-540
	a. Interest Payments (net)	-193	-164	-164
	b. Freight, and Insurance (net)	-84	-83	-100
	c. Other, incl. errors and omissions	-215	-319	-276
5.	BALANCE GOODS AND SERVICES (3+4)	-54	-316	-340
6.	NET DONATIONS	36	25	50
7.	CURRENT ACCOUNT BALANCE	-18	-291	-290
8.	PRIVATE CAPITAL	113	251	208
	a. Direct Investment and Loans	74	70	80
	b. Suppliers Credit	46	90	90
	c. Instruction 289 (net)	104	103	80
	d. Swaps	-111	-12	-12
9.	OFFICIAL CAPITAL	-10	205	110
	a. AID Program Loans	152	145	92
	b. Project Loans	87	186	156
	c. PL-480 Title I & IV	37	44	32
	d. Amortization Projects	-212	-170	-170
	e. Capital Subscriptions Int'l Organizations	-70	--	--
10.	BALANCE OF PAYMENTS (7+8+9)	89	165	28

1/ Dated July 12, 1967

(Continued)

	Actuals 1966	GOB 1/ Projections 1967	Embassy Projections 1967
11. MONETARY MOVEMENTS	-89	-165	-28
a. Convertible	-76	-157	-28
1. Assets (increase: -)	40	--	121
2. Liabilities (decrease: -)	-116	-157	-149
(a) Inflows	--	--	--
(1) IMF Drawings	13	--	--
(2) Private Bank Loans	--	--	--
(3) Debt Rescheduling	49	--	--
(b) Outflows	-134	-157	-141
(1) IMF Repurchasings	-39	-30	-30
(2) Private Banks	-44	-118	-111
(3) Official	-45	-9	--
(c) Arrears (net)	-44	-8	-8
(1) Oil	-44	-8	-8
(2) Other	--	--	--
b. Inconvertible (net)	-13	--	--

1/ Dated July 12, 1967

Enclosure 3

PROGRAM ASSISTANCE APPROVAL DOCUMENT

PAAD No. 67-12 (Amended)
Loan No. 512-L-064
Brazil

Pursuant to the authority vested in the Administrator, Agency for International Development, by the Foreign Assistance Act of 1961, as amended, and the delegations of authority issued thereunder, I hereby amend Program Assistance Approval Document No. LA-67-12, dated March 1, 1967, for A.I.D. Loan No. 512-L-064 (Brazil - $100,000,000), to read as follows:

"Block 1. PAAD No.: LA-67-12 (Amended) - Loan No. 512-L-064
Block 2. Country: Brazil
Block 3. Category: Commodity Financing Standard Procedure - Regulation I (Except Small Business)
Block 4. Date:
Block 5. To: The Administrator
Block 6. OYB Change No.: N.A.
Block 7. From: Acting U.S. Coordinator, AFP
Block 8. OYB Increase: None
Block 9. Approval Requested for Commitment Of: $100,000,000
Block 10. Appropriation - Allotment: 72-11X4111 389-65-598-00-57-71
Block 11. Type Funding: Loan
Block 12. Local Currency Arrangement: Informal
Block 13. Estimated Delivery Period: February 28, 1968
Block 14. Transaction Eligibility Date: PAAD approval date
Block 15. Commodities Financed: Any eligible commodities approved by USAID.
Block 16. Permitted Source: U.S. only: $100,000,000
Block 17. Estimated Source: U.S.: $100,000,000
Block 18. Summary Description:

1. The proposed loan, in addition to A.I.D. project loans and resources to be made available from other U.S. Government and international agencies, or other public and private sources, will provide effective support for Brazil's comprehensive 1967 program of stabilization and development, details of which are set forth in the Program Assistance Loan Paper (AID-DLC/P-513), especially Section II and Annex I, the GOB letters to the CIAP). The economic considerations

justifying this loan have been set forth at length in the Loan Paper (particularly Section I and II) and are not repeated here.

2. The Borrower shall repay the loan to A. I. D. in U.S. dollars within forty (40) years from the first disbursement, including a grace period of not to exceed ten (10) years. Borrower shall pay to A. I. D. in U.S. dollars interest at the rate of one (1) percent per annum on the disbursed portion of the loan during the grace period, and two-and-a-half (2 1/2) percent thereafter.

3. Subject to the provisions of paragraph 5 below, the loan shall be divided into three tranches, in the amounts of $25 million ("first tranche"), $37.5 million ("second tranche"), and $37.5 million ("third tranche") respectively, and

a. The first tranche shall be released upon satisfactory fulfillment of such conditions precedent to disbursement of the loan as may be determined by USAID/Brazil.

b. The second tranche shall be released upon determination by USAID/Brazil that

i. The Government of Brazil ("GOB") has delivered to CIAP a letter, satisfactory to A. I. D., setting forth its reformulated program for stabilization, development and reform in 1967.

ii. As of September 15, 1967, or such later date as may be agreed to by USAID/Brazil, the evidence indicates that the GOB is making progress satisfactory to A. I. D., in achieving the reformulated objectives set forth in said letter to CIAP.

c. The third tranche shall be released upon determination by USAID/Brazil that as of December 31, 1967, or such later date as may be agreed to by USAID/Brazil, the evidence indicates that the GOB has continued to make progress, satisfactory to A. I. D., in achieving the reformulated objectives set forth in the said letter to CIAP.

4. Subject to the provisions of paragraph 5 below, the following amounts shall be set aside, within each tranche, to provide medium-term credit to importers for importation of capital equipment from the U.S. ("Investment Import Stimulation Fund"):

a. First tranche: $10 million
b. Second tranche: $15 million
c. Third tranche: $15 million or such amount as USAID/Brazil may deem appropriate.

5. On or about September 15, 1967, USAID/Brazil will conduct a special review of operations under the loan to determine:

a. whether the overall assistance requirements of Brazil are significantly less than anticipated at the time that the loan was authorized and whether disbursement of up to $25 million of the loan should be deferred; and
b. whether previous performance and prospects for future use of the Investment Import Stimulation Fund require any changes to be made in the level of allocations to said Fund, and whether any changes should be made in the distribution of the fund between credit for the agricultural sector and credit for the industrial sector.

If, on the basis of such reviews, a partial deferral of the loan or a change in the amount or distribution of the Import Stimulation Fund is indicated, such indicated action shall be taken by USAID/Brazil, notwithstanding any provision to the contrary in paragraphs 3 or 4 of Block 18 of this PAAD, subject, however, to the prior approval of the U.S. Coordinator of the Alliance for Progress, or his Deputy.

6. Commodity procurement under the loan shall be subject to A.I.D. Regulation I, provided, however, that Section 201.22, 201.23 and 201.24 of said Regulation shall not apply unless USAID in consultation with AID/W agrees that it should apply in whole or in part. All procurements shall be made in accordance with sound commercial practices and subject to procedures satisfactory to USAID.

7. The loan shall be subject to other terms and conditions as USAID may deem appropriate."

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Administrator

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(New language underscored).