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Amembassy RIO DE JANEIRO March 14, 1968

Structural Changes in the Brazilian Economy since 1964

1. Structural changes in the Brazilian economy, initiated by the Castello Branco Government in 1964 and continued by the Costa e Silva Government, are now providing the basis for a more balanced growth of the economy. The most significant of thesestructural changes are:

a) Shift to agricultural sector growth relative to industrial growth and beginning of shift to non-coffee agricultural production compared with previous coffee sector growth; (paras 14-16)

b) Stimulation of housing construction after a long period of stagnation in housing; (paras 17-18).

c) With reduced possibilities of import substitution, the Government shifted to export promotion as a stimulant to growth and to restoring balance of payments equilibrium (paras 19-22).

d) Shift from a growing to a reducing public sector role in the economy, permitting a larger share of the resources to be allocated to the private sector; (paras 23-25).

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Pre-1964 Objectives and Policies

2. To understand the nature and implications of the structural changes in the Brazilian economy of the past four years, it is necessary to consider the general nature of the Brazilian economic policies prior

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ECON: MAllen ADDP: JHKaufmann Min. Van Dyke (in draft) Ambassador Tuthill (in draft) to 1964 and the consequences of these policies in the form of structural and financial distortions in the economic system.

3. Prior to 1964, the GOB economic policies were directed toward the overriding objective of industrialization. To this end, the GOB developed a high protective tariff and exchange control system. As a means of restraining upward pressures on wage costs, the government also began to control domestic prices of foodstuffs, rents and public services, even prohibiting exports of some agricultural foodstuffs, i.e., beef, to this same end. In general, the industrial sector was assured of adequate financial inducements, both on the price and cost sides, to produce rapid growth. The results for the industrial sector were remarkable as industrial output grew at an average annual rate of 8% for over 20 years.

4. Meanwhile, agricultural output, growing at a rate of 4% per year, barely kept pace with population growth during the 20 years prior to 1964. Government policies favoring industrial growth had an unfavorable impact on agricultural output. Price controls on rice, beans, beef, milk and other agricultural commodities reduced the incentives to produce these commodities. An unfavorable exchange rate and inadequate provisions for export promotion reduced the incentives for producing and exporting agricultural commodities, as cocoa, sugar and cotton. With available credit channeled primarily to industry, little financing was left over for fertilizer, seed, storage facilities and other forms of agricultural investment.

5. Only the coffee sector was exempt from the unfavorable economic policies affecting the agricultural sector. Coffee producers had a guaranteed minimum price, adequate financing for the crops, and export prices which weren't affected by the exchange rate -- domestic support price is the determining factor, not the exchange rate. As a consequence, the incentives for farmers to produce coffee was excessive, resulting in a continuing buildup in coffee stocks, the financing and purchase of which had an inflationary impact.

6. Holding the line on public utility prices (i.e., railway, bus, telephone, electricity and gas), as on agricultural food prices, was also part of the GOB policy to maintain living standards of urban workers in the face of growing inflation. As with the agricultural sector, the consequence was reduced level of investment in and production of public services and a growing need for subsidies from the federal budget. The federal subsidies increased the budget deficits which, financed by borrowing from the monetary authorities, expanded the money supply and generated further inflationary pressures. Rising prices necessitated tighter price controls, lower production, larger deficit and expanded money supply in a vicious circle.

7. Rent controls and the paucity of savings -- both associated with the inflation -- severely limited housing construction, and the construction industry remained in a state of severe depression. Interest rate controls limited savings and distorted the flow of credit into non-economic speculative type activities. Finally, heavy protective tariffs and disincentives to, even prohibition of, exports, combined with a loss of confidence in the economy and capital flight, led by 1961 to a depletion of foreign exchange reserves, exhaustion of available foreign credits and periodic exchange crises which continued through 1964.

8. Already by 1962, the opportunities for profitable investments in the import substitution industries, the primary growth industries during 1950's, were severely limited. A declining industrial growth rate and increasing idle industrial capacity provided ample evidence that industrial capacity had out-ran the domestic demand for industrial goods. Artificial fiscal stimulation provided temporary relief in generating higher demand, but after 1961 the industrial sector generated little new investment. Since this was the only growth sector, the Brazilian economy stagnated; real income per capita barely maintained itself during the years 1962 to 1966.

9. By 1964, the Brazilian economy was burdened by several significant distortions which served to limit growth, to elevate prices at an accelerating rate and to bring the foreign accounts to a state of bankruptcy. These distortions may be summarized as:

a) An agricultural sector without incentives for investment or increasing production;

b) A stagnant housing sector, with neither incentives nor financing for growth;

c) An industrial sector with excess capacity, inadequate domestic demand, a cost level too high for exporting and an inflationary environment discouraging investment.

d) A stagnant foreign trade sector, with disincentives to exports and high tariffs limiting imports;

e) Excessive growth in the coffee sector, which already had excess production, drawing resources from the production of other agricultural products in short supply;

f) An excessive growth of an unproductive public sector with attendent heavy burden on the private sector, both through increased taxation and forced savings through inflation; and

g) A distorted financial structure which limited severely the level of savings and channeled credit into non-economic speculative activities.

Post-1964 Objectives, Policies and Measures

10. The basic objectives of the post-1964 government are summarized briefly as follows: (a) stabilization of prices; (b) growth of per capita GNP; and (c) restoration of balance in the foreign accounts. Policies directed specifically at stabilization included reduction of the fiscal deficit, the primary source of the inflationary pressures, wage controls, credit restrictions and trade liberalization. Liberation of price controls and rent controls and an increase in public utility rates were policies directed at stimulating investment and increased production, but they also served to conflict in the short-run with the stabilization objective. Also, institutions and mechanisms were developed to generate savings and to channel these savings to the productive sectors. Measures and policies directed at elimination of the balance of payments deficit included liberation of the exchange system from encumbering restrictions, elimination of the obstacles to exports and improvement in the financing of exports. Facilitating the achievement of the above objectives was the development of new institutions (i.e., the Central Bank, Housing Bank and intermediate credit institutions) new programs, as the minimum price program, and new mechanisms, as monetary correction.

11. Through 1966, the results of the above policies were mixed. The balance of payments improved sharply in 1964 and 1965 and at a slower rate in 1966, but this improvement was at the cost of a large current account surplus, that is, a net exportation of goods and services. This net exportation, added to the low level of production in the Brazilian economy, permitted no increase in real incomes, and actually reduced real incomes in many segments of the economy during 1964 to 1966. Moreover, low levels of production, liberation of price controls, continuing monetary expansion -- resulting from the inability of the government to grapple effectively with the budget deficit -- and a balance of payments surplus, provided a continuing upward pressure on prices.

Structural Changes and Their Consequences -- Summary

12. The accumulated effects of the several structural changes in the Brasilian economy, induced by the new policies, measures and institutions are now having a significant impact on production, employment and prices. The rate of agricultural growth, no longer burdened by price controls, but favored with good market prices, guaranteed minimum prices, and more adequate financing is increasing. Starting in 1967, housing construction accelerated sharply with the inflow of funds, via the Housing Bank, from the social security pension funds. Growth in production and incomes in these two sectors generated demand for industrial production so that through the first quarter of 1968 there has been at least a year of sustained growth in all major sectors. Moreover, starting in 1967, the current account of the balance of payments, primarily as a consequence of the import liberalization program initiated in 1966, moved into deficit by about $300 million, thus adding significantly to the availability of resources in the economy. The end result

for the year was a small balance of payments deficit, but a reduction by almost half in the rate of price increases and an estimated growth in GNP of five percent.

13. The prospects for 1968 are for a continuation of the trends of 1967 with agricultural production and construction as the leading sectors in generating a continuing demand for industrial production, a higher level of employment (since those two industries are labor intensive), and increased investment (with no investments in these sector for many years there's only one way to go).

Agricultural vs. Industrial Growth

14. For twenty years prior to 1964, agricultural production rose barely more than the rate of population growth. GOB statistics indicate a growth rate averaging about four percent per year while industrial output grew at an average annual rate of eight percent. The slow rate of growth in agriculture was primarily attributable to:

a) Controls on agricultural food prices reduced incentives for production;

b) Inadequate financing for the agricultural sector. The banking system by its very nature channels its resources to industry. There was no mechanism, instrument or institution to channel financial resources to agriculture;

c) High tariff walls and exchange controls, to provide protection for industrial growth, raised prices of agricultural imports;

d) Limitations, and in some cases, as beef, actual prohibitions of exports of agricultural products, with the justification that exports of food meant higher domestic prices, limited incentives; and

e) An unrealistic exchange rate which effectively reduced the incentive for exporting. As the result of (d) and (e), exports of agricultural products other than coffee, declined from $519 million in 1955 to $488 million in 1964.

15. Since 1964, the GOB has eliminated most of the disincentives to investment in agriculture and has added a number of new incentives to increasing agricultural production. Firstly, and most importantly, price controls were eliminated on all agricultural commodities. Next, the minimum price support program extended to all major agricultural commodities the same minimum price guarantee that coffee had been privileged to for years. Thirdly, financing was improved through a variety of sources; the minimum price program provided financing through the Bank of Brazil; agricultural paper was included as part of compulsory reserves of the commercial banks thus providing incentives to lend more to agriculture; special credits were made available for fertilizer

and tractors. Finally, barriers were removed and improved financing made available to exports.

16. The above policies are redressing the balance in the economy, both in inducing a more rapid growth in agriculture compared with industry, but also a more rapid growth in non-coffee agriculture compared with coffee. Available statistics on agricultural production, while not particularly reliable, indicate that the annual rate of growth from 1964 to 1967 averaged close to 7 percent, and if coffee is excluded, the increase in agricultural output appears to be slightly higher. While good weather is an important factor in this growth record, there is good reason to believe that favorable prices and improved financing facilities also played an important role. Exports of non-coffee agricultural products also show the same upward trend after 1964. Non-coffee agricultural exports averaged 41 percent more by value during 1965 to 1967 than during the previous three years 1962 to 1964.

Housing Construction - Stagnation vs. Stimulation

17. For many years the construction industry remained in a state of stagnation as inflation reduced savings and poor economic policies diverted credit from the housing field. On the one hand, rent controls provided a disincentive to construction of new homes, while on the other, the lack of savings precluded any long-term credit for housing. Even in 1966, with inflation still at an annual rate in excess of 40 percent, credit for housing was limited to two years; down payments were usually 50 percent; interest rates varied from 12 percent and up.

18. Rent controls were relaxed gradually starting in 1964 but, without credit, housing was not significantly stimulated through 1966. Starting in 1967, two developments generated a torrential flow of resources to the construction industry. Firstly, new legislation effective January 1967 channeled the social security pension funds into the Housing Bank for application in the housing area. Secondly, the application of monetary correction to mortgage bonds, as well as to the housing loans, attracted additional funds to the housing sector. Together, these two sources generated over NCr$800 million, or over one percent of gross national product for housing in 1967. For 1968, the flow of resources to the Housing Bank is expected to double. This sudden growth of funds stimulated housing construction in 1967, quickly exhausting available construction material. The construction industry in turn, without investment for years, was awakened to the prospects for further growth and in turn generated a demand for industrial production.

Foreign Trade - Protection vs. Liberalism

19. A significant development objective of the Castello Branco Government was the shift from import substitution to export promotion as a basic stimulus to economic growth. The leading growth industries prior to 1964 had been those, i.e., automobiles and durables, which produced substitutes for imports behind a high protective tariff wall. Export industries, on the

other hand, had suffered under the twin handicaps of high costs of capital goods and barriers to exportation. As a consequence, exports stagnated; capital fled the country as confidence waned; the balance of payments deficit grew; reserves dwindled and foreign indebtedness expanded to the point where it became necessary to reschedule the foreign debts, which was done in 1961 and again in 1964.

20. Elimination of the barriers to exports, establishment of financing facilities for exports, reduction of capital goods and raw material costs were some of the measures taken by the Castello Branco Government to stimulate greater exports. The growth of agricultural production, described above, also contributed significantly to the export expansion. As a consequence of these measures, non-coffee exports rose by 44 percent from 1963 to 1967, and exports of manufactured goods almost quadrupled (from $37 million to $143 million) during the same period.

21. Following an improvement in Brazil's exchange reserve position in 1965, the GOB initiated a dramatic and sweeping import liberalization program, reducing average tariff rates plus exchange premiums effective in 1967 to about one-third of what they were in 1964. This liberalization program was the major factor in the 11 percent growth of imports in 1967 (to the highest level on record) and contributed to the 38 percent increase in imports in 1966 (the upswing in the economy was the major factor during that year).

22. The shift in the foreign trade policies of Brazil from a highly protected system to a more liberalized system tended to introduce more competitiveness in the economy, to reduce production costs, and consequently tended to have a favorable impact on prices. The agricultural sector has benefited most from the liberalization of trade, in terms of its capacity to expand both domestic production and exports. A continued growth of exports, particularly of agricultural products, and imports is projected for 1968.

Public Sector vs. Private Sector

23. The public sector has long imposed a heavy economic burden on the Brazilian economy. According to a World Bank study, Brazil has one of the heaviest tax burdens among less developed countries, with a ratio of government current revenues to total national product of over 30 percent. 1/ Despite this high level of taxation, government expenditures outran revenues continuously, leaving a high fiscal deficit and imposing further forced savings on the private sector.

24. Recognizing the need for a reduction in the relatively uneconomic public sector, the Castello Branco government initiated, as part of its stabilization effort, a program to shift resources from the public sector to the private sector. Since 1964, the tax system has been reformed, taxes cut, tax enforcement improved and expenditures, relative to GNP, reduced. After a

1/ Includes federal, state and municipal governments.

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continuing increase through 1963, federal government expenditures as a percentage of GNP have been gradually reduced to 1967. In 1959 the ratio of central government expenditures to GNP was 12.6 percent, rising to 16.2 percent in 1963 and falling to 13.2 percent in 1967. The fiscal deficit has also been reduced significantly both as a percentage of total revenues and GNP. In turn, the lower deficit has contributed to the reduced rate of inflation.

25. Although there has been progress in reducing the public sector in the Brazilian economy, a major effort in this area still lies ahead. The GOB appears to be pursuing in 1968 a fiscal program which portends a more permanent reduction in public sector expenditures and deficits. The 1968 cash budget is under tighter control than at any time during the past few years and there is some grounds for belief that, while the 1968 cash deficit remains higher than is desirable, the basis may be laid for a significant reduction in the deficit during 1969. Since the federal deficit is the single most important cause of the inflation in Brazil, a reduction in the deficit should have a favorable impact on price developments in 1969.

26. The above represents the Embassy's appraisal of some of the basic long-term trends in the Brazilian economy. The more immediate pressing issues of an economic, social and political nature will be analyzed and reported in a classified companion piece.

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