3. BRAZIL

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3.1 Introduction

Brazil (officially República Federativa do Brasil, Portuguese for Federative Republic of Brazil), the fifth largest country in the world, is exceeded in size only by Russia, Canada, China, and the United States. It covers an area of 8,547,404 square kilometres, or about half of South America. It faces the Atlantic Ocean along 7,491 kilometres of coastline and it also borders on every nation of the South American continent except Chile and Ecuador. Stretching for approximately 3.440 from north to south and from east to west, it contains no desert, high mountain, or Arctic environments that limit the extent of human occupancy. In fact, putting aside recurring droughts in northeast, floods and occasional frost in south, Brazil is subject to no natural hazard of vast proportions.

The physical and human features of this broad land are rich and various. It is rich in natural resources, and its burgeoning cities, huge hydroelectric and industrial complexes, mines, and fertile farmlands have placed it among the world's most productive countries. In spite of these so promising features, Brazil has long been frustrating its population’s expectations to become a really developed country. Brazilians frequently regret that their country is an asleep giant (after a verse of Brazil’s anthem: “Deitado eternamente em berço esplêndido” - in English: eternally laid on a splendid cradle). Indeed Brazil is not only famous for its soccer, carnival and coffee, but also for presenting until recently astonishing annual inflation rates and sharp income inequality. The former seemed to have been sorted out, but the intensity with which the ongoing international financial crisis has beaten Brazil reveals that the persisting unbalances and distortions of its economy are far from going away.

Table 3.1

MAIN FACTS (1996 Census):			
Area:	8,547,404 km	Population:	157 ,079, 573
Density:	18.4 persons per km	Urban/rural dist.:	78,4% / 21.6%.
Growth rate of pop.:	1,4%	Illiteracy rate:	14,7% of people not under 15
Life expectancy:	67,6 years.		

A. Physical Features

Brazil’s physical geography may be divided into several upland and lowland regions, but the Amazon River Basin in the north and the Brazilian Highlands, or Plateau, in the south so dominate the landscape that all other important areas are defined by their relationship to these two features. The Brazilian Highlands, a plateau having an average elevation of 1,000 m above sea level, contains some rugged mountains--a few of which rise to more than 2,700 m - primarily in the south-east. The Brazilian Highlands themselves are bordered by the Rio de la Plata Basin (which is mostly located in Uruguay and Argentina) in the south; by the narrow coastal lowlands set off by the Serra do Mar, which is part of the Great Escarpment, to the east (where the highlands often drop more than 760 m to sea level in a single steep slope); and on the north by the Amazon Basin, which lies generally at elevations of less than 800 feet (250 m) above sea level.

The Amazon River with its more than 1,000 known tributaries constitutes the largest river basin in the world - over 7,047,000 square km. About two-thirds of the Amazon Basin lies in northern Brazil and comprises about 45 percent of the nation's total territory. The river, which is navigable for nearly its entire 6,400-kilometre length, is a major transportation artery. Its gentle gradient, however, prevents its widespread use for hydroelectricity or for irrigation. The rapid increase in the irrigated agricultural area of Brazil during the 1970s occurred, for the most part, south of the Amazon in the country's other major river basins: those of the São Francisco and the Plata. Most of Brazil's hydroelectric capacity is provided by dams along the Paraná River in the Plata Basin (including Itaipu Dam, with one of the world's largest hydroelectric-power stations, inaugurated in 1982).

Brazil's climate varies little within the Amazon Basin, with annual average temperatures of about 26° C. Most locations in the basin receive between 2,000 and 3,000 mm of rainfall annually, with some locations averaging as much as 5,000 mm. Most of the rest of the country has adequate precipitation with the exception of the semiarid São Francisco Basin in the north-east, which averages only 600 mm annually (and often receives less than 250 mm). The south-eastern coastal plain has a hot, moist climate similar to that of the Amazon Basin.

Only about 7 percent of Brazil's land area are ploughed, whereas three-fifths of the country are forested. The greater part of the arable land is in the Plata Basin and along the coastal areas. However, the extent of arable land has been expanded in the last years thanks to the introduction of modern techniques of fertilization of vast areas located mainly within the afore-mentioned Plateau and covered by a sort of savannah vegetation called *cerrado* in Brazil. Besides the *cerrado*, the country has a rich and varied tropical vegetation system that includes the immense tropical evergreen and rain forests in the Amazon Basin, as well as much smaller forests along the narrow south-eastern coastline. There are tall grass prairies, remnants of larger grasslands, in the state of Rio Grande do Sul; in the drier north-east is a thorny deciduous scrub woodland known as caatinga. Just west of the narrow coastal rain forests, at the highest elevations of the Brazilian Highlands, there are semideciduous forests, and the greater part of the interior highlands is a mixture of scrubby deciduous woodland and savannah. The less populous northern areas still abound in wildlife, with a variety of plant species unequalled on earth flourishing in the rain forests of the Amazon Basin.

B. Population

Most of the inhabitants of Brazil, the world's fifth most populous nation, are concentrated along the seaboard. However, its national capital, Brasília is located inland, on the outer edge of intensive settlement. Planned from scratch, it replaced Rio de Janeiro as the capital in 1960.

Brazil is unique among the nations of the Americas: this former colony of Portugal did not become fragmented into separate countries, as did the British and Spanish possessions, but retained its identity through the following centuries and a variety of forms of government. The Portuguese language is, therefore, universal except among a few thousand native Indians in the most remote reaches of the Amazon River system.

Brazil has the largest population of any Latin-American state. The 1996 census counted 157 079 573 inhabitants and 164 million are estimated for 1999. Although its population has increased very rapidly, trebling in the period from 1940 to 1981, the country's mean population density remains relatively low: 18.4 persons per sq. km (1996). Its several different ethnic groups have intermixed progressively from the earliest days of its colonial history, when the Portuguese mixed with the Indians and with the Africans brought to work the plantations and mines. Today the areas primarily populated by Indians are restricted to the most remote, economically unattractive parts of the Amazon Basin.

The Brazilian population is characterised by its rapid growth, its youth, its diverse origins and its geographic mobility. However, in the last decades the growth rate of the population has been declining. Accordingly to the 1996 census this rate was 1,4%, down from 2,5% in the 1970's. More recent estimates reduce it to 1,2%. In fact, the Brazilian population, renown for its youth, is growing older, due both to the declining in the birth rate and to improvements in social indicators, which results in a longer life expectancy. This poses a challenge unexpected a couple of decades ago, namely, how to sustain an increasing population of aged and retired people. The age breakdown was as follows in 1995: under 15, 32,2%; from 15 to 29, 26,9%; from 30-44, 20,6%; from 45-59, 11,9%; 60 and over, 8,4%. Another steady trend is urbanisation. Today each four Brazilians out of five live in urban areas.

Illiteracy rate is still high, but it has been steadily declining. While in the early 70s it was as high as 30% among those aged 15 and over, the figure recorded in 1996 was 14,7%. The main social problem, itself related to bad educational background to a considerable extent, is the perverse income distribution. According to a survey released by the World Bank this year, Brazil is the sixth most unequal country in the world, standing a little far from Sierra Leone, Guatemala, Guinea-Bissau, Paraguay and Panama. 64,2% of total income go to the richest 20% of the Brazilian population, whereas only 2,5% go to the poorest 20%. Overall around 50 million Brazilians are poor. Such inequality does not arise only among the household, but also throughout the different regions and states of the country. Income in the Federal District (Brasília) is seven times higher than in Piauí or Maranhão, the poorest states in the northeast. Some of the causes of this inequality lie in Brazil's history – in the highly unequal landholding pattern bequeathed by colonialism, and in almost four centuries of slavery (it was to be abolished in 1888), whose legacy included a neglect of mass education. But inequality was further aggravated by half a century of industrial protectionism, and by chronic inflation used as a way of settling conflicts over the distribution of resources. Only the higher income workers and those holding banking account could keep their purchasing power during the long period of hyperinflation.

C. Economy: general features

Table 3.2

BRAZIL'S ECONOMY MAIN FACTS:	
Gross national product (1998):	U.S.$777,100,000,000
Per capita GDP (1998):	U.S.$ 4,803.13
Inflation rate (1998):	INPC: 3.78
GDP growth rate (1998):	-0,12%
Public debt: July 31st 1999):	R$ 495,3 billion (49,5% of GDP)
External debt (July 31st 1999):	US$ 229.6 billion
International reserves: (September 17th 1999)	US$ 41,936 million (int'ntl. liquidity concept)
Exchange rate (September 20th 1999):	US$ 1,00 = R$ 1,873

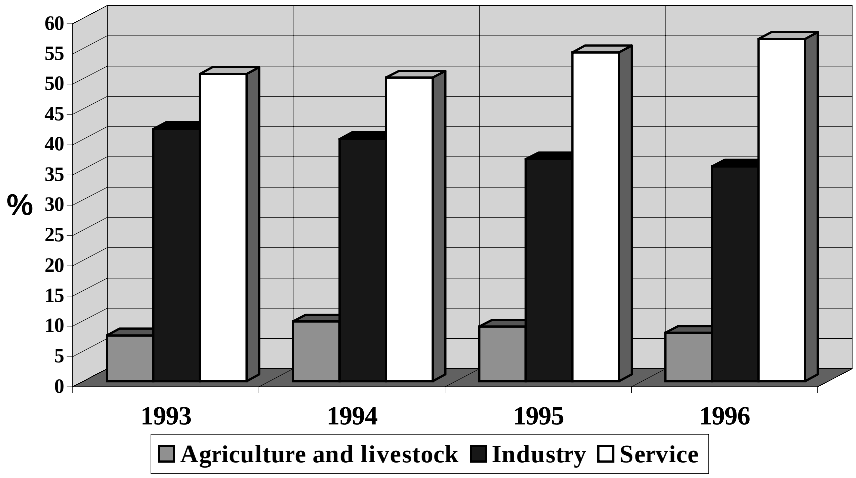
Agriculture has long accounted for about around one-tenth of the gross domestic product (GDP) and employs about one-fifth of the labour force. This share however shows a tendency to decline, as the table and graph below demonstrate.

Cereals, mainly corn (maize), rice, and soybean, are the principal crop, occupying one-third of the arable land. Brazil is the world's leading producer of coffee, sugarcane, soybeans, papayas, oranges, and cassava. It also ranks among the world's leading producers of bananas, cocoa beans, tangerines and mandarin oranges, and avocados. Livestock raising is an important activity, and Brazil's cattle, chicken and pig stocks are among the largest in the world. Brazil's extensive forests are concentrated in the Amazon River region where there are large stands of still-unexploited tropical forest, although the rate of depletion of these forests (with much of the timber used for fuel) is now so rapid that environmental concerns may force the imposition of controls. Brazil's lumber industry is well developed and based largely on harvests from plantations of eucalyptus, Honduras pine, and other exotic species raised in the southern part of the country. There are good fishing areas both in the ocean along the coast, which is fished commercially, and inland in the long river systems, particularly along the Amazon.

Brazil is well endowed with sundry reserves of metals. It has the third largest reserves of bauxite in the world, the largest reserves of columbium, one of the largest of beryllium, high-grade iron ore, gold, and some of the world's largest reserves of manganese and tin. Brazil is one of the largest petroleum producers in Latin America; its oil and natural gas reserves have become substantial with the development of offshore fields. Brazil's rich mineral deposits remain largely unexploited. The principal minerals produced include iron ore, tin, phosphates, petroleum, natural gas, limestone, bauxite, coal, salt, copper, manganese, kaolin clay, chrome ore, barite, uranium, zinc ore, gold, diamonds, and quartz crystals. About nine-tenths of the country's electrical energy is produced by hydroelectric-power plants.

Manufacturing accounts for about one-fourth of the GDP and, together with mining, employs one-sixth of the labour force. It is well diversified, producing refined petroleum products, steel ingots, pig iron, cement, raw sugar, coke, fertilisers, rubber, paperboard products, ferrochromium alloy, machinery, aircraft, armaments, electrical goods (including computers), textiles, and automobiles and commercial vehicles. Construction generates about one-twentieth of the GDP and employs a comparable proportion of the labour force. Construction is concentrated on industrial plants, roads, railroads, and dams and hydroelectric-power plants. Tourism in Brazil is well developed and is a growing industry, being concentrated on cities and beaches along the Atlantic coast. But just a little of the potential has been exploited. Brazilian tourists spend abroad much more than foreigners visiting the country.

Figure 3.1   The Economy by Sector



Brazil's major trading partners are the European Union, the United States, Argentina and Japan. The country's principal exports are non-electrical machinery, iron ore, transport equipment, metals (including iron and steel), coffee beans, soya products, and footwear; the principal imports into Brazil include petroleum and other mineral products, non-electrical machinery, chemicals (including fertilisers), and food products.

Brazil's railways, which are partly government-owned and partly privately owned, are only a minor factor in the nation's transport network, with the exception of certain commuter lines and bulk-oil carriers. Although only a small portion of the road network is paved, intercity bus services are well developed. River-borne transport handles about one-tenth of all Brazilian domestic cargo, and there are numerous deepwater Atlantic ports. Air transport is very important, especially in the Amazon River region. There are 21 international airports; the airports at Rio de Janeiro and São Paulo, however, handle most of the international traffic.

D. A glimpse of history

Little is known of pre-Portuguese Brazil. The native inhabitants, Indians, mostly Tupi-Guarani, were not empire builders as were the Incas to the west or the Aztecs to the northwest. Their settlements were scattered, and their life-style was mostly nomadic.

The European discovery of Brazil is credited to the Portuguese naval commander Pedro Álvares Cabral, who was on his way to India when he veered westward enough to sight Brazil in 1500. Portuguese interest was minimal at first, but the discovery there of a type of wood containing a valuable red dye known as *brasil*, from which Brazil takes its name, and the increased competition from the French, who were also exploring the coast, led Portugal to step up colonisation attempts. The first colonising effort began in 1530 under the direction of Martim Afonso de Sousa, who founded São Vicente in 1532. A donatary system of settlement was set up that created great landholdings with numerous feudal characteristics. Indians were used for manual labour on the great sugar plantations, then replaced by black Africans who were brought as slaves. Also significant at this time were the Jesuits, who did the work of Christianising and educating the Indians and who generally served as their protectors. The westward expansion into the interior of Brazil originated mostly from São Paulo and was led by the *bandeirantes*, who organised great expeditions to capture Indian slaves and to find gold and precious stones.

Rebellion in Brazil against Portuguese rule began as early as 1789, but independence came about in an unusual way. Fearing an invasion by Napoleon, the Portuguese prince regent, Dom John, fled to Brazil in 1808. He instituted certain reforms and by 1815 had made Brazil coequal with Portugal in the new United Kingdom of Portugal, Brazil, and the Algarves, with the seat of government at Rio de Janeiro.

Revolutionary movements at home forced John, now King John VI, to return to Portugal. The Portuguese *Cortes* wanted to return Brazil to colonial status. The Brazilians were incensed, and prince regent Dom Pedro, who had stayed in Rio de Janeiro, declared Brazil's independence on Sept. 7, 1822. A shaky first two decades followed, but the long reign of Pedro II (1840-89) resulted in growth, prosperity, and stability for the kingdom. When military leaders staged a revolt in 1889, Pedro II abdicated and a republic was established.

Accompanying increased immigration and growth in manufacturing in the 20th century were frequent military coups and suspensions of civil liberties. Construction in the 1960s of a new capital at Brasília, intended to spur the development of the country's interior, increased Brazil's public debt and worsened the inflation rate. After 1979 the military government of President João Baptista de Oliveira Figueiredo began a phased return to democratic practices, which culminated in 1989 in the first popular presidential election in 29 years.

E. Political conditions

Political and social reforms usually come later to Brazil than to Spanish-speaking Latin America, and are often more gradual and ambivalent, though also more peaceful. While Spanish America split into separate independent republics trough war and revolution in the 1820's, Brazil turned the descendants of its last Portuguese king, who had been brought up in the country, into emperors who kept its huge territory united. Slavery, as said above, lingered longer in Brazil than anywhere else in the Americas. In 1889 the emperor Dom Pedro II was overthrown and a republic was established. Bloodless as it was, that was the first of many military interventions in the political affairs, which would become a recurrent event for the intervening hundred years. Presently the country is a federal republic divided into 26 states plus the federal district where the capital Brasília is located. The states themselves are divided into municipalities, which currently amount to 5.507.

The National Congress (Congresso Nacional), which consists of the Chamber of Deputies (Câmara dos Deputados) with 513 seats, and the Senate (Senado), with 81 seats, exercises legislative power. Deputies are elected to four-year terms and senators to eight-year terms. The president, who exerts at the same time the functions of chief of state and head of government, is elected every four years through universal suffrage, one single re-election being permitted for another four-year term.

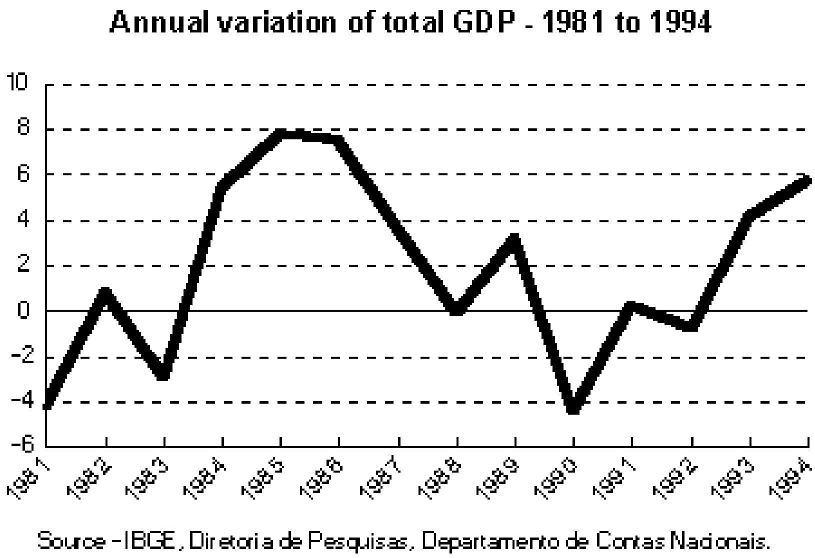
The current president, Mr. Fernando Henrique Cardoso, is supported by a coalition which gathers the major right-wing or moderate Brazilian parties, namely Brazilian Social Democracy Party or PSDB; Brazilian Democratic Movement Party or PMDB; Liberal Front Party or PFL; Brazilian Workers' Party or PTB and Brazilian Progressive Party or PPB. Together these parties control three fourths of the Parliament. The opposition leading party is the leftist Workers' Party or PT.

But for many Brazilian parliamentary representatives, party labels are merely flags of convenience. In the 1994-98 Congress, 230 out of 513 lower-house members changed parties, some of them up to four times. To govern with so weak parties requires endless negotiations. Actually legislators reserve their loyalty to non-party attachments, such as their own home patch and cross-party sectorial lobbies. The *ruralistas* or farmers' lobby had around 130 supporters in the 1994-98 Congress, more than the biggest party. Many of these problems are exacerbated by the electoral system, which gives a disproportionately large representation to voters in states with small populations. These states, mainly in the north and northeast, are net recipients of federal money. Thus, São Paulo has one Congress member for each 333.000 voters; Acre has one for each 40.000.

3.2 Overview of Macroeconomic Activity and Fiscal Position

Brazil earned the reputation of being a "miracle economy" in the late 1960s and early 70s when double-digit annual growth rates were recorded and the structure of the economy underwent rapid change. Brazil's dramatic reduction in output growth—average annual GDP growth was only 1.5 percent over 1980-93—reflected its inability to respond to the events of the late 1970s and 1980s: the oil shock, increases in real interest rates, the debt crisis, and the resulting cut-off of foreign credit and foreign direct investment (cf. graph below). These shocks, in combination with poor management of public finances and heavy state intervention, resulted in large fiscal deficits at state and federal levels. Although the fiscal deficits were reduced after 1990, heterodox policies, generalised indexation, and exchange rate management contributed to keeping inflation high and increasing. Monthly inflation skyrocketed from 3 percent in the late 1970s to 50 percent in mid-1994. Brazilian income distribution, already poor, worsened significantly in the 1980s.

Figure 3.2



Against this background, the achievements of the Real Stabilisation Plan in effect since mid-1994 brought Brazil a precious interlude of economic stability. The core of Real Plan consisted of:

a) thorough abolishment of price indexation;
b) strengthening of the national currency (the Banco Central do Brasil - Central Bank of Brazil stopped stimulating exports by devaluating systematically; in the first years the Brazilian currency appreciated against the US dollar;
c) elimination or reduction of legal or tariff barriers to imports;
d) introduction of a vast privatisation programme;
e) widespread deregulation aiming to foster competition and to attract foreign investments.

Figure 3.3

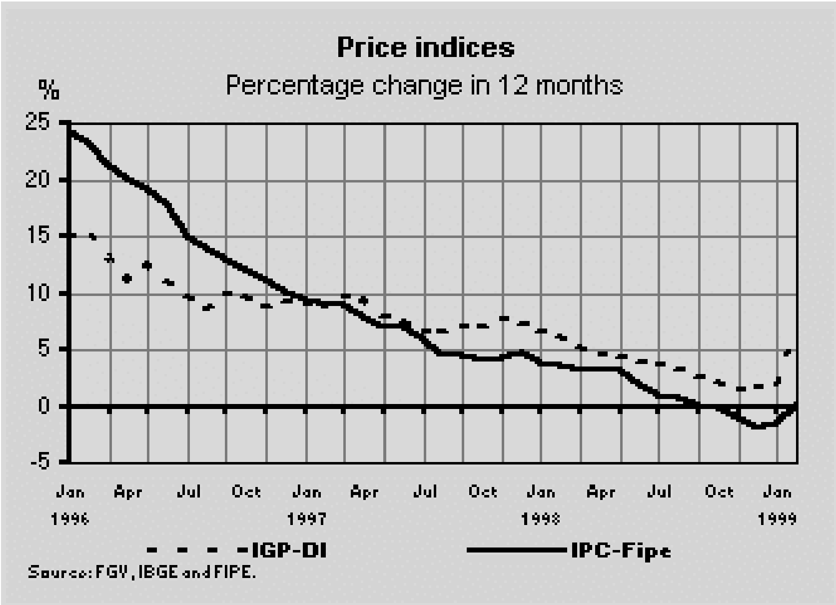
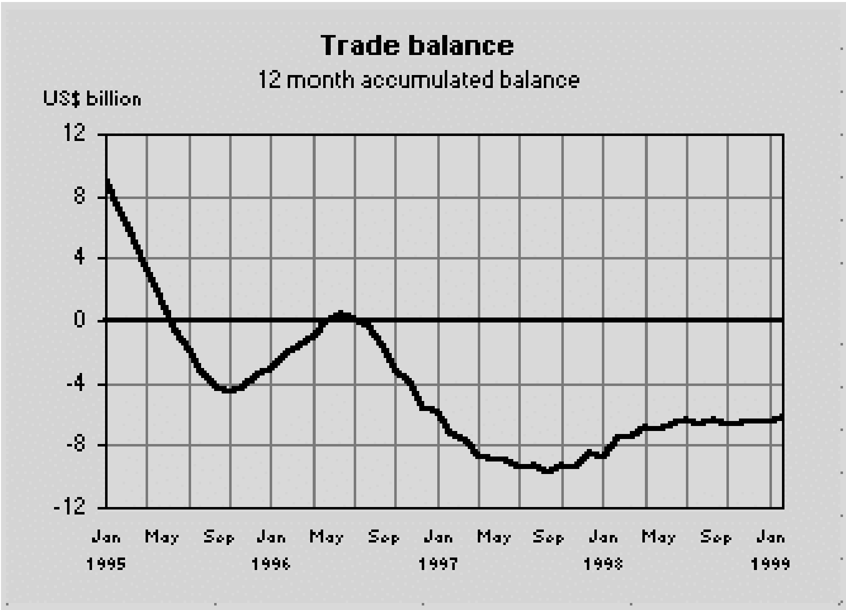


Figure 3.4

Combined with more open trade, the strong and stable currency forced the Brazilian business to cut costs and invest in new technology. Between 1994 and 1998, the retail price of a colour television fell from $700 to $400, and that of a bicycle from 300 reais to 90 reais. Consumption soared. Between 1993 and 1998, sales of products as diverse as yoghurt, shampoo, cars and colour televisions more than doubled. The low inflation increased the purchasing power of millions of Brazilians, especially poor ones, making economic stability hugely popular. Falling inflation helped to preserve the value of wage increases granted in 1994-95. The result was a sharp decline in poverty and inequality. In 1994, 33% of those living in Brazil's six biggest cities were officially deemed poor; by 1996 (that best year of the

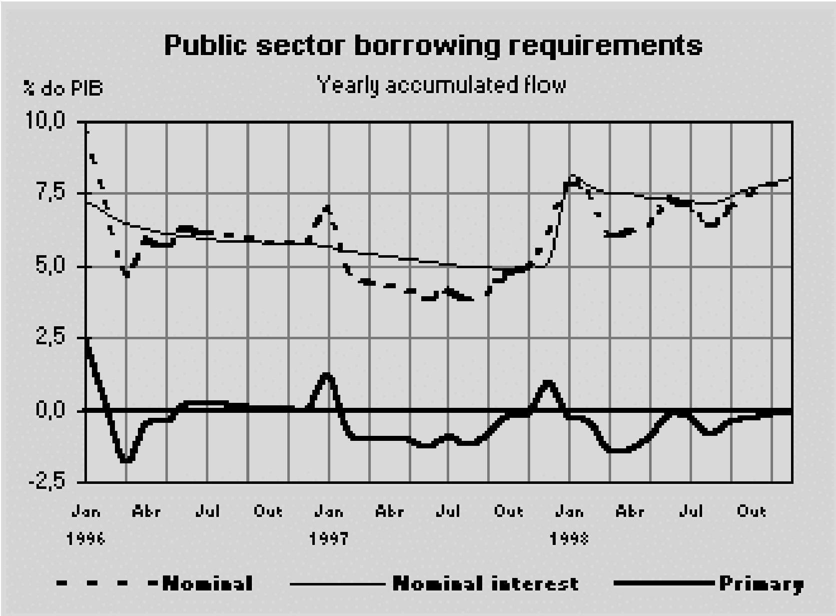
Real Plan), that number had fallen to 25%, according to a study by IPEA, a think-tank linked to the government.

Figure 3.5



Unfortunately, this rosy picture would be shaken by unexpected difficulties arising in the external front. As the Asian crisis burst in September 1997, Brazil found itself heavenly dependent from external flow of foreign currency. As early as March 1995, financial markets had first attacked the real, in the wake of Mexico's peso devaluation. Brazil responded by adopting a pegged exchange rate, under which the real devalued by 7.5% a year against the dollar. This succeeded in bringing inflation down, eventually, to just 2,5% in 1998, its lowest level in half a century. But for the scheme to be sustainable, it was vital for government as well as firms to cut costs; and the government had failed to act decisively to reform public finances. And an increasing deficit both in the trade balance and in the balance of payment boosted the pressure over the real to levels almost unbearable.

Figure 3.6



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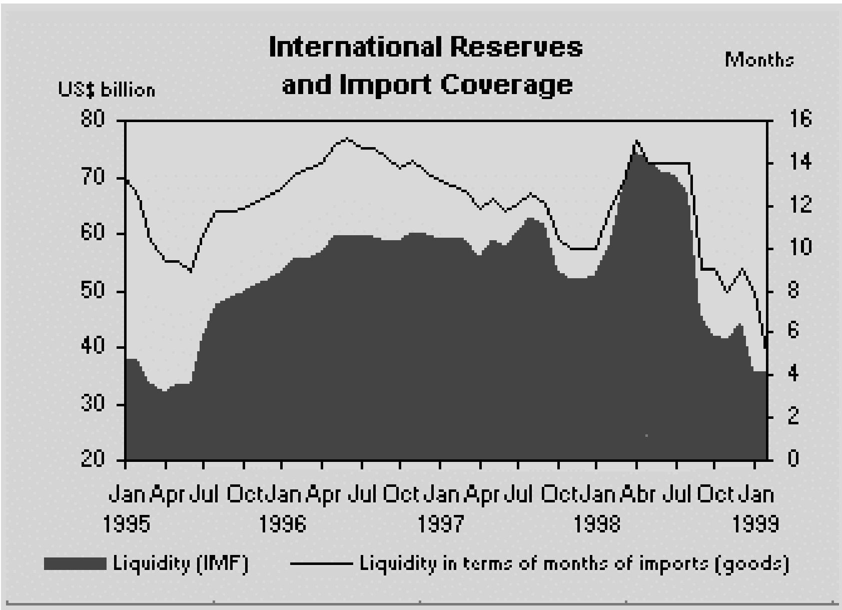
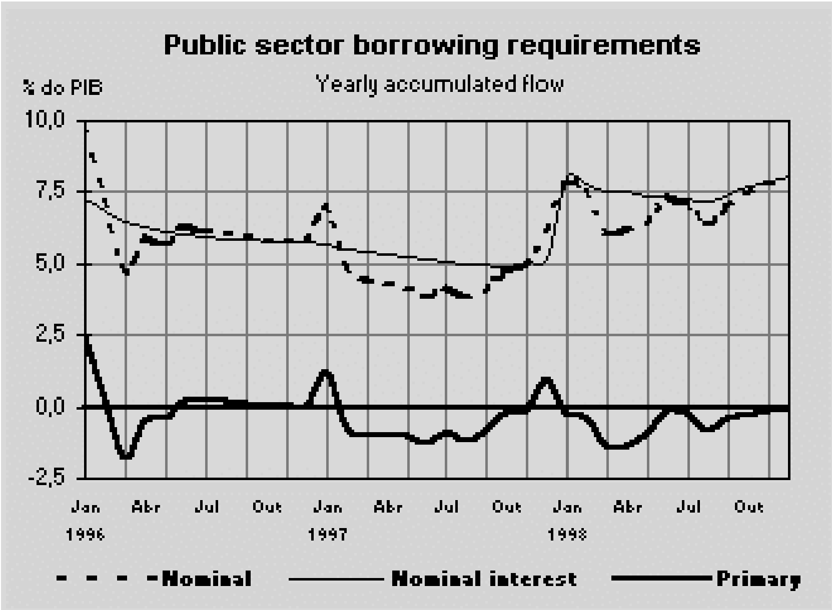


By the end of 1997 Brazil’s combination of an overvalued currency, a loose fiscal policy and tight money had resulted in a large and growing public-sector deficit and a big hole in its current account. The government first response was to sacrifice growth for currency stability. Twice in less than a year it pushed interest rates to stratospheric and announced big fiscal constraints. Last November the country won a $ 41,5 billion package, led by the IMF and tied to an emergency programme of tax increases and spending cuts worth 28 billion *reais* (then $23.5 billion, or 3% of GDP). The idea was that the package would avert the need for a forced devaluation, but investors became convinced that devaluation was on the way, and fled. In all, between last August and early January, around $50 billion left the country, as first foreign and then local investors pulled out.

Figure 3.8



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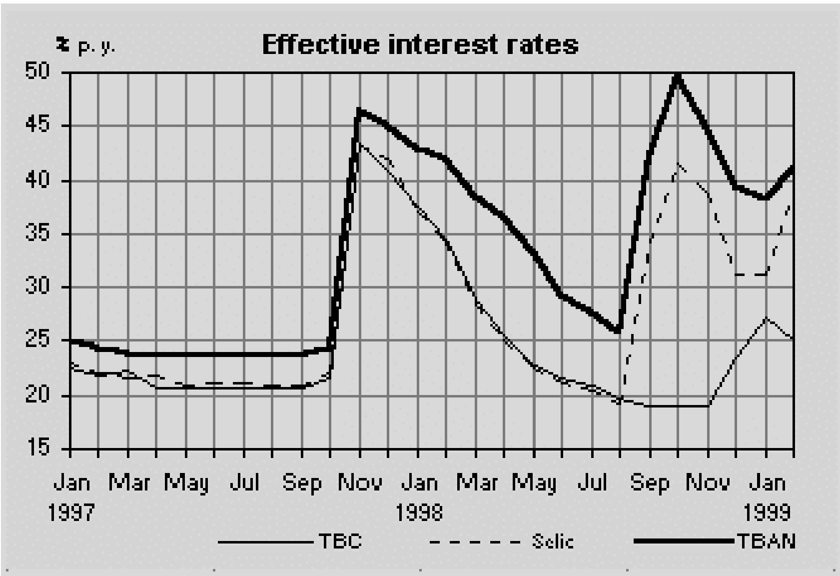
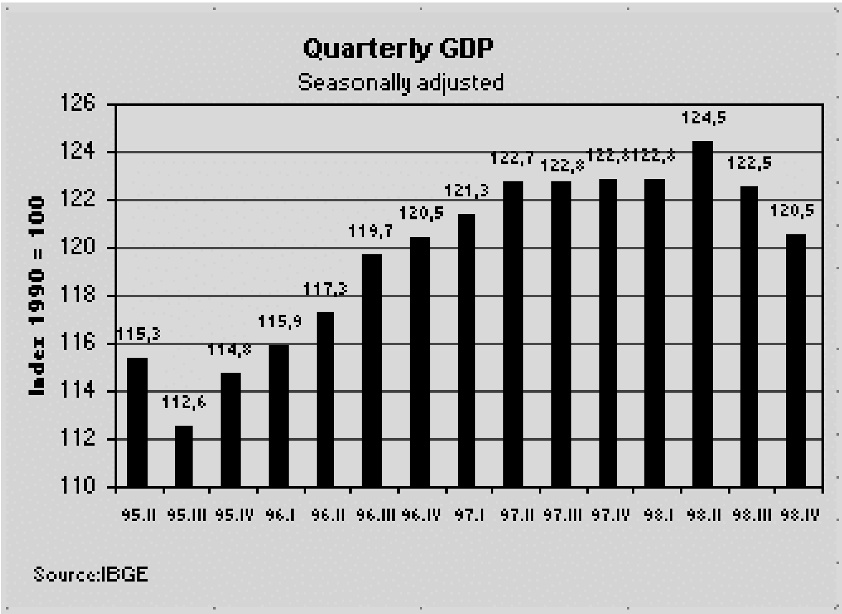


As a result of so high interest rates, Brazilian economy was already sliding into recession before the dramatic episodes of January, when the government eventually left the real to fluctuate. In 1998 the GDP presented a growth rate of meagre 0.2%. This figure is deceitful, because in the second semester the economy actually shrank. Another deleterious effect of the high interest rates was to swell the domestic public debt (cf. the graphs bellow).

When the devaluation finally came in the middle of January analysts from all over the world heralded the apocalypse. The GDP, according to the most pessimistic forecasts, would reduce 5% and the annual inflation rate would soar to 70%. But as early as in the beginning of May the eminent disaster seemed to be avoided. The exchange rate, after reaching the maximum of 2.17 *reais* per U$1 in March, fell and had been reasonably oscillating between 1.64 trough 1.73. The inflation was kept under control, despite the fact that the national currency had lost nearly 35% of its purchasing power in dollar since January. It was put an end to the capital flight, the international reserves has been settled around $42 billion, after had sunk down to 29 billion in February. In September this year the official interest rate was in 19.5%, down from 49% in January, and finally instead of reduction now its is expected a 1% growth of the GDP.

Figure 3.10



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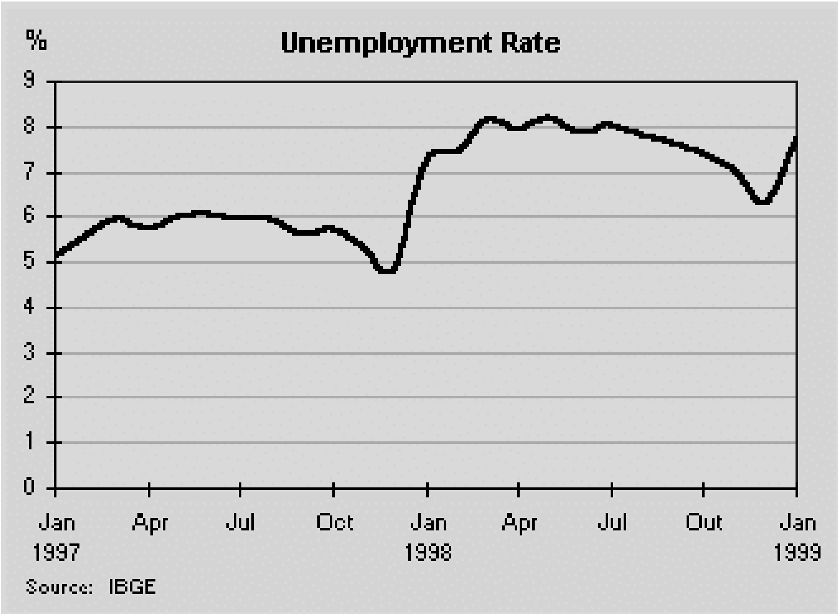

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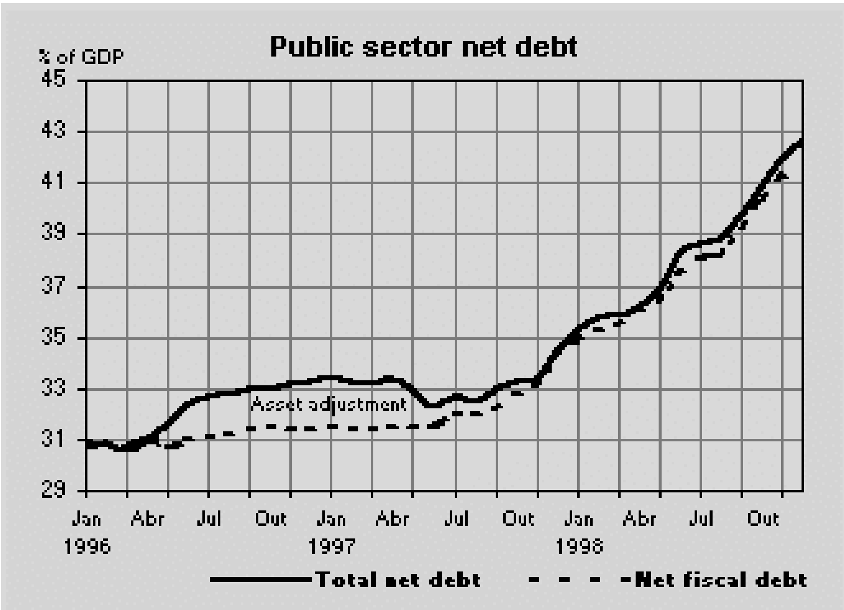


Main reasons explain the Brazilian rapid recovering. I would highlight the following:

a) although unskilfully conducted, the devaluation came when the country's reserve was enough to cover the amount due in the short run;
b) the economy had already sunk into recession, which appeased inflationary pressures;
c) the ratio between imports plus exports and GDP is relatively low in Brazil;
d) most huge debtors in dollar had protected themselves in advance agains the long-expected devaluation;

e) eventually the government succeeded in persuading the Congress to approve important measures that seemed to lead to substantial reduction of the fiscal deficit.

None the less, from the beginning of July onwards the scenario has become a little bit bleak again. With the devaluation, the real has lost its enchantment, not only for proving itself weaker than most Brazilians believed, but also for letting the abhorrent face of inflation arise again, although still timidly. This, combined with high unemployment and falling wages, make President Cardoso's popularity decline sharply, and so does his political support. As Mister Cardoso politically weakens, the pressure to loose his so far austere fiscal policy gains momentum. To make things worse, Brazil, bad as it is, is doing best among the other South American countries (Argentina, Chile, Ecuador, Colombia are going deep into recession, not to mention political distresses). This put all nations of the region under suspicion, as the international investors are not addicted to make distinctions. In the case of Brazil, they are not completely wrong, because Latin America is the main importer of the country's manufactured goods. Furthermore, the price of Brazilian major commodities could not be lower. As a result, Brazilian exports, in spite of the huge devaluation of the national currency, are taking too long to react. Thus, poor outcome in the external front and political fragility internally somewhat outshine the prospect presently.

So much for the sake of an overview, but this rather lengthy exposition is intended to set a helpful background such as to make it easy to interpret the details we shall now go into.

3.3 Macroeconomic Activity

Brazil and the IMF – International Monetary Fund, along with other international institutions, announced an agreement signed in the end of 1998, by which the country would be granted a bailout totalled up to 41 billion dollars. Since then, as a matter of course, the main goal of Brazilian macroeconomic activity has been to accomplish the terms of that agreement. But apart such sense of commitment, the Brazilian economic authorities assert that they are firmly convinced that tight fiscal policy is the best way to overcome the current crisis and secure growth with stability in the near future.

When the agreement was concluded in November 1998, it was chiefly intended to help Brazil hindering the intense flight of capital from its financial markets. It was implicit that Brazil should keep the national currency pegged to the dollar, as this exchange system had been seen as crucial for the Real Stabilization Plan, hitherto quite successful. However, very before long this strategy would fall short and Brazil would be driven to devaluate the real as early as in January, adopting a floating exchange rate system. By March the IMF has already agreed to review all the economic goals set forth in November, so that they could match the state of things resulting from a depreciated and floating currency. Accordingly, all the following economic data and the respective analysis will refer to this new environment.

Table 3.3

BRAZIL'S SELECTED ECONOMIC INDICATORS					
	1995	**1996**	**1997**	**1998**	**1999 (prj.)**
Domestic Economy	(in percent)				
Change in real GDP	4.2	2.8	3.7	0.1	-1.0
Unemployment rate[1]	4.6	5.4	5.7	7.6	7.6
Change in consumer prices (IPCA)	22.4	9.6	5.2	1.7	8.0
External economy	(in billions of U.S. dollars)[2]				
Exports, f.o.b.	46.5	47.7	53.0	51.1	52.0
Imports, f.o.b.	50.0	53.3	61.4	57.7	49.0
Current account balance	-18.0	-23.0	-33.3	-33.6	-22.2
Capital account balance	31.5	32.0	25.4	16.2	14.2
o/w Foreign direct investment	3.9	9.4	16.9	26.1	19.8
Gross official reserves	51.5	60.1	51.7	44.0	...
Current account balance (in % of GDP)	-2.6	-3.0	-4.1	-4.3	-4.0
Financial variables	(in percent of GDP)[2]				
Public sector borrowing requirement	7.2	5.9	6.1	8.0	9.0
Primary balance of the federal government	0.6	0.4	-0.3	0.6	2.4
Net public debt	30.5	33.3	34.5	42.6	51.0
Change in broad money (in %)[3]	26.2	13.0	14.9	7.6	11.1
Average overnight interest rate (in %)	53.1	27.4	24.8	28.8	...

Source: Brazilian authorities and IMF staff estimates.
[1]7-day reference period
[2]Unless otherwise noted.
[3]M2, based on IMF definition.

A. International Environment

Trade balance

In 1998, the balance of trade deficit closed the year at US$ 6.4 billion or 23% less than in 1997 (US$ 8.4 billion). Balance of trade performance varied sharply during the course of the year. In the first half of 1998, exports expanded by 4.8% relative to the same period of the previous year. In the second half, however, the growth pace cooled considerably as international commodity prices waned. Consequently, in the final quarter of the year, exports closed at a level below the same period of the previous year and ended 1998 at US$ 51.1 billion, for a drop of 3.5% when compared to 1997. Imports, which declined by 2% in the first half of the year relative to the same period of the previous year, ended with a cutback of 6.2% reflecting reductions in oil prices and in the level of economic activity in the second half of the year. In 1998, imports totalled US$ 57.6 billion. In spite of the falloff in the export sector, the trade balance deficit was lower in 1998.

The external trade deficit declined to US$618 million in the first half of 1999, from US$1.8 billion in the corresponding period of 1998 and US$6.6 billion (0.8 percent of GDP) for 1998 as a whole. The improvement was limited by a significant terms of trade loss, which was mainly the result of the recovery in oil prices, and weakness in the prices of Brazil's major commodity exports. The current account deficit in the first half of 1999 declined to under US$12.3 billion from US$13.4 billion in the corresponding period of 1998, and US$33.6 billion (4.3 percent of GDP) for the year 1998.

Developments so far in external trade have been less favourable than projected. The trade balance has continued to show a small deficit in the first semester of 1999. This reflects a slower than projected response of export volumes, and a significant deterioration of the terms of trade, as international oil prices recovered, while those of other important Brazilian commodity exports remained depressed. In addition to that, a less steep decline in import volumes has been recording, which is in line with the stronger than anticipated domestic demand. The trade balance is expected to improve from mid-year on, as the response of exports to the real exchange rate depreciation strengthens, export financing constraints continue to ease, and the terms of trade stabilise. This improvement is, however, expected to be contained by the relatively depressed demand conditions in some of Brazil’s major trading partners, and by the foreseeable gradual recovery of imports, as domestic economic activity picks up in the second half of the year. Thus, now economic authorities project the trade surplus to remain under US$4 billion for the year as a whole, well below the level (US$10.8 billion) initially agreed with the IMF.

Many analysts consider that 4 US$ billion surplus still too optimistic, foretelling a little more than 1 US$ billion. No one can deny Brazilian exports have been facing a rather unfortunate international set of conditions. But much of their bad outcome can be well blamed on lack of competitiveness arising from internal problems. One always mentioned is the awkward tax system, which imposes too expensive compliance costs over the taxpayers and embodies many taxes with cascading effects. It must be remembered also the long period during which the interest rates soared, in order to sustain the overvalued national currency. Deficient infrastructure, particularly transportation and ports, and poor educational background of the labour force fill up the not so enthusing picture.

Current account and balance of payments

The current account deficit in the first half of 1999 declined to under US$12.3 billion from US$13.4 billion in the corresponding period of 1998, and US$33.6 billion (4.3 percent of GDP) for the year 1998. Most of the 1998 deficit came from the service account, which turned in a negative result of US$ 30.7 billion, an increase of US$ 3.4 billion relative to the previous year. The headings that made the strongest contributions to this growth were net profit and dividend remittances, which increased from US$ 5.6 billion to US$ 7.2 billion, and net interest payments, which rose from US$ 10.4 billion to US$ 12.1 billion.

In the first half of 1999 the current account deficit declined to under US$12.3 billion from US$13.4 billion in the corresponding period of 1998, and US$33.6 billion (4.3 percent of GDP) for the year 1998.

The capital account of the balance of payments, which had suffered significant outflows in the initial part of the year, benefited from a recovery of confidence from March 1999 onwards, as reflected in Brazil's revived access to international capital markets and continued strong foreign direct investment. As a result, the deficit in the overall balance of payments was contained to around US$11 billion in the first half of 1999, about US$4 billion less than projected by the time that the macroeconomic goals agreed with the IMF went trough an overhaul.

The Ministry of Finance, however, believes that the balance on services is likely to continue to improve faster than forecast, facilitating a reduction of the current account deficit of the balance of payments to around US$21 billion, from the US$33.6 billion recorded in 1998. A further, significant improvement in the external accounts can be expected in 2000, when, in the absence of new shocks, the trade surplus should strengthen to over US$9 billion, and the current account deficit in the balance of payments decline to under US$19 billion.

The outlook for the capital account of the balance of payments for the rest of this year remains uncertain. Like most other emerging markets, Brazil is still vulnerable to shocks in international financial markets, although the strengthening of economic policies and the shift to a floating exchange rate regime have significantly reduced this vulnerability. In the absence of a major shock, Brazilian authorities expect net capital inflows to exceed current account financing needs by a modest margin in the second half of 1999, leading to an overall balance of payments surplus of around US$3 billion. The moderate recovery of capital inflows so far has been accompanied by a lengthening of their maturity, which should help reduce their volatility.

Table 3.4

BALANCE OF PAYMENTS					
					US$ million
Itemization	**1998**			**1999***	
	Jul	**Jan-Jul**	**Year**	**Jul**	**Jul-Jan**
Trade balance	-423	-2,263	-6,591	94	-525
Exports	4,970	30,938	51,120	4,117	26,563
Imports	5,393	33,201	57,711	4,023	27,088
Services (net)	-1,758	-14,198	-28,798	-1,872	-14,567
Interest	-673	-5,888	-11,948	-925	-8,644
Other 1/	-1,084	-8,310	-16,850	-947	-5,923
Unilateral transfers	244	1,120	1,778	171	1,263
Current transactions	-1,936	-15,341	-33,611	-1,607	-13,830
Capital account	1,284	33,423	25,641	2,457	11,764
Investments	3,404	19,471	20,883	4,243	18,345
Amortizations	-3,437	-14,032	-33,587	-4,752	-34,499
Med/long-term loans&fin	3,759	40,563	62,368	2,976	24,446
Cap. curto prazo	-4,215	-9,670	-27,333	685	-2,806
Other capitals	1,773	-2,909	3,310	-696	6,279
Change in reserves (-=increase)	652	-18,082	7,970	-850	2,065
Current transactions/GDP (in %)	---	-3.41	-4.33	---	-4.23

Source: Banco Central do Brasil.

To give the most up-to-date information available, in July the current account deficit amounted to US$ 1.6 billion, down 17% from July 1998. As for the current year as whole, the result represented a reduction of 10%. It must be pointed out that reduction in expenditures on non-factor services and improvements in trade results are offsetting the rise in interest outlays. The result of balance of payments in July confirmed that autonomous capital composed mostly of direct foreign investments has recovered its position as a major source of current account financing. For the first time since December 1994, accumulated 12-month net inflows were greater than the current account deficit in the same period. The foreign reserve position in the international liquidity concept increased by US$ 811 million as a result of placements of Bonds of the Republic denominated in euro.

Net expenditures on international travel added up to US$ 162 million. This result demonstrates that outlays made by Brazilians travelling abroad were far below those of the periods prior to adoption of the floating exchange rate system. In the first seven months of the year, net expenditures on international travel came to US$ 719 million or 31.7% of the total registered in the same period of the previous year. In comparison to July 1998, net expenditures on transportation diminished by 29%. Looking at both export and import flows, the reduced volume of trade generated lesser revenues and expenditures on freight and related transportation services. The 24% reduction in expenditures was greater than the 13% drop in revenues as a consequence of a sharper decline in imports when compared to exports and also as a consequence of the drop in outlays on international air travel. Profit and dividend remittances in July remained close to the average for the year even though, when these remittances are analysed separately, the individual results were quite different from those of previous months. In comparison to the average of the first half of the year, remittances of dividends and bonuses increased by US$ 163 million, while profit remittances diminished by US$ 186 million.

Table 3.5

SERVICES					
					US$ million
Itemization	1998			1999	
	Jul	Jul-Jan	Year	Jul	Jan-Jul
Total	-1,758	-14,198	-28,789	-1,872	-14,567
Revenue	1,224	7,825	13,222	789	6,123
Expenditure	2,982	22,023	42,020	2,661	20,690
Interest	-673	-5,888	-11,948	-925	-8,644
Revenue	420	2,411	3,895	105	1,144
Expenditure	1,094	8,298	15,843	1,030	9,788
International travel	-423	-2,266	-4,146	-162	-719
Revenue	137	935	1,586	119	974
Expenditure	560	3,201	5,732	281	1,693
Transportation	-326	-1,868	-3,259	-230	-1,543
Revenue	164	1,097	1,865	142	932
Expenditure	490	2,965	5,124	372	2,475
Insurance	16	54	81	-20	-99
Revenue	44	229	390	4	74
Expenditure	28	174	309	24	172
Profits and dividends	-159	-2,944	-7,181	-413	-2,710
Revenue	50	336	488	15	423
Expenditure	210	3,280	7,669	428	3,133
Reinvested earnings	-12	-70	-124	-	-
Government	-28	-162	-385	-31	-210
Revenue	29	398	548	29	172
Expenditure	57	560	933	61	382
Current transactions/GDP	-152	-1,054	-1,837	-91	-642
Revenue	380	2,420	4,451	374	2,405
Expenditure	532	3,473	6,288	465	3,047

Source: Banco Central do Brasil.

Net interest payments increased by US$ 253 million relative to July of last year due to the reduction in interest revenues on international reserves from US$ 420 million to US$ 105 million. Expenditures closed with a reduction of US$ 63 million. Net outlays on diverse services registered a decline of US$ 61 million, in comparison to July 1998. Net expenditures on services related to production factors dropped by US$ 20 million, concentrated mostly under cutbacks in outlays on technology and industrial technical co-operation. Net payments of services not related to production factors registered an even sharper decline due, basically, to an increase of US$ 30 million in banking revenues.

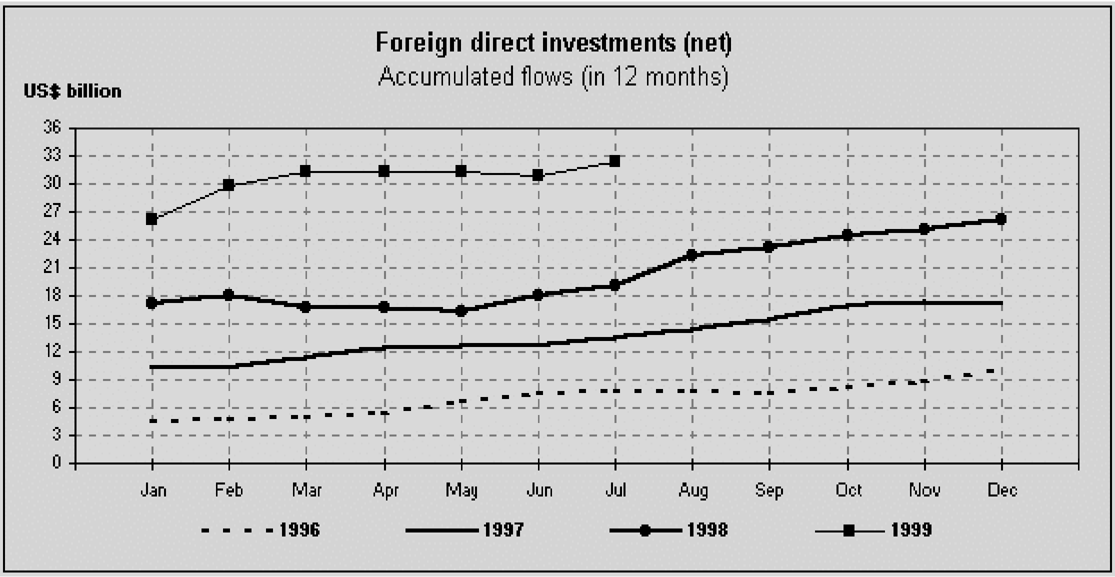
Medium and long-term foreign financing registered net amortisation of US$ 463 million or practically one third of the June result. Net payments to suppliers and buyers diminished by US$ 487 million, as the reduction in disbursements was easily surpassed by a reduction in amortisation. International agencies released a net total of US$ 195 million, as compared to net amortisation of US$ 285 million in the previous month. Here, one should highlight the net disbursements totalling US$ 408 million effected by Eximbank of Japan. Medium and long-term foreign loans registered net amortisation of US$ 1.3 billion partly as a result of the lesser volume of note placements, the instrument most commonly utilised to obtain loans. Disbursements under this type of operation, which came to a monthly average of US$ 885 million in the first half of the year, totalled US$ 271 million in July. Other factors that impacted net imports in the period were payment of US$ 2 billion on operations with notes, of which US$ 1.5 billion re-entered the country in the form of direct investments (privatisation).

Foreign Direct Investment

Foreign direct investments - FDI totalled US$ 26.1 billion in 1998, up 53% from 1997 and as much as to cover to cover 75% of the current account deficit. Of this sum, 23.4% corresponded to privatisations. And FDI have continued at a strong pace throughout 1999. In fact, could it not have counted on FDI, Brazil would not have managed to easily get along with its heavy current account deficit. It amounted to US$31.3 billion in the 12 months ending in May 1999 and to US$10.7 billion during January-May 1999.

In July this year, net direct foreign investments added up to US$ 4.1 billion and were below only those of August 1998. For the year, the total came to US$ 17.1 billion or 57% more than in the preceding year. Privatisation accounted for 40% of the July inflow and were mostly related to payments tied to sale of the telephone system last year. The position of net flows of portfolio investments was inverted relative to June and closed at US$ 112 million. This turnaround resulted from a sharp drop in redemption of investments in fixed income funds. These operations also benefited from the reduction in the IOF rate from 2% to 0.5%.

Figure 3.13



Given the currently unfriendly behaviour of the international markets, the Ministry of Finance had been cautious in its estimating the FDI to for 1999 as a whole. US$ 18 billion was the initial figure, equivalent to 85% of the forecast current account deficit. Happily, the sum accumulated so far affords much better expectations. Now FDI are predicted to close the least at US$ 23 billion, despite a possible delay to early 2000 of some privatisation operations originally planned for the last quarter of 1999. The devaluation of national currency explains a great deal of this strong inflow of investments. A weaker real means cheaper Brazilian companies to overseas buyers, and the increasing number of acquisitions bears witness to it. It explains also why many multinationals are deciding to convert credits they hold against their Brazilian subsidiaries into direct investment. (Please cf. the table "Capital" some pages ahead.)

International Reserves

Net international reserves (excluding drawings under the IMF program and the facility arranged by the Bank for International Settlements) stood at US$24.4 billion at the end of July 1999. On the same date, gross international reserves amounted to about US$42.2 billion (equivalent to nearly 9 months of imports of goods and non-factor services, and to over 180 percent of short-term external debt). It must be added that the Banco Central made no interventions on the domestic exchange market in July, while in charge of managing the reserves. Insofar as the Banco Central operations with the foreign sector are concerned, the surplus came to US$ 929 million, with net revenues of US$ 829 million generated by eurobond placements on the international market. Interest revenues totalled US$ 108 million while other operations registered outflows of US$ 8 million.

Regarding 1998, the international reserve position declined during the course of the year. Based on the cash concept, reserves closed the year at a level of US$ 43.6 billion, for a reduction of US$ 7.7 billion in comparison to 1997. Utilising the international liquidity concept, reserves closed the year at US$ 44.6 billion, for a reduction of US$ 7.6 billion relative to 1997, when the total had come to US$ 52.1 billion. Under the prism of the cash concept, the final 1998-reserve position corresponded to nine months of imports. Therefore, except for February 1999, when still in the wake of the sudden devaluation of the real, they hit the bottom of less US$ 30 billion, since the last months of 1998 the Banco Central has been able to keep the reserves at around US$ 40 billion, or slightly over.

Borrowing from abroad

Even in a framework of an expanding current account deficit, in 1998 foreign borrowing requirements dropped sharply to 1.1% of GDP from 2% in 1997. In December 1998, the Brazilian foreign debt totaled US$ 229 billion for an increase of US$ 29 billion relative to December 1997. Of this total, US$ 201 billion refer to the medium and long-term foreign debt and US$ 29 billion to the short-term debt.

Figure 3.14

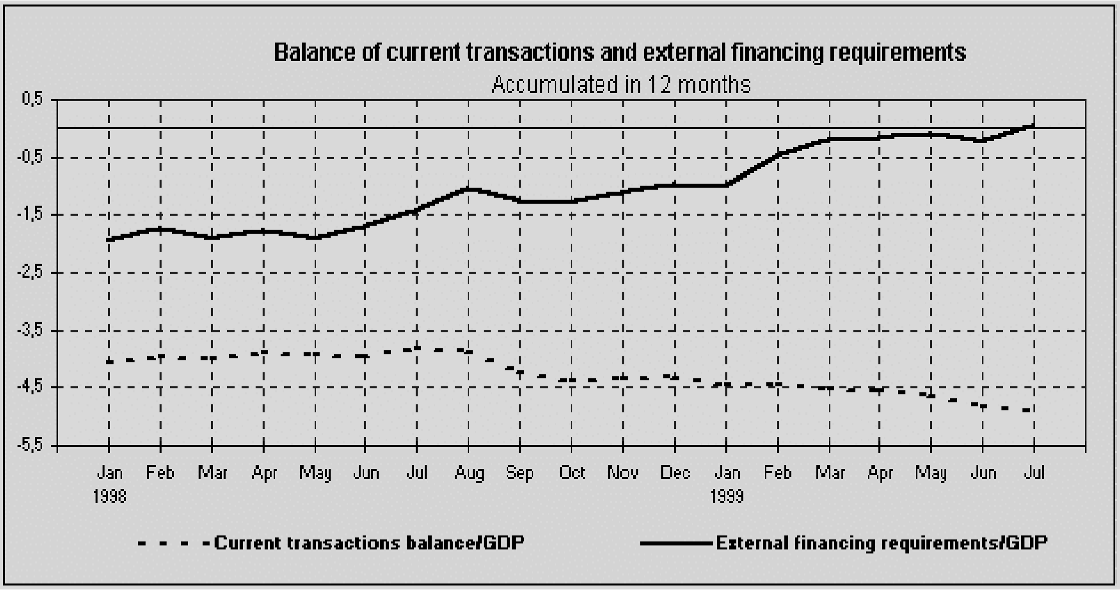


Table 3.6

CAPITALS					
					US$ million
Itemization	**1998**			**1999**	
	Jul	**Jul-Jan**	**Year**	**Jul**	**Jul-Jan**
Investments	3,404	19,471	20,883	4,243	18,345
Foreign	3,737	20,349	24,281	4,206	18,424
Direct	2,535	10,895	26,133	4,094	17,149
Portfolio	1,202	9,453	-1,851	112	1,275
Brazilian (net)	-333	-877	-3,398	37	-79
Medium-& long-term loans & fin.	322	26,531	28,781	-1,776	-10,054
Foreign	501	26,672	31,535	-1,753	-9,791
Financing	456	5,979	3,781	-463	-3,946
Disbursements	2,216	14,065	23,449	1,505	10,120
Int'l organizations	238	2,236	4,170	194	2,651
Government agencies	68	582	1,144	419	786
Sups'/buyers's cred.	1,910	11,246	18,135	892	6,684
Amortization	1,761	8,805	19,668	1,969	14,607
Int'l organizations	86	841	1,459	164	1,334
Government agencies	44	1,234	2,060	224	1,135
Sups'/buyers's cred.	1,631	6,011	16,149	1,581	11,597
Loans	46	20,693	27,754	-1,289	-5,845
Disbursements	1,722	26,639	41,673	1,493	14,588
New money	1,722	26,639	41,673	1,493	13,588
Refinancing	0	0	0	0	1,000
Amortisation	1,676	5,947	13,919	2,783	20,433
Paid	1,676	5,947	13,919	2,783	19239
Refinanced	0	0	0	0	1,193
Brazilian (net)	-179	-140	-2,755	-23	-262
Short-term	-4,215	-9,670	-27.333	685	-2,806
Lines of credit	4,017	1,391	-9,194	961	-1,370
Trans.with foreign inst.	-1,270	-9,248	-24,795	-565	-5,347
Loans to residents	-516	3,604	-1,366	3	583
Other	-6,446	-5,417	8,022	286	3.327
Other capital	1,773	-2,909	3,310	-696	6,279
Total	1,284	33,423	25,641	2,457	11,764

Source: Banco Central do Brasil.

In fact, in the period stretching from the announcement of suspension of payment of Russian foreign debt, in August 1998, to a couple of months after the devaluation of the real, Brazil experienced increasing difficulty both to obtain new loans or to renew the old ones. By the middle of February 1999, foreign financing virtually ceased thoroughly. However, from the beginning of March onwards, the country has been gradually but steadily recovering its credibility. Indeed, the Republic and a number of public and private companies (including banks) have returned to international capital markets in recent months. Following the successful US$3 billion global bond issue (of which US$2 billion involved new money) in late April 1999, further sovereign bond issues are planned for the second half of the year. These issues—the timing, amounts and maturities of which will be determined in light of prevailing market conditions—will be primarily aimed at refinancing maturing external public debt and establishing benchmarks along the yield curve for private sector borrowers. The government intends to gradually reduce over time the share of external and foreign exchange-linked debt in the total public debt, pari passu with the further development of domestic capital markets.

Table 3.7

TOTAL EXTERNAL DEBT BY DEBTOR			
			US$ million
Itemization	**Dec 1997**	**Dec 1998**	**Jun 1999**
Medium- & long-term debt	163,283	210,660	207,324
Non-financial publlic sector	79,967	90,598	97,383
Private sector	83,316	120,062	109,941
Short-term debt	36,715	24,139	23,160
Nonfinancial public sector	5,737	4,304	4,033
Private sector	30,978	19,835	19,127
Total external debt	199,998	234,799	230,484

Source: Banco Central do Brasil.

The stock of interbank credit lines is now 4.5% higher than in February 1999 (reference date in the agreement with private banks for the maintenance of such lines), despite a fall in import financing reflecting the decline in imports. In cooperation with the domestic banks, the Banco Central do Brasil (BCB) has substantially improved its monitoring of developments in these lines. It is expected that bank credit lines will continue to be rebuilt in the months ahead, as confidence continues to strengthen and demand for trade-related credits increases.

In June the total estimated foreign debt came to US$ 230.5 billion or US$ 5.6 billion less than in May. This reduction was partly due to payments effected by the public sector, including US$ 1.2 billion on the restructured debt and US$ 1.4 billion related to the financial assistance program led by the IMF. The medium and long-term private sector debt remained at the same level, though a reduction was registered among several individual credit categories, such as interbank import financing lines. Inflows through security issues were greater than amortizations in the period and offset net payments on import financing operations. The short-term debt also declined, particularly under interbank credit line available to the trade sector and net payments of credits contracted for transfer to the agroindustrial sector. However, with increased inflows through short-term placements of securities, other short-term registered debts turned in positive growth just as did the credit lines set aside for petroleum imports.

Exchange rate and exchange system

In mid-January, the Brazilian government opted for adoption of a flexible exchange rate system. This measure was taken when it became clear that foreign investor wariness of assuming new risks, coupled with the literal shutdown of international resources flows to the emerging economies, had begun imposing a too much heavy burden on the nation's reserve position.

Initially, the change in the exchange system led to sharp devaluation of the real, though this process would be partially reversed in the following months The increase in the prices of imported goods that resulted from the exchange devaluation exerted pressure on the prices of tradable products and on wholesale price indices. However, these pressures soon proved little harmful to the price index. Indeed, in spite of a devaluation of around 40% of the national currency against the US dollar, the inflation remains relatively low, beeing expected no to cross the mark of 10%, for the annual rate.

At the botton, the exchange rate had sunk into R$ 2.18 against US$ 1.00, but as early as late March the real started its recovering. At its best, it rated at R$ 1.60. Last August, however, the US dollar rose again. This was largely due to problems in the political field. Doubts have been raised about the ability of the government to keep its tight fiscal policy. As a result, the financial market has looked askance at the real. None the less, the government considers this suspicious behaviour no more than temporary. It is to be overcome briefly as soon as the economy resumes to give more positive signs, which are expected to happen from the second half of the second semester.

Table 3.8

US DOLLAR / REAL EXCHANGE RATE			
Year	**Month**	**Selling rate at the end of period**	**% change**
1995		0,9725	14,95
1996		1,0394	6,88
1997		1,1164	7,41
1998	Jan	1,1237	0,65
	Feb	1,1304	0,60
	Mar	1,1374	0,62
	Apr	1,1443	0,61
	May	1,1505	0,54
	Jun	1,1569	0,56
	Jul	1,1634	0,56
	Aug	1,1769	1,16
	Sep	1,1856	0,74
	Oct	1,1932	0,64
	Nov	1,2012	0,67
	Dec	1,2087	0,62
1999	Jan	1,9832	64,08
	Feb	2,0648	4,11
	Mar	1,7220	-16,60
	Apr	1,6607	-3,56
	May	1,7240	3,81
	Jun	1,7695	2,64

Source: Banco Central do Brasil.

B. Domestic Environment

Economic growth

The table on the next page presents the evolution of both the GDP and the per capita GDP from 1986 to 1998. In all likelihood 1999 will record a growth rate near to zero, as did last year. So if one takes into account the estimate for the current year, it is rather regrettable that for fourteen years the real GDP will have accumulated a growth of only 26,5%, which means an average annual rate of meagre 1,7%. Even more frustrating are the figures for the per capita GDP. In the same period it will have advanced trifling 5%. Had not declined the growth rate of population, it could have undergone a reduction.

To speak solely about the more recent developments, Brazilian economic performance in 1998 was strongly impacted by a worsening international crisis and by fiscal and monetary measures adopted by the Brazilian government in order to cope with the profound alterations that occurred in the international scenario during the course of the year.

In this sense, analysis of the seasonally adjusted series released by IBGE – Instituto Brasileiro de Geografia and Estatística (Brazilian Institute of Geography and Statistics) indicates that gross domestic product (GDP) dropped by 1.64% in the fourth quarter of the year relative to the previous quarter. This reduction was generated by declines in the sectors of crop and livestock farming (6.45%), industry (2.45%) and services (0.65%). In 1998 as a whole, GDP expansion came to 0.15% as against 3.47% in 1997. A breakdown of the 1998 result shows growth of 0.36% and 0.75% under crop and livestock farming and services, but a falloff of 0.98% in the industrial sector.

Table 3.9

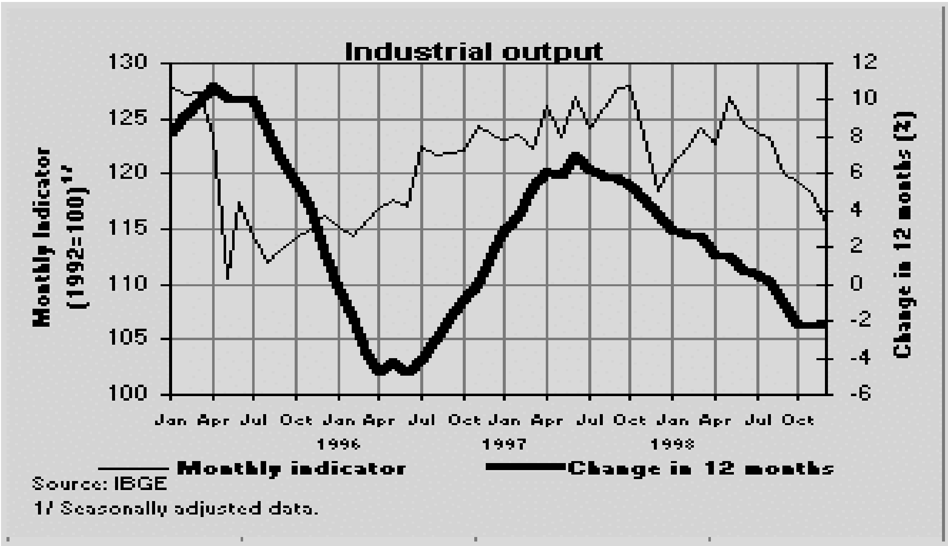
GROSS DOMESTIC PRODUCT EVOLUTION						
Year	GDP at current prices in R$	GDP Real change rates (%)	Real GDP index 1998=100	Per capita GDP		
				At constant 1998 prices (R$)	Real change rate (%)	Real index 1998=100
1986	1,274	7.5	79,0	5,285.23	5.4	94,9
1987	4,038	3.5	81,7	5,367.56	1.6	96,3
1988	29,376	-0.1	81,7	5,266.46	-1.9	94,5
1989	425,595	3.2	84,3	5,337.90	1.4	95,8
1990	11,548,795	-4.3	80,6	5,042.49	-5.5	90,5
1991	60,285,999	1.0	81,4	5,013.80	-0.6	90,0
1992	640,958,768	-0.5	81,0	4,910.39	-2.1	88,1
1993	14,097,114,182	4.9	85,0	5,075.21	3.4	91,1
1994	349,204,679,000	5.9	90,0	5,294.59	4.3	95,0
1995	646,191,517,000	4.2	93,7	5,440.71	2.8	97,7
1996	778,820,353,000	2.8	96,3	5,514.09	1.3	99,0
1997	866,827,479,000	3.7	99,9	5,639.87	2.3	101,2
1998	901,405,984,832	0.1	100,0	5,571.46	-1.2	100,0

Source: IBGE

According to IBGE, industrial production fell by 2.2% in 1998 when compared to the previous year's results. This performance reflects negative results registered in the sectors of capital goods (-1.9%), intermediate goods (-0.9%) and consumer goods (-5.5%). Based on IBGE data from which Banco Central has purged seasonal factors, January 1999 registered 1.83% growth in industrial production relative to the preceding month. However, this growth should not be construed as a sign that the downward slide under this heading that began at the end of the first half of 1998 has been reversed. Figures for the real billings of the retail trade sector in the metropolitan region of São Paulo were 3.8% below the results of the previous year. When one considers the series from which Banco Central has eliminated seasonal impacts, sales expanded by 0.32% in January 1999 when viewed against the previous month's performance and by 4.21% relative to the same month of the previous year. In the 12 month period up to January, sales declined by 2.96%. A breakdown of this figure shows that sales of consumer goods increased by 4.52%, while the automotive sector registered a reduction of 23.72% and sales of construction material dropped by 15.05%. According to the Brazilian Association of Wholesalers and Industrialized Product Distributors - ABAD, real billings of the wholesale sector expanded by 5.98% in 1998, while the data released by the Brazilian Association of Supermarkets - ABRAS points to growth of 7.63% in the same period.

As to the current year, The GDP presented in the second quarter of 1999 a percentage change of 0.93%, in the seasonally adjusted series, maintaining a positive change for the second consecutive quarter. As regards its groups variations, agriculture presented a negative change of -0.79%, while manufacturing, mining and quarrying presented growth of 2.04%, and services, of 0.5%. None the less when comparing the second quarter of 1999 and the same quarter in 1998, the GDP presented fall of -0.76%. When we analyze this result by its three groups, we observe growth in agriculture (1.57%) and in services (0.04%), and fall in manufacturing, mining and quarrying (-3.24%). During that period, the highlights are the results of the following subgroups: animal products (5.13%), mining (13.00%), manufacturing (-3.62%), construction (-5.11%), and transport (-5.71%).

Figure 3.15



As a whole, Brazilian economy in the first half of 1999 performed significantly better than projected in the revised support program led by the IMF. Following the pronounced decline in the second half of 1998, the first quarter of 1999 GDP began to send signs of an incipient recovering, which derived most from a strong increase in agricultural output. Yet this timid wakening is not believed to go further. Actually, at first the economic authorities had projected a decline of 3,5 to 4%, assessing conservatively the aftermath of the real devaluation. Also such gloomy forecast was logically entailed by the severe set of fiscal measures the government committed to undertake subsequently. But the national currency has not sunk so deeply as feared, and the inflation rate remains reasonable. Although the exports are taking longer to react, the foreign direct investment has been acting as a surprisingly good counterbalance. Thence that preliminary projection was later shifted up to only a 1 % decline. Now even a more optimistic prediction is gaining support among the analysts. If they are right, the 1999 GDP will close at the same level as the previous year. Whatever the prediction, all of them stress the dependence on the extent to which the strengthening of confidence, both domestically and abroad, will reflect an easing of financing constraints.

National accounts: GDP, consumption, investment and capital stock

The table on the next page provides a good overview of the behaviour in the last six years of the major items that make up the national accounts, such as consumption, investment, and capital stock along with GDP itself.

In respect specifically to 1998, it ought to be noted that participation of the gross fixed capital formation at current prices in GDP remained stable, at 19.92%. At the preceding year prices, we observe fall from 20.32% to 19.79%. In spite of these results, the accumulated real growth of the gross fixed capital formation continues to be higher than the GDP's, considering the base in 1990. The degree of opening of the economy to foreign products went down from 17.8% in 1997 to 17.5% in 1998.

Table 3.9

NATIONAL ACCOUNTS						
	1993	**1994**	**1995**	**1996**	**1997**	**1998**
GDP at market prices (R$ 1,000)	14 097 114	349 204 679	646 191 517	778 820 353	866 827 479	901 405 985
Real GDP change rate (%)	4,9	5,9	4,2	2,8	3,7	0,1
Implicit GDP deflator (%)	1 996,2	2 240,2	77,6	17,3	7,4	3,9
Nominal GDP change rate (%)	2 099,4	2 377,1	85,0	20,5	11,3	4,0
Net income/pay-ments abroad (R$ 1,000)	355 453	5 912 805	10 153 742	12 923 004	17 110 252	25 155 300
GNP at market prices (R$ 1,000)	13 741 661	343 291 874	636 037 775	765 897 349	849 717 227	876 250 685
Net unrequited transfers (R$ 1,000)	50 243	1 478 647	3 324 649	2 626 743	2 022 936	2 210 370
Gross national disposa-ble income (R$ 1,000)	13 791 904	344 770 521	639 362 424	768 524 092	851 740 163	878 461 055
Balance of payments deficit in current account (R$ 1,000)	106 832	3 207 077	18 226 492	26 314 197	37 883 110	40 835 600
Consumption expen-ditures and gross capital formation (R$ 1,000)	13 898 736	347 977 598	657 588 916	794 838 289	889 623 273	919 296 655
Consumption (R$ 1,000)	10 960 002	270 644 256	513 561 741	633 825 577	705 341 287	...
Gross capital formation (R$ 1,000)	2 938 735	77 333 342	144 027 175	161 012 712	184 281 986	...
Gross savings (R$ 1,000)	2 831 903	74 126 265	125 800 683	134 698 515	146 398 876	...
GDP (US$ billion)	429,7	543,1	705,4	775,4	804,2	776,9

Source: BCB, IBGE

Employment

As anyone can easily infer from the table on the next page, the unemployment rate has been steadily worsening since 1989. It began its way up from comfortable 2.36% in 1989, and it was as high as 8,20 % in May 1998, when it reached its peak. In fact, since the first quarter of 1998 it has been fluctuating around 8%, so that little improvements are recorded only to be offset in the following months. Needless to explain how the already notorious international financial crisis has contributed to such sad results.

However, some two remarks must be done in order to prevent these figures from being misunderstood. Both have to do with methodology. First, painful as the picture depicted is, it may not reflect accurately all the troubles Brazilian labour force has been going through. That is because the government adopts a fairly restricted concept of unemployment. The IBGE (agency officially in charge of economic statistics) only will compute as unemployed people who, being at the age of 15 or over, are seeking a job or awaiting the result of an employment proposal at the time of the survey. No matter why any individual stops searching for a job, this one will be ignored, even it is simply the case of a bare surrender. The DIEESE, a private institution closely related to labour unions conducts a parallel survey, taking a much broader concept of unemployment. Their search is limited to São Paulo, but they count everyone who has been dismissed and is still able to work. So while the IBGE rate rotates around 8%, the DIEESE finds figures which soar as high as 20%.

Table 3.10 Unemployment Rate

Period		Average rate	São Paulo	Rio de Janeiro	Belo Horizonte	Porto Alegre	Salvador	Recife
1989	Dec	2,36	1,95	2,51	2,40	2,04	3,80	3,51
1990	Dec	3,93	4,22	3,07	3,37	3,91	5,70	4,59
1991	Dec	4,15	4,98	3,04	3,15	3,33	5,23	4,72
1992	Dec	4,50	4,78	3,47	4,00	3,92	6,24	6,61
1993	Dec	4,39	4,58	3,90	3,60	3,27	6,07	6,04
1994	Dec	3,42	3,61	2,70	2,87	2,92	5,81	4,01
1995	Dec	4,44	5,09	3,15	3,56	4,40	6,49	4,41
1996	Dec	3,82	4,06	2,90	4,16	4,13	5,41	3,10
1997	Dec	4,84	5,18	3,76	4,60	4,09	7,64	4,96
1998	Jan	7,25	8,51	4,96	7,38	5,88	8,59	8,12
	Feb	7,42	8,78	5,03	8,12	6,93	8,85	5,65
	Mar	8,18	8,97	6,32	8,08	7,92	9,94	8,76
	Apr	7,94	8,56	6,12	6,93	8,27	9,98	9,50
	May	8,20	9,11	6,44	6,96	7,96	9,62	9,76
	Jun	7,90	8,57	5,99	7,65	7,37	9,86	9,57
	Jul	8,02	8,95	5,77	7,48	7,71	10,02	9,68
	Aug	7,80	8,64	5,73	6,95	7,85	9,11	9,79
	Sep	7,65	8,68	5,11	6,85	7,80	9,53	9,39
	Oct	7,45	8,88	4,68	6,58	6,95	9,19	8,74
	Nov	7,04	8,12	4,59	7,16	6,73	8,12	8,17
	Dec	6,32	7,26	4,07	5,96	6,00	8,39	7,14
1999	Jan	7,73	9,18	5,37	8,62	5,71	8,41	7,60
	Feb	7,51	8,38	5,04	7,96	7,43	9,72	7,78
	Mar	8,16	8,87	5,98	8,70	8,13	9,86	8,80
	Apr	8,02	8,75	5,79	8,39	7,54	10,24	8,94
	May	7,70	8,56	5,31	7,73	7,04	10,11	8,97

Source: IBGE

Second, if one follows the series on the table above, one may come across an unusually steep drop recorded in the passage from December 1997 to January 1998. Actually a change in the IBGE criteria from this point onwards accounts for much of it. Before that IBGE's concept of unemployment was still narrower, so much that its index losing credibility. Thence, the sharp drop does not mean that things suddenly worsened at a short notice. It is also a mistake to believe that the dramatic prospect brought about by the real devaluation has augmented unemployment. In this respect nothing substantial has changed, as the economy was already sunk into dejection. Even during the *real* heyday, the unemployment was quite high, largely due to the fact that it was in course an intensive restructuring process of private sector.

On the other hand, one of the laudable outcomes of the aforementioned restructuring process is the gain in the terrain of productivity, although this phenomenon seems to be near to exhaustion. Indeed, the year 1998 shows, for the economy as a whole, that labour productivity remained stable by comparison with the prior year, since the change observed during the period was of 0.24%. When we analyse the major sectors of activity, both agriculture and services remained stable, presenting changes of -0.59% and 0.19%, respectively, while manufacturing, mining and quarrying obtained a productivity growth of 2.21%. In the first two sectors, this behaviour resulted from stability both in the aggregated value and the people employed. In manufacturing, mining and quarrying we observed a more marked decline of people employed, although the fall of the value added, interrupted an increase movement that began in 1993. Among the 32 groups of industry, the productivity gains resulted in large part of the fall of employment, which reached 3.5%. However, in some important segments, such as electronic equipment and transport equipment, the drastic change in the aggregated value implied fall in the productivity indicator, despite the significant labour reduction, resulting partly from the decrease in the levels of economic activity and demand for durable consumer goods.

As regards the current year, according to the IBGE, the first half of 1999 presented an unemployment rate of 7.82%, similar to the one observed in the same period of 1998. Average real income of people employed presented fall by comparison with 1998 (-4% from January to May). Together, those two factors contributed to the poor performance of the demand.

The same agency has just released a report about the survey carried out for last July, when it was found a fall in the number of people looking for work from June to July (-5.1%), and from July 1998 to July 1999 (-6.4%). Thus the open unemployment rate of July was 7.5%, against 7.8% in the previous month, and 8% in the same month of the past year. By comparison with June, the number of economically active people fell 1.2%, and the number of non-economically active people increased 1.9%. Percent changes, by comparison with July 1998, were -0.2% and 6%, respectively. In terms of employment, the monthly change (June/July) and the annual change (July/July) were -0.8% and 0.4%, respectively. When we disintegrate these results by economic activity sector, from June to July of the current year, we observe fall in the number of people working in manufacturing industries (-2.7%), in construction and in trade, around 2%. In the services sector, there were no significant changes. The comparison month/same month of past year shows that the level of employment continues to increase in the services sector (1.4%). On the other hand, it continues to fall in construction (-4.8%) and manufacturing (-1.4%). In the previous month, the changes in these sectors were -1.5% and -2%, respectively. After two months with a slight increase, the trade sector also presented a lower level of employment (-1.3%).

The real average income of people employed, says the IBGE, increased 0.9% in June, against May of the current year, and fell 3% by comparison with June of the past year. In the first type of comparison, the growth was due to the raise in the income of people without a formal contract (4%) and of self-employed people (2.8%). The income of employees with a formal contract fell 0.7%. In the second type of comparison, the change in the income of self-employed people (-8%) and that of employees with a formal contract (-1.8%) have caused the fall, changes that confirm the trend of income fall for those two classes of worker. Conversely, the income of employees without a formal contract continues to grow (3.5%). The year’s first half ends with fall of 4.1% in the real average income of people employed, by comparison with the same period of the previous year, due to the decline of income for self-employed people (minus 7.3%) and employees with a formal contract (minus 2.6%).

Inflation rate

For a country whose younger generations had never known price stability, the lowest inflation rates over half a century were indisputably the greatest achievement of the Real Stabilisation Program. Accordingly, the devaluation of the national currency in January raised strong fears that the raging inflation could return. At first, this scaring prospect grew closer and closer to reality. However, as a beneficial effect of recession, soon it became clear that inflation would only rise a little, at still tolerable levels. Actually, following the decision on January 15, 1999 to float the Brazilian Real, the initial overshooting of the exchange rate was corrected relatively quickly. The pass-through of the depreciation to prices has been relatively modest so far, and consumer price inflation in the first seven months of 1999 remained around 5 percent. At the end of this year the annual rate is expected to reach 12% at worst, and 8% at best, and will hopefully come to around 6% next year, provided Brazilian economy is well managed.

Table 3.11

PRICE INDICES					
					Annual % change
Period		**IGP-M**	**IPC-Fipe**	**IPCA**	**INPC**
Year	**Month**				
1990	Dec	1 699,70	1 639,08	1 620,97	1 585,18
1991	Dec	458,35	458,61	472,70	475,10
1992	Dec	1 174,00	1 129,49	1 119,10	1 149,06
1993	Dec	2 567,40	2 490,99	2 477,15	2 489,11
1994	Dec	869,79	941,25	916,46	929,32
1995	Dec	15,24	23,17	22,41	21,98
1996	Dec	9,20	10,03	9,56	9,12
1997	Dec	7,74	4,82	5,22	4,34
1998	Dec	1,78	- 1,79	1,65	2,49
1999	Jan	1,66	- 1,53	1,65	2,28
	Feb	5,14	0,01	2,24	3,05
	Mar	7,92	0,81	3,02	3,86
	Apr	8,55	0,66	3,35	3,88
	May	8,09	- 0,24	3,14	3,19
	Jun	8,07	- 0,50	3,32	3,10

IGPM: General price index (market).
IPC-Fipe: Consumer price index (Fipe).
IPCA: National consumer price index (extended).
INPC: National consumer price index.
Source: FGV, Fipe, IBGE

Seeking to confer more transparency to its anti-inflationary measures, the government has decided to institute a *formal inflation targeting framework policy*, beginning in July 1999. The Minister of Finance announced at the end of June the following targets for inflation in consumer prices, as measured by the increase in the national IPCA price index through the year: 8% in 1999, 6% in 2000, and 4% in 2001 (in each year with a tolerance interval of +/-2 percentage points). The BCB has been given the responsibility to secure the achievement of these targets through its conduct of monetary policy. It will prepare quarterly inflation reports to explain to the public the considerations that guided its policy in the preceding quarter, and the inflation performance during that period, as well as its forecast of future inflation and its policy response to them. The BCB will base these forecasts on a range of indicators, including its ongoing survey of market expectations, short-term forecasting models and structural econometric models of the transmission mechanisms of monetary policy, as well as its ongoing assessment of prospects for relevant economic variables, including the exchange rate, the fiscal policy stance, and aggregate demand conditions.

Money supply

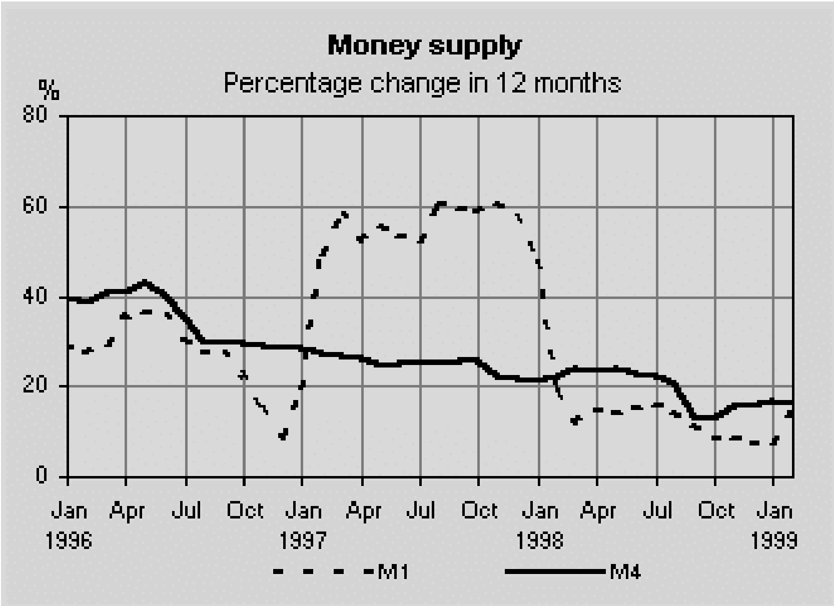
In December 1998, the restricted monetary base totalled R$ 39.3 billion when calculated according to the concept of average daily balances. This result was well within the parameters forecast by monetary programming for the fourth quarter of the year. In the month, the monetary base expanded by 17.5%, while 1998 closed with growth of 21.7%. Currency issued and banking reserves registered respective rates of growth of 21.1% and 12.4% in December and closed the 1998 period with expansion of 17.9% and 27.8%.

The expanded monetary base, which corresponds to the restricted base plus compulsory cash deposits and federal public securities outside Banco Central, came to R$ 352.3 billion in December and closed within the parameters specified in monetary programming for the fourth quarter of 1998. In the month, growth under this aggregate came to 0.4%, while the year closed with expansion of 25.8%.

The money supply (M1) totalled R$ 49 billion in December when viewed under the concept of average daily balances. This figure represented growth of 14.8% in the month and 7.4% in the year and was well within the parameters defined in monetary programming. In the same period, currency held by the public and demand deposits added up to R$ 20.5 billion and R$ 28.5 billion, respectively, with growth of 20.7% and 10.8% in the month, and 16.7% and 1.6% in 1998 as a whole, in the same order.

The broader monetary aggregate (M4) came to R$ 453.4 billion in December and closed within the maximum and minimum limits defined in monetary programming for the quarter. In the month, growth under this aggregate came to 2.3%, as against 15.6% in the year.

Figure 3.16



According to the Banco Central do Brasil, programming for monetary aggregates in the second quarter of 1999 was based on probable performance scenarios for inflation, GDP, interest rates and the monetary impact consequent upon National Treasury operations and Banco Central interventions in the financial system.

Table 3.12

Table 3. Monetary program for 1999 1/

R$ billion

Itemization	Second Quarter		Year	
	R$ bilhon	% change 12 months 2/	R$ bilhon	% change 12 months
M1 3/	44,4 - 52,1	13,7	50,0 - 58,8	11,1
Restricted base 3/	34,6 - 40,7	13,7	39,9 - 46,8	10,3
Expanded base 4/	368,9 - 433,0	17,9	401,6 - 471,4	23,9
M4 4/	439,0 - 515,4	10,7	469,2 - 550,8	12,5

1/ It refers to the final month in the period.
2/ Percentage changes are based on the medium point of forecast.
3/ Working-day balance average of last month in the period.
4/ End-of-period balances.

Money supply projections (currency held by the public plus demand deposits) were based on forecasts of internal interest rates and growth in nominal income in coming months. Twelve-month growth in the average daily balances of the money supply in June 1999 was estimated at 13.7%.

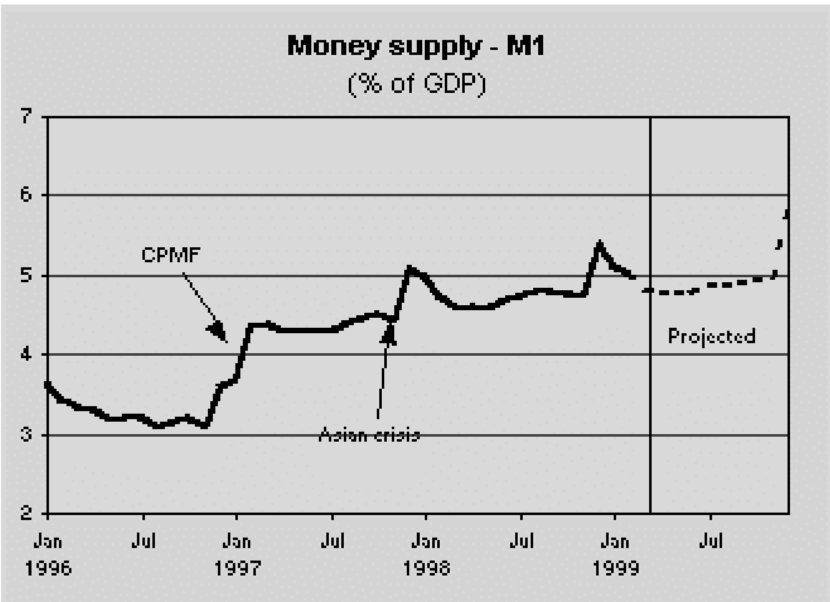
The upward trend in the ratio between M1 and GDP that has existed since the start of the Real Plan can be ascribed to the process of monetisation of financial assets that occurred in the wake of the stabilisation program and, starting in 1997, to the introduction of taxation on financial operations (CPMF). Up to the month of June, no significant changes are expected in the M1/GDP ratio.

Based on expected currency demand, as well as on the expected scenario for obligatory reserves on demand resources, 12-month growth in the average monetary base balance (currency issues plus banking reserves) is projected at 13.7% in June 1999.

Projections for the expanded base (a measurement of the federal monetary and securities debt), which presuppose neutralisation of undesired impacts of conditioning factors on the restricted monetary base, took due account of the fact that interest on the federal securities debt - considered the major expansionary factor in coming months - will to a great extent be offset by the primary results achieved by the National Treasury and by Banco Central operations on the exchange market. With this, 12-month growth in this monetary aggregate is projected at 17.9% in June 1999. In much the same way, and in a manner consistent with the performance standard of the other aggregates, 12-month M4 growth is estimated at 10.7% in June 1999. In the first half of the year, the ratio between M4 and GDP is not expected to increase, since the projected performance of the expanded base in the period will reflect the fiscal adjustment measures and the more restrictive monetary policy adopted and will be quite similar to GDP growth.

Growth of the monetary aggregates is summarised in the following table, which shows the results achieved in 1998 and in the January/February 1999 period, as well as the figures expected for the second three month period of 1999. It should be noted that the demand for base money during the second half of 1999 may be affected by the reintroduction of the tax on financial transactions (CPMF) in June and the Y2K problem (also known as the millenium bug). The monetary programming framework for the fourth quarter of 1999 and 2000 will be reviewed in the context of the fourth review of the program, and adapted as needed to the new inflation targeting framework.

Figure 3.17



The most up-to-date report released by monetary authorities refers to last July and describe the effective outcome as the monetary programming has been carried out so far. In this bulletin, the Banco Central argues that the fact that the monetary aggregates expanded at a pace above the seasonal pattern of the period points basically to changes in currency demand following reintroduction of the CPMF.

Table 3.13

Table 4. Evolution of monetary aggregates 1/

Itemization	1998 Year		1999 January - February		1999 Second quarter 2/		1999 Year 2/	
	R$ billion	% change in 12 months	R$ billion	% change in 12 months	R$ billion 3/	% change in 12 months	R$ billion 3/	% change in 12 months
M1 4/	49,0	7,4	48,4	13,6	48,2	13,7	54,4	11,1
Restricted base 4/	39,3	21,7	39,2	22,7	37,7	13,7	43,3	10,3
Expanded base 5/	352,3	25,8	401,6	36,5	401,0	17,9	436,5	23,9
M4 5/	453,2	15,5	472,0	16,5	477,2	10,7	510,0	12,5

1/ It refers to the final month in the period.
2/ Projected.
3/ Medium point of forecasts.
4/ Working-day balance average in month.
5/ End-of-period balances.

Based on the criterion of average daily balances, the monetary base came to R$ 39.1 billion, for growth of 6.9% in the month and 16.7% over the past 12 months. Among the base components, the balance of currency issued came to R$ 21.2 billion while that of banking reserves closed at R$ 17.9 billion, for respective growth rates of 3.3% and 11.5%.

Viewed under the prism of end-of-period positions, the monetary base balance totalled R$ 41.2 billion in July, with expansion of 24.1% in the month and 24.8% in 12 months. The balance of currency issued came to R$ 20.5 billion, for growth of 3.6% in the month, while the balance of banking reserves moved to R$ 20.7 billion, expanding by 54.3%.

Insofar as sources of monetary issues are concerned, an analysis of accumulated flows in the month of July shows that overall operations with the financial system accumulated net monetary growth of R$ 291 million. For the most part, this result was due to releases of compulsory reserves on Financial Investment Fund (R$ 210 million) and Brazilian System of Savings and Loan (R$ 41 million) deposits.

The monthly flow of operations with the National Treasury generated a contractive impact of R$ 1.6 billion. The tax inflow came to R$ 11.7 billion, for growth of 18.1% relative to the previous month. Operations with federal public securities during the month generated expansion of R$ 9.3 billion, including Banco Central operations aimed at adjusting money market liquidity. In the case of the primary market, redemptions came to a net overall result of R$ 8.4 billion, including R$ 4 billion in Banco Central papers and R$ 4.4 billion in securities issued by the National Treasury. Net purchases in the secondary market totalled R$ 1.1 billion, while net sales on the extra-market sector came to R$ 100 million.

The expanded monetary base balance moved to R$ 406.9 billion at the end of July, with growth of 1.5% in the month and 18.2% in accumulated 12-month terms. Among the various components of the base, the balance of federal public securities outside the Monetary Authority portfolio climbed to R$ 346.3 billion, as compared to R$ 347.9 billion in the month of June. The balance of securities issued by the National Treasury registered expansion of 0.6% in the month and closed at R$ 267 billion, while the balance of papers issued by Banco

Central declined by 4% in the month to a level of R$ 79.2 billion.

Based on the concept of average daily balances, the money supply (M1) registered expansion of 5.4% in the month for accumulated 12-month growth of 11%. Among the components, currency held by the public registered growth of 3.4% and demand deposits expanded by 6.6%. Viewed from a 12 month perspective, manual currency registered growth of 15.8% and accounting currency expanded by 8.1%. In the case of the broader concept (M4), the money supply balance came to R$ 503.3 billion in July, for growth of 0.9% in the month. The stock of federal public securities held by the non-financial market came to R$ 229.9 billion, for growth of 2.2%. The aforementioned figure is equivalent to 45.7% of the total aggregate, as against 45.1% at the end of the previous month. Savings deposits totalled R$ 111.6 billion, for a drop of 0.3%, while total private securities moved to R$ 97.3 billion, a reduction of 2.5%. The M4/GDP ratio moved to 51.2%, as compared to 50.9% in June.

In the month of June, normally performing credit operations came to R$ 256.8 billion, for a decline of 0.3% in the month and growth of 0.8% in the year. In the accumulated 12-month period, expansion came to 2.2%. In this way, the percentage participation of credits relative to GDP came to 26.2%, as compared to 27.6% at the end of the first half of 1998.

C. Fiscal Position

Government expenditure and revenue

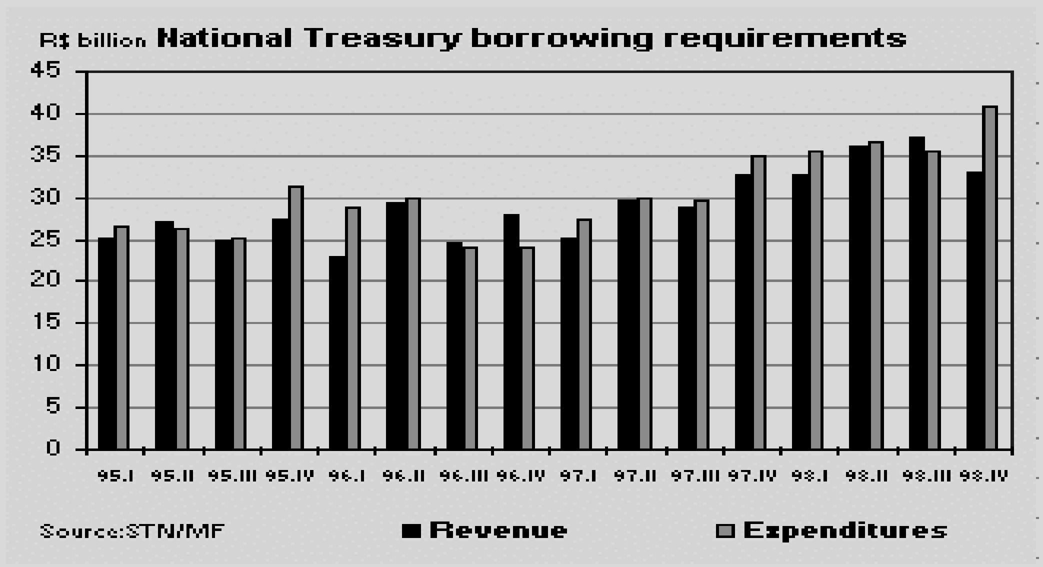
In 1998, National Treasury budget operations registered revenues of R$ 140 billion and expenditures of R$ 149 billion. A comparison with 1997 data indicates that revenues expanded by 15.1% in real terms as a consequence of alterations introduced into the legislation governing tax on imports, as well as an atypical inflow of funds generated by telecommunications service concessions and incorporation of deposits abandoned in the financial system totalling R$ 11.2 billion, as against R$ 1.5 billion in 1997. Moreover, the January to March period witnessed introduction of taxation on the balance of fixed income funds accumulated up to December 31, 1997, totalling R$ 1.8 billion. At the same time the rate of the tax on investments in fixed income funds was raised from 15% to 20% in January.

For 1999, in accordance with the agreement signed with the IMF late in 1998 and reviewed March this year, the government is endeavouring to achieve a fiscal surplus while gradually reduce the ratio between public debt and gross domestic product. With this, the strengthening of the fiscal adjustment process in early 1998 is expected to generate a primary surplus of about 3.1% of GDP in 1999. It was precisely with this in mind that various measures have been adopted to curtail current expenditure outlays, raise tariff prices, limit budget outlays, intensify the privatisation process and improve the social security system, among others.

So far government's reports assure that fiscal developments have been, on balance, better than projected in the program. The R$6 billion floor for the first quarter 1999 primary surplus of the consolidated public sector—comprehensively defined in Brazil to include the federal government, the BCB, the states, municipalities, and the non-financial public enterprises of all levels of government—was met with a wide margin, as the surplus exceeded R$9.3 billion (4.1 percent of period GDP). About R$2.2 billion of the over-performance was accounted for by non-programmed collections of tax arrears at the federal government level. The consolidated primary surplus of states and municipalities and that of public enterprises were also somewhat higher than projected. As a result of the better performance of the primary balance, the rapid strengthening of the exchange rate from early March through mid-May, and the steeper than projected decline in interest rates, the indicative program ceiling on the net public debt for March 1999 was met with an ample margin, as the net debt declined to R$470 billion (48.3% of GDP) at the end of March, compared with the R$506 billion (52.2% of GDP) projected.

In the month of June, the consolidated public sector primary result was a surplus of R$ 2.6 billion. With this performance, public accounts closed the first half of the year with a primary surplus of R$ 13.6 billion (2.9% of gross domestic product), a figure that was R$ 0.7 billion above the amount estimated in the agreement with the IMF.

Figure 3.18



Of the primary surplus accumulated up to June (R$ 13.6 billion), R$ 11.9 billion or 2.5% of GDP refer to the Central Government (federal government, INSS, Banco Central and federal state companies), while regional governments and their state companies turned in a surplus of R$ 1.7 billion.

Outlays on nominal interest came to R$ 8.4 billion in the month of June due partly to exchange devaluation in the month (2.6%) and its impact on the federal securities debt indexed to exchange (24% of the total) and on the net foreign debt. In the alternative methodology, in which charges on the internal debt indexed to exchange are appropriated in the cash concept, net interest outlays came to R$ 6 billion in June (R$ 7.1 billion in May).

The primary result accumulated in the last 12 months demonstrates the government's commitment to the fiscal adjustment: up to April, the surplus totalled R$ 6.5 billion (0.66% of GDP), reaching R$ 7.5 billion in May (0.76% of GDP) and R$ 13.1 billion up to June (1.36% of GDP). In the nominal concept, which incorporates financial charges into the primary result, public sector borrowing requirements came to a June level of R$ 5.8 billion. The accumulated result for the year was a deficit of 15.5% of GDP, when compared to 17.3% of GDP up to May, while flows over the twelve month period up to June pointed to a deficit of 12.1% of GDP.

In the same context, viewed under the prism of the nominal concept, borrowing requirements came to R$ 3.4 billion in June. In accumulated terms up to June, the result was a deficit of 6.7% of GDP, as compared to 7.2% of GDP up to May. The result of these flows in the 12-month period ended in June was a deficit of 7.4% of GDP.

Table 3.14

SUMMARY OF NATIONAL TREASURY PERFORMANCE										
Cash basis										Flows in R$ million
End of period	Revenues	Expenditures	Cash balance	Federal security	Remuneration of	Result of the Banco	Federal security	Renegotiation of	Domestic and	Resources available

				operations	available funds in Banco Central	Central	charges / Banco Central portfolio	foreign debt and acquirement of warranties	external contracted debt and amortization	
1994	48 180	46 810	1 370	-21 297	7 880	5 135	-3 709	18 483	-1 383	6 488
1995	86 294	90 256	-3 962	20 539	4 950	-	-3 408	1 972	-5 130	14 961
1996	97 132	106 257	-9 125	20 846	3 386	-	-1 671	-6 504	-5 321	1 611
1997	116 034	121 680	-5 646	29 209	3 843	-	-3 146	-161	-9 947	14 152
1998	139 086	148 333	-9 247	31 240	9 821	-	-4 269	-578	-8 260	18 707
1999										
Jan	10 038	11 817	-1 779	-7 340	1 149	-	-91	-270	-300	-8 631
Feb	11 475	13 173	-1 698	388	1 086	-	-1 501	0	-628	-2 353
Mar	13 793	14 587	-794	17 226	1 137	-	-888	0	-1 311	15 370
Apr	14 453	14 312	141	17 463	1 360	-	-474	0	-362	18 128
May	11 315	13 402	- 2 087	18 293	1 641	-	- 1 597	0	-539	15 711

Source**:** STN

In speaking about recent fiscal performance of Brazilian government, an aspect that one would never unduly emphasise is the dramatic impact of the devaluation of the national currency on public accounts. A great deal of government bonds was denominated in US dollars, the Banco Central had sold a host of options of US dollars in market of futures. Altogether the public debt denominated in US dollars amounted to by US$ 56 billion, which then corresponded roughly to 20% of the national debt. Furthermore, the devaluation entailed an immediate augment in interest expenses, as the basic interest rate was rose to 49,5%. Both the increases in value of the debt and interest expenses were recorded without deferment. That explains why the government seems satisfied with a nominal deficit as high as 15.5% of the GDP for the first half of the year, as mentioned above. Such astonish deficit was incurred despite a primary surplus of 2,9% of the GDP was recorded for the same period. The interests paid amounted to R$ 84.6 billion, from which the exchange rate devaluation responds for 39.4 billion. It is important to note that, in order to cope with the turmoil in the financial market following the devaluation, the Banco Central was driven to rise the interest rate up to 49%. This rate fortunately soon began to decline, but remained high enough to violently swell the nominal deficit and public debt. Anyway, although the initial devaluation overshooting has been overcome, it is undeniable that the overall fiscal performance becomes extremely sensitive (not to say dependent on) as to the evolution of the exchange rate.

Table 3.15

NATIONAL TREASURY EXPENDITURES									
Cash basis									Flows in R$ million
End of period	Payroll and social levies	Transfers to states and municipalities	Other earmarking	Federal security charges	Government credit operations	Charges on contracted debt / domes-tic and external	Current expenditures and investment	Amount to be paid	Total expenditures
1994	17 932	9 053	3 454	3 325	1 969	2 141	8 848	88	46 810
1995	35 497	18 320	6 266	7 078	3 443	4 661	14 351	640	90 256
1996	40 505	20 830	6 357	10 809	2 288	5 183	18 007	2 278	106 257
1997	42 848	25 042	7 151	10 169	2 522	7 806	24 252	1 890	121 680
1998	47 296	29 166	9 302	18 475	2 394	9 231	32 469	0	148 333
1999									
Jan	3 841	3 037	470	2 447	283	198	1 541	0	11 817
Feb	4 480	2 929	426	2 776	326	249	1 987	0	13 173
Mar	3 581	3 256	545	3 270	705	210	3 020	0	14 587
Apr	3 787	2 857	516	2 714	2 299	197	1 942	0	14 312
May	3 655	3 092	440	2 171	791	197	3 056	0	13 402

Source: STN

Public borrowing

Public sector borrowing requirements recorded an accumulated nominal deficit of 8.02% of GDP up to December 1998. When nominal interest (8.03% of GDP) is deducted from this amount, the result is a primary surplus of 0.01% of GDP. In 1998, the central government - encompassing the federal government, Banco Central, social security system and federal state companies - closed with a primary surplus of 0.32% of GDP, while regional governments, including state and municipal government administrations and state and municipal government companies, turned in a deficit of 0.31% of GDP.

Still in December 1998, the net public sector debt (DLSP) added up to R$ 379.8 billion (41.6% of GDP), as external indebtedness reached a level of 6.6% of GDP. In the same month, the net internal debt came to 36% of GDP. Of the aforementioned total, 21.1% referred to the central government, 11.8% to state governments, 1.9% to municipal governments and 1.3% to state government companies.

As observed earlier, the government had assumed a considerable huge debt denominated in US dollar short before the time the exchange rate devaluation took place, as much as to account for about 20% of the net debt. At first, an overshot of the devaluation rate drove the national currency to depreciate over 44%. Later its loss receded, and since then has been oscillating between 30% and 35%, but the impact it had on national debt was appalling, making it rise from 41,6% of the GDP to over 50%. As to the public borrowing requirement, it soared up to 15% of the GDP. The real depreciation acted together with the skyrocketing interest rate to cause such dramatic outcome. Accordingly, under the assumptions of a broad stabilisation of the exchange rate around R$1.75 per U.S. dollar), and gradual decline of the overnight interest rate, the economic authorities aim at to contain public borrowing at about 9% of GDP, and the net public debt at the equivalent of 51 percent of GDP by year-end. So far this goal has been proving feasible, as the following information shows.

Table 3.16

PUBLIC SECTOR BORROWING REQUIREMENTS (Last month prices)			
Flows in 12 months			**R$ million**
Itemization	**Apr 1999**	**May 1999**	**Jun 1999**
Nominal deficit	117,661	121,159	118,859
Central government	92,209	95,651	92,637
Federal government and the BCB	89,860	93,452	89,779
Federal enterprises	2,349	2,119	2,858
Regional government	25,452	25,508	25,952
State government	19,665	19,632	19,489
Local government	3,044	3,127	3,453
State enterprises	2,208	2,105	2,324
Local government enterprises	533	644	686
Nominal interest paid	124,075	128,531	131,945
Central government	98,978	103,212	106,360
Federal government and the BCB	98,877	102,920	105,685
Federal enterprises	101	292	675
Regional government	25,097	25,319	25,585
State government	17,398	17,575	17,708
Local government	5,062	5,104	5,189
State enterprises	2,447	2,447	2,491
Local government enterprises	190	192	198
Primary deficit	-6,414	-7,372	-13,357
Central government	-6,769	-7,561	-13,723
Federal government and the BCB	-9,017	-9,468	-15,906
Federal enterprises	2,249	1,907	2,183
Regional government	355	189	367
State government	2,267	2,057	1,781
Local government	-2,017	-1,977	-1,735
State enterprises	-238	-342	-167
Local government enterprises	343	451	488

Source: Banco Central *(Negative figures mean surplus.)*

In July, the net public sector debt came to R$ 491.1 billion (49.8% of GDP), as compared to R$ 483.2 billion (49.5% of GDP) in May. This amount is R$ 23.2 billion less than the total estimated for the month of June (R$ 514.3 billion, 52.7% of GDP) in the agreement with the International Monetary Fund.

Table 3.17

PUBLIC SECTOR BORROWING REQUIREMENTS (As percentage of GDP)			
Flows in 12 months			**% of GDP**
Itemization	**Apr 1999**	**May 1999**	**Jun 1999**
Nominal deficit	12.06	12.47	12.10
Central government	9.45	9.85	9.45
Federal government and the BCB	9.21	9.62	9.16
Federal enterprises	0.24	0.23	0.29
Regional government	2.61	2.63	2.65
State government	2.02	2.02	1.99
Local government	0.31	0.32	0.35
State enterprises	0.23	0.22	0.24
Local government enterprises	0.05	0.07	0.07
Nominal interest paid	12.71	13.23	13.46
Central government	10.14	10.63	10.85
Federal government and the BCB	10.13	10.60	10.78
Federal enterprises	0.01	0.03	0.07
Regional government	2.57	2.61	2.61
State government	1.78	1.81	1.81
Local government	0.52	0.53	0.53
State enterprises	0.25	0.25	0.25
Local government enterprises	0.02	0.02	0.02
Primary deficit	-0.66	-0.76	-1.36
Central government	-0.69	-0.78	-1.40
Federal government and the BCB	-0.92	-0.97	-1.62
Federal enterprises	0.23	0.20	0.22
Regional government	0.04	0.02	0.04
State government	0.23	0.21	0.18
Local government	-0.21	-0.20	-0.18
State enterprises	-0.02	-0.04	-0.02
Local government enterprises	0.04	0.05	0.05

Source: Banco Central *(Negative figures mean surplus.)*

Table 3.18

FEDERAL SECURITIES' MATURITY SCHEDULE	
Period	**R$ million**
Aug/1999	13,240
Sep/1999	32,989
Oct/1999	27,362
Nov/1999	10,464
Dec/1999	17,459
Jan/2000	9,634
Feb/2000	14,388
Mar/2000	23,166
Apr/2000	17,413
May/2000	20,415
Jun/2000	12,062
Jul/2000	10,880
As of Aug/2000	145,808
Total	355,370

Source: Banco Central *(Position in Aug 19, 1999; total at market; amounts based on colateral price.)*

The federal securities debt outside Banco Central totalled R$ 384.2 billion (38.6% of GDP), an increase of 0.3% relative to the previous month. Despite net redemption of National Treasury Notes - Series D - NTN-D, which surpassed net issues of Banco Central Notes - Special Series - NBC-E, the participation of papers indexed to exchange increased from 24% to 24.3% of the total federal securities debt outside Banco Central due to exchange devaluation in the period. In July, average maturity of federal securities issued in public offers remained at 3 months. This was brought about by an increase in the maturity of exchange papers issued by Banco Central, offset by the reduction in the redemption terms of pre-set National Treasury papers. The average terms of federal securities increased from 8.3 to 9.1 months, stimulated mostly by growth in the maturity terms of LFT (from 9.9 to 12.7 months).

As far back as June, asset adjustments in the concept of borrowing requirements (traditional methodology) came to a net total of R$ 2.1 billion. Of this total, R$ 1.6 billion correspond to anticipated payment of the third instalment of the Telebrás System privatisation; R$ 260 million refer to recognition of CESP judicial deposits; R$ 1.3 billion to issues of securitised credits; as well as R$ 137 million to the Program of Incentives to Reduction of the State Public Sector in Banking Activities (PROES); and R$ 2.8 billion refer to the methodological adjustment applied to the foreign debt. In the alternative concept, the asset adjustment came to R$ 4.5 billion, including a methodological adjustment of the internal and external debts indexed to changes in the rate of exchange (R$ 5.2 billion).

Table 3.19

NET PUBLIC SECTOR DEBT						
						R$ million
Itemization	**Dec 1997**		**Dec 1998**		**May 1999**	
	Balance	**% of GDP**	**Balance**	**% of GDP**	**Balance**	**% of GDP**
Total net debt	308,426	34.5	388,667	42.6	491,064	49.83
Federal gov'nt and the BCB	167,742	18.8	231,258	25.4	302,157	30.6
State gov'nts	100,257	11.2	113,160	12.4	132,800	13.5
Local gov'nts	15,635	1.7	17,745	1.9	19,957	2.0
State owned enterprises	24,793	2.8	26,504	2.9	36,150	3.7
Federal	8,906	1.0	7,377	0.8	13,666	1.4
State	15,077	1.7	17,836	2.0	20,806	2.1
Local	810	0.1	1,291	0.1	1,678	0.2
Internal net debt	269,846	30.2	328,693	36.0	381,940	39.0
Federal gov'nt and the BCB	150,254	16.8	192,455	21.1	223,536	22.7
State gov'nts	96,447	10.8	107,673	11.8	124,686	12.6
Local gov'nts	15,141	1.7	17,084	1.9	18,935	1.9
State owned enterprises	8,004	0.9	11,481	1.3	14,783	1.5
Federal	-4.397	-0.5	-3.195	-0.4	-975	-0.1
State	11.594	1.3	13,389	1.5	14,085	1.4
Local	807	0.1	1,287	0.1	1,673	0.2
Foreign net debt	38,580	4.3	59,974	6.6	109,124	11,1
Federal gov'nt and the BCB	17,488	2.0	38,803	4.3	78,620	8.0
State gov'nts	3,810	0.4	5,487	0.6	8,115	0.8
Local gov'nts	493	0.1	661	0.1	1,022	0.1
State owned enterprises	16,789	1.9	15,023	1.6	21,367	2.2
Federal	13,303	1.5	10,573	1.2	14,641	1.5
State	3,483	0.4	4,447	0.5	6,720	0.7
Local	3	0.0	4	0.0	5	0.0

Source: BCB – Banco Central do Brasil

3.4 Tax structure: institutions and the reality

The Constitution endows each state and the federal district, as well as each municipality, with competence, among others, to collect their own taxes and to enact laws to provide rules for this collection. So there are as many tax systems as there are states and municipalities, that is, 5.506 municipal systems, 26 state one and finally one for the single federal district. This multitude of tax systems, however, should not differ so much from each other, as all must be accordant with the framework prescribed by the Constitution and the National Tax Code.

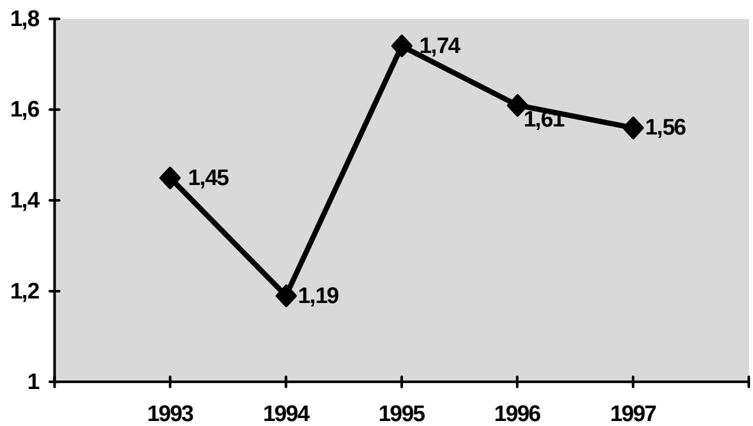
Brazilian jurists usually classify Brazilian tax duties into two major cathegories:

1. the taxes which are levied only if and when the government renders any public service to the taxpayer, such as the issuance of any certificate, the maintenance of electric lights along the streets; we will ignore them, because these exactions are rather a sort of fee than real tax;
2. the others, whose collection does not imply that the government should give any kind of return to taxpayers.

The municipalities have the right to collect the following taxes: service tax, urban real property tax and real property acquisition tax. Taxes pertaining to the states are the following: added value tax, inheritance and gift tax, and vehicle property tax. In adition to that, both states and municipalities are also allowed to collect a tax on the salaries paid to their own personnel, which tax is destined to finance their personnel's social insurance. A much more enhanced tax competence is conferred to the Union, namely: income tax; profit business tax; federal value added tax (which taxes only manaufactured goods); import tax; export tax; rural land property tax; banking transaction tax; loan and investment tax; turnover tax; and payroll tax (to which the government employees are also subject).

Each of the afore-mentioned political unit has its own tax authority, no matter how small its territory and population are. As to the federal taxes, not only a single authority is in charge of of them all. Most are levied by the Secretaria da Receita Federal – SRF (Secretariat of Federal Revenue), but the payroll tax is collected by two detached agencies. In fact this tax is threefold. One part burdens the employees, another the employers, and both of these parts are collected by the INSS - Instituto Nacional da Seguridade Social (Social Insurance National Institute). As to the third part, which is supposed to finance a unemployment insurance and a house-acquisition fund, it is administered by a state owned savings bank , the CEF – Caixa Econômica Federal.

Figure 3.19 Federal Tax Administration: Cost-Revenue Ratio in %



Source: Secretaria da Receita Federal.

The SRF is responsible for both running the customs and collecting internal federal taxes, except the cases mentioned above. It does not have have the status of an autonomous agency. Although it has its own head and staff, it is actually a section of the Ministry of Finance. As a result, the SRF does not have a proper personnel policy. Remuneration, recruitment and the like are matters decided according to rules set up for the civil servants as a whole. The graph on the previous page shows the cost-revenue ratio achieved by the SRF from 1993 to 1997.

All federal taxes are self-assessed and every liability is paid to commercial banks, never to tax offices. Very before long the amount is transferred to the National Treasury. In return for rendering this services, the banks charge a small fare. With regard to the states and municipalities, the taxes which account for the bulk of the revenue are also self-assesed and paid trough banks. Even when tax authorities assess the liability, the attendant payment is made through banks, except for very exceptional cases, such as when the taxpayer who has no known settlement is caught carrying merchandise without fulfilling certain formalities.

Table 3.20

TABLE – CONSTITUTIONAL TRANSFERS FLOW	
FROM / TO	**% OF REVENUE TRANSFERRED BY TAX SPECIES**
Union / States	• 24.5% of income tax and federal value added tax
	• 30% of loan and investment tax levied on gold
	• 10% of federal value added tax, in proportion to exported amount of manufactured goods
	• total income tax withheld at source from each state's own public servants
Union / Municipalities	• 22,50% do income tax and federal value added tax
	• 70% of loan and investment tax levied on gold
	• 50% of rural land property tax
	• total income tax withheld at source from each municipality's own public servants
States / Municipalities	• 50% of vehicle property tax to the municipality where the vehicle is registered
	• 25% of state value added tax

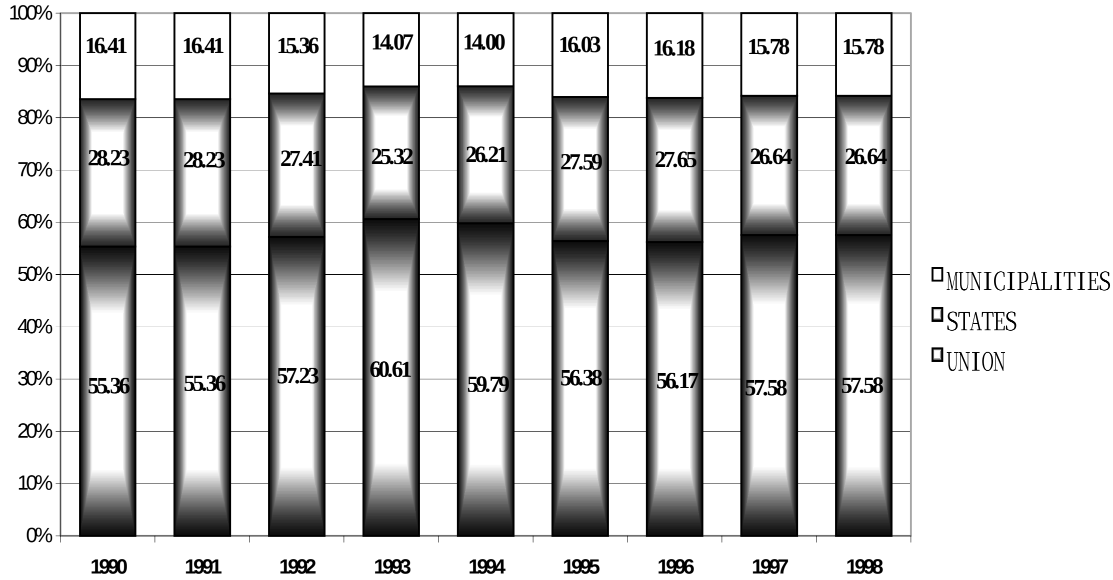
Source: Federal Constitution.

In allotting competence to administer and collect the levies which comprise the tax system, the Constitutions grants to the Union the lion's share. Next come the states, leaving to the municipalities just a small portion. That is why the Constitution itself commands both states and the Union to transfer part of their tax revenue to them. The states also receive some part of the federal tax revenue. The table above describes how the transfer system works, and a graph on the next page shows how the net share in tax revenue among Union, states and municipalities has evolved throughout the last nine years.

Now let us discuss the main deficiencies of Brazilian tax system. It seems they might be summarized as follows.

First should be mentioned the concentrated tax burden. Save for the indirect taxes, the bulk of taxation falls on the wage and salary earner middle class and a few corporations. In a total population of over 160 m, less than 10 m file tax returns. Furthermore, a large portion of the national income is not recorded (it is estimated that the black market amounts to a third of the gross national product), thence it escapes from taxation. To make things worse, the tax system is growing steadily unfair in the last years, for the government, whenever there is a need to balance the budget, chooses rather to rise the taxes already paid by regular taxpayers than trying to expand the tax base and to tackle evasion.

Figure 3.20 Hare in Tax Revenue after Constitutional Transfers (%)



Next comes the excevessively complexity and irrationality of the system. This is partially due to the lack of coordination among the union, states and municipalities. It is not unusual that a single taxable event induces multiple taxation. For instance, the gross revenue of a manafacturer is subject to the state VAT, to the federal VAT and the turnover tax. As the Constitution earmarks the revenue of some tax for certain expenditures, the government, to turn round such restriction, frequently introduces a nearly identical tax but labeled diferently. Indeed, there are two federal taxes on business profit and also other two on turnover. Moreover, although for different reasons, Brazil also has three VAT tax. One for the federal government, levied only on manufactures goods. Another one for the states, which taxes manufactured goods again and whatever tradable good, and does not tax services, except for a few ones. Finally, comes the municipal VAT, designed to tax only services. The state VAT, which along with the payroll tax is the largest source of tax revenue, varies from state to state; there are more than 3.000 exemptions for particular products. Since 1995 states' governors have been resorting to tax breaks, which means VAT exemptions, to persuade multinational manufacturers to build new plants in their territory. So fierce is the competition among the states, that that practice is called tax war in Brazil.

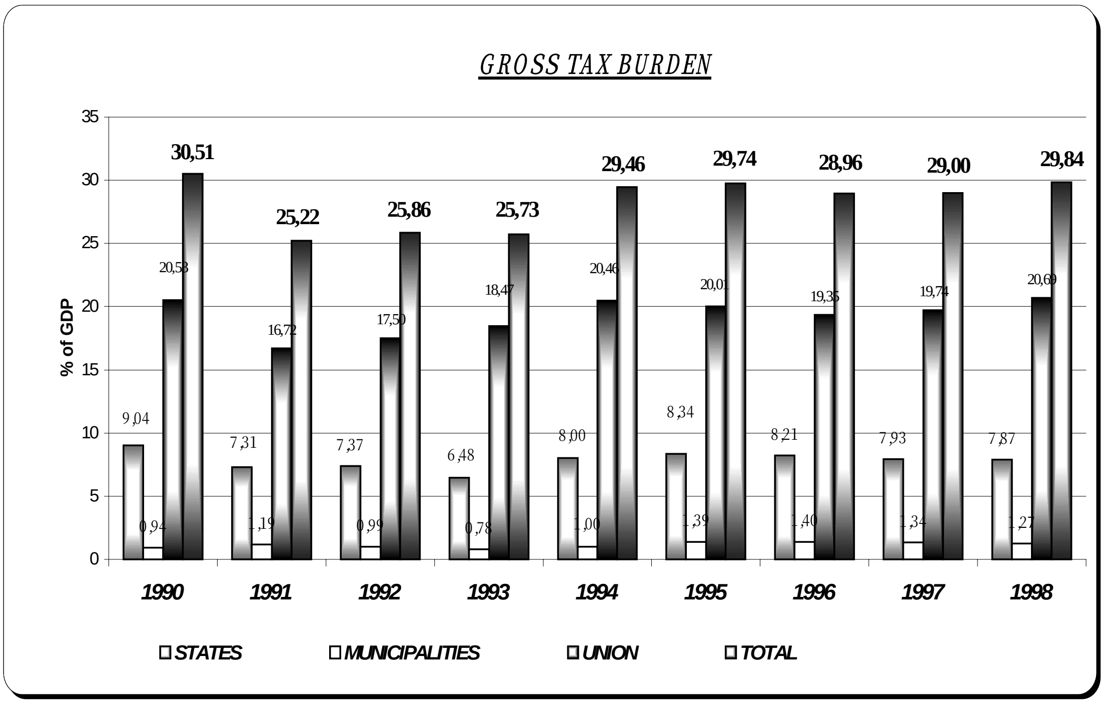
Lack of economic efficiency is the third problem. The complexity as above described is itself a source of inneficiency, since the most tax are self-assessed and the taxpayers have to hire a cohort of lawyers, bookkeepers and so on in only for the purpose of keeping records and calculating their tax liabilities. It should also be mentioned the cascading effects of important taxes such as the turnover tax and the bank transaction tax, which penalise production and exports.

Last but not least, I would point out rich taxpayers' high litigiousness. Brazilian lawyers specialized in tax affairs run a prosperous industry. They take advantage of the loopholes and complexity of tax laws as well as of some distortions of the judiciary system and easily obtain from the courts a writ which exonerates their clients from paying tax liabilities or at least allow them to postpone the payment for a long period. Of course, tax lawyers are doing nothing but their job. The charge must be rather properly addressed to lawmakers.

Both tax administration and politicians are quite aware of all these problems. A bill which is intended to overhaul the whole system has been under discussion in the Congress since 1992, but it is always hampered when it comes to define how to distribute the tax revenue among the union, states and municipalities. More recently the taxpayers have taken part in the discussion. They wish the tax burden were lightened and more fairly distributed. Certainly they are quite right as to the unfairness, but as one can take issue on how heavy the system really is.

The graph below (taken over from a study newly released by the SRF) indicates that the overall tax burden reached its peak in 1990. After declining in the following three years, since 1994 it has been oscilating around 29% of GDP. However high it may be for Brazilian taxpayers, it appears reasonable when compared to what happens in major developed countries. To that, the taxpayers would certainly argue that, given the insuficency and poor quality of the services provided by Brazilian state, it is not suitable to appeal to figures presented by industrialised countries. Yet the tax authorities could reply that, bearing in mind the size of the underground economy, the effective tax burden is lighter than it appears. The latter is true, but rather than solving the problem, it stresses and urges a solution for the question of unfairness. If the last version to appear in the Parliament comes to gather universal approbation (what a formidable chalenge!), the tax reform will extinguish the turnover tax, merge and uniformise the three VATs, and keep without much change the present income tax, except for abolishing the business profit tax also. If such a proposal comes to reality much will have been done at least in the way of simplification and reduction of compliance cost.

Figure 3.21



As for the distribution of tax burden across the several tax species the table on the next page provides a good picture. It affords also the weight of major taxes in the aggregate revenue. Its figures refers to 1998.

Table 3.21

TAX BURDEN AND REVENUE BY TAX SPECIES				
TAX SPECIES	**COMPETENCE**	**REVENUE R$ MIL**	**%OF TOTAL REVENUE**	**% OF GDP**
Payroll tax /1	Union	65.905.376,71	24,50	7,31
State value added tax	States	60.885.712,00	22,63	6,75
Income tax	Union	47.723.797,12	17,74	5,29
Turnover tax /2	Union	24.786.036,94	9,19	2,75
Federal value added tax	States	16.096.731,09	5,98	1,79
Banking transaction tax	Union	8.112.838,14	3,02	0,90
Business profit tax	Union	6.542.091,84	2,43	0,73
Taxes on international trade	Union	6.503.673,51	2,42	0,72
Service tax	Municipalities	4.522.374,29	1,68	0,50
Vehicle property tax	States	4.451.016,00	1,65	0,49
State public servant payroll tax	States	3.633.000,00	1,35	0,40
Urban real property tax	Municipalities	3.550.384,24	1,32	0,39
Loan and investment tax	Union	3.521.098,82	1,31	0,39
Real property acquisition tax	Municipalities	793.083,97	0,29	0,09
Municipal servant payroll tax	Municipalities	383.000,00	0,14	0,04
Inheritance and gift tax	States	318.060,00	0,12	0,04
Rural land property tax	Union	206.250,39	0,08	0,02
Remaining tax species	Diverse	11.153.476,75	4,13	1,23
		TOTAL:	100	29,84

Source: Secretaria da Receita Federal – SRF.
/1 – It includes contribution of private employers and employees, federal civil servants and the amount paid to fund for labour insurance.
/2 – It includes the revenue provided the two federal taxes on turnover.

The table on the next page shows the evolution of tax revenue in the last five years. Its figures are expressed in US$ dollars, which may be a little tricky, as the variation to some extent derives from the exchange rate oscillation. Actually, the national currency appreciated against the US dollar only in 1994. This explains much of the shining figures for that year, but there was a real increase, as the economy grew firmly. From 1995 to 1998, however, the real had been losing value against the dollar, little by little, year after year. Besides, since 1997 the economy has been sluggish. Thus, one could expect a declining tax revenue across these years. Nevertheless, it has remarkably keept going up. On the negative side, it must be observed that this increase was achieved chiefly at expenses of rising tax rates or creating new taxes with economically distortionary effects, rather than by tackling evasion or broadening the tax base of existing taxes. As a result, in the last years the tax system has worsened in terms of ineficiency, unfairness and complexity.

Now let us take a closer look at the major federal taxes.

Import tax

If the good imported is classified as a manufactured one, it is not only subject to this tax, but also to the federal value added tax, which next I shall describe.

Depending on the kind of import, it will be applied either a specific rate or an ad valorem one. Most goods are subject to the ad valorem rate. Being the case of applying the latter, the tax base will be the ordinary price at which the good concerned is sold at the importer's market, included the freight from the origen to the destination. In the end of 1997, as part of the package of measures comprising the fiscal adjustment, the ad valorem rates were raised in three points. In December 1998 the calculated average rate was 17%.

The tax liability is due by the time the import statement is registered.

Table 3.22

TAX REVENUE BY GOVERNMENT LEVEL AND TAX SPECIES					
					US$ Million
	1994	**1995**	**1996**	**1997**	**1998**
AGGREGATE REVENUE	160.012	209.808	224.572	224.881	231.878
Variation %		31,12	7,04	0,13	3,10
Income tax	22.099	33.993	36.055	34.597	41.131
Personal	1.488	2.259	2.361	2.365	2.436
Corporate	6.703	9.883	12.402	10.933	10.392
Withholding	13.908	21.850	21.292	21.299	28.303
Federal value added tax	11.819	14.667	15.216	14.854	13.873
Loan and investment tax	3.728	3.500	2.824	3.370	3.035
Import and export taxes	2.805	5.343	4.221	4.569	5.605
Rural land property tax	12	108	196	217	178
Banking transaction tax	5.742	174		6.182	6.992
Payroll tax /1	35.537	48.083	54.390	53.375	56.800
Turnover tax /2	19.266	22.460	24.201	22.889	21.362
Business profit tax	5.062	6.129	6.178	6.453	5.638
Remainder	4.790	6.721	6.768	6.532	6.173
TOTAL UNION REVENUE	111.129	141.180	150.048	153.039	160.786
Variation %		27,04	6,28	2,00	5,06
State value added tax	40.035	51.558	55.453	53.292	52.474
Vehicle property tax	930	2.684	3.108	3.436	3.836
Inheritance and gift tax	119	195	201	238	274
State public servant payroll tax	1.561	2.970	3.326	3.006	3.131
Remainder	824	1424	1560	1510	1472
TOTAL STATES REVENUE	43.469	58.830	63.648	61.483	61.187
Variation %		35,33	8,19	-3,40	-0,48
Service tax	2.305	3.625	4.335	4.039	3.898
Urban real property tax	1.136	3.015	3.341	3.232	3.060
Real state acquisition tax	460	706	734	733	684
Remainder	1.514	2.452	2.464	2.355	2.264
TOTAL MUNIC. REVENUE	5.415	9.798	10.876	10.360	9.905
Variation %		80,94	11,00	-4,74	-4,39

Source: Secretaria da Receita Federal – SRF.

/1 – It includes contribution of private employers and employees, federal civil servants and the amount paid to fund for labour insurance.

/2 – It includes the revenue provided the two federal taxes on turnover.

Federal value added tax

This tax is only levied on goods classified as manufactured by the law, no matter wether from domestic origen or imported from abroad. Therefore, any service or raw material are out of its scope as well as craftworks and other products so declared by the law.

The tax base is the bare value of the transaction. But if it is an import, the tax base will be the tax base on which the import tax has been calculated plus the import tax liability and other expenses occasionally incurred in the process of importing. On the other hand, any manufactured good intended for export is thoroughly exempted.

What characterizes this tax is that it has a multiplicity of brackets. That is because the Constitution command it to be selective, that is, the tax rate structure shall be based on the essentiality of the good concerned. As a result, cigarettes bear the highest rate, such as the tax lilability accounts for 41,25% of the price consumers pay for each box of cigarettes. Thus, it operates also as a sort of excise tax. Indeed, basic food and clothes, for instance, are subject to a zero rate.

As it ranks among the VAT type of tax, the tax due in each transaction may be compensated by the amount charged im previous transactions. Exemption or non-levy, except as otherwise determined in the law, do not imply credit for compensation relative to the amount due in the subsequent transactions. Taxpayers are supposed to assess and pay the tax liability each ten days, that is, thrice a month. However, no specific return is required. Actually a brief report concerning this tax is enclosed with the annual corporation income tax return.

Income tax

For the sake of explanation, this tax can be unfolded into three other ones: the personal income tax, corporation income tax and withholding tax. Yet it is better to view it as single tax, since they are fairly integrated and the same law provides for all of them. Indeed, when filling their tax returns, taxholders may offset the tax on dividends with the tax liability already declaredy by their respective company. Regarding business, not only incorporated interprises are liable to the income tax, but even firms owned by a single individual.

Unlike the Japanese personal income tax, there is no final year adjustment. Therefore, every income earner is liable to file a tax return, unless he or she is relieved for a reason specified in the law such as not having earned more than certain amount in the fiscal year concerned. As for the corporate tax, no such scheme as the Japanese blue and white system are available. However, lowest and middle gross turnover firms may chose to file a simplified tax return. Doing so, their tax liability is calculated as though the income tax were converted into a turnover tax, as the tax base turns out to be the gross revenue instead of the profit.

For the personal income tax, the rates are as follows.

Table 3.23

Annual taxable income in R$			
Over	**But not over**	**Tax rate %**	**Amount to be deducted in R$**
0	10,800	-	-
10,800	21,600	15	1,620,00
21,600	-	27,5	4,320,00

For the corporate tax there are also two rates, but no threshold. Annual profits not over R$ 240,000,00 are subject to a 15% rate. The amount which exceeds that value are liable to an aditional 10% rate.

Turnover tax

For the sake of simplifying the exposition, I put under this heading two federal taxes, both collected on the turnover of virtually all firms. They hard difer from each other, adopt the same method of assessment and are designed to have the same scope. However, one of them has a broader universe, because it encompasses even the banking sector.

Apparently the rate is low (coupled the two taxes, it reaches 3,75%), but as they are cumulative, they end up affording very large collection. Notwithstanding, the government had better merge them, for levying twin taxes only adds to the complexity of the system, besides posing a wasteful compliance cost. Still better, they should be extinguished, as they have cascading effects, which is extremely harmful for the competitiveness of Brazilian exports.

Business profit tax

This tax, for the benefit of simplification and minor compliance cost, should also be merged to the corporate income tax, to which it is quite akin. Maybe the most significant difference is that the Constitution earmarks its revenue, which is totally alloted to social insurance budget. Its basic rate is 8%, but for 1998 and 1999 it was temporarily raised to 12%.

Banking transaction tax

This is another rather controversial tax, because being cumulative it has also cascading effects. In adition to that, its scope is quite arbitrarious. Everyone who keeps a banking account should pay it, because it is levied whenever a withdrawal is processed. Even when the money remains in the bank, being simply transferred to, say, an interest yielding account, the tax is due. Not surprisingly, this tax has been under fierce criticism, but many side with it, including the tax authorities. They argue that it is easy and cheap to collect and difficult to evade. Furthermore, it would have a tax base broad enough to catch the underground economy. Actually, despeite it brings economic efficiency, it has proven a good source of tax revenue. Its basic rate is 0,2%, but it was temporarily raised to 0,38% for 1999, and to 0,30% for 2000 and 2001.

3.5 Country-specific fiscal issues

The Real Stabilisation Plan holds the undeniable merit of having tamed the hyperinflation (it had skyrocketed as high as 2.330% in 1993, to drop to 3% in 1998). But much of it was achieved at expenses of an increasing dependence on inflows of foreign capital, reflected in a current account deficit around 4-5% of GDP. In order to sustain the partly dollar-pegged exchange rate, the government had kept the interest rate excessively high for a long period. The consequent increase in the interest expense resulted in a fiscal performance, which ended up with another huge deficit of over 8% of the GDP in the nominal concept. Accordingly, the net public debt has experienced a dramatic augment, as much as to correspond to half GDP now. At the same time, the high-interest rate policy, maintained for so long, led the economy to be entrapped in a recession hard to emerge from.

It must be remembered that the present government was driven to that foreign-financing policy for not being able to cope with the already huge deficit legated by former rulers. The government was not resolute enough to implement policies that could have produce sounder results in the fiscal front. If so, the country would have found itself so vulnerable to the ongoing financial international crisis. Therefore, as never the government should persevere with a fiscal policy as much tight as possible to produce a primary surplus. This will afford the Brazilian State to recover its ability to stimulate the economic growth without resorting to international market, which has proven so dangerously volatile.

In the long run, the main source of trouble for the National Treasury, the Ministry of Finance asserts, is the negative net result of the social insurance system. Indeed the present value of its deficit is said to amount to five times as much as the GDP. But it also contributes to increase deficit currently. Through the lengthening of minimum periods of contribution to the pension systems, and the elimination of certain constitutional rigidities in the determination of pension benefits, the constitutional amendment on pension reform, approved in late 1998, represented an important step forward in this area of particular weakness in the public finances. The government recognises, however, that the reforms enacted to date are not sufficient to either ensure the financial viability of the social security system over the medium term, or adequately improve its equity. Therefore, it intends to continue to work with congress, and garner society’s support for further reforms of the public pension system, while promoting, with appropriate safeguards, the development of complementary pension plans designed to supplement this system, foster private saving for retirement, and help deepen domestic capital markets.

In this latter respect, three draft bills regulating complementary pension plans for private and public workers were presented to congress in March 1999, and it is hoped that they will be approved in the course of this year. However, as anyone easily could reason, this question raises widespread concern, because it affects everyone’s life thouroughly. To cut down social benefits demmands at any rate a formidable political struggle. Anyway, the government plans to proceed in steps over the next few months. Specific draft laws will be presented shortly to reform the pension regimes for the self employed, rural workers, and the military. For private sector workers, the system of individual accounts will be extended and improved, to ensure that each contributor’s account reflects accurately henceforth the contributions made. This measure will help reduce fraudulent claims for unearned pensions, and allow the eventual shift to a notional-defined contribution system, under which pension benefits will reflect the lifetime contribution histories of recipients—with an appropriate accounting rate of return—as well as life expectancies at retirement. For new public sector workers, the reform is intended to limit basic pension benefits to the ceiling set for private workers, supplementing them through fully funded complementary pension plans. For existing public employees, the government is exploring feasible ways to promote a closer correspondence between benefits and contributions, while maintaining the defined-benefit character of the system. The government is also pressing ahead with administrative improvements to strengthen the enforcement and collection of social security contributions, and reduce abuses, in particular for disability pensions.

The privatisation program has been a sound manner of easing the burden over the National Treasury. It has the further advantage of transferring to private sector the management of activities not suitable to the public sector. However, most major sales of state-owned companies planned for this year was postponed for 2000. It is not that the government has lost its willingness to carry on the program. It is rather that, if it insisted in doing it now, it would alienate valuable assets for ridiculously debased prices, given the presently adverse market conditions.

It is true that so far the government has been accomplishing its tough fiscal targets. Nevertheless many experts warn that such remarkable achievement is unlikely to be repeated in the following years, on the ground that a large portion of the federal revenue has originated from many one-off items, such as sales of telecoms licences, extraordinary tax collection resulting from tax amnesty, and reduction of constitutional transfer to states and municipalities in virtue of a provisional amendment of the Constitution. While the economic authorities recognise the gravity of the problem, they assure to have been working it out. The next years will also come with its own one-time revenues, and, if confirmed the prospect of a 4% growth rate, the tax revenue will follow suit. Anyway, the government assures it will not hesitate to tighten still further its fiscal policy, whenever the circumstances happen to require it.

3.6 Conclusion: where we stand and where we go

Brazilian economy is performing much better than expected in the beginning of the year. Then, the degree of uncertainty was extremely high, as a result of the Russian crisis and the floating of the exchange rate. A contributing factor for this reversal of expectations has been the moderate passthrough of the exchange rate devaluation to prices, associated with economic activity improvement between the last quarter of 1998 and the first quarter of 1999. Prospectively, the favorable evolution of the intermediate goods sector and the non-durable and semi-durable consumption goods sectors, along with the declining interest rate path and a record crop indicate that the figures for GDP in 1999 may be surprising. GDP growth projections for 1999 have already been upwardly revised from -3.8% to -1%. Although the government has conservatively kept this figure as the oficial target after the release of economic indicators referring to the second quarter, now the economy is expected at worst to shrink 0,5%, and at best to present a slight growth.

The industrial output is expected to sustain its steady positive growth, at least, sufficient to rebuild inventories. In the capital goods sector, the agricultural income growth plays the leading role, complemented by the improvement of the import substitutes' prices, and the continuous demand generated by infrastructure investments, mainly in the transport, electric power and communication sectors.

In the consumer goods sector, recovery is still sluggish, but should improve significantly in the next year. The durable goods sector, which operates with a relatively high level of imported components and depends heavily on credit supply in the domestic retail market, should respond more slowly. Furthermore, durable goods consumption is treated as a household investment; thus, its demand declines when interest rates rise. A stronger recovery in consumer credit supply would only be possible with lower interest and lower unemployment rates. The other sectors, as a whole, are expected to remain neutral in the short-term.

In spite of the modest influence of the devaluation in the real economy, it is possible to foresee a progressive improvement in the export-related sectors from 2000 onwards. The recent experience shows that the effects of devaluation on exports take place only after some delay. The industry has already started to receive orders for manufactured goods, due to more competitive prices. The scarcity of credit lines, which was limiting the export effort has started to show signs of reversal, as suggested by recent capital inflows channeled through domestic private banks. It is worth noting, however, that most of the firms in the durable and non-durable goods sectors produce for the domestic market, and their income depends on overall domestic earnings.

Agriculture deserves special consideration. The coming of the summer harvest resulted in a very favorable supply shock. Low agriculture commodities prices, in historical terms, were offset by the exchange rate devaluation, giving rise to a significant increase of gross output value. The consequent recovery in agriculture income and its multiplying effects on the related product chains, such as the increased demand for tractors, fertilizers, pesticides and other supplements, partly explain the upward revision in GDP decline for 1999. The excellent performance registered in crops with significant weight in the consumer basket (rice, beans, and soybeans) was very important in reducing current inflation. Considering the participation of the food group in the price indices, total impact of the agriculture supply shock was responsible for the unexpected reduction of about one percentage point in the consumer price index in the second quarter of 1999. With respect to the trade balance, the agricultural sector performance should be taken as positive: exports tend to maintain the same value in dollars observed last year, but the imports, especially food segments, may fall by 30% to 40%. This will generate an agriculture surplus of nearly US$ 11 billion. Additionally, the recent signs of recovery in Asian economies, particularly in Japan, may lead to a further increase in demand for commodities, especially for agricultural goods.

The trade deficit declined to US$618 million in the first half of 1999, from US$1.8 billion in the corresponding period of 1998 and US$6.6 billion (0.8 percent of GDP) for 1998 as a whole. Although such trend is welcomed, it is rather disappointing, if one remembers the sharp drop experienced by the exchange rate. In fact, as already said earlier, the government has been sistematically forced to cut down its estimate of the trade balance. Many comentators believe that hopefully the country will close the year with no more than a US$ 1 billion surplus. So far the decrease in the deficit mainly reflects a reduction in imports, which are more sensitive to changes in prices and income. When compared to imports, exports tend to respond with a longer lag to exchange rate changes due to the need to redirect production from internal to external markets. Also, Brazilian exports were negatively affected by the declining prices of commodities, by the reduction in world demand and by the contracting of external financing.

Indeed the reduction of the external financing available for emerging countries is still an important restriction. Despite the observed improvement that occurred lately, capital inflows for emerging countries are still volatile. Brazil's capability of reverting its trade deficit through increases in exports depends heavily on the normalization of external commercial credit lines and on the growth of the world economy. Access to external credit has been continuously increasing. According to the forecasts of international organizations, such as the World Bank, growth in world demand will reach 2.3% in 1999, which represents an expansion of 3.9% in global commercial trade. However, excluding the United States, estimates for growth of Brazil's major trade partners are even lower or negative. Again, the positive signs of recovery observed in the Japanese economy are worth mentioning.

Fortunately, regarding the foreign sector, only the trade news has not improved so much as expected. The recent stability in the international outlook, as well as the favorable domestic evolution, are helping to revert the external financing constraints that the Brazilian economy faced in the beginning of the year. In this sense, recovery of long-term financing through public and private bond issues can be observed, as well as the continuation of massive foreign direct investment.

In the labor market, the layoff-trend is still present in the industrial sector. However, the unemployment rate in the first five months of the year was very similar to the one observed in the same period of 1998.

The evolution of the most important price indices shows that the impact of exchange rate devaluation on inflation was mostly captured in the figures of February and March. The general price indices, which reacted more intensively to the exchange rate devaluation in the beginning of the year, presented a falling trend between April and May, with deflation being observed during this period. Concerning the year-over-year inflation, the average increase for the general price indices between December/98 and Jun/99 was 8 percentage points. Such an increase, which is small compared to the exchange rate devaluation, points to the definite elimination of the price indexation mechanisms that prevailed in the Brazilian economy before the introduction of the Real Plan. The overall trends of the consumer price indices are similar to the general price indices. Nevertheless, it should be noted that the 12-month accumulated inflation for the consumer indices is already close to the one observed by the end of 1998. It is estimated – (and this has been confirmed by price indices recorded in July and August) that inflation measured by the major price indices should increase during the third quarter because of the increase in utility fees and fuel prices. However, the government expects this increase in the inflation rate neither expected to propagate, nor to be persistent and nor to alter the downward path of inflation.

The Brazilian economy has already overcome major uncertainties regarding its future since the exchange rate devaluation occurred in January 1999. There are now much better conditions for individual strategy planning, which means gradual output growth, without any inflationary pressure. However, it is important to observe how prices react to a more robust economic recovery, which is expected to happen in the second semester of 1999. Within its inflation target strategy, Central Bank has commited to be aware of any imbalance that threatens that strategy in the period under consideration. This procedure demands rapid and preventive action by the monetary authority.

Government shows a firm commitment to the fiscal austerity plan. public accounts closed the first half of the year with a primary surplus of R$ 13.6 billion (2.9% of gross domestic product), a figure that was R$ 0.7 billion above the amount estimated in the agreement with the International Monetary Fund (IMF). It should be stressed that adequate evolution of the fiscal adjustment is essential for the continuation of the decline in interest rates.

Some risk to the fiscal outlook for 1999 is entailed by recent court challenges to some of the revenue measures enacted earlier this year (notably the increases in the social security contribution of civil servants and the turnover tax). The government is confident that the primary balance target can be achieved even in the event of unfavourable decisions on some of these cases. Moreover, it is fully committed to taking additional measures, as needed, to ensure strict adherence to the primary fiscal target for the year as a whole. The government has also continued to firmly enforce the payment by the states of the service of their restructured debt. This fact, together with the strict limits enacted by the Senate on the states' access to new financing, is promoting a progressive improvement in their primary balance, which is expected to move into a small surplus in 1999. The proposed restructuring of the debt of some municipalities, which is in the process of being approved by the Senate, will also help increase over time the consolidated primary surplus of the municipal sector.

The government is fully committed to sustaining, and indeed strengthening, the fiscal adjustment in the years ahead, in line with the objectives set out in the previous Memorandum of Economic Policies. Specifically, for the year 2000 the primary surplus of the consolidated public sector is targeted at the equivalent of 3¼ percent of GDP. The federal budget proposal for next year, which was submitted to congress in August, is consistent with this objective and the prospects for the finances of the other components of the public sector. Achievement of the primary target in 2000 will be facilitated by the full-year impact of some of the tax and other revenue-raising measures enacted in the course of 1999. On the other hand, the federal government finances will be adversely affected by the disappearance of certain once-off or temporary revenues, and by the elimination of the Fiscal Stabilisation Fund, which will boost constitutionally mandated federal transfers to the states. Therefore, continued spending restraint at all levels of government will be needed to secure the achievement of the targeted primary surplus. For this purpose, the federal government will continue its effort to contain its payroll; the recent legislation regulating the implementation of the constitutional administrative reform will require similar, or even greater, efforts by state and local governments. A moderation of the growth of social security benefits will result from the implementation of the constitutional amendment for the pension reform and from ongoing administrative efforts in this area (see paragraph 15 below). The remaining limited subsidy programs will continue to be contained, and other current and capital spending in the federal budget will also be capped to an overall level consistent with resource availability. Within this limit, the government intends to continue to give priority to expenditures on education, health, and other cost-effective social programs, especially those targeted to vulnerable groups. Priority programs in the 2000 budget will be selected in accordance with the strategy set out in the 4-year Plan, presented to congress at the same time as the budget. The outlook for the public finances in 2000 will be analysed in greater detail in the course of the fourth review of the program later this year.

Progress continues to be made in various areas of structural fiscal reform. Specifically, an important step toward improving fiscal transparency and promoting fiscal sustainability at all levels of government was taken in April 1999, with the submission to congress of a proposed Fiscal Responsibility Law, which is currently expected to be approved before the end of the year. This bill proposes that quantitative limits be set on indebtedness, and on personnel and other current expenditures, excluding entitlements, for federal, state and municipal governments. It also prohibits the use of borrowed resources to finance current spending (the so-called golden rule). Each quantitative limit will have both a maximum permissible value, and a prudential one. The law sets out adjustment rules in the event of excesses over the maximum values, and forbids new borrowing when the prudential limit on indebtedness is exceeded. The proposed law also prohibits further refinancing of debts of one level of government by another. A short transition period is envisaged, to facilitate adjustment by public entities to the requirements of the law. To promote transparency, the law requires each level of government to provide comprehensive and timely financial reports to the next higher level, with the federal government consolidating these reports into a quarterly report on the state of the nation's finances. Finally, the law sets out the principle of individual responsibility of civil servants for its observance, and envisages a system of individual penalties for non-compliance.

Efforts are being stepped up to move forward in the rest of 1999 the proposed comprehensive reform of the present system of indirect taxation. These efforts involve an intensified dialogue with the legislative branch, state and municipal governments, and the private sector, to secure an adequate base of support for a revised proposal to consolidate and streamline most of the existing indirect federal, state and municipal taxes into a national VAT, to be shared among all levels of government, complemented by a retail sales tax with a low rate and by selected excises at the federal and state levels. The proposed reform aims at eliminating the scope for "fiscal wars" among states, reducing evasion, and minimising distortions due to tax cascading. In addition, the government has promised to present shortly a draft law aimed at, among other things, reducing the scope for tax avoidance, and limiting revenue losses from excessive tax litigation.

Following the shift in mid-January 1999 to a flexible exchange rate regime, the priority objective of monetary policy in recent months has been to avoid that the initial boost to prices of traded goods from the depreciation of the *real* would lead to a sustained acceleration of inflation and inflationary expectations. This required a sizeable jump in early March of interest rates from their already high level, which, in conjunction with the other elements of the policy framework, was instrumental in allowing an early correction of the exchange rate overshoot and a rapid decline in the monthly rate of inflation. Since then, the central bank has reduced interest rates in steps, generally following, rather than leading, market expectations, to a level which, when deflated by current indicators of expected inflation, remains somewhat above what the Banco Central do Brasil –BCB (Central Bank of Brazil) regards as an appropriate real interest rate in the present macroeconomic conditions. In reflection of this view, the BCB had kept until July a downward bias, allowing the President of the bank to reduce rates between the regular periodic meetings of the Monetary Policy Committee (COPOM), which is responsible for setting the BCB's intervention rate (SELIC) in the overnight interbank market. However, recent developments have led the BCB to halt the way downward of the interest rate, hanging it at the level of 19,5% in the last two months. The domestic factor which has caused was a newly increase in the inflation rate, as an immediate consequence of rising prices of fuel and utility fees. Externally, one should mention the fear of US Federal Reserve's promoting further increases of interest rate.

All this sounds very good. The sticky commitment of the government to tight fiscal policy deserves endless praise. Yet Brazilian investors, consumers and business leaders still feel insecure and unhappy. The markets are rattled: on August 20th, the *real* fell to almost 2 against the dollar, its lowest level since early March and a 13% fall in three months (though it has since recovered somewhat). And even if things could have been much worse, they are still bad enough: taking annual statistics, for the second successive year the economy is unlikely to show much growth, while living standards are falling. Fairly or not, Brazilians blame this on President Fernando Henrique Cardoso: one recent poll found 59% disapprove of him, and only 12% approve. That has encouraged his opponents. A "March of the 100,000", organised by the left-wing opposition, converged on Brasilia to demand changes in policy, including the renegotiation of Brazil's deal with the International Monetary Fund, job-creation measures and lower interest rates. Mr Cardoso already faces a queue for government handouts that is getting longer and noisier: farmers and state governors are demanding debt relief, truckers want cuts in road tolls and fuel prices; judges and congressmen want pay rises.

The lesson, which may be taken from this picture, is that, while to a macroeconomic standpoint things are going well, the government grows weaker and weaker in terms of political support if the population sees no probability of reaping any benefit from such a policy in the close future. And weak rulers are unlikely to inspire confidence to market.

Maybe the Brazilians would be more patient with their government, if the economy had not stopped growing since the second half of 1997. Some economists hold that, in order to guarantee employment to thousands of youngster that every year start to seek for job for the first time, the GDP should expand at least at the annual rate of 5%. Most of them can feel nothing but hopeless of find any occupation.

The persistent high unemployment rate coupled with the notorious Brazilian sharp income inequality has raised the fear of social unrest. Actually the criminal rate is on the edge of the unbearable, and this obviously has much to do with the economic troubles. So to some extent the opposition is grounded when it often charges that the government neglects the social problems and cares only about the stabilisation. Stabilisation, they argue, is not itself an end, but must be seen as way to prosperity.

That is a mistaken reasoning, since it is hard to devise any policy which effectively leads to sustainable growth, if one is to dismiss monetary and fiscal stability. On the other hand, however, no nation can flourish steadily without a reasonable level of social cohesion. But to solve this problem, the whole Brazilian society must seek for and come to a universal compromise, instead of waiting for the current ruler's initiative. The Brazilian distortions and unfairness has been so long and deeply rooted, that no government by itself is able to conduct such formidable a task, however politically strong it may be.

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