Statement by Balmiki Prasad Singh  
Date of Meeting: May 24, 2001

BRAZIL: (i) Country Assistance Strategy Progress Report, (ii) First Programmatic Financial Sector Adjustment Loan; and (iii) Fiscal and Financial Management Technical Assistance Project

We welcome the discussion on the Brazil CAS Progress Report, the First Programmatic Financial Sector Adjustment Loan and the related Technical Assistance loan. The documents are exhaustive, with a wealth of information and analysis. We compliment staff for a job generally well done. In little over a year and a quarter, this will be the third intensive Board discussion on Brazil – the CAS and Fiscal & Administrative Reform Special Sector Adjustment Loan (US $505 million) in March last year, and the Programmatic Fiscal Reform Structural Adjustment Loan (US $757 million) in January of this year. In fact, we also benefited from the discussion on the very interesting investment loan on land purchase using rural communities as it marked an unusual departure from the traditional approaches to resource redistribution. All these represent a significant opportunity for Brazil to effect structural and far-reaching change.

2. Brazil is at an interesting stage of its development where, while it needs occasional project investment to tackle gaps in physical and social infrastructure, the country and its development partners at the same time should look at the larger, holistic picture. Over the last decade, social indicators have improved significantly backed by considerable progress towards macroeconomic stability. The unfinished agenda has basically two aspects. First, to push the re-distributive and equity aspects especially in rural landholding and secondly, to improve the investment climate so that inclusive, sustained growth is promoted. The present set of proposals addresses the second aspect and deserves our support.

3. There are a few areas that we thought we should draw attention to, to substantiate the reasons for our support and also to express at our unease at what we feel is an inadequate appreciation of the situation. We look at Brazil and the resolution of its problems as setting the way for other countries, who as they grow will face similar challenges, and the way in which the Bank, other MDBs and the Fund collaborate to get over these and other challenges.

4. Brazil’s macro environment is much less volatile. The quick and strong response to the crisis of 1998 led growth to rebound to 4% by 2000, inflation was brought under control (currently at 6%), exports have increased significantly, FDI flows were around US $30 billion for the past two years and are expected to be US $23 billion this year.

5. Despite such achievements, the situation is far from stable, with only a fair chance of sustained
growth. In fact, the Bank team has visualized two options, either a soft or a hard landing. As we had pointed out in our written intervention on the Programmatic Fiscal Reform Structural Adjustment Loan, Brazil's exports are import intensive, and its terms of trade have moved adversely (by around 17-18%) since the currency was unpegged. The current account deficit was brought under control by an import squeeze. As the economy rebounded and exports surged, after a time lag, imports have picked up significantly. This now poses significant risks to not just the strength of the currency, but also to the fiscal situation and ultimately to growth.

6. The hike in interest rates by the Central Bank in March is a response to this risk. Traditionally, Brazilian real interest rates have been high. It was hoped that with its newly acquired stability, fiscal surplus and reduction in public debt, interest rates would come down. This is essential to promote sustained and widespread growth. To quote the main loan document in paragraph 20 on page 7 "the impact of interest rates on growth in Brazil has been statistically significant, as well as the impact of growth on poverty reduction". Further that "declines in interest rates will play a fundamental role in raising growth and increasing the speed of poverty reduction". Over the last two years, rates had declined. The reversal in March risks sacrificing the recent gains. Unfortunately neither the CAS Progress Report nor the Loan document have analyzed this. Paragraph 94 of the Loan document, which goes into the alternative possibilities of a hard/soft landing and refers to the effects of what it hopes would be temporary increase in interest rates, seems out of sync with the rest of the analysis. Possibly it was added on as a reaction to the action of the Central Bank. We would like staff to spell out more clearly how they visualize the impact of the tightening of interest rates on the economy as a whole, and on poverty reduction more specifically.

7. The limited depth and breadth of the financial markets are unusual for an economy as developed and sophisticated as Brazil. For a typical Brazilian company's finances, capital markets contribute 3-4 percent, commercial banks finance 14 percent and internal resources account for 72 percent. Such features in the market economy highlight the inadequacy of both the banking sector and capital markets. It is only appropriate that the Bank should be so closely involved with the country in its efforts to modernize its financial sector. The series of adjustment operations probably is the best way to go about it. No doubt some of our Board colleagues, particularly from Part I countries are a little uncomfortable with single tranche operations since it deprives the Board of effective monitoring. These doubts were raised at the time of the Country Assistance Strategy discussions last year and again in January when we discussed the Programmatic Fiscal Reform Structural Adjustment Loan. The management has done well to clearly delineate a roadmap against which progress is to be judged and future loans decided. Whilst this is appropriate and clearly enhances monitoring, we feel that the roadmap itself is unambitious and in some cases there seems to be a lack of link between activities and objectives. For example, while broadening the access of the poor and unserved to the banking sector is a priority activity, steps to do so involve mostly surveys of actual coverage (Table I on page 28). No doubt the latter is a useful activity but clearly not adequate to meet the objectives. We understand that there are sensitivities involved, since the development strategy has to be owned by the country, yet through the medium of AAA and ESW, could these not have been made more focused and effective?

8. We would also be watching with interest how the regulatory regime develops in Brazil. It is unusual to have so many different independent regulators in dealing with different aspects of the financial market. While the independent regulatory regime is essential to insulate investment decisions from political pulls and pressures, the existence of different regulators having varying competencies may not be the best possible solution. The documents are a little unclear on how this has happened. On the one hand we are informed that under Article 192 of the Constitution of 1988, there should be a single enabling law for the entire financial sector and on the other, these regulatory regimes have come
up in a piecemeal manner. Staff may like to elaborate.

9. We do feel that the Bank's financial involvement with the country is quite modest as compared to the needs of the country and the value addition that can come from the Bank's involvement. To elaborate, we are informed by the present set of documents that this year, Brazil's current account deficit will be in the region of $27 billion, its debt amortization would be around $29 billion, and the Government's lending program is placed at $15 billion. The FDI flows are estimated at $23 billion and fund flows from multilateral at $5 billion. In this situation, the $400 million being advanced through the present loan seems quite inadequate. No doubt it is for the sovereign government to decide as to how much it would like to borrow from any development agency/financial institution. Still, in the context of these financial requirements, the Bank's contribution seems short of even strategic, even keeping in mind the country exposure limits. We would like further elaboration on this.

10. In conclusion, we support the present proposals and would be watching with great interest how the financial sector of Brazil evolves and what exactly would be the role of the Bank in this process.