I wish to thank staff for this progress report, which provides an excellent update on the main macroeconomic developments in Brazil and on the CAS implementation. The report has been discussed with the government authorities who are in broad agreement with the analysis.

This year will be Brazil’s sixth consecutive year of growth in per capita income and the fifth consecutive year of reduction in inflation, as a result of the implementation of the Real Plan.

The most important change that has happened since the CAS was discussed last year has been the impact of the Southeast Asian financial crisis on Brazil. This has been the second international crisis that has occurred since the launch of the Real Plan. As in the case of the 1994 Mexican crisis, the government has reacted quickly and forcefully and managed to avoid the risks of contagion. In October last year, the government used US$ 8 billion of international reserves to defend the exchange rate and doubled interest rates. In November the government announced a fiscal package which should yield a fiscal gain of US$ 18 billion in revenue increases and expenditure cuts. Social expenditures, however, have been protected from cuts.

These measures were successful in maintaining investor confidence and in avoiding contagion. International reserves recovered and now substantially exceed pre-crisis level, standing at US$ 75 billion, equivalent to 12 months of imports and to 1.95 times the short-term foreign debt. Foreign direct investment remained unabated and provided financing for about half of the current account deficit. The current account deficit, on the other hand, has declined from 4.1% of GDP last year to 3.2% of GDP in the first quarter of this year.

But the measures adopted also had a short-term cost in terms of level of economic activity and fiscal results. The higher interest rate meant additional interest payments, additional primary
expenditures such as unemployment benefits and lower fiscal revenues as a result of a slowdown of economic activity. As the lags in fiscal policy tend to be longer than lags in monetary policy, we are now in a situation where the short-term adverse fiscal effects of the monetary measures have already been felt, while the positive effects of the fiscal measures have not yet fully worked themselves out.

The Brazilian government attaches the utmost priority for improving the fiscal stance and is actively pursuing this objective in a number of areas. The need for temporary increase in interest rates, the goal of preserving social spending, and the constraints posed by a highly decentralized federal system where half of total public expenditure is made by sub-national governments do create difficulties. But the government is confident that the medium term prospects for strengthening the fiscal position are favorable. Interest rates have been gradually reduced since January and now approach their pre-crisis level. The Congress has finally approved the public administration constitutional reform. The social security constitutional reform is in its final stages of consideration. Both reforms will have a significant positive fiscal impact from next year.

As mentioned in the report, the government has achieved very good results in financial sector reform and in the privatization program. The financial sector reform started in early 1995 and has led to important restructuring through merges, closures, capitalization, and entry of foreign banks, to improved prudential regulation, strengthened supervision, and privatization of federal and state banks. It has been an important advantage in the context of the Asian crisis.

Privatization revenues in 1997 have been higher than the total collected from 1990 to 1996, representing around 3% of GDP last year alone. Privatization revenues equivalent 2% of GDP have been used to reduce public debt, been instrumental in reducing by one third the impact of the fiscal deficit on the net debt of the public sector. Additional progress is expected in the current year with the privatization of the telecommunication holding Telebrás.

The strategy and objectives of the CAS for the Bank, IFC and MIGA remain valid and appropriate for the current conditions. The improvement in portfolio performance, with a reduction in the share of unsatisfactory projects down to 5.2 per cent compared to the target of 20 per cent, the reduction in the number of problem projects to two and the acceleration of disbursements are encouraging. In this connection, the government is very pleased with the results of decentralization, which led the Bank to be closer and more responsive.