1. This is a critical period for Brazil. Substantial economic progress has been made since the introduction of the Real Plan in mid-1994; hyper-inflation (the harshest tax on the poor) has been tamed, and economic reform is taking root throughout the economy. Under the government’s development strategy, Brazil is clearly becoming a more outward-looking and more efficient economy. At the same time, progress on reforms has not been uniform and formidable development challenges must still be overcome before Brazil can achieve a sustainable growth path commensurate with its enormous potential. Many of these challenges stem from the complex economic and political relationships within states and between states and the federal government.

2. We are seriously concerned by the serious risks -- noted in the CAS -- which Brazil’s large fiscal and current account deficits currently pose to continued progress on stability and reform. The attention the Government is giving to addressing the long-standing problem of excessive fiscal imbalances is encouraging, but the scale of needed adjustment -- at both the state and federal level -- is formidable and will require sustained and aggressive action. This includes reforming the overly generous public sector pay, pension and other benefits system with its perverse implications for the poor. The scale of the current account deficit -- now expected to be between $30-39 billion this year -- also underscores the importance of vigorous efforts to increase economic efficiency and competitiveness. As the CAS warns, fiscal and current account imbalances imply a period of increased vulnerability to external and domestic shocks.

3. We commend staff for the quality of the CAS presentation and particularly applaud the effort to integrate IBRD and IFC priorities. In a country as large and diverse as Brazil, it is particularly important to establish clear Bank priorities and, as noted in the CAS, to maximize the Bank’s catalytic role. We believe the CAS does a good job in setting broad priorities, and that the inter-related focus on growth and stability, and social sector development is appropriate. While the Assistance Strategy Matrix provides considerable detail on future Bank lending, the priority and sequencing of individual projects does not appear as transparent as in other CASs -- perhaps a reflection of the complexities of Brazil’s development challenges and the uncertainties on both the pace of reform and evolving state/federal relationships. The
extensive ESW Work Program should also help to sharpen and strengthen the effectiveness of Bank Group's development agenda. It is nevertheless very clear that the Bank's ability to provide the envisioned level of support will be contingent on federal and state government efforts to sustain reform efforts and maintain an economic environment where Bank support can be used effectively.

4. We strongly support the emphasis both the Government's program and the CAS place on social development, and on the disadvantaged North East. High rural and urban poverty levels and the very wide income disparities within and among states is a matter of serious concern. Poverty reduction must be front and center of the Bank's policy and operational agenda. We agree with the CAS on the importance of achieving greater sustainability in poverty projects and the need to increasingly target development of the poor in project design. Much greater efforts are required to remove the economic distortions which disadvantage the poor. As noted in the 1995 Poverty Assessment, there is also considerable scope for improving the allocation of social spending to better reach poverty populations.

5. While the Bank's social development agenda is likely to substantially benefit Brazilian girls and women, the lack of a specific CAS focus on gender considerations is a serious concern. The Bank must integrate gender concerns into both policy dialogue and program design, and we have a long way to go in this area. We would appreciate staff comment on the gender dimensions of the Brazil program.

6. We fully endorse the major thrust the CAS places on support for education, and the proposed Bank partnership with the Government in achieving universal completion of primary education by the year 2007. It will now be important for the Bank to develop sound conditionalities at the individual project level. It will also be essential for the Government to demonstrate its commitment to this objective by ensuring adequate budgetary resources for primary education.

7. We are specifically concerned that unless action is taken to reduce the disproportionately high level of spending for university education — currently accounting for about 75 percent of the Government's education budget — it will be difficult to secure the necessary budget resources for primary education. As long as there is close to a 100 percent subsidy to university (and largely middle- and upper-class) students, efforts to expand and improve the quality of primary education are likely to be significantly underfunded. While we understand the political sensitivity of this issue, state and federal governments must move proactively to take advantage of all opportunities for reallocating funding to more accurately reflect the true cost of higher education.

8. We also note the important role played by land reform in addressing rural poverty. We hope that the Bank's experience with the innovative pilot land reform project which we approved in April will establish a sound foundation for identifying new opportunities for accelerating Brazil's land reform program.

9. We strongly support Bank efforts to improve environmental sustainability. The emphasis on improving the implementation performance of existing operations is well placed. We also hope that ESW provides expanded opportunities for new Bank operations. In particular, we believe the Bank should play a key role in helping to strengthen Brazil's
institutional capacity for more effective federal and state environmental protection. Brazil's ambitious infrastructure plans will inevitably pose additional serious challenges to the environment and it is vital that Brazil have the capacity to address these challenges in an environmentally sustainable way. At the same time, we do have some concerns on decentralizing environmental responsibilities to the states; a key uncertainty being the mixed record of some state governments in this area. Staff comments on efforts to help strengthen Brazil's management capacity would be appreciated.

10. Brazil is one of the IFC's largest clients, and we welcome the planned support for Brazil's banking sector and the increased focus on second-tier companies and small and medium-scale enterprises. We are also pleased to note the IFC will be increasing its support for the North East.

11. As colleagues know, our authorities have a number of serious concerns regarding sub-national lending. The weak borrower ownership and poor implementation capacity which have often affected the Bank's overall sub-national portfolio provides ample grounds for caution. We therefore thank Management for the Approach Paper circulated yesterday which describes some of the issues raised by the increased demand for Bank lending in support of state and provincial reform. This week's very useful CODE discussion of the Joint Brazil/World Bank Commission Report also flagged the importance of determining how lending to states impacts on the Bank's poverty focus. We look forward to follow-up discussions in CODE and elsewhere on these important topics. With regard to Brazil, we believe that any lending to states should be highly selective, with the focus on the poorer, less developed states strongly committed to reform, and that this commitment and a capacity to reform must be monitored very closely. As is the case with all lending, good performance on existing portfolio should be a pre-condition for access to new lending.