BRAZIL

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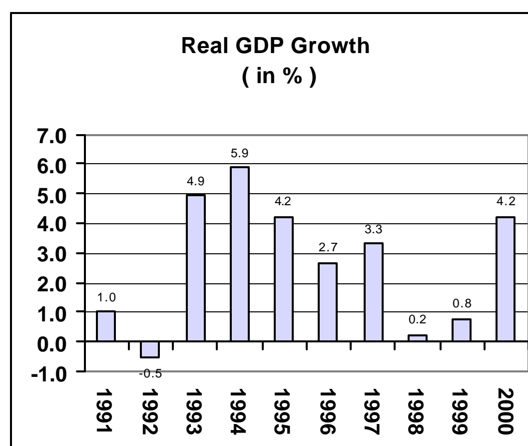
Recent Developments

In late 1999, Brazil began a gradual recovery from the effects of the deep recession that was triggered by the Asian crisis and Russian moratorium. This recovery gathered increasing momentum throughout 2000, despite the increasing signs of financial volatility in the U.S. economy, the sharp hike of petroleum prices and the mounting economic uncertainty in neighboring Argentina. The salient features of this upturn were rising output and employment, substantial progress towards a fiscal adjustment, and gradually decelerating rates of inflation. The major problem area remained the trade balance, which registered generally disappointing results, subsequent to the January 15th, 1999 decision to free the exchange rate. Taken together, however, Brazil's economic performance during 2000 positively impacted investor confidence and also the nation's medium-term prospects. The continuing surge in foreign direct investment, higher rates of capital formation, and several upgrades in Brazil's foreign currency bonds support this assessment.

With respect to output, real GDP rose 4.2 percent in 2000, its largest increase in five years. The most rapid growth was achieved by the secondary sectors, whose combined value added jumped 4.8 percent. This surge was led by manufacturing, whose output expanded by 6.5 percent, the highest growth since 1994. In part, this was a consequence of the hike in production for export markets that resulted from exchange rates that were not only more competitive but also which remained extremely stable throughout the year. Most of the recovery in manufacturing output, however, was attributable to bank lending rates, which declined substantially in real terms during 2000. This decline, coupled with the rapid expansion of credit, was sufficient to ignite a steady increase in demand for a widening variety of capital goods and consumer durables. The rise in demand especially benefited the key automotive sector, which accounts for 10 percent of Brazil's manufacturing output. By year-end, automobile production rose 23.2 percent to 1.67 million vehicles, the largest increase since 1994.

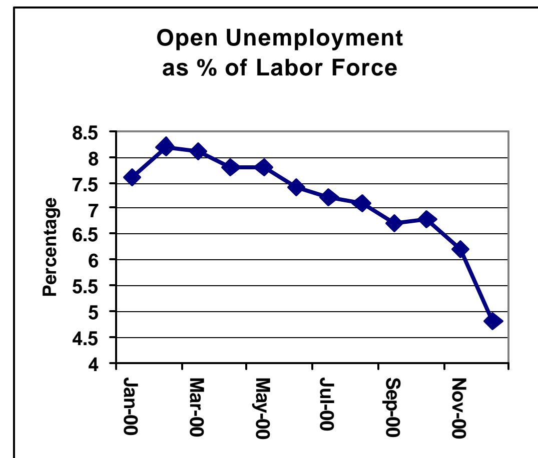


Real value added by the tertiary sectors, which accounts for about one-half of Brazil's GDP, expanded 3.6 percent during 2000, up from the 2 percent increase in the previous year. For the most part, this reflected the buoyant performance of the communications sector, which recorded strong growth for the second consecutive year due largely to the rapid expansion of the telephone network and the implementation of large privatization-related investments. Commerce also rebounded strongly from the 1999 recession, as retail sales

accelerated during the final months of 2000. This outcome, in turn, was mostly due to the growth of employment and the gradual upturn in aggregate purchasing power. Finally, agricultural output growth slowed to 2.9 percent, owing to weather related problems in Brazil's southern states.

Notwithstanding the acceleration of economic activity during 2000, the open unemployment rate averaged an almost constant 7.9 percent of the labor force during the first five months of the year, a result that was unchanged from the l999 annual average. The explanation of this apparent paradox is that large numbers of previously discouraged workers returned to the labor force as active job seekers, due to the improved prospects for obtaining employment. By mid-year however, much of this pool of previously discouraged workers had been absorbed. This enabled the unemployment rate to begin declining. By December 2000, the monthly unemployment rate had plummeted to 4.8 percent, while the yearly average fell to 7.1 percent, its lowest level in three years.

Of even greater importance, however, is that, after a decade of virtual stagnation, some 765,000 new jobs were created during 2000. Moreover, the quality of jobs created improved, since nearly half of the increase (364,000) occurred in the formal sectors of the economy, i.e. among officially registered workers (*trabalhadores com carteira*). This gain much more than offset the loss of 195,000 formal sector jobs during the 1995-99 period, when job creation was overwhelmingly concentrated in the informal sectors as Brazil lost external competitiveness and was increasingly impacted by the Asian financial crisis and the recession which ensued.



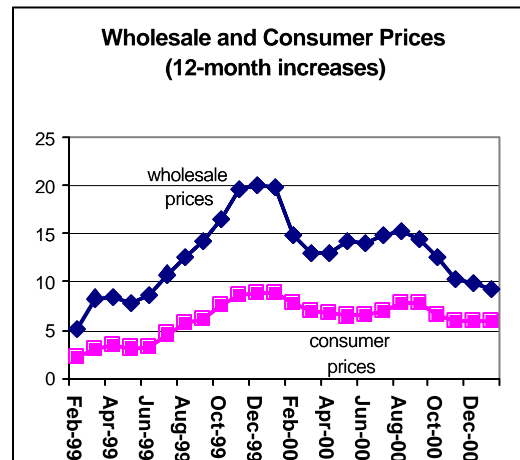
The positive employment trends, however, were not translated into significant wage gains. On the contrary, average real wages in Brazil's major metropolitan areas declined 0.4 percent for the 12 months through October. In part, this was an inevitable consequence of the previous year's devaluation on real wages. It also reflected the fact, however, that the recovery in activity levels occurred only gradually. Nevertheless, available data suggest that this situation began to change at year-end, especially since interest rates continued their downward trajectory and confidence in the sustainability of the economic recovery became more firmly entrenched. These trends were clearly mirrored by the fact that many of the seasonal workers that are normally hired in December and then dismissed in January were being retained in 2001 and, in many cases, being given permanent contracts.

With the January 1999 devaluation, Brazil faced the challenge of maintaining price stability without the assistance of an exchange rate anchor. However, due largely to the opening of

the economy that began a decade earlier and the elimination of monetary correction mechanisms after mid-1994, the nation was able to absorb the initial impact of the devaluation with comparative ease. This success was revealed by wholesale prices (measured by the IGP-DI) and consumer prices (measured by the IPCA), which recorded increases through December 1999 of 20 percent and 8.9 percent, respectively–both well below the initial expectations of most analysts.

Inflationary pressures continued to abate during 2000, as the growth of wholesale prices slowed to 9.8 percent, while that of consumer prices declined to 5.9 percent. Moreover, this deceleration occurred despite rising activity levels and significant price adjustments for petroleum and public transportation that were implemented throughout the year. Food prices also rose substantially during June and July, due partially to freezes in Brazil's southern states and the fact that the aforementioned months correspond to the period between agricultural harvests. A second bout of pressure on food prices occurred in November, when the wheat and corn harvests were again affected by frost and drought. Perhaps the principal source of pressure on the price level during 2000, however, resulted from higher petroleum prices, which reached their highest level in 10 years in September and continued to rise before peaking in mid-November, when the price of oil reached US$35 per barrel.

The deceleration of inflationary pressures during 2000 was extremely important for two reasons. First, it reveals that the economy is developing an increasing ability to absorb temporary price shocks, without producing lasting effects on the price level or perpetuating inflationary expectations. These were precisely the problems that progressively crippled the nation's growth performance after the early 1970s, when Brazil's economy became fully indexed. Also, the second consecutive year, the nation was able to achieve the inflation target, which it had agreed to with the IMF (8 percent in 1999 and 6 percent in 2000). This fact did much to enhance the credibility and growing confidence in the quality of Brazil's monetary policy and overall macroeconomic management.



With respect to the balance of payments, recent trends have been mixed. In 1999, for instance, exports declined 6.1% in value to US$48 billion, notwithstanding the rapid growth in volume that followed the January devaluation. This result largely reflected the fact that the devaluation was implemented in the context of severe contraction of international trade in Latin America (especially MERCOSUR), while at the same time, prices for Brazil's key primary commodity exports plummeted. Imports decreased even more sharply, however, falling almost 15 percent to

US$49.2 billion, owing to the effects of devaluation and Brazil's recession during most of the year. As a result, the nation's trade balance, despite declining US$5.4 billion, still closed the year with a US$1.2 billion deficit, considerably less than the US$3.5 billion surplus that had been projected earlier.

With respect to 2000, however, these trends changed in several fundamental respects. Merchandise exports, for example, jumped 14.7 percent, rising US$7.1 billion to $55.1 billion. Much of this increase was attributable to the vigorous recovery in sales of manufactured goods to the U.S. and Latin America, especially to non-MERCOSUR nations. The increase in exports of manufactured goods was essential for offsetting the continued lackluster performance of key primary commodities and semi-processed goods such as poultry, coffee, soybean oil, sugar and orange juice, all of which fell in value terms. These declines were most pronounced in Asia and Europe. In the case of Asia, this reflected the slow pace of economic recovery and, in the case of Europe, the fact that the *euro* depreciated heavily against the US dollar throughout the year.

At the same time, imports, after their sharp decline in 1999, also rebounded, rising 13.2 percent to US$55.8 billion in 2000. In part, this surge was an expected consequence of Brazil's economic recovery, especially the increased demand for raw materials and intermediate and capital goods. In the latter two areas, it was particularly evident that imports would rise, since limited capacity existed for expanding domestic production, even prior to the recovery. A second, more specific factor stemmed for the telecommunications sector's voracious demand for imports of semiconductors and related high value items, most of which are not produced in Brazil. The third and most important factor underlying the US$6.5 billion growth of imports during 2000 was the hike in world oil prices, which caused Brazil's purchases of crude petroleum and derivatives to jump from US$4.8 billion in 1999 to nearly US$7 billion.

As a result of these trends, Brazil's trade deficit narrowed to $698 million during 2000, equivalent to nearly half the previous year's level, but substantially less than the US$3 billion surplus that had been projected earlier in the year. At the same time, however, the service imbalance also declined fractionally, falling US$123 million to US$25.7 billion. This outcome was largely attributable to a US$500 million reduction in profit remittances and a small decrease in interest payments, which more than offset increased outlays for travel and transportation. Taken together, the reductions in the merchandise trade deficit and service imbalance produced a modest decline in the current account deficit, which decreased from US$25.1 billion in 1999 to US$24.6 billion (4.2 percent of GDP) in 2000.

As was the case in 1999, however, the current account deficit was more than financed by the continued surge in foreign direct investment, which reached US$30 billion for the second consecutive year. Again, this massive inflow not only reflected mounting confidence in Brazil's medium-term prospects but also excellent opportunities for investors in such areas

as telecommunications, banking, energy and gas.

Finally, Brazil's external debt, which had risen sharply during 1997-98 when the Asian crisis erupted and the exchange rate was overvalued, stabilized at around US$240 billion in 1999, equivalent to 46.5 percent of GDP. This outcome was facilitated by the fact that large amounts of short-term debt were amortized. For 2000, these same trends largely continued as Brazil's external debt declined to US$231 billion through November 2000, a result that was aided by the decision to prepay a substantial part of the US$41.5 billion emergency financing package that had been mobilized in late 1998.

Specifically, on April 12, 2000, the authorities amortized US$10.3 billion in principal and interest payments that were due in June and October. Including this prepayment, Brazil had repaid US$18.2 billion of the US$20.1 billion obtained from the IMF, the BIS and the Bank of Japan. The total amount borrowed from these institutions was US$32 billion, of which US$12 billion was not utilized. From the total financing package, Brazil still owes US$1.8 billion in low interest loans to the IMF, which are due in quarterly installments beginning in March 2002. The remaining US$9 billion in outstanding liabilities corresponded to fast disbursing loans obtained from the IDB and the World Bank to provide support to basic reforms and priority social programs.

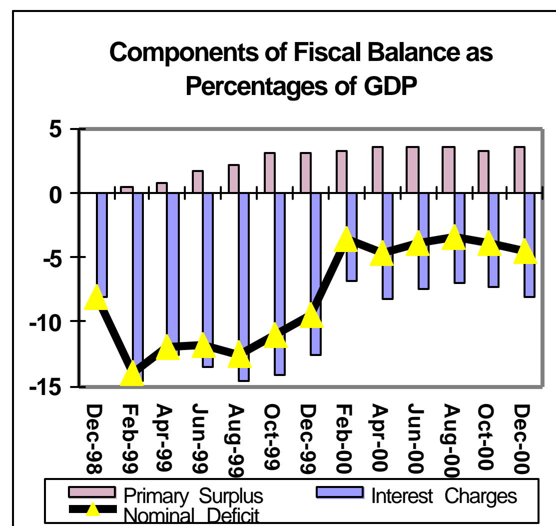
As a result of the prepayment, Brazil's net international reserves immediately fell from US$34.8 billion on April 11, 2000 (equivalent to eight months of import coverage) to US$28.8 billion on April 12 (equivalent to seven months of import coverage). This drop was not a source of concern, however, since the authorities considered the reserve requirements for a flexible exchange rate regime to be considerably less than for the previous crawling peg regime. The IMF also supported this judgement by requiring that Brazil maintain a floor of US$25 billion. At the same time, the IMF softened the nation's reserve requirement from a "performance criterion," which is binding, to an indicative target, which is not. These changes posed no difficulties, since by year-end the indicative target for international reserves was easily surpassed, as Brazil's reserves recovered by US$4.2 billion between April 12, 2000 and December 31, 2000 to reach US$33 billion, equivalent to eight months of imports. Among other factors, the drop in interest rates and the improved ratings on the nation's sovereign debt facilitated this result.

A major factor underlying the renewed confidence in Brazil's economy during 2000 stemmed from the authorities' continued commitment to achieving a satisfactory fiscal adjustment and complying with the IMF Stand-by accord, which was approved in November 1998. The authorities focused particular attention on achieving the targets for the primary surplus, which excludes interest charges. In this regard, highly satisfactory results were obtained, as Brazil achieved a primary surplus of R$38.2 billion by year-end 2000, equivalent to 3.6 percent of GDP, up from R$31.1 billion and 3.1 percent of GDP in the preceding year. This improvement in the primary surplus, which exceeded the IMF's target for 2000 by R$1.4 billion, largely reflected

rate increases for several key levies and continued tight control over expenditures.

In the case of accrued interest charges, less satisfactory progress was achieved. It should be noted that in 1999, interest charges had skyrocketed to a 13.6 percent average of GDP, more than double the average of the preceding year. This reflected the fact that around 20 percent of the Federal Government's securitized debt was dollar-linked and, thus, immediately impacted by the devaluation. By late in the year, however, the fiscal cost of the devaluation was rapidly absorbed. This was attributable to the relatively short-maturity structure of government debt instruments, the appreciation of the *real* in mid-1999 and especially the drop in "overnight" interest rates, which correspond to the rate at which the Government finances about 60 percent of its debt obligations.

As a result of these factors, accrued interest charges plummeted from 12.6 percent of GDP in December 1999 to 6.9 percent of GDP in February 2000, their lowest level in 18 months. During the rest of 2000, however, this trend was reversed as interest charges rose in small monthly increments, reaching 8.1 percent of GDP by year-end. This upturn largely reflected the uneven impact of trends in "overnight" interest rates and the exchange rate on interest charges. With respect to former, "overnight" interest rates continued to decline throughout 2000, a fact which tended to reduce debt-servicing requirements. However, the decline occurred at a much slower pace than in the previous year. In the case of exchange rates, the *real* devalued by only seven percent in nominal terms during the year. However, the bulk of this increase was concentrated in the second half of the year, when the economic situation in neighboring Argentina became increasingly unsettled. As happened in 1999, the renewed weakening of the *real* immediately impacted the stock of securitized debt, since the share of dollar-linked debt obligations remained essentially unchanged at around 20 percent. In short, the negative impact of devaluation more than offset the reduction of interest rates, thereby causing interest charges to slowly rise after February 2000. Taken together, however, the rise in the primary surplus approximately equaled the increase in interest charges. This produced a relatively stable nominal deficit equivalent to 4.6 percent of GDP in December 2000, unchanged from the level in January, but still the lowest level in years.



Economic Policy

With the January 1999 devaluation, it became evident that Brazil could no longer rely upon an exchange rate

anchor to maintain price stability. For this purpose, a new nominal anchor was clearly required. Toward this end, the authorities undertook an intense research effort, which concluded that an inflation-targeting framework would be the best suited for preserving price stabilization under the new floating exchange rate regime, with the inflation targets themselves assuming the role of the nominal anchor.

Formally adopted in June 1999, the new policy framework faced difficult hurdles. The most important was to meet the stringent targets that had been fixed (8 percent for 1999 and 6 percent for 2000). As indicated, however, Brazil achieved the targets for both years. This was a remarkable accomplishment, especially given the initial technical difficulties posed by the implementation of the new policy framework and also by the large number of exogenous price shocks that had to be dealt as well as the growing crisis in Argentina. As indicated earlier, the nation's success in meeting the targets was facilitated by the reduction of tariffs after 1990 and the substantial progress that had been achieved in de-indexing the economy after 1994.

In addition to complying with the 6 percent inflation target for 2000, the authorities also succeeded in lowering market interest rates. Achieving this second major objective of economic policy, however, was not an easy matter. A critical problem in this regard is that the level of "overnight" rates, in addition to being vitally important to Federal Government's debt servicing obligations, also serves as a floor for the level of market interest rates. The latter, however, have not only remained substantially higher but, until recently, did not decline as the same pace as the "overnight" rates. In part, these difficulties reflected the fact that much of the credit extended to enterprises and especially consumers before the Asian crisis was affected by arrears problems during the 1998-99 recession. These problems caused the banks to raise cut back on lending to the private sector and concentrate on relatively riskless, high-yield government securities.

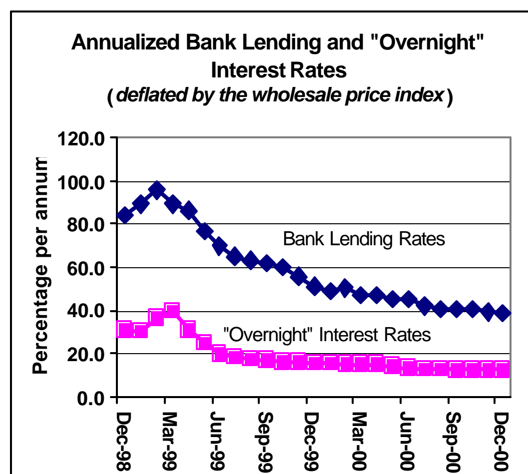
Concerned with the fact that the high level of market interest rates was posing a major obstacle to Brazil's return to a path of sustained economic growth, the authorities began taking a series of measures to lower market rates and increase the supply of credit. In September 1999, for instance, reserve requirements for demand deposits and time deposits were lowered from 75 percent to 65 percent and from 20 percent to 10 percent, respectively. Subsequently, during 2000, additional reductions in the reserve requirements on demand deposits were implemented, first to 55 percent in March, and then to 45 percent in early June. Also, in 2000, the long-term interest rate charged by the National Economic and Social Development Bank (BNDES) was lowered from 12 percent early in the year to 9.75 percent in October. Finally, in November 2000, the Central Bank took additional measures aimed at the creation of a system of credit derivatives, the improvement of guarantee instruments in credit operations and the reduction of the costs of financial transactions.

By year-end 2000, encouraging progress had been achieved. The "overnight" rate, for instance, declined from 19 percent in early January to 15.75 percent at year-end. Subsequently, in January,

2001, an additional cut was implemented by the Central Bank's Monetary Council (COPOM), which lowered the "overnight" rate to 15.25 percent, or 2.6 percentage points less than it was when it was created by the Central Bank in January 1986. Despite this, the authorities were unable to reduce the "overnight" rate during 2000 as rapidly as they wished. However, this was more of a consequence of mounting preoccupation with developments in Argentina, than concerns about Brazil's economic policies. Moreover, because of the growing confidence in monetary policy and the ebbing of inflationary pressures, the exchange rate remained remarkably stable at R$1.83 per U.S. dollar, almost unchanged from the previous year.

At the same time, by virtue of its role as the floor interest rate in Brazilian financial markets, the successive reductions in "overnight" rates during 2000 also began to impact market interest rates. This became increasingly evident during the last quarter of the year, when the effect of each reduction was bolstered by the strengthening economic recovery. These mutually reinforcing trends, coupled with the measures mentioned above to lower reserve requirements, facilitated a more rapid expansion of credit and, of particular importance, steady decreases in bank lending rates.

By year-end 2000, for instance, bank-lending rates to businesses had declined to 26.8 percent in real terms, down from 41 percent from a year earlier. In the case of consumer credit, real interest rates remained considerably higher at 50.4 percent; owing largely to the fact that consumers accounted for most of the accumulation of arrears during the 1998-99 recession.



In addition to the need to lower interest rates, the credibility of the new inflation-targeting policy framework required the prudent management of the public finances. As indicated, however, this has already constituted one of the major objectives of Brazil's economic policies since November 1998, when the current Stand-by with the IMF was signed. In this regard, an important problem that confronted the Federal Government during early 2000 was an expected decrease in collections from extraordinary sources of revenue such as payments of back-taxes and fines, which, in 1999, had accounted for 2.2 percent of GDP.

To deal with this projected shortfall, the authorities increased the rates on several key levies. The first was the Tax on Financial Transactions (the CPMF or "check tax"), whose rate was hiked from 0.3 percent to 0.38 percent; a measure that enabled receipts to nearly double to 1.4 percent of GDP during 2000. Similarly, the rate for Cofins, one of Brazil's most important labor charges, whose proceeds are used to finance social security and priority social

programs, was raised from 2 percent to 3 percent, thereby enabling collections to rise by almost one half a percentage point to 3.8 percent of GDP in 2000. These measures, coupled with various other minor changes in legislation, offset the decline in extraordinary receipts, which fell to 1 percent of GDP, as well as from several other levies such as the personal income tax and the tax on industrial products. This permitted total net revenues of the National Treasury to remain unchanged from 1999 at 18.3 percent of GDP.

With respect to expenditures, strict austerity was maintained in accordance with the commitments established in the IMF accord. Meeting this challenge was not easy, since cuts were required in various categories of outlays in order to accommodate a hike in the minimum wage in May that increased both the government's wage bill and pension outlays. Moreover, the authorities had to resist pressures to expand outlays prior to nationwide elections for mayors that were held in October. These efforts were largely successful, however, as total outlays remained almost unchanged from their 1999 level of 16.3 percent of GDP. Taken together, these trends in revenues and expenditures enabled the Federal Government to record a primary surplus equivalent to 2 percent of GDP by year-end 2000. This was only fractionally lower than the 2.1 percent of GDP level that was recorded in 1999 and also equal to two-thirds of the primary surplus recorded by the entire public sector.

Despite these generally satisfactory results, several fiscal policy issues acquired increasing importance during 2000. First, much of Brazil's fiscal adjustment since late 1998 has been in the form of higher revenues from temporary levies, most of which will expire over the next several years. Although this fact points to the need for comprehensive tax reform, the various proposals under consideration became increasingly bogged down during 2000, due to the lack of political consensus. The issue is complex, since the present "patch-work" tax mechanism has proved to be highly effective in mobilizing the tax revenue required to meet the nation's sizeable budgetary obligations.

The reluctance in making major changes to the existing tax mechanism is illustrated by Brazil's principal labor charges (e.g. the FGTS and Cofins), which mobilize large amounts of revenue and are directly collected by firms and through employee contributions. A similar situation occurs in the case of the CPMF, which, despite its regressive nature, also generates large amounts of revenue and is collected automatically by the banks, at nearly zero cost to the central government. An additional feature of the CPMF is that it provides a convenient means to investigate tax evasion by permitting an individual's transactions through the financial system to be compared with the amounts declared (or not reported) on income tax returns.

Partially because of the large discrepancies that have been uncovered through the CPMF and the need to obtain additional sources of revenue for the 2001 federal budget, the government announced an innovative proposal on November 1, 2000 to alter long-standing legislation protecting the confidentiality of individual bank accounts. Specifically, the new measure obliges

suspected tax evaders to open their banking accounts to examination, without regard to confidentiality or a prior judicial order. Although the new law is being challenged in the courts, the government is optimistic that it will be upheld. This is because there is a growing public consensus that such a measure could not only generate substantial amounts of revenue but also foster an improvement in income distribution and strike a major blow at organized crime.

Another continuing policy issue for the public finances during 2000 was the uneven pace of reform on the nation's social security system, which recorded a total deficit equivalent to 4.6 percent of GDP in 1999. In the case of the private sector regime, which encompasses the great majority of covered workers, it should be noted that some progress is being achieved. In 1999, for instance, the private sector regime recorded a deficit of R$9.4 billion, equivalent to only 1.0 percent of GDP. Although this imbalance widened to R$10.1 billion in 2000, it dropped fractionally as a share of GDP to 0.9 percent.

Despite the fact that the deficit grew in absolute terms during 2000, its small decrease in relation to GDP was nevertheless encouraging, since it marked the first such decline in years. In part, this result was attributable to the faster rate of economic growth during 2000, which boosted contributions, primarily through the growth of employment in the formal sectors. However, it was also a consequence of recent revisions to existing legislation, which, by progressively linking the size of pensions received to worker contributions, are resulting in fewer applications for retirement. By 2000, for instance, the number of monthly pension applications based on length of service declined to 9,557, down from 24,821 in 1998, while over the same period the average age for retirement rose 5.7 years to 54.5 years.

The improving performance of the private sector regime during 2000 also reflected other important legal changes. Among others, these modifications: obligate outsourcing firms to deduct 11% from their employee's paychecks; require states and municipalities to remain current with their social security collections; establish provisions for labor courts to collect debts in indemnity cases, rather than just reporting them to the social security system; and require that companies contesting social security debts in court, deposit 30 percent of the amount claimed up front. Taken together, these new measures generated R$3.7 billion in additional revenue for the system during 2000, an amount that is expected to rise rapidly over the near-term.

The major challenge for reform of the social security system, however, concerns the regime for the public sector. This regime, which covers only 2.2 million of the nation's 20.3 million retirees, accounted for nearly 80 percent of the system's total deficit of 4.6 percent of GDP in 1999. In this regard, the most salient problem is that the contributions made by civil servants are extremely small (and often made for short periods of time), compared with the size of the pensions received. These payments represent an especially heavy burden in such states as São Paulo, Rio de Janeiro, Rio Grande do Sul. Progress in reforming the public sector regime,

however, has been difficult due the well-organized political opposition.

With respect to its external sector policies, Brazil attempted to maintain an open dialogue with its MERCOSUR partners during 2000. However, progress was limited, especially with Argentina, due to the tensions arising from that nation's adherence to a fixed-exchange rate regime. In mid-year, efforts to reactivate the common automotive accord between the two nations, which had been suspended in 1999, were also unsuccessful, due to disagreements in the formulas for measuring "national content" in the manufacturing process. Moreover, a number of tariffs and quotas enacted following Brazil's devaluation had yet to be removed by year-end 2000, owing to Argentina's concerns of unfair trade practices by Brazil. On a broader front, Chile's decision in late 2000 to accept the U.S.'s offer to start negotiations for a bilateral free-trade arrangement within the context of the F.T.A. generated uncertainty about the future course of MERCOSUR. At present, these issues are difficult to evaluate, since a variety of possible outcomes from the negotiations are possible.

Other important country and industry specific trade disputes also arose during 2000 that merit comment. First, a disagreement erupted between Brazil and Canada, when each country accused the other with granting subsidies to their respective aircraft industries. The problem intensified when Brazil was found to be in violation of WTO rules through its export-financing program (PROEX), which provides below-market rates for Brazilian aircraft. At the same time, however, it was determined that the Canadian government's production subsidies for essentially the same purpose did not violate WTO rules. This outcome enabled a Canadian company to win a large contract to supply aircraft to a U.S. regional airline in January 2001. The Brazilian authorities immediately protested and requested that the WTO revisit the issue.

Apparently in retaliation to Brazil's protest, Canada announced the suspension and recall of all beef from Brazil, alleging that the "theoretical" possibility existed that such products could be affected by mad cow disease. Most analysts were puzzled by Canada's reaction, not only because Canada's beef imports from Brazil are negligible but also because agriculture constitutes an area where both countries have common interests and potential for expanding trade. Because of the negative publicity received, however, Canada lifted the ban on beef imports in late February.

A second dispute involved concerns by U.S. and Swiss pharmaceutical companies that Brazil will soon begin to produce generic versions of costly drugs used in the battle against AIDS. The use of these drugs, which are currently protected by international patents, raise far-reaching health issues for several reasons. First, Brazil's highly successful AIDS program is largely based on the free or low cost distribution of generic drugs, whose patents were registered before May 11, 1997. With respect to drugs developed after that date, Brazil has attempted to comply with WTO rules by enacting a patent law that broadly committed the nation to respect international patents, but which requires the production of generic varieties of the

protected drugs within a three-year period.

The key issue, then, is the cost of the drugs that are still protected by patents and for which no generic equivalents are available. Specifically, the Brazilian authorities are insisting that U.S. and Swiss firms either begin to produce two urgently needed drugs in Brazil so that generic versions can be offered or, alternatively, slash the import price of the drugs substantially. The WTO will soon hear the arguments of the involved nations and is committed to issue a decision by June 2001.

Much is at stake in this dispute. First, there is issue of cost, since the treatment for an AIDS patient in the U.S. is estimated at US$12,000 annually, whereas in Brazil, the cost falls to about US$4,700. Even at this reduced cost, many poor Brazilian patients cannot afford the drugs. Even with these problems, the fact remains that Brazil's AIDS program is highly regarded as a model for other poor and cash-strapped nations, since it is credited with having reduced the number of deaths caused by the virus by 50 percent in just four years.

Finally, Brazil's aggressive stance on the aforementioned issues indicates that resort to the WTO has become a basic instrument to further the nation's economic and social policy objectives. From the time the WTO was created in 1995 until October 2000, Brazil requested dispute panels only four times and those were basically to contest alleged barriers to exports. Since last October, however, Brazil has requested eight panels, which include an increasingly wide variety of topics considered to be vital to the nation's interests.

Outlook

Brazil's prospects for the near-term remain favorable, especially since no fundamental departures from the favorable trends observed during 2000 are anticipated. Real GDP growth is projected to accelerate by at least 4.5 percent in 2000. This upturn would stem almost completely from increased private consumption outlays, as the continuing decline in interest rates would stimulate greater industrial production, further job creation and also hasten the recovery of real wages. This forecast also takes into account the projected increase in the agricultural harvest for the 2000-01 crop year, which, based on estimates of the area under cultivation, could reach a record 91.6 million tons, 10.3 percent higher than in the preceding year. Such an increase would not only provide an important boost to output, but also do much help Brazil achieve the 4 percent "inflation target" agreed to with the IMF for 2001.

The most important risks to this scenario arise from exogenous factors. Especially noteworthy are the problems that a significant slowdown in the U.S. economy could cause for Brazil's external sector. Recent simulations by Brazil's Institute for Applied Economic Research (IPEA), for instance, indicate that if U.S. growth decelerates to 2 percent in 2001, Brazil's exports to that market –the nation's most important trading partner– would rise only 8.4 percent, compared to the 24 percent expansion that occurred in 2000. A slowdown of the U.S. economy, in turn,

would produce a ripple effect in import demand by other nations as well. This would limit Brazil's total export growth to around 9 percent in current dollar terms, or about US$3 billion less than the previous year's total of US$55.1 billion. It is also unlikely that sales to Argentina, Brazil's second most important trading partner, will increase over the near-term, due to that nation's limited capacity to import and economic stagnation.

It should be noted, however, that an even greater weakness in Brazil's export growth in 2001 will be averted by buoyant demand for several of Brazil's major agricultural products, including beef, poultry, sugar and, especially, soybeans. In the latter instance, Brazil, now the world's second largest producer after the U.S., is expected to benefit from a record harvest of 35 million tons and soaring international prices. This outlook is based on rising demand in Asia and especially Europe, where it is anticipated that soybeans will increasingly be used as cattle feed in order to halt the possible spread of mad cow disease. At the same time, however, import demand for raw materials and a wide variety of intermediate goods is expected to continue expanding as a consequence of Brazil's on-going economic recovery and the slow pace of import substitution investment. Moreover, it should be noted that imports of automobiles jumped to US$126 million in January 2001, or 306 percent more than in the same month of the preceding year.

Taken together, these trends suggest that Brazil will again register a trade deficit in 2001. Although preliminary projections indicate an imbalance of only US$200 million, it appears that the result will be considerably higher by year-end, given that an accumulated trade deficit of nearly US$400 million occurred in the first two months of the year. At the same time, some widening in the service imbalance is also anticipated, due to higher interest payments and profit remittances. Based on these initial projections for the trade balance and services, the current account deficit would rise around US$1.4 billion to US$26 billion.

In principle, however, financing this imbalance is not expected to be a problem, even with a projected US$6 billion drop in foreign direct investment to US$24 billion. This is the case primarily because Brazil's access to international capital markets has improved due to recent reductions in the risk premium on Brazilian debt and also because of the reductions in U.S. interest rates enacted by the Federal Reserve in January 2001. A possible complicating factor, however, was the increasing financial turbulence in Turkey, which, in late February and early March, was generating a new wave of uncertainty for emerging market nations, including Argentina and Brazil. Finally, it should be noted that Brazil's near-term external sector prospects would also be conditioned by the outcome of the various disputes now pending with the WTO.

Other potential sources of uncertainty are more domestic in nature. Especially important are those surrounding the forthcoming presidential elections in October 2002. In this regard, two types of imponderables merit comment. The first is the issue of presidential succession, since the ideology of the

new administration could have an important impact on the direction of economic policy and the behavior of key variables such as foreign direct investment. Second, relatively little time remains to approve and implement pending reforms prior to the elections. This is especially the case of the reforms needed to consolidate the process of fiscal reform, where many complex issues need to be resolved.

In this regard, it must be emphasized that, despite the impressive progress that has been achieved since the Asian crisis, Brazil's investment coefficient, at 19 percent of GDP, is still too low to sustain satisfactory growth rates over the medium term. Again, the major problem is that public savings (which include a part of interest payments) remain negative when measured on a national account basis, a fact which clearly reveals that the process of fiscal adjustment is far from complete. Moreover, the fact that public savings are still negative greatly restricts the government's ability to undertake investments that are urgently needed in the social sectors and for expanding the nation's physical infrastructure.

BRAZIL

Statistical Profile[1]	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 p
Real Gross Domestic Product (GDP)[2]					(Average Annual Growth Rates)					
Total GDP	1.0	-0.5	4.9	5.9	4.2	2.7	3.3	0.2	0.8	4.2
Agriculture, Forestry and Fishing	1.4	4.9	-0.1	5.4	4.1	3.1	-0.8	1.9	7.4	2.9
Industry	0.3	-4.2	7.0	6.7	1.9	3.3	4.7	-1.4	-1.6	4.8
Services	0.3	0.3	1.8	1.8	1.3	2.3	2.6	1.1	1.9	3.6
Non-Financial Public Sector					(As a Percent of Current GDP)					
Primary Balance (- Deficit)	2.9	2.3	2.7	5.3	0.4	-0.1	-1.0	0.0	3.2	3.5
Borrowing Requirements[3]	23.3	43.1	59.0	45.5	7.2	5.9	6.1	7.9	10.0	4.6
Nominal Interest Payments	26.2	45.4	61.7	50.8	7.5	5.8	5.1	7.9	13.3	8.1
Money and Credit[4]					(As a Percent of Current GDP)					
Domestic Credit	31.4	29.2	24.1	43.8	32.7	37.6	35.3	42.3	47.2	45.4
Public Sector	20.2	15.9	12.2	14.3	4.2	10.2	10.5	16.1	18.2	16.6
Private Sector	11.2	13.3	11.9	29.5	28.6	27.4	24.8	26.1	29.0	28.7
Money Supply (M1)	3.2	2.0	1.2	2.6	3.2	4.0	4.8	5.4	5.2	5.0
Interest Rate[5]	...	...	...	...	53.1	27.4	24.8	28.8	25.6	17.4
Prices and Salaries					(Average Annual Growth Rates)					
Consumer Prices	432.8	951.6	1,928.0	2,075.9	66.0	15.8	6.9	3.2	4.9	7.0
Real Wages[6]	-16.9	-7.9	9.4	5.9	10.4	7.4	2.1	-0.4	-5.5	-0.4
Exchange Rates					(Reals per Dollar)					
Market Rate[7]	-	-	0.03	0.64	0.92	1.01	1.08	1.16	1.81	1.83
					(Index 1995 = 100)					
Real Effective[8]	108.5	117.2	112.7	112.8	100.0	94.2	93.9	98.8	148.8	137.8
					(Index 1995 = 100)					
Terms of Trade	71.2	74.2	79.9	91.5	100.0	101.0	106.8	104.6	94.4	87.5
Balance of Payments					(Millions of Dollars)					
Current Account Balance	-1,450.0	6,089.0	20.0	-1,153.0	-18,136.0	-23,248.0	-30,491.0	-33,829.0	-25,073.0	-24,594.7
Trade Balance	10,578.0	15,239.0	14,329.0	10,861.0	-3,157.0	-5,453.0	-6,652.0	-6,603.0	-1,207.0	-697.7
Exports of Goods (FOB)	31,619.0	35,793.0	39,630.0	44,102.0	46,506.0	47,851.0	53,189.0	51,136.0	48,012.0	55,085.6
Imports of Goods (FOB)	21,041.0	20,554.0	25,301.0	33,241.0	49,663.0	53,304.0	59,841.0	57,739.0	49,219.0	55,783.3
Service Balance	-3,891.0	-3,342.0	-5,590.0	-5,346.0	-7,495.0	-8,059.0	-9,309.0	-9,045.0	-6,695.0	-7,468.0
Income Balance	-9,651.0	-7,997.0	-10,322.0	-9,091.0	-11,105.0	-12,177.0	-16,344.0	-19,617.0	-18,859.0	-17,956.0
Current Transfers	1,514.0	2,189.0	1,603.0	2,423.0	3,621.0	2,441.0	1,814.0	1,436.0	1,688.0	1,527.0
Capital and Financial Account Balance	270.6	10,028.3	9,585.2	8,982.8	29,961.0	34,059.7	25,848.9	30,125.0	16,883.9	19,879.0
Capital Account Balance	42.0	54.0	81.0	173.0	352.0	494.0	482.0	375.0	339.0	...
Capital Transfers	42.0	54.0	81.0	173.0	352.0	455.0	396.0	321.0	339.0	...
Financial Account Balance	228.6	9,974.3	9,504.2	8,809.8	29,609.0	33,565.7	25,366.9	29,750.0	16,544.9	19,879.0
Direct Investment	89.0	1,924.0	801.0	2,035.0	3,475.0	11,667.0	18,608.0	29,192.0	30,979.0	30,812.0
Portfolio Investment	3,808.0	14,466.0	12,322.0	51,135.0	9,745.0	20,832.0	10,058.0	18,419.0	1,923.0	...
Other Investment	-3,710.4	-6,469.7	-3,699.8	-44,533.2	16,037.0	572.7	-3,781.1	-18,236.0	-16,590.1	...
Change in Reserves (- Increase)	369.1	-14,670.3	-8,709.4	-7,215.0	-12,919.7	-8,326.1	8,284.3	6,989.7	7,782.5	2,261.7
Errors and Omissions	852.3	-1,393.0	-814.8	-441.8	1,446.7	-1,991.6	-3,160.2	-2,910.7	745.6	2,454.0
Total External Debt[9]					(Millions of Dollars)					
Disbursed Debt	123,910.0	135,949.0	145,726.0	148,295.0	159,256.0	179,935.0	199,998.0	241,644.0	241,468.0	232,387.0
Debt Service Actually Paid	17,041.0	14,988.0	18,043.0	17,468.0	19,228.0	23,592.0	36,409.0	42,625.0	59,846.0	61,646.0
					(In Percent)					
Interest Payments Due/ Exports of Goods and Non-Factor Services	27.2	20.8	18.0	16.6	12.6	14.8	12.8	14.1	15.5	...

[1]Source: IDB Statistics and Quantitative Analysis Unit and Regional Operations Department.

[2]Based on a chain linked index 1990=100 (source IBGE). GDP measured at market prices; sector of origin at factor cost.

[3]Excludes monetary correction.

[4]Mid-year values.

[5]Overnight market rate (source IPEA).

[6]January - October for 2000.

[7](-) Indicates that the exchange rate is less than half of a significant digit, given the magnitude of the depreciations experienced.

[8]Trade-weighted calculated using the period average nominal exchange rate.

[9]End of September for 2000.