

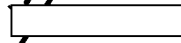
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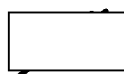
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Brazil: Prospects for Economic Reform and Implications for Relations With the United States

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National Intelligence Estimate

*This Estimate represents the views
of the Director of Central Intelligence
with the advice and assistance of the
US Intelligence Community.*

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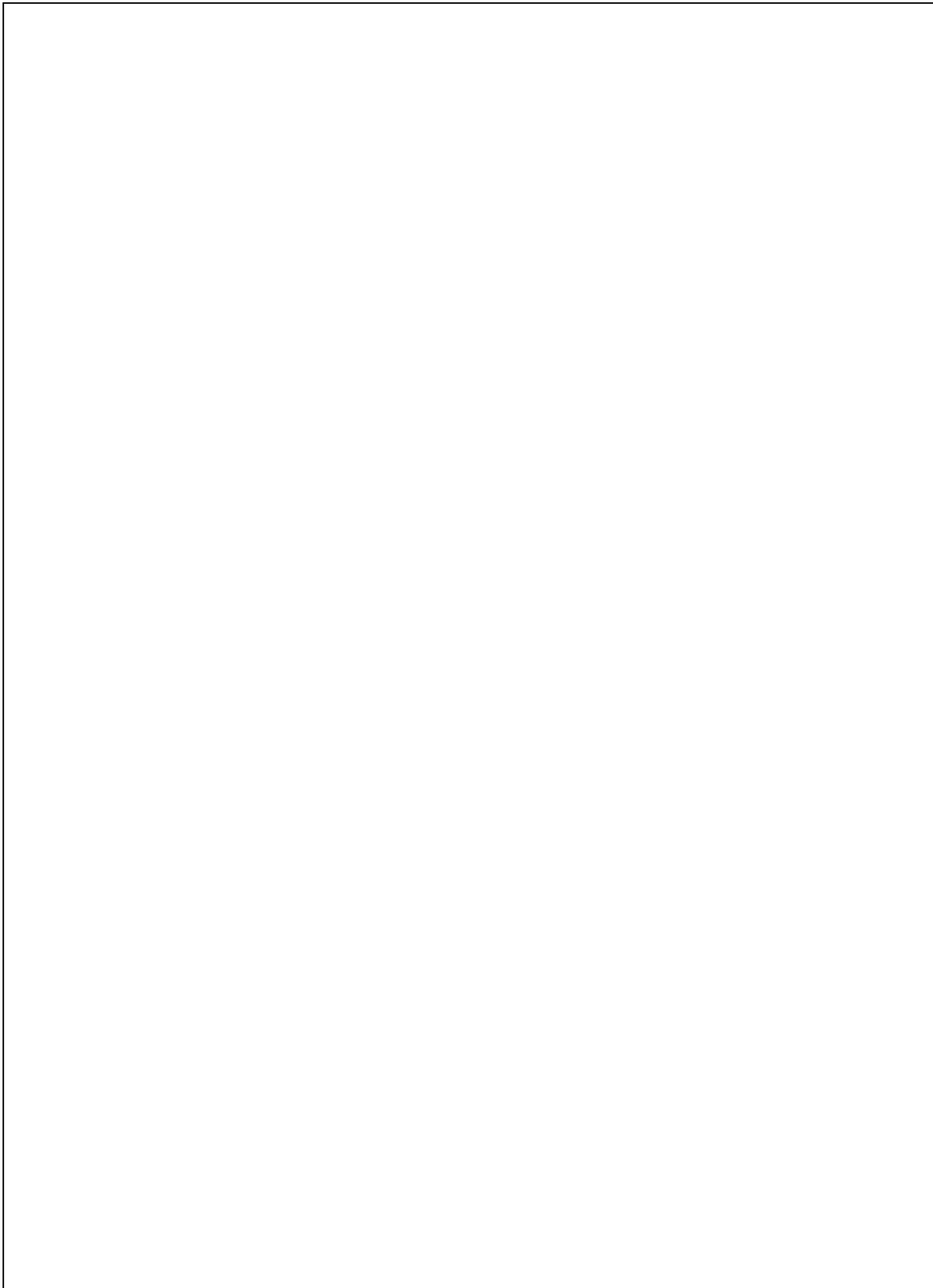
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NIE 93-90

Brazil: Prospects for Economic Reform and Implications for Relations With the United States

*Information available as of 8 August 1990 was used
in the preparation of this Estimate.*

*The following intelligence organizations participated
in the preparation of this Estimate:*

The Central Intelligence Agency
The Defense Intelligence Agency
The National Security Agency
The Bureau of Intelligence and Research,
Department of State
The Office of Intelligence Support,
Department of the Treasury
The Office of the Deputy Assistant Secretary
for Intelligence, Department of Energy

also participating:

The Director of Naval Intelligence,
Department of the Navy
The Assistant Chief of Staff, Intelligence,
Department of the Air Force

*This Estimate was approved for publication by the
National Foreign Intelligence Board.*

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**Brazil: Prospects for
Economic Reform and
Implications for Relations
With the United States**

- We judge that President Collor and his team have a better-than-even chance between now and mid-1991 of achieving their basic goals of controlling inflation, reducing the fiscal deficit, and building momentum in implementing market-oriented structural reforms. (S/NF)
- Collor should be able to preserve public confidence, relying on his strong leadership, determination, and self-assurance.
- Collor will continue to seek closer bilateral relations, but problems will persist in some key areas.

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Key Judgments

President Fernando Collor de Mello has undertaken the most ambitious and extensive market-oriented reform program ever implemented in Brazil in an attempt to stabilize and restructure the economy. Inheriting an economy on the brink of hyperinflation, he has brought price increases down to manageable levels and has launched measures to promote efficiency, growth, and economic competition, as well as to root out corruption.

We judge that, despite formidable challenges, including the most recent disruptions in oil supply from the Middle East, Collor and his team have a better-than-even chance between now and mid-1991 of meeting the basic stabilization objectives of the economic program and of building momentum in implementing long-range structural reform. Specifically, he is likely to hold inflation to a monthly average of about 10 percent as a first step toward price stability. This will be accomplished by an effective monetary policy and a reduction of the fiscal deficit from 8 percent to 3 percent of GDP—a respectable showing, although short of the 1.2-percent surplus projected by the government. We expect a 3- to 5-percent decline in GDP in 1990, followed by a gradual upturn in production in 1991 that will be accompanied by a slight increase in job creation, rising exports, and monthly trade surpluses of about \$750 million. Brazil will probably reach an agreement with the IMF this year and move forward on negotiations with other creditors. Negotiations with foreign commercial banks will be contentious, but an ironing out of differences is possible by mid-1991.

Key interest groups, hurt by the austerity measures and reordering of the economy, can be expected to raise the following challenges:

- Labor, facing layoffs and reduced real income, could become increasingly disruptive.
 - Cooperation of business will erode if Collor backslides on fiscal reform, a key element in bringing down inflation.
 - A recalcitrant bureaucracy could hinder efficient implementation of reforms.
 - The Brazilian Congress will insist that it be a key player and may block important aspects of the plan.
 - Opponents will use the courts to challenge elements of the program.
 - Several other sectors, including the military and the lower classes, worried about their well-being, will press Collor for equitable treatment.
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Nonetheless, Collor's political strengths outweigh his weaknesses. Through his strong leadership, determination, and self-assurance, Collor will probably succeed in preserving the public's confidence. Also in his favor are the lack of a credible alternative to his plan and the disorganization and divisions among his detractors. [redacted]

We believe there is a less-than-even chance that the program will encounter difficulties serious enough to provoke either spiraling inflation or a protracted downturn. In either case, Collor would face a decline in public confidence, encouraging his political opponents and weakening the resolve of his congressional supporters. He would then grudgingly make concessions and slow the pace of reform, allowing the economy to muddle through—thus losing his best chance to reverse Brazil's economic fortunes. [redacted]

Collor has made clear his goal of improving relations with the United States and other Western nations as key to modernizing and putting Brazil on the track to becoming a member of the First World, and he has launched several foreign policy initiatives to demonstrate his sincerity. Focusing especially on trade, he has made impressive strides in opening Brazil's economy to market forces, while playing down excessive nationalism and has strongly endorsed the Enterprise for the Americas Initiative. He has been accommodating on sensitive bilateral issues, such as lowering import restrictions and promising pharmaceutical patents, and demonstrated a pragmatic approach to environmental, narcotics, and arms transfer issues. We judge that progress on Collor's economic reform program and some resumption of debt servicing will form the basis for a restructuring of Brazil's \$115 billion foreign debt. [redacted]

While over the next 12 months we expect bilateral relations to continue to improve, problems will persist in several areas, such as technology transfer, access to US markets, and nuclear safeguards. Brasilia will insist that Washington respond to Collor's economic reforms by allowing broader access to US markets, particularly in the agricultural sector, and to high technology, including assistance to Brazil's space launch vehicle program. It is also likely to continue differing to some extent with Washington on the Uruguay Round of the GATT and the pace of liberalization of some domestic sectors, such as informatics. Even though Collor has signaled an interest in waiving into force the Treaty of Tlatelolco—which forbids the presence of nuclear weapons in Latin America—Brasilia will resist accepting full-scope IAEA safeguards on its nuclear program. [redacted]

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Discussion¹

President Collor's Economic Program

When he took office in March 1990, Fernando Collor de Mello, the flamboyant, 40-year-old former governor of Alagoas, set out to revolutionize the economy with an ambitious reform program designed to:

- Halt near hyperinflation.
- Dismantle entrenched and inefficient statist policies.
- Reorient the economy toward efficiency and growth by creating a more competitive, market-oriented environment.
- Root out corruption.

For Collor, Brazil's high inflation and economic malaise are due almost entirely to mismanagement, which has resulted in perennial public-sector budget deficits, excessive government controls, the lack of foreign competition, collusive private cartels, and antiquated technology [redacted]

His efforts to reform an economy in crisis and restore faith in government will take years to complete. Although imbued with a sense of mission and strongly determined to achieve rapid gains, Collor began office as a political outsider with an economic team lacking in experience. While his record to date has generally been positive, we believe he has barely scratched the surface of the multiple problems he faces. Over the next 12 months or so—the time frame of this Estimate—the Collor government probably will be able to overcome only some of the formidable obstacles to reform. We expect a pattern of bold initiatives coupled with periodic setbacks, out of which will emerge a sense that the Collor government is generating momentum in overcoming Brazil's deep economic crisis and its social and political malaise [redacted]

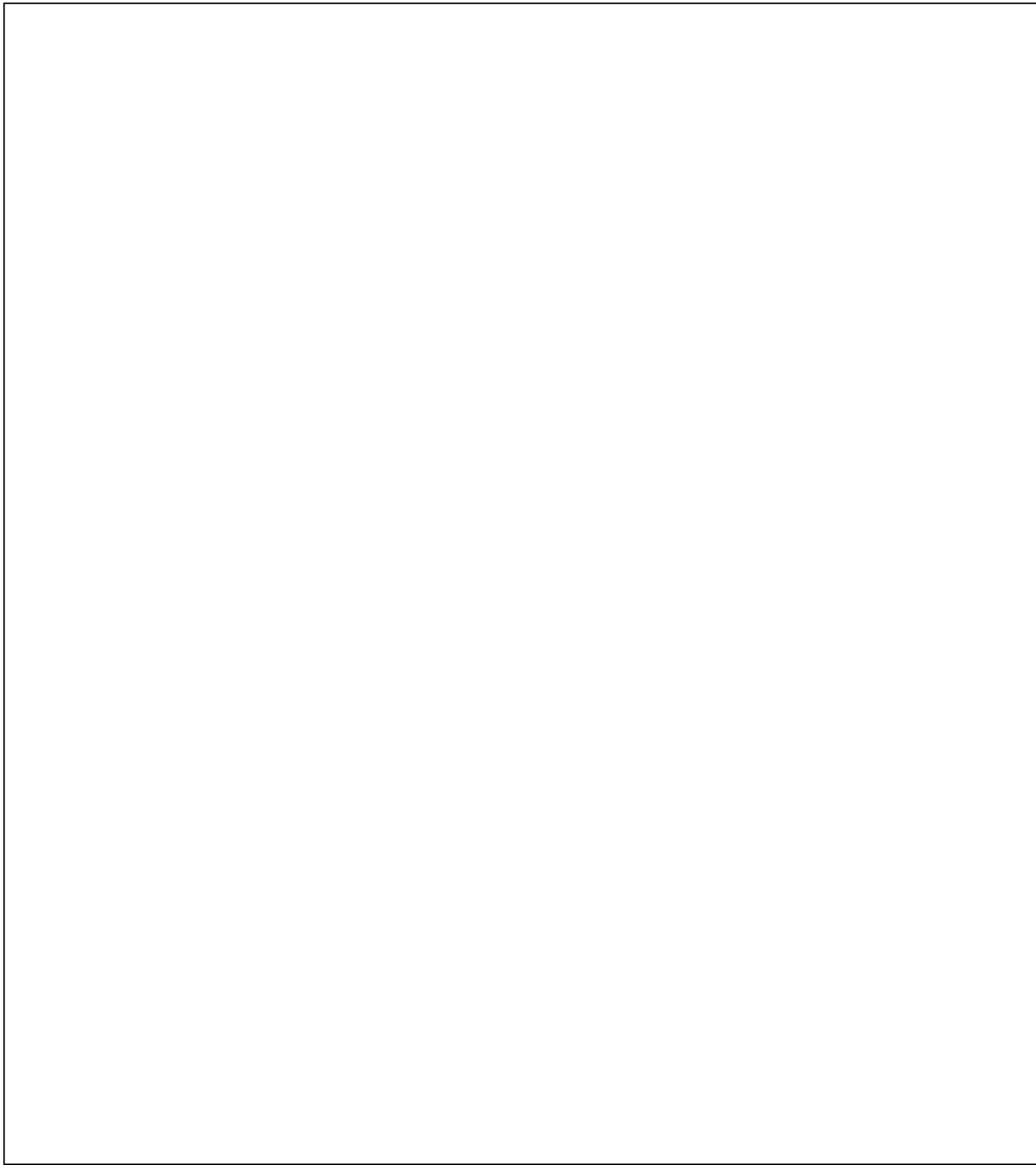
¹ This Estimate was initiated by the National Intelligence Officer for Economics to assess the prospects for one of the most comprehensive and ambitious market-oriented reform programs ever attempted in the largest and economically powerful new democracy in South America. It covers the period between now and mid-1991. It provides a focus for planning for President Bush's upcoming trip to Brazil during his South American visit [redacted]

Collor's program contains the most sweeping economic shock measures and structural reforms ever implemented in Brazil. To attack the root causes of inflation and promote growth, the program has:

- Placed a temporary cap on prices and a leaky 18- to 30-month freeze on bank accounts and government bond holdings that initially bottled up an estimated 80 percent of liquid assets.
- Abolished most subsidy programs for industries and specific exports.
- Reduced the government from 23 to 12 ministries and abolished 24 federal agencies, while initially promising personnel reductions of 20 to 25 percent of the public-sector work force this year—which could amount to roughly 360,000 employees.
- Imposed a one-time capital gains tax on financial assets, taxes on financial transactions, and higher taxes on agricultural profits.
- Initiated aggressive enforcement of tax laws and made the head of the federal police responsible for tax collection in an anticorruption move.
- Established a new currency and freed the exchange rate, although some controls on foreign exchange dealings stayed in place.
- Raised fuel prices and utility charges, proclaiming that Brazilians would have to pay the real cost for government goods and services.
- Established guidelines for privatizing all but a few key parastatal firms—some 180 federal firms producing about 10 percent of GDP will be affected.
- Eliminated most nontariff barriers, to be replaced with tariffs that will gradually be reduced.

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- Promised to reduce impediments to foreign investment.
- Largely deindexed the economy by breaking the automatic linkage between wage and price increases. []

The impact of the shock measures—plunging inflation and production—has begun to wear off, and Collor is having difficulty controlling wage demands. Most firms were able to gain access to their frozen accounts during the first several weeks of the program through special provisions and loopholes. Although the increased liquidity helped rekindle output, prices—aided by seasonal influences—also began to climb. []

Relying on a small circle of trusted advisers, Collor has used a highly centralized and interventionist approach to regulate and implement the plan. In the first few months, this approach was accompanied by hasty decisions, several policy flip-flops, retractions, and delays—often attributed to the inexperience of key economic team leaders—that at times confused business and labor, played into the hands of congressional opponents, and reduced public confidence in the plan. Particularly embarrassing to the government was the ease with which many firms quickly gained access to most of their frozen accounts soon after the program was announced. Despite these failings, we believe Collor has suffered little lasting damage, although he may reshuffle the Cabinet after the October elections. []

Political Challenges Facing Collor

Collor's quick and unequivocal commitment to overcome Brazil's severe economic problems, address social inequities, and fight corruption helped him to win early support for his program. As the first popularly elected president in 30 years, he benefited from a high degree of popularity and legitimacy in launching the first phase of his economic plan. []

However, popular support for both Collor and his program has declined significantly from the euphoria of the first weeks in office and his political skills will be tested severely. Opposition political parties, labor unions, and business groups, which initially were

stunned and subdued by the sheer magnitude and boldness of Collor's reforms, have begun to react and are searching for ways to dilute the program's toughest measures. []

Collor had relatively few problems warding off initial congressional attempts to obstruct the plan, but the legislature began to assert itself by May—in large part assisted by missteps by Collor and his team. In that month, Congress reversed a presidential decree limiting the powers of regional labor courts to grant cost-of-living wage increases. When the Supreme Court blocked Collor's effort to circumvent Congress by issuing a nearly identical decree, he suffered his first major political setback. []

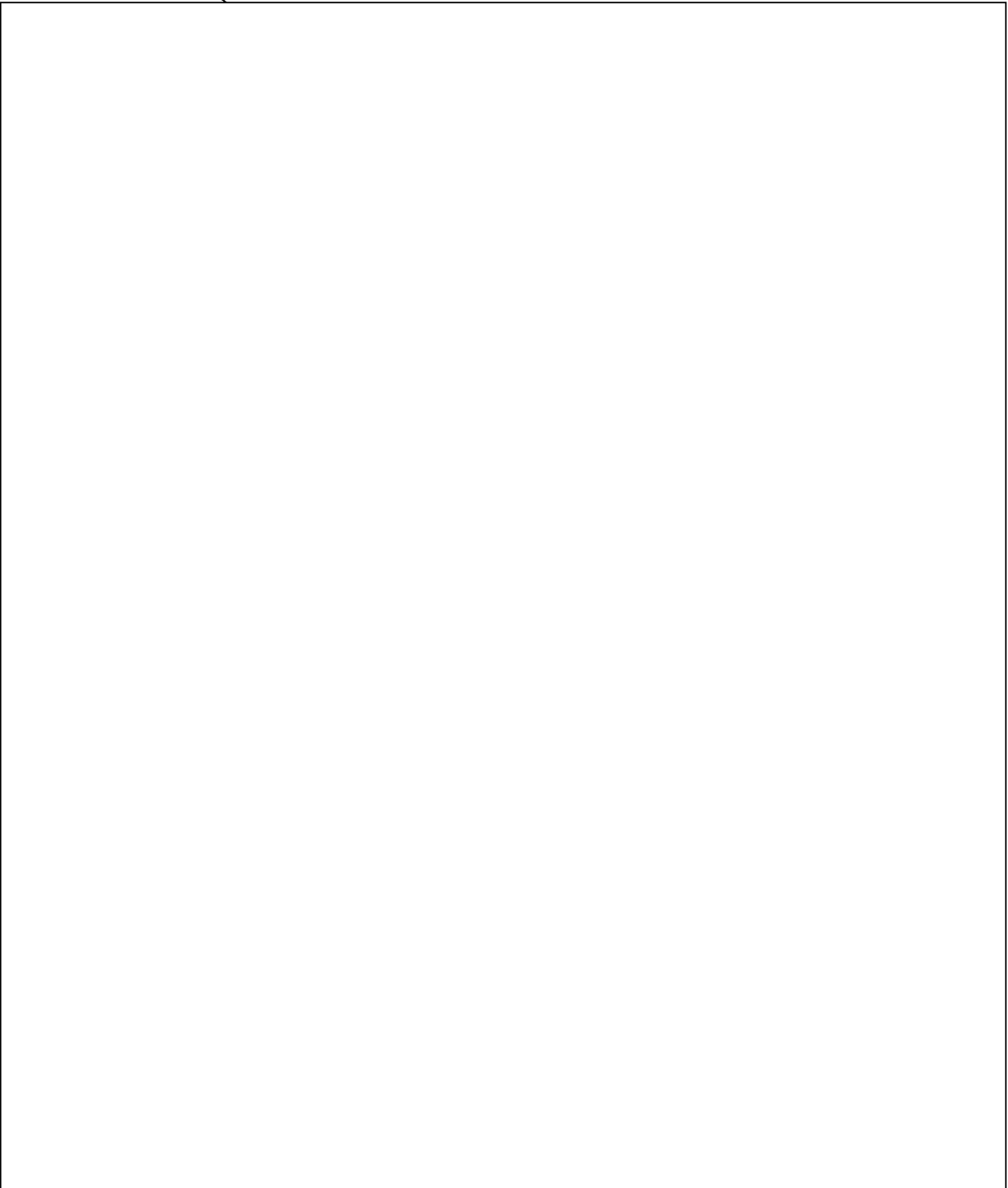
In his dealings with the Congress from now until early 1991, when the new legislature is seated, Collor will focus on forestalling any new effort by the majority opposition parties to undermine his program. He will seek to prevent the formation of an opposition bloc that could out vote his own center-right allies, using legislative maneuvers to keep opponents off balance. After the election in October, Collor should have an easy time outmaneuvering the lame-duck congress and in putting off consideration of key measures until after the new body is installed. We expect the new congress to be fragmented but with a strong moderate base that will permit Collor to construct a working, albeit shifting, coalition of support. []

Collor also will have to overcome opposition or uneasiness over his program by key interest groups. (C/NF)

Labor. One of the most difficult tasks Collor faces is to keep labor from rebelling against his economic reform program. Much of organized labor—about 20 percent of Brazil's work force—initially acknowledged the need for economic reform but is increasingly worried about recession, privatizations, and private- and public-sector layoffs. The most forceful effort to challenge Collor's labor policies has come from the Sole Workers Central (CUT), the more radical of the two main labor groups, which is promoting repeated strike actions and hopes eventually to stage a prolonged national strike. The CUT also is protesting

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reductions ordered by Collor in the public-sector work force—one of the CUT's strongest enclaves—and is trying to make Collor's labor policies a central issue of the election campaign. [redacted]

As workers confront the reality of still high monthly inflation rates, continuing recession, and Collor's firmness against returning to full wage indexation, strike activity is likely to pick up, at least for the remainder of 1990, and become more disruptive. To defuse labor protests in the private sector this year, Brasilia is delaying until August 1991 the introduction of free collective bargaining. Meanwhile, the government is permitting full inflation compensation for the lowest wage earners. [redacted]

The government is counting heavily on the prospect that, once the economy moves upward, firms will begin to rehire workers, lessening labor militancy. Public-sector employees will pose a special problem as long as planned federal work force cuts are pursued. Collor may be forced to stretch out dismissals until well into 1991. [redacted]

Lower Classes. Collor probably will avoid trying to launch ambitious welfare programs broadly promised during his campaign until the economy is more robust and the budget picture improves. He already has announced small-scale, low-cost, but well-publicized, programs to demonstrate his seriousness to the lower classes. We believe that such measures, coupled with the success of the stabilization program, will keep the poor quiescent in the short run as long as Collor moves toward financing a more comprehensive social program. [redacted]

Business. By definition, Collor's structural reforms threaten a significant portion of organized business, which has been dominated by inward-looking, protectionist-inclined sectors. But reforms also offer great opportunity to many other industrial and agricultural sectors capable of competing internationally. If reform succeeds, the latter sectors will gain ascendancy and provide Collor with one of his principal constituencies. [redacted]

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The shock measures contained in the economic program were initially a source of friction with the business community, but with most businesses having regained access to their blocked funds, concern has turned to Collor's implementation of the program's broader goals. In general, business is urging Collor to cut public expenditures faster and pursue fiscal reform in order to reduce inflationary pressures. If inflation is stabilized at current levels (10 to 12 percent monthly) or declining and the economy shows signs of resumed growth, we believe the business community is likely to maintain its general support for the reform effort. At the same time, however, it is important that Collor continue seeking feedback from the business community and show some flexibility in the pace of liberalization to avoid severe damage to industry.

The Bureaucracy. Opposition to Collor from the government bureaucracy stems from those who implemented prior administrations' interventionist policies and employees whose jobs Collor has promised to eliminate. However, widespread public perception that the bureaucracy is ineffectual, overstaffed, and corrupt is obviously in Collor's favor. While he may continue to meet legal challenges to his efforts to cut unnecessary government employment, he is not likely to meet widespread popular opposition.

The Military. To date, Collor has succeeded in asserting command over the armed forces and reducing their political influence without major challenges. Despite minor irritants, Collor appears to have won the respect of senior officers because of his assertive, no-nonsense leadership and visionary determination to build a better, more competitive Brazil. Long one of the most vociferous proponents of statist policies, the military establishment has accepted Collor's call for privatization of most state-owned enterprises because the generals see no effective alternative. Collor has been careful not to demean the military as an institution. He probably will continue to cultivate a solid relationship with the high command to offset any potential carping from the generals that the armed forces are being singled out for budget cuts or being ignored.

The Catholic Church. Collor also is concerned about the influence that the progressive wing of the Catholic Church exerts on lower-class attitudes. Many progressive clergy openly urged their flock to support his presidential opponent. Consequently, Collor probably will try to influence the church's conservative hierarchy to support his economic policies and to have them counter any efforts by the progressives against his government.

Constitutional Challenges. Serious questions already are being raised about the constitutionality of several aspects of Collor's economic plan. The 1988 Constitution imposes significant restraints on executive power, making the courts a probable continuing battleground for a president with authoritarian tendencies. His orders to fire large numbers of public-sector employees have spurred challenges on the basis of job security guaranteed under the 1988 Constitution to tenured civil servants. Other court challenges have occurred against Collor's attempts to deindex wages and limit wage increases. Persistent negative rulings by the courts could undermine the administration's plan to break the cycle of inflation, if the government cannot find a legal way to circumvent adverse decisions. We believe that the President's dogged determination to overcome obstacles will enable him to keep the legal challenges from derailing key components of his economic program during the period of this Estimate.

On Balance. Collor's political strengths outweigh his liabilities as he attempts to implement his multifaceted reform program. He is in tune with public sentiment in offering Brazilians a new vision and hope for the future, and many see him as possessing the leadership qualities required to meet the challenge of restructuring Brazil's economy and restoring credibility to the government. Working in Collor's favor is likely to be the diffused nature of criticism from special interests, which has focused on specific parts of the plan rather than rejecting it entirely. In our view, Collor's task will be to prevent these politically disparate groups from mounting a sustained campaign to block his reform measures on an issue-by-issue

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basis. On balance, we believe Collor's determination and self-assurance—along with the technical competence and growing experience of his team as well as the lack of a credible alternative to his plan—will succeed in preserving the public's confidence and offsetting his detractors. []

Prospects for the Economy Through Mid-1991

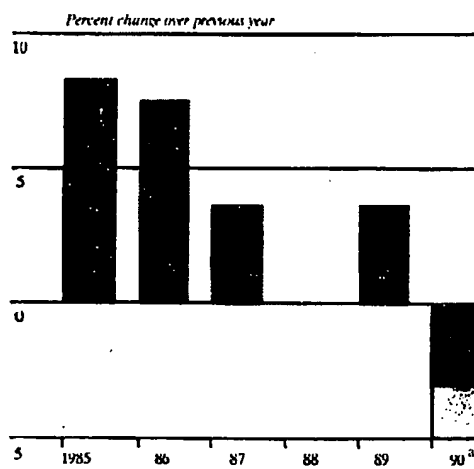
We judge that the Collor team has a better-than-even chance between now and mid-1991 not only of meeting the basic stabilization objectives of the economic program but also of generating a sense that the government is building momentum in implementing its long-range structural reform goals. In the process, we also believe that the government will continue to be widely seen as putting Brazil back on the path to sound economic growth and effective economic management. []

We base this judgment of relative success on the following projections: Collor is likely to hold inflation down to manageable levels—at a monthly average of about 10 percent—through effective management of the money supply and a reduction of the fiscal deficit. We also expect some improvement in other key economic indicators, including a gradual upturn from the current recession accompanied by a slight increase in job creation, and a trade surplus at about \$750 million monthly, based on oil prices of roughly \$30 per barrel. Although the shock program will cause a contraction of GDP in 1990, we believe that the sharpest decline has already occurred and that output is poised today to rebound. []

We estimate that the Brazilian economy can adjust to the embargo of Iraqi and Kuwaiti oil supplies without substantial damage to Collor's economic reform program. Brazil is 80 percent energy self-sufficient, and the economy is largely self-contained. Exports are diversified and constitute about 10 percent of GDP. A prolonged crisis in the Middle East and continued dramatic rise in oil prices, however, would have a major inflationary and recessionary impact on Brazil's economy. []

Inflation and the Money Supply. In a major step to avoid monetization of the budget deficit, the Central Bank announced in May it will no longer purchase

Figure 2
Brazil: GDP Trends



^a Projected range.

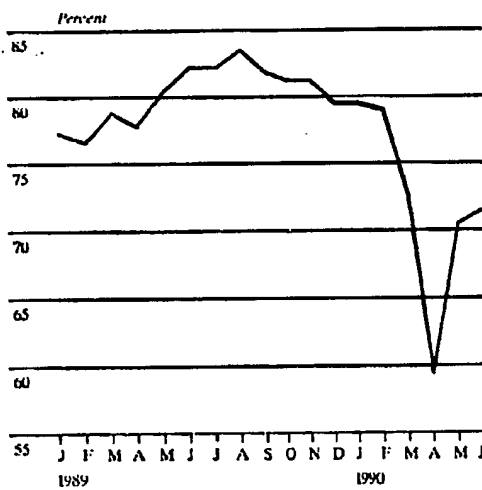
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government securities that the market will not buy. The bank is attempting to use orthodox tools to manage the money supply—adjusting reserve ratios, utilizing open-market operations, and buying and selling foreign exchange—but both the bank and the players in the market are still learning. We expect inflation to drop below 12 percent in August and September because of tight controls on monetary growth. Thereafter, Collor's task becomes more complex as he decides how to accommodate higher oil import costs. We believe that he will allow the state oil company only gradually to pass through the costs in higher prices and will relax monetary policy only slightly to add liquidity to the system. []

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Figure 3
Brazil: Capacity Utilization in Industry^a



^aSao Paulo industries only.

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The government is using supplementary measures to help hold down prices and inflationary expectations. In late June, it introduced a wage policy designed to provide workers with partial shelter from inflation, without the full reindexation advocated by Congress. The Collor team correctly argues that indexation would put strong pressure on prices. In addition, the government requires firms to present cost data to justify any price increases, excluding increased labor costs. Collor also has shown a willingness to put external pressure on price increases by lowering tariffs on goods that have shown the greatest price increases. Finally, the recession itself has kept downward pressure on prices

The Fiscal Deficit. We believe that the government will be able to meet only about half its planned cut in its budget deficit in 1990 but that this achievement would be a solid showing and enough to keep inflationary pressures in check. We foresee the deficit falling from the 8 percent of GDP prevailing when Collor took office to a 3-percent deficit by yearend.² The government itself is more optimistic. In May, it projected a surplus equivalent to 2 percent of GDP. It has since backpedaled its projection to a still healthy 1.2-percent budget surplus. We believe that this projection is too optimistic because spending will not be cut as much as expected and the large increase in revenue reported through mid-1990 will not continue. Specifically, the government's projection does not take full account of setbacks in the schedule for privatization, difficulties in cutting subsidies quickly, and increases in debt service payments as inflation exceeds the promised zero percent. Moreover, recession will hold down revenues and use of the blocked accounts to pay taxes cannot be repeated.

Progress in reining in the deficit will again be difficult in 1991, largely because at least half the revenue gains this year have a one-time impact. Additional sources of revenue should become available, however, assuming that the privatization process is in full swing in 1991, economic growth picks up, and cost-saving cuts in the federal work force continue. In addition, officials have said that the government will adopt new tax measures if necessary. If the government continues to pay strict attention to cutting expenses and enhancing revenues, it can sustain the improvement foreseen for 1990 and perhaps better it next year.

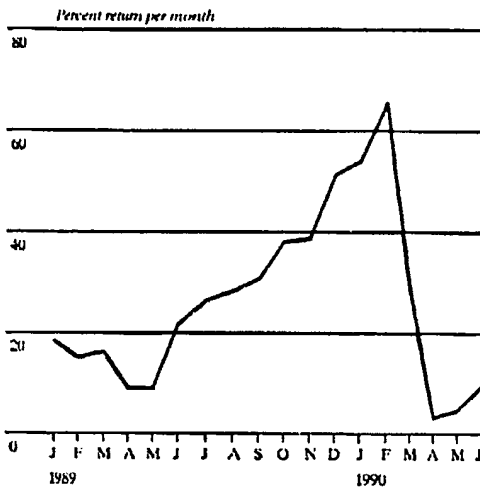
Gross Domestic Product. The GDP decline for the year should be 3 to 5 percent, and the economy will probably achieve a small positive growth in 1991.

² We believe half the reduction in the deficit will come from reduced service costs on the domestic debt—one percentage point savings each will come from the elimination of subsidies and the streamlining of parastatal companies—and only a 0.5-percent reduction will come from the delayed privatization program.

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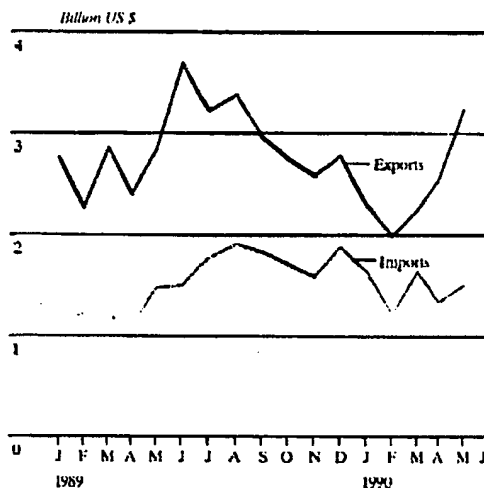
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Figure 4
Interest Rate on Government Securities



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Figure 5
Brazil: Foreign Trade Trends



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With the bulk of funds initially frozen now circulating again and wage increases being granted, a gradual rebound in production is likely. In addition, we expect the Central Bank to continue to allow the exchange rate to depreciate in order to stimulate exports. Coupled with Collor's continued, confirmed commitment to his plan, such recovery should give the business community enough confidence to increase capital investments in 1991—possibly including the return of some flight capital. Even though in the short term the recovery is not expected to be robust, it could form the basis for faster growth in 1992.

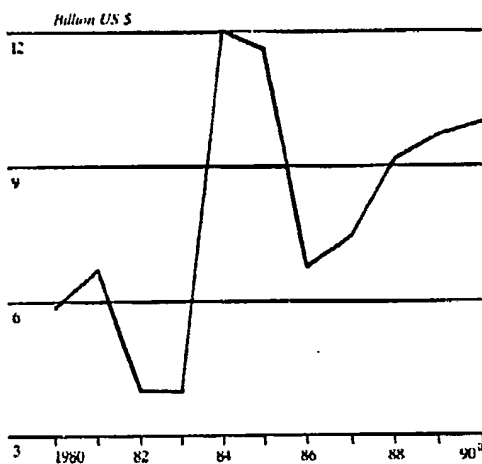
Foreign Trade and Investment. The hike in oil prices caused by the crisis in the Middle East will raise import costs and dampen export sales. In the face of

lasting oil shortages, Brazil can increase domestic oil production 10,000 to 20,000 barrels per day and reemphasize its fuel alcohol program, although it will take several months to revitalize. If current oil market conditions persist, with oil prices at about \$30 per barrel, monthly trade surpluses will probably dip to about \$750 million during the remainder of 1990 after averaging about \$1 billion earlier in the year. Nonetheless, with improvements in the quality of Brazil's manufactures, currency devaluations, and the shift of goods into the export market until the economy picks up, exports are likely to grow, eventually rebuilding the surplus. By mid-1991, if economic indicators confirm our assessment, the climate for foreign investment should improve.

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Figure 6
Brazil: International Reserves



^a End of April 1990.

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Foreign Debt. The Collor team believes that achieving an agreement with foreign creditors is essential to overcome the international financial community's growing resentment of Brazil resulting from the de facto moratorium on debt service payments on both commercial and official loans begun under the Sarney administration. Although we expect an International Monetary Fund (IMF) program to be in place this year, with Brazil drawing at least \$500 million by mid-1991, an agreement will be contingent upon progress in talks with commercial banks. Brazil began token payments to bilateral creditors in July, and we expect a Paris Club agreement to follow the IMF agreement. Talks with commercial lenders will be more difficult and confrontational. Brazil will insist on debt relief at least as favorable as the Mexico

package. Nevertheless, Brazil's \$67 billion foreign commercial debt forms a significant share of bank loan portfolios and banks still see future opportunities in Brazil. We believe an ironing out of differences is possible by mid-1991. Brazil will probably still be a net repayer to the Inter-American Development Bank (IDB) and the World Bank because of Brazil's large repayment commitments and lags in receiving disbursements from new loan programs.

Privatization. Privatization is getting off to a slow start but the machinery is in place. The government scaled back the number of firms to be sold in 1990 from 12 to 4, and we believe sales from these firms will yield no more than \$2 billion. Many of the firms chosen for the first series of sales are profitable, and major layoffs are not likely to occur. Foreign creditors will be allowed to participate in the program and obtain up to 40 percent of the voting shares, but debt-equity swaps will probably be delayed until 1991 because the Central Bank fears an inflationary impact.

Alternative Scenarios

In administering a complex set of fiscal and monetary controls, Collor's team is walking a fine line between controlling inflation and producing a debilitating recession. While most Brazilians support the need for reform, all groups are paying a price. Their willingness to continue paying that price will be determined by their confidence in the future and their perception of equitable burdensharing during the period of austerity.

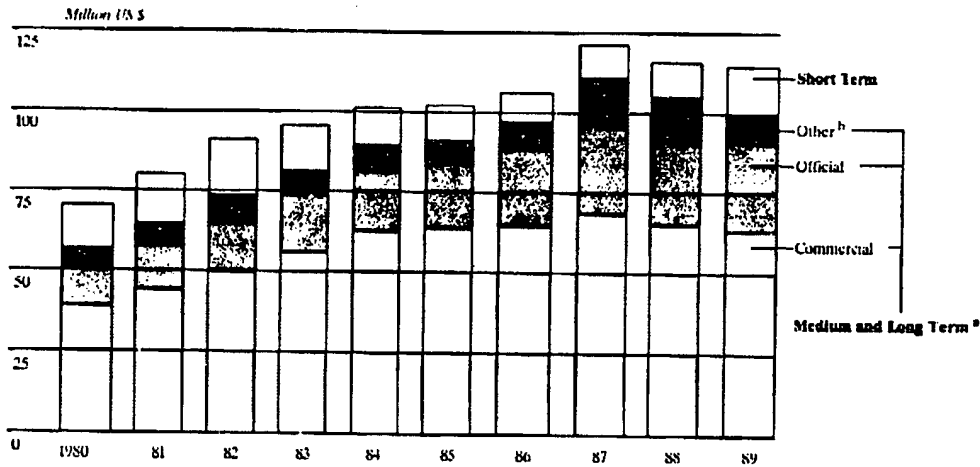
We estimate that, in the face of spiraling inflation or a protracted downturn, Collor will try to maintain the basic elements of his program. These scenarios—which we give a somewhat less-than-even chance of occurring—could develop if:

- Budget targets were not achieved because constitutional challenges successfully blocked efforts to reduce public-sector employment and privatize parastatal enterprises; tax revenues fell far short of expectations because of the slack economy, and

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Figure 7
Brazil: Foreign Debt, 1980-89



^a Includes arrears (see below).

^b Includes bonds, suppliers credits, and intercompany loans.

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- Collor decided to monetize the resulting deficit; or
- Huge wage concessions obtained either through court decisions or congressional action to reindex wages or a major surge in farm prices because of badly slumping production, produced a resurgence of near-hyperinflation, and
- Continued tight monetary policy produced deepening recession and rising unemployment.

If confidence in Collor falters badly, the chances of an obstructionist Congress increase. Even if the newly elected body initially supports Collor, a subsequent decline in public confidence would embolden political opponents and weaken the resolve of the President's congressional supporters.

If this scenario takes place, the President probably would grudgingly decide to make concessions, slowing implementation of his reforms and hampering control of the budget. Collor might reimpose wage and price controls as a temporary measure but continue to strongly resist a full return to reindexation—arguing this would signal a return to the Sarney years. He would probably attempt to regain momentum by announcing major Cabinet changes and renew efforts to implement his program. However, Collor would probably have to bring in outside economic experts of stature, surrendering some of his authority. Under these circumstances, he still might be able to make less ambitious adjustments to the economy but would, nevertheless, have lost his best chance of reversing Brazil's economic fortunes.

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~~Secret~~**Implications of Collor's Program for the United States**

The success of Collor's reforms is important to the United States. His presidency represents the consolidation of democracy in Latin America's largest and economically most powerful country. Moreover, he has succeeded in a matter of months in revitalizing the population's faith in Brazil's future, with his promise to put the country back on the path to "grandeza" and modernization. He joins a growing list of Latin American leaders espousing major market-oriented economic reform as the only way to promote sustained economic development and growth, and his program compares favorably with market-oriented reforms undertaken elsewhere in the region.

But Collor has made it clear that his goal of improving Brazil's relations with the United States and other developed countries is not an end in itself, rather a key component of his overarching objective of modernizing the country and carving out a place for Brazil as an influential actor in the First World. Collor realizes that Brazil has become increasingly isolated economically and noncompetitive technologically, especially in relation to the growing economic integration taking place in East Asia and Europe.

With such goals in mind, Collor has launched several foreign policy initiatives to demonstrate his sincerity. Focusing especially on trade, he has made impressive strides to open Brazil's economy to free market forces and has played down excessive nationalism. Collor has enthusiastically endorsed President Bush's Enterprise for the Americas Initiative.

Collor realized that, to break the logjam in US-Brazilian relations, he had to aggressively pursue rapprochement with the United States by showing flexibility on some sensitive bilateral issues. He has lowered import restrictions, promised pharmaceutical patents, and demonstrated a pragmatic approach to environmental, nuclear proliferation, and arms transfer issues. Moreover, he and his team have developed good personal rapport with their Washington counterparts.

Over the next 12 months, we expect bilateral relations to continue to improve. Although the overall record will be positive, talks on some issues—particularly nuclear proliferation and transfer of advanced technology—will continue to be difficult. Brasilia will insist that Washington respond to Collor's economic and fiscal reforms by allowing increased technology transfer and broader access to US markets.

Trade and GATT. Collor moved quickly to reorient Brazil's highly protectionist trade regime away from nontariff barriers to a tariff system, removing the main roadblocks to improved bilateral relations. This positive start, however, will be tempered by Brazil's need to sustain trade surpluses necessary to bolster international reserves and service its foreign debt obligations. Brasilia may also come under heavy pressure by some domestic interest groups claiming that too rapid liberalization would undermine less competitive domestic firms.

However, Brazilian complaints against US agricultural policies remain key topics on the new administration's bilateral trade agenda. Brasilia claims that the US Export Enhancement Program (EEP) for soybeans is undercutting their exports to traditional markets and may take the issue to the GATT unless the United States discontinues this subsidy. Brazil also will probably press harder for increases in US quotas on imports of various agriculture products, especially orange juice and processed meats.

Although the United States and Brazil will continue to differ on some important issues as the Uruguay Round of the GATT negotiations enters its final months, we believe that last-minute bargaining and greater Brazilian flexibility will improve chances for an accommodation with Washington. Brasilia will persist, however, in its determination to maintain provisions for "special and differential" treatment for developing countries that helps protect Brazil's industries and still will attempt to place limits on US initiatives involving services, intellectual property rights, and investment in the GATT.

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Foreign Investment. We expect the Collor team to take specific steps to dismantle the complex set of policies restricting foreign investment. Progress is most likely in areas where the President faces the least constraints on his authority, such as softening local content requirements and removing barriers to royalty payments and technical fees to foreign firms. Serious barriers to investment in computer-related fields will continue to be a problem [redacted]

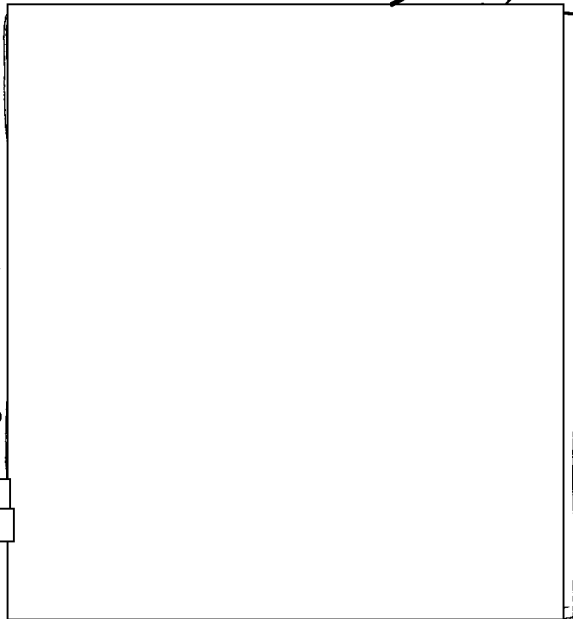
Nuclear Safeguards and Proliferation. There have been indications of flexibility in Brazil's past refusal to waive into force the Treaty of Tlatelolco, but no movement is expected on Brazil's longstanding refusal to sign the Nuclear Non-Proliferation Treaty. Collor has signaled he may move forward on Tlatelolco—which forbids the presence of nuclear weapons in Latin America—evidently in the belief that this precedent-breaking move would make Brazil appear more "responsible" and thereby facilitate its access to Western technology. Collor also has launched a basic review of Brazil's nuclear program, reflecting his intention to place it under civilian control [redacted]

[redacted]

Progress on Tlatelolco will most likely be difficult. The treaty's terms would obligate Brazil to negotiate and accept a full-scope IAEA safeguards agreement within 24 months of waiving Tlatelolco into force. Collor will have to overcome strong objections from senior military officers opposed to outside inspection of parallel nuclear program facilities. In any event, we expect negotiations on safeguards to drag on beyond the scope of this Estimate. [redacted]

Arms Sales. Brazil's arms sales to Iran, Iraq, and Libya have been a contentious issue in relations with the United States. With this onset of the crisis in the Middle East, Collor imposed an embargo on arms sales to Iraq that we expect him to honor as long as the UN sanctions are in place. Further, we expect Brazil to honor its previous assurances that it will not approve the sale of high-technology equipment to Libya. Nevertheless, Brazil's main arms exporting companies, motivated by ongoing financial difficulties, are likely to pursue further arms sales to other clients in the Middle East. Collor is unlikely to

authorize any politically sensitive arms transfers out of concern not to undercut his objective of drawing closer to Western industrialized countries. (S&TF)



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Technology Transfer. The whole question of US Government controls over transfer of sensitive technology will remain one of the most contentious topics in US-Brazil relations. Many senior Brazilian officials, business executives, and military officers believe these controls are designed to cripple Brazilian companies that are potential competitors of US firms. This perception has been strengthened by the long delays Brazilian companies have experienced in their attempts to purchase US high-technology items, such as supercomputers. We expect Brazilian officials will press Washington harder to cut through the legal restrictions and bureaucratic redtape hindering access to US high technology. Brazil's reluctance to accept full-scope nuclear safeguards or other technology controls will cause this issue to remain a major bilateral irritant. [redacted]

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Environment. Government funding of environmental projects will remain difficult because of conflicting demands on a tight budget. Nevertheless, Collor appears seriously interested in addressing environmental problems, and we expect continued improvement in the bilateral dialogue in this area. The President is genuinely concerned about Brazil's ecology, even though he wishes to prevent the appearance of Brazil's being dictated to by other nations on environmental issues. He also desires to end delays in disbursements from international loan agencies because of questions about environmental assurances. Thus, Collor has ended most environmentally destructive subsidies to large-scale agricultural projects in the Amazon Basin that were previously suspended under the Sarney government. Moreover, he has all but formally endorsed the use of debt-for-nature swaps—a policy reversal—to help in funding environmental projects. [redacted]

Despite the improved tone on environmental issues, we expect Brazil to continue to insist that the developed countries take greater responsibility for global environmental problems. Members of the Collor team will urge the United States and other developed

countries to be more forthcoming on technology transfer that would modernize Brazil's industry and reduce ecological damage. As it prepares to host the 1992 UN Conference on the Environment, Brazil is likely to assume less nationalistic positions on environmental issues to avoid incurring further international criticism. [redacted]

Narcotics. The Collor government has assumed a higher profile in the antinarcotics arena than its predecessor, but devoting major resources to the problem in a time of economic belt-tightening will be difficult. We believe, however, that Collor is concerned about the broad impact of narcotics in Brazil. He probably will continue publicizing the need for Brazil to address the problem. He will also take some concrete action to expand governmentwide antinarcotics efforts, including involvement of the Brazilian armed forces. Nevertheless, he will steadfastly rebuff any suggestions by other countries to deploy foreign military forces in Brazil's domestic counternarcotics activities. [redacted]

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