IPEA
004

Planning Foreign Aid for Brazil

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March 1967

This note is concerned with planning aggregate financial aid to Brazil: the amount of aid implied by a given set of assumptions about policy and behavior, the domestic implications of given aid levels, and appropriate policy measures to be taken by the Brazilian government with a given aid program.

Such an analysis must be centered on the factors determining aggregate needs for financial resources. The conventional way to analyse this problem (on which we have no improvements to suggest) is to estimate either the difference between desired investment and expected domestic savings, or the difference between import demand and expected exports. These estimates can be called, respectively, the domestic gap and the external gap. The two are equal in an accounting or ex-post sense. However, they are usually calculated independently of each other, either because of an a priori judgement that the factors influencing one are more important than the factors influencing another, and that therefore the other will adjust in value to equal the first, or in order to investigate the relative importance of each. The a priori judgement usually leads to calculating only one and forgetting the other; the investigation of relative importance leads to something like the recent "two gap" work by Chenery and others.*

Every estimate with which the author is familiar considers or implies that the external gap is the more important one for Brazil. This includes a preliminary try by the author in 1964, the work by Chenery and Strout cited above, and, perhaps, the EPEA "framework". (I say "perhaps" because the simulations with the framework also bump into an inflation constraint, which is certainly a symptom of a domestic gap.)

Estimates which are based on econometric studies of historical data have, of course, one very important weakness: they show only what the gap would be under continuation of those past conditions and policies which are not included in the model. This, of course, does not mean that the results cannot be useful; it means only that we must

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* see, for example, Chenery and Strout, "Foreign Assistance and Economic Development", American Economic Review, Sept. 1966.

keep the ceteris paribus in mind when making inferences from the results.

The EPEA "framework" model has several strengths, in this sense, which few other such models have had. It has (completely or partially) taken out of the ceteris paribus such factors as the relative price of imports, the government deficit, and the rate of inflation. It has not been possible, however, to include such other important factors as a total domestic resource gap, private demand, income distribution, the effects of the balance of payments on inflation,* and wage levels. The simulations done with the model for the Plano Decenal did not include the effects of varying the price of imports. The import demand functions are based on the structure of Brazilian productive capacity throughout the 1950's, and early 1960's. That structure was of course changing rapidly, and at present is rather different than it was in the period on which the model is based.

It is not clear to me in what sense, and under what conditions, the external gap will be a more serious problem than the domestic gap; to what extent the single, actual gap which may in fact appear should be dealt with by measures aimed at imports and exports rather than by measures aimed at domestic consumption, investment, and savings; and whether aid needs are really determined by a structural inability to export enough to pay for certain goods which must be imported, or whether, on the contrary, aid needs are determined by the domestic gap, which in turn implies managing imports and exports so as to let the desired amount of aid flow in.

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During 1965 and 1966, Brazil's balance of payments has been in surplus, and a significant amount of aid has been lent at the same time. The surplus has aggravated inflationary pressures, and the coincidence of surplus and the aid has caused some embarassment. There is some difficulty in using external gap analysis to justify aid when a country has a surplus in its balance of payments. Non-economic factors, of course, are important, but the most effective defense on economic grounds is probably the short-run nature of the surplus.

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* a recent note by Sam Morley discusses this point.

Imports fall and exports rise as the domestic economy stagnates; resume domestic growth and a deficit will surely reappear. In spite of the obvious likelihood that this will in fact happen, the apparent inconsistency in the short-run situation has induced some people to question even the longer-run justification of aid as a device to pay for imports. There is a growing feeling that large amounts of financial aid are not only not sufficient, but not even necessary for satisfactory economic growth in Brazil. I think that this feeling is based on an external-gap way of looking at aid needs. The idea goes as follows: First, there probably exists a set of policies whereby Brazil can grow at a reasonable rate and not run afoul of balance of payments problems; second, large amounts of aid will not insure either growth or the eventual end of apparent needs for aid, in the absence of proper steps by the government and people of Brazil; finally, does a country with an industrial park as extensive and diversified as Brazil's really have a structural import demand problem that can only be solved by aid?

Set off against these questions and doubts is the obvious fact that Brazil is a poor country. Poor in income. Poor in education. Poor in housing. Poor in health. Real material resources are needed to provide capital and other inputs which will raise the productivity of labor, build schools and pay teachers, build houses, etc. Aid can finance real material resources. Who says Brazil doesn't need aid?

Perhaps the relevant way to estimate aid needs is to look at the domestic gap. If structural problems can indeed be solved by slow but steady export promotion and intermediate-run import substitution where necessary, the constraint that remains is the basic insufficiency of total resources to meet total demands.

If one compares the list of Brazil's imports to her productive capacity, one may guess (as does the author) that somewhere between one third and two thirds of these imports could be produced domestically, at costs not much more out of line than Brazil is already paying for a wide range of recently substituted products. (Some empirical investigation of this would be interesting.) One is led more and more to believe that, with reasonable growth of exports and perhaps some extension of foreign debt repayment, Brazil's constraint will not be that it can't produce the lathes, locomotives, and transformers but that it can't save enough to pay for them.

The thesis of this note can be summarized in three points:

First: It makes more sense to think of the total need for aid in terms of a supplement for domestic savings, facilitating growth by allowing more investment with less inflation and less drastic squeezes on consumption, than to think of it as additional foreign exchange with which to purchase needed imports.

Second: Aid can only be absorbed if Brazil imports more than it exports. The foreign sector must be managed so as to allow the desired amount of resources actually to enter the country. (Note that in this scheme, imports are in a sense determined by aid needs, rather than vice versa.)

Third: Actions which aid donors might appropriately desire are thus focused on elimination of the domestic gap. (In addition to keeping exports growing fast enough so that the balance of payments in fact does not become the key problem). These actions would be, I suppose, a mixture of fiscal discipline to increase savings (continued control of public consumption, increasing tax receipts, capital market reform, etc.) and a balanced and profitable-in-the-long-run investment program, including a lot more progress in education than has recently taken place.

How would a desirable level of aid be established within such a scheme? On the side of the recipient, one can think of two possible limitations. One is the ability to find things on which to spend productively. The basic limit here must be pretty far away, but practical limits might be reached in the ability to implement and administer the investments, or if donors and recipients did not agree on priorities, or if donors emphasized a "project" approach. A second limit might be reached in problems in running a large balance of payments deficit. As a counterpart to these "absorptive capacity" problems, limitations on the donor side, in addition to the basic availability of funds, include tying aid to purchases from the donor country (this is especially a problem if a large part of the lending is for projects; a well-industrialized recipient like Brazil may then have real trouble in finding enough things to import), the time and information requirements of the project approach, and the reluctance to finance local-currency expenses. (This last need have no restricting effects if aid is available to finance a broad range of general imports.)

Regardless of the forms in which aid is lent or the ways in which it is administered, the calculation of the total amount and the desired performance of the recipient are global matters. The actual function of the aid is to add to total resources. The need for aid will be reduced only by increasing the amount and productivity of total resources. This does not mean that inefficiency or neglect of important problems should be permitted in aided projects; rather it means that only through increasing efficiency in all activities and working towards solutions of all important problems will Brazil become independent of the need for financial aid.