PROPOSED SYSTEM OF FOREIGN EXCHANGE CONVERSION AND EXPORT PROMOTION

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I N T R O/D U C T I O N

The suggested exchange rate policy and program of export promotion are presented as a series of recommendations. Many of these recommendations are far-reaching and represent substantial departures from the present system. It is strongly felt that these changes are required for effecient operation of the foreign sector of the Brazilian economy.

Exportation can be strongly influenced by the exchange rate system together with related monetary and fiscal policies and institutional arrangements. On the other hand, exchange rate adjustments and changes in related policies often are induced by variations in rates of exportation. Thus there is an important interaction by which exports influence and are influenced by exchange rate policy.

Because of this inter-relationship, the following recommendations cannot be distinctly divided between those related solely to the exchange rate system and those belonging only to export promotion However, in general first are presented those recommendations pertaining principally to exchange rate policy followed by those emphasizing export promotion.

It should be remembered that many of the recommendations, if adopted, will effect wide areas of the Brazilian economy - not just the international sector. Full extent of these effects cannot always be pre-determined; however trends are discernible in addition to the influence on the Brazilian economy in general. The recommendations were not disigned to strengthen the international sector as an end in itself, but to form a system which is most favorable to the entire Brazilian economy.

The recommendations are first presented in outline form in order to show the general framework of the system being proposed. Related to each recommendation is an explanatory note. These notes, because of their length and possible distraction from the composite picture, follow the outline of recommendations. The notes serve to explain the recommendations in detail, the rationale for their adoption, relationship in the system, and the mechanics of their utilization.

The proposed system for foreign exchange conversion and export promotion was designed to possess characteristics of: simplicity, automaticity, smoothness of change, flexibility, consistency, and continuity. Relevance to the system of each of these desired characteristics is described below.

1. Simplicity - The system ought to be devoid of confusion and easily understood by all interested persons. Paperwork and processing time should be reduced to a minimum. The system should be so constructed that anyone with reasonable intellegence can conduct his own affairs in the foreign sector without requiring assistance from a specialist or an intermediary between himself and government officials.

2. Automaticity - Adjustments in the system should occur according to pre-determined formulas and should not depend upon individual discretion.

3. Smoothness of change - Adjustments in the system should be gradual, smooth, and well-ordered. Sharp and spasmodic fluctuations should be avoided.

4. **Flexibility** - The system should be sufficiently flexible to permit efficient operation under all economic conditions to which the system is likely to be exposed.

5. **Consistency** - Factors and forces within the system should complement each other harmoniously. Fulfilling one policy should not nullify nor limit the successful carrying out of another policy.

6. **Continuity** - The system should be long-lasting - providing understandable and predictable processes for pursuing specified and long-range policies.

OUTLINE OF RECOMMENDATIONS

1. FREE MARKET FOR FOREIGN EXCHANGE

   A. Purchase and sale of foreign exchange should be freely permitted.

   B. There should be no official registering or licensing of foreign exchange transactions.

2. FLOATING EXCHANGE RATE

   A. The rate at which the cruzeiro is exchanged for any foreign unit of account should be permitted to fluctuate according to the related forces of supply and demand.

   B. The government's only effort to influence directly the exchange rate should be to reduce very short-term (e.g. day-to-day) oscillations through employment of the proposed STERS fund.

3. FORWARD EXCHANGE MARKET

   Formation and development of a forward exchange market should be strongly encouraged.

4. EFFECTIVE EXPORT EXCHANGE RATE (Alternative to 2)

   If Recommendation 2 is not adopted and a pegged exchange rate is maintained, then the effective exchange rate for exports should be adjusted in conformity with domestic production costs.

5. BI-LATERAL TRADING AGREEMENTS

   A. Bi-lateral trading agreements should be evaluated individually and be formed under conditions which allow Brazilian officials greater flexibility to negotiate.

   B. Subsidies under bi-lateral trading agreements should conform to Brazil's exchange rate system and general trade policies.

6. SIMPLIFICATION AND IMPROVEMENT OF EXPORT PROCEDURE

A. Eliminate all export licensing except for a few specified products.
B. Use one reporting form.
C. Permit self-service
D. Improve Customs Administration.

7. REGULATION OF INTERNAL PRICES THROUGH EXPORT CONTROL

A. All quantitative restrictions on exports should be eliminated as the means for influencing internal prices.
B. Instead, there should be employed a system of export taxes combined with tax refund for similar imports within a specified period.

8. EXPORT CREDIT AND BANKING

A. There should be established a special Export Credit Fund to permit commercial banks to provide low cost financing of export contracts.
B. Inexpensive loans should be offered for encouraging expansion of export capacity.
C. Cooperation between Brazilian and foreign banks should be strengthened.

9. LONG-TERM EXPORT AGREEMENTS

A government sponsored agency should investigate possibilities for establishing long-term export agreements with important international marketing organizations or distributors.

10. FOREIGN PROMOTION OF BRAZILIAN EXPORTS

A. Make better [illegible]
B. [illegible]

ADDITIONAL SUBJECTS FOR RECOMMENDATIONS

Number

11. Quality Control of Exports

12. Educational Program about Exportation

13. Tax Incentives for Exportation

14. (Perhaps) Development of Foreign Tourism in Brazil

NOTE 1 - FREE MARKET FOR FOREIGN EXCHANGE

There should exist complete freedom for all types of foreign exchange transactions.

The basic objectives behind proposal of this and the successive recommendation are: provide the proper atmosphere for strengthening the foreign exchange market in Brazil, encourage inflow of foreign savings and investments, reduce present trade distortions and discrepancies, and make automatic and harmonious the equilibrating process in the balance of payments.

The domestic banking system can and should serve as an important adjunct of the foreign exchange market. Therefore this note includes suggestions related to the role of Brazilian banking in conjunction with the recommended form of the foreign exchange market.

In order to provide a free foreign exchange market with the desired ancillary relationships, the following eight conditions should be present in Brazil.

A. Buyers and Sellers of Foreign Exchange Should Be Free To Determine For Themselves The Transfer Prices of All Foreign Exchange

The government should not try to favor nor to penalize specific types of: foreign exchange, transactions, sources, or buyers (by imposing special rates or conditions, restricting markets, etc.). Thus with a free foreign exchange market there would tend to be at any given time in Brazil only one exchange rate between the cruzeiro and any foreign unit of account. Of course some differences will occur because of commissions and other costs of transfer, various degrees of liquidity and safety for different types of money instruments, imperfect knowledge, etc.

It is intended that there be full freedom of exchange among all moneys. Thereby, arbitrage (in which the government, through the Central Bank, also can participate) would tend to eliminate disparate cross rates in the Brazilian market.

B. Anyone Should Be Permitted To Own (And/Or Hold) Any Quantity Of Foreign Exchange Anywhere and In Any Form.

The Brazilian Government should not restrict maintenance of funds anywhere by any of its citizens nor limit holding of funds in any form in Brazil by anyone. Thus Brazilian banks would be able to hold customer deposits in any unit of account.

C. Anyone Should Be Able To Engage In Foreign Exchange Transactions Without Governmental Control.

There should be no official limit on the number or kind of exchange houses and banks engaged in conversion of foreign moneys.

Holders of foreign exchange should be able to dispose of their foreign exchange as they desire within the full range of possibilities offered by the free market; while purchasers should be able to obtain foreign exchange from any available source.

The government would have no special privileges in the Brazilian foreign exchange market and would operate subject to the same kinds of forces as any other buyer or seller. However because of the potential size of its transactions, the government can greatly influence exchange rates. In a free market the government's potential ability to cause appreciation of the rates equals its foreign reserve and international borrowing capacity. In the other direction, the government's potential ability to cause depreciation is only limited by its capacity to create domestic money. The extent to which the government should influence exchange rates is described in Note 2.

D. <u>There Should Be No Official Licensing Nor Any Other Form Of Governmental Control On Transfer Of Funds Into And Out Of Brazil</u>

Complete freedom of international transfer of funds is essential for operation of a free foreign exchange market.

Presently there exists considerable movement of capital into and out of Brazil which is not recorded because such movement occurs illegally through under and over-invoicing, smuggling, etc. - all of which encourage corruption and distort trade figures upon which projections and plans are based. With removal of incentives for this circumvention of the law - by allowing full, uncontrolled freedom in the international transfer of funds - Brazil gains: 1) confidence of foreign and domestic investors, 2) elimination of much bureaucratic control, and 3) reduction in possibilities and temptations for corruption.

A principal method for retaining foreign investment in Brazil has been to limit profit remittances. Apparently this and other restrictive efforts have been unsuccessful - as is not surprising, given the available opportunities of evasion. Although since 1955 much new foreign investment occurred in Brazil, the declared return on this investment only averaged between 3 and 4 percent. It is estimated that foreign investment in Brazil requires at least a 20 percent net return (in real value) in order to prove attractive. One must therefore assume that a large portion of actual profits were not declared and that considerable illegal transfer of remittances has taken place. Officials of the Central Bank believe that these illegal remittances are now being made largely through the parallel market (which is receiving the un-official support of the government).

It is firmly felt that adoption of the policies suggested here will create an atmosphere conducive to providing foreign capital

in Brazil on a scale considerably larger than could be secured by even successful restriction of profit remittances. For this reason the policy of full freedom of capital transfer should be applied to profits the same as to capital derived from any other source.

E. Interest Rates Should Be Freely Determined Without Governmental Interference.

There should be no fixing of legal maximum rates of interest nor limitation on interest payments for any type of deposit. Adoption of this policy may require a series of gradual adjustments. Otherwise, instantaneous conversion to fully free interest rates might cause unnecessarily severe economic repercussions. As a general rule, it would seem that the greater the difference between existing interest rates and those under the anticipated free market situation, the longer is required for relatively undisruptive conversion to free rates.

Freedom of interest rates when coupled with freedom in the foreign exchange market would provide an important stabilizing force for Brazil's balance of payments. Foreign held capital should be attracted to Brazil in large sums by the substantial interest rate differentials now existing. The anticipated large capital inflow will lower internal interest rates which in turn will greatly improve investment opportunities in Brazil.

It is important to realize that freedom of the interest rate to fluctuate according to the market forces of supply and demand will provide in conjunction with the exchange rate (see: Recommendation 2) the basis for: 1) maintaining balance of payments equilibrium, 2) determining the flow and size of private capital movements, and 3) allocating efficiently private (Brazilian and foreign) investments.

The exchange rate and the interest rate can and should be

closely interrelated. The freedom of one to fluctuate should not be restricted or distorted by lack of freedom for the other to fluctuate. Given this freedom, resulting smooth and harmonious adjustments in response to internal and external changes should provide the atmosphere and means for Brazil to continue development along the economically most efficient path.

F. Anonymity Of Depositors Should Be Allowed

Individual bank accounts should be free from governmental inspection so that Brazilian banks can legally provide numbered accounts or other means of secrecy if desired by their clients.

Provision of secrecy is one method of competing with foreign money markets in attracting both foreign and Brazilian savings. Presently bearer type stock shares (i.e. ações ao portador) serve as another method by which private wealth can be held secretly (including from the government). Thus officially-sanctioned secret holding of wealth in form of bank deposits would not represent a unique condition for Brazil but could prove an important additional stimulus for increasing the supply of loanable funds in the Brazilian banking system.

G. There Should Be No Taxation Of Income Earned From Bank Deposits.

With secrecy of bank account ownership there would really be no way to enforce payment of income received from bank deposits. Many countries now exempt from taxation all income derived from bank deposits held by foreigners. Brazil should do likewise in order to compete for international capital, and in addition should also eliminate taxation of income from deposits held by Brazilians. With this removal of any moral stigma or doubt about obligation of related income tax payment, Brazilians might then be further encouraged to place their funds with domestic banks.

There is presently no taxation of income derived from exportation of most manufactured products. Another form of export earnings is obtained from the interest and dividends earned on Brazilian-owned loanable funds held abroad. Income from this source usually is not declared and often neither this income nor the principal is returned to Brazil for fear of taxation or confiscation, etc. Therefore freeing from taxation income earned from foreign held bank deposits probably would not diminish governmental tax revenues and might well encourage a capital inflow into Brazil, especially if income from Brazilian bank deposits is free from taxation.

H. Bank Deposits Should Be Adequately Insured

Potential depositors may doubt that the Brazilian Government will adhere to a program composed of the preceding seven conditions. Such doubts, unless satisfactorily assuaged, could seriously limit the flow of capital into Brazil and the full functioning of this program. In particular, potential foreign (and Brazilian) investors may worry about continuance of unrestricted repatriation of their funds held in Brazil and about the solvency and reliability of Brazilian banks. Reduction, if not removal, of these doubts should be accomplished through provision of two types of insurance.

One type of insurance would guarantee transferance of bank deposits (and possibly wealth held in other forms) from Brazil. This insurance should be provided to bank depositors, etc. from sources outside of Brazilian control, e.g. Loyds of London. The Brazilian Government could underwrite this foreign supplied insurance through assignment of some of its international deposits.

The other type of insurance would guarantee solvency of deposits held in Brazilian banks. This insurance could be supplied, or at least underwritten, by the Brazilian Government. In conjunction with this second type of insurance (which should cover deposits of all sizes), the government should impose and strictly enforce banking regulations in order to protect itself from insurance claims and to establish an international reputation of dependability in Brazilian banking.

Through use of these two types of insurance, depositors in Brazilian banks would be fully protected, and the free foreign exchange market, as envisaged here, could be utilized for maximum benefit to Brazil.

NOTE 2 - FLOATING EXCHANGE RATE

A. The Exchange Rate Should Be Permitted To Fluctuate According To The Forces Of The Free Market And Without Governmental Intervention (Except On The Limited Basis Described In Part B)

> "O principal objetivo é simplificar o sistema cambial vigente, com a unificação cambial num mercado regido por uma taxa de câmbio livre e flexível, que reflita as tendencias internas e externas de preços, bem como as condições de mercado."
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> Fonte: Programa de Ação Econômica do Governo 1964-1966, 2nd. Ed., Ministerio do Planejamento e Coordenação Econômica, Maio de 1965, p. 48.

There are many advantages in using the type of flexible exchange rate which is recommended here for Brazil. This type of exchange rate will hereafter be referred to as a "floating exchange rate" and is determined according to the free market forces with the government providing limited and prescribed reduction of short-term oscillations.

Objections to use of a floating exchange rate usually concern reserve (or key) currencies. The Brazilian cruzeiro is not such a currency and, therefore, these objections are not applicable for Brazil. Rate variations under the floating exchange rate system proposed for Brazil would not disturb economies of other countries. Actually, the opposite should occur. The increased stability accruing to Brazil's economy through use of a floating exchange rate should prove beneficial to other countries.

The traditional advantages of a floating exchange rate have been described often in the related technical literature.[1] Some

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1. Some of the principal literature in which use of floating exchange rates is recommended is: Milton Friedman, "The Case for Flexible Exchange Rates" in Essays in Positive Economics, (Chicago: University of Chicago Press, 1953) pp. 157-203; Frank D. Graham, "The Cause and Cure of the Dollar Shortage", Essays in International

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of these advantages which are most pertinent for Brazil will be summarized later in this part of Note 2. However there is a further advantage which because of its special relevance for Brazil should be explained now so that its importance can be appreciated during the subsequent discussion.

1. Predictability

Brazil's future economic development will be highly dependent upon expansion of Brazilian export earnings. Since the years immediately following World War II, Brazilian exports have been seriously retarded by use of fixed exchange rates in conjunction with internal inflation. If this internal inflation continues (as is anticipated for at least the next few years), a floating exchange rate should be employed in order to allow Brazilian exports to expand in conformity with development requirements.

The existing system provides potential Brazilian exporters with such limited profit predictability that results of only very short-term export undertakings can be forecast with any substantial degree of certainty. All exporters must try to anticipate their foreign sale prices and related costs. However Brazilian exporters are confronted with the additional (and usually more difficult) problems of trying to anticipate the number of cruzeiros obtainable from each unit of foreign exchange (i.e. exchange rate variations) and the internal purchasing power of those cruzeiros when finally received. These additional factors of uncertainty place the Brazilian exporter at a serious competitive disadvantage which in turn has considerably hampered Brazilian

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1. ...Finance No. 10, (Princeton: Princeton University, 1949); Gottfried Haberler, "Currency Convertibility" (Washington: American Enterprise Association, 1954); James E. Meade, "The Future of International Trade and Payments", The Three Banks Review, No. 50, June 1961; George N. Halm, "Fixed or Flexible Exchange Rates" in Factors Affecting the United States Balance of Payments (Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, 1962) pp. 255-266.

export capabilities.

For all but short-term sales, the potential Brazilian exporter cannot now accurately pre-determine the cruzeiro value of his future export receipts and costs, and thus his profits or losses. Past variations in the exchange rate have been irregular (both in occurance and size) and, for the average exporter, unpredictable. Moreover for any given export undertaking exchange rate devaluations, when and if they occur, may or may not be sufficient to compensate for the rising related internal costs of production.

Lack of profit predictability for Brazilian exports discourages orientation of investment and production toward exportation, and limits possibilities for capturing and maintaining foreign market shares on a continuing and reliable basis. As a result, it is not surprising to find that Brazilian exports consist principally of traditional agricultural products. These products require no specialization for exportation and to some extent are often the objects of price support and/or other control and subsidy. Thus marketing risks are minimized for producers. The recent spurt (1964-66) in manufactured exports stems primarily from an internal recession which caused transference of existing production from the internal to the external market. With domestic economic recovery, the direction of transfer may be reversed -- leading to a relative decrease in importance of the exported share of manufactures. The primary attractiveness of the internal market is the increased certainty arising from the generally parallel rise of production costs and sale prices. Existing mineral production is largely exported and suffers considerably from the unpredictability of relating domestic costs to export earnings.

In order to encourage and sustain at higher levels Brazilian exports of all kinds, increased profit predictability is required. This objective should be attained with use of a floating exchange rate in conjunction with a forward market for forward exchange (see: Recommendation 3).

2. Operation of a Floating Exchange Rate

A floating exchange rate provides the equilibrating link between internal and external price systems. Normally, a floating exchange rate will vary in accordance with changes between the domestic purchasing powers of the two moneys related by the exchange rate.

With a rise of internal prices (assuming constant external prices in terms of foreign moneys), a unit of domestic money loses domestic purchasing power while maintaining its external purchasing power -- at any given exchange rate. This type of change in the purchasing capacity of domestic money encourages capital exports and imports of goods and services while discouraging exports of goods and services. Given this set of conditions there are two possible forms of independent adjustment (short of administrative control).

1) If the exchange rate is held constant (i.e. a pegged rate) then there will be an outflow of foreign exchange and gold. With continuance of inflation, this outflow will persist until international reserves are exhausted. Obviously, few if any governments could (or would) risk complete loss of their international reserves (and theoretically, eventually ending their foreign trade) in order to maintain a given rate of exchange in face of persistent internal inflation. Therefore, if inflation endures, devaluations become inevitable. These devaluations are made in order to end loss of international reserves by giving to a unit of domestic money relatively more domestic purchasing power. Actually, devaluation accomplishes such a change in purchasing capacity of domestic money through reducing the foreign purchasing power component of this capacity.

2) The other basic form of adjustment is to rely on

automatic exchange rate variations to preserve that balance of the domestic and foreign purchasing power of domestic money which holds the level of international reserves constant. This means that in the foreign exchange market the forces of supply and demand determine the exchange rate without significant stabilizing intervention by the government. The result of such a policy provides a floating exchange rate.

With a floating exchange rate, internal inflationary pressures influence the price of foreign exchange -- and thereby domestic prices of all imports and exports -- the same manner as inflation influences all (non-controlled) prices of internally supplied goods and services. An inflation-induced rise in these prices causes a fall in the purchasing power of a unit of domestic money in both the internal and external markets.

Simultaneous loss of purchasing power in both markets occurs because of the automatic devaluation which holds constant the relationship between the foreign and domestic components of the purchasing capacity of a unit of domestic money.

Thus it is seen that with continuing internal inflation both forms of adjustment depend upon devaluation. The first of these forms is used by Brazil and relies upon infrequent and relatively large scale devaluations which are based on administrative discretion and usually arise in response to losses of foreign reserves. The second form of adjustment consists of one continuing devaluation, the intensity of which is determined automatically by the rate of internal inflation without change in the country's international reserves.[2]

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2. With use of a short-term stabilizing fund, a country's international reserve position could be modified slightly as explained in Part B of this note.

3. Advantages Of A Floating Exchange Rate

Brazil could receive many advantages from converting to use of a floating exchange rate instead of maintaining its present system of a pegged exchange rate with sporadic variations. Already mentioned was the necessity for providing profit predictability to exporters and how this necessity can be met with the proposed floating exchange rate system. Following are other advantages to be gained and factors to be considered in making the recommended change.

a. Speculation - Past changes in Brazil's exchange rate have been made principally in response to balance of payments problems. These problems have been signalled by Brazil's loss of foreign reserves.

Thus one cost of operating the present pegged rate system has been the loss of foreign exchange and gold required to signal the need of variation in the exchange rate.

This signal, however, has not been reserved for exclusive observation of relevant governmental officials, but has been (almost by necessity) public knowledge. Interested persons have been able to determine the likelihood of an exchange rate variation, and with almost complete certainty the direction of such a change. Therefore speculation has been encouraged.

Under the present system, the cost to a speculator for guessing incorrectly has been relatively small -- equaling commission charges for money conversion and possible loss of interest (i.e. between returns from investments in cruzeiros and in foreign exchange). On the other hand, possibility of a speculator's profit has been considerable -- representing (in the typical case) the net addition to a speculator's ownership

exchange and then, after devaluation, back again into cruzeiros.

The government loses what the speculator gains. With the existing form of speculation where devaluation is successfully anticipated, the government supplies domestic money and receives nothing in return -- except for prolonging use of a given exchange rate. No additional goods or services are provided the domestic market in compensation for the supply of money received by the speculators. It should therefore be apparent that the present Brazilian exchange rate system (i.e. of pegged exchange rates with sporadic devaluations) encourages a form of speculation which contributes to domestic inflation and devaluation.

Of course the stimulus to inflation, described above, can be offset by taxes, reduction in governmental spending, etc. However the net effect is the same: a redistribution of wealth favoring speculators in foreign exchange.

Until now, the burden of profitable foreign exchange speculation has been borne by the government. Not only has the government been forced to increase unnecessarily the domestic money supply, but because of the pressures of profit opportunities provided by speculation the government has been obliged to devalue sooner and probably to a greater degree than had speculation not existed.

Speculation however should not be blamed for these perverse results from operation of the present exchange rate system. Existing speculation is merely symptomatic of the distorted price relationship caused by combining a pegged exchange rate with internal inflation. Regardless of this inflation, speculation can serve as a beneficial factor when operative under the recommended floating exchange rate system.

As was explained, adjustment to changes in demand and supply conditions in the foreign exchange market now is made (initially, at least) through variation of foreign reserves. Because of Brazil's continuing inflation, the adjustment process has also required recurrent devaluations. It is this form of devaluation which makes speculation detrimental to the national economy.

In contrast, under a floating exchange rate system adjustment to changes in demand and supply conditions in the foreign exchange market is made through variation of the exchange rate while foreign reserves remain (largely) unaffected. Because the adjustment mechanism with a floating exchange rate has little or no dependence upon foreign reserves, the government can hold a much smaller amount of those reserves with a floating exchange rate system than with a pegged rate system.

Under both systems, speculators profit by correctly anticipating exchange rate variations. In constrast to a pegged rate system, with a floating exchange rate system the government does not (or need not) finance speculators' profits. Such profits may be obtained at the expense of other speculators who guessed incorrectly. Primarily, a speculator's profit represents his reward for holding in the form of one currency for which later other persons will be willing to sacrifice an increased amount of another currency.

An example may clarify this last point. Let us imagine that between Periods I and II there was an increase in the cruzeiro price of the dollar (i.e. depreciation of the cruzeiro) under a floating exchange rate system. The resulting reward to successful speculators (in the foreign exchange market) is paid by those persons who preferred (for whatever reason) to hold wealth between Periods I and II in cruzeiros -- or in another form which for effi-

ciency required conversion first to cruzeiros -- before conversion in Period II to dollars. These other persons were free to choose the form in which they held wealth. They could have converted earlier to dollars. The net cost of such a conversion if made in Period I would have been: 1) loss of profits available from uses of wealth in cruzeiros minus profits gained from available uses of wealth in dollars; and minus 2) the increase in the cruzeiro value of the wealth when stated in dollars. The other persons believed (correctly or not) that this cost was too high and therefore held their wealth in cruzeiros. The successful foreign exchange speculators were willing to accept this cost of holding dollars and so in Period II are being rewarded (according to the value as judged in the market) for their service of having held wealth in dollars instead of in cruzeiros.

Sometimes it is suggested that speculation under a floating exchange rate system is destabilizing and that speculators can induce a wave of panic buying or selling of foreign exchange. Let us examine separately both parts of this criticism.

First, there is no reason to suspect that speculation is more destabilizing than stabilizing. Furthermore, as speculators are specialists in this field and are dependent upon this activity for remuneration, it is necessary for them to be correct a majority of the time. Being correct means that they must accurately anticipate exchange rate variations resulting from forces other than their own. When successful, speculators lead the exchange rate from one equilibrium to another. If they do not successfully antipate a new equilibrium exchange rate, the original speculators themselves, or those who followed and assumed their commitment, must lose. But because speculators on balance remain in operation, we must assume their success and therefore their stabilizing function of arbitrage over time among equilibrium exchange rates.

Secondly, panic action by the general public in the foreign exchange market can be triggered as easily by speculation under a pegged rate system as under a floating exchange rate system. With the first system, the action causing panic is variation of foreign exchange reserves; while with the second system, the action is variation of the exchange rate. Either form of action could promote panic which would extend the degree of variation initiated by the original speculation. Here fault rests not in speculation associated with either system but with basically unstable internal conditions which allow self-accelerating shifts in the demand to hold wealth in terms of one unit of account instead of another.

In addition, it should be recognized that a governmental program of short-term exchange rate stabilization, such as is proposed for Brazil in Part B of this note, will serve to discourage destabilizing speculation under a floating exchange rate system.

b. Automaticity - In Brazil under the present pegged exchange rate system, devaluations are made by administrative decision. Accurate determination is an exceedingly difficult and complex task. The responsible administrators must try to estimate future demand and supply conditions in the foreign exchange market. This estimation in turn depends upon attempts to evaluate future levels of import and export demands, capital flows, rates of inflation and income growth, investments, etc. Thus not only must administrators endeavor to pre-determine a complex set of conditions but also they must try to devalue by that amount which best conforms to those conditions.

Primarily, decisions determining degrees of devaluation have been based, at best, on educated guesses. Such a guess, although made in good faith, is likely to be inaccurate -- either under or over-estimating the desired degree of devaluation. Under-estimation

for a given set of conditions implies continued loss of international reserves and necessity for one or more further devaluations. On the other hand, over-estimation of the degree of devaluation causes an increment in international reserves which is undesired (otherwise it would have been planned) at the related cost of decreased imports and increased internal inflationary pressure. Correction for over-estimation can be made by decreasing the cruzeiro price of foreign exchange.

The problem of determining the proper degree of devaluation in Brazil is magnified by the internally generated inflation. We have seen that a series of adjustments might be required before obtaining a pegged exchange rate which independently equilibrates supply and demand in the foreign exchange market for a given set of conditions. However even though such a rate is found it will only provide for a short period of time the desired link between internal and external conditions. Inflation creates new sets of conditions which in turn require new rates of exchange.

Conditions do not exist in Brazil for administrators to determine consistently the proper degrees of devaluation. Costs of this inadequacy have been mentioned with respect to under and over-estimation. These same costs occur whenever the exchange rate does not equal the independent equilibrating level -- that is whenever the pegged rate is under or over-valued. Administrative movement of the exchange rate toward the equilibrating level reduces these costs. The question is not whether the movement should take place but how. The fault with administrative action is that it is incapable of efficiently reaching and maintaining the proper equilibrium rate. The degree of inefficiency associated with administrative adjustment is measured by the costs resulting from pegging exchange rates at levels divergent from the level of the indepen-

dent equilibrating rate.

Use of a floating exchange rate is free from administrative decision with respect to exchange rate variation. The market forces automatically determine and maintain the equilibrium exchange rate so that the economy suffers none of the above mentioned costs associated with use of the pegged exchange rate system.

There is possibility of an additional cost when administrative discretion determines devaluation. It was explained how with use of a pegged exchange rate system speculators can profit, to the rest of the economy's detriment, by correctly anticipating devaluation. Information about a future devaluation if coming from an authoritative source can remove related risk and thereby greatly encourage this undesirable form of speculation which increases the cost to the government for a given devaluation. Sometimes strong pressure can be applied to responsible officials to divulge such information.

In contrast, under the proposed floating exchange rate system there need be no fear of information leaks and corruption in government concerning exchange rate variations. Such variations are determined in the free market, which offers to everyone possibility of equal participation and does not provide governmental officials with special privileges to bestow.

c. Absorption of External Influences - A floating exchange rate system cushions the domestic economy from shocks which originate externally. Otherwise under a pegged rate system these shocks are transmitted to the domestic economy in full force. Advantage of a floating rate over a pegged rate in easing internal adjustment to changes in external conditions becomes evident when we compare the processes of adjustment under each type of exchange rate system.

Let us suppose that ther is a sudden drop in foreign

demand for Brazilian exports. The resulting fall in Brazilian exports is less under a floating exchange rate system than with use of a pegged exchange rate. The drop of demand does not alter the pegged rate, but does effect the floating rate. The floating rate depreciates (i.e. the cruzeiro price of foreign exchange rises) so that Brazilian exports become cheaper to foreigners. Consequently after a given reduction in foreign demand, Brazil exports more if using a floating instead of a pegged exchange rate.[3]

With a pegged rate there is no variation in the cruzeiro price of imports -- unless the foreign exchange price of imports changes. Therefore, there is a tendency to continue importing at the same rate -- modified only by loss of income from the export sector. Obviously as Brazilian exports fall and imports continue at the previous pace, there will tend to be a deficit in Brazil's foreign trade and balance of payments. The burden of adjustment rests fully upon Brazilian income which, because of downward inflexibility of internal prices, could decline by some multiple of the initial decline in exports.

Decline in foreign demand for Brazilian exports causes depreciation of a floating exchange rate which raises the cruzeiro price of imports. Therefore Brazilian imports decrease. Correspondingly there is some increase in demand for internal products because of the change in relationship between internal and external prices, as expressed in cruzeiros. There

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3. Here we are discussing exports quantitatively. The important measure of exports is foreign exchange. For the situation described in the text, foreign exchange export earnings will be greater under a floating exchange rate than under a pegged rate for all products for which the foreign demand (in foreign exchange) is relatively elastic with respect to price. Coffee, and possibly castor oil, are the only Brazilian exports for which this demand condition may not occur. Coffee exportation is subject to special controls which can prevent related export receipts from falling if they would otherwise do so because of employing a floating exchange rate.

occurs no deficit in Brazil's balance of payments because of the automatic adjustment process with use of a floating exchange rate. As a result of this adjustment, Brazilian imports fall more and Brazilian exports fall less than with a pegged exchange rate. In addition, Brazilian income and most likely employment decline less with the floating exchange rate.

The absolute difference in income decline between use of floating and pegged exchange rates could be considerable. The initial drop in domestic income (because of the autonomous fall in external demand for Brazilian exports) is less with a floating exchange rate than with a pegged exchange rate. This obtains because, as was mentioned, with a floating exchange rate: 1) exports fall less and 2) there is substitution of internal demand away from imports to domestically produced goods and services.

The more inflexible downward are internal prices the greater must be the additional decreases of domestic income which result from the reciprocating external and internal income changes set in motion by the original decrease in foreign demand for Brazilian exports. Also with these induced adjustments, incomes will be less effected when the floating exchange rate is used. This is so because the floating exchange rate makes flexible the external prices of all goods whether or not they have rigid internal prices, while the pegged rate transfers internal inflexibility directly to the external market.

In this part of Note 2 we have so far compared internal reactions to an autonomous decrease in external demand for Brazilian exports. When, on the other hand, there is an autonomous increase in external demand for Brazilian exports, the internal reactions are symetrically opposite to those which we have just discussed. Briefly, we shall list these reactions.

With a pegged exchange rate, the increased demand

for exports raises Brazilian income -- which can be inflationary if there results a surplus in the Brazilian balance of payments. With a floating exchange rate the income rise is less, and because the cruzeiro price of foreign exchange is lowered, imports are greater and exports are smaller than with a pegged exchange rate. The automatic adjustment process under a floating exchange rate system keeps the balance of payments in equilibrium so that, there will be neither an inflation generating surplus nor a deflationary deficit.

In summary, it has been shown that use of a floating exchange rate, in comparison with a pegged rate, reduces domestic income variations resulting from external influences.

d. Complementarity With Internal Influences - In the previous part we reviewed the manner by which external influences are transmitted to the domestic economy in relation to the type of exchange rate employed. In this part we shall examine the roles of these exchange rates in assisting the domestic economy to adjust to influences which originate internally.

Let us first suppose that Brazil is experiencing an economic recession. Now the government seeks to stimulate recovery by one or more of the usual methods, i.e. increasing its expenditures, reducing taxes, providing cheaper and more loanable funds, etc. As recovery commences, there is an increase in Brazilian demand for domestic products and for imports.

Rise in demand for domestic products causes transference of some Brazilian output from sale in the export market to sale in the internal market -- which lowers export earnings. With a floating exchange rate this transference will be less than with a pegged rate because as export earnings decline the floating exchange rate depreciates (i.e. the foreign exchange price of cruzeiros falls) -- thus making Brazilian exports more attract-

ive in terms of their foreign exchange prices.

Depreciation of the floating exchange rate also occurs (further retarding export decline) because of the increased Brazilian demand for imports. Therefore in the process of recovery at any income level, less is imported and more is exported with a floating exchange rate than with a pegged exchange rate. For a given stimulus, economic recovery is faster and larger with a floating exchange rate than with a pegged rate because with the former rate induced income injections (from exports) decline relatively less while induced income leakages (from imports) increased relatively less than with a pegged rate.

Next, let us suppose that Brazil is suffering from severe inflation. The government endeavors to reduce inflation by one or more of the traditional means, i.e. decreasing its expenditures, increasing taxes, reducing the supply and raising the cost of loanable funds for the private sector, etc. As reduction in the rate of inflation commences there is a decrease in Brazilian demand for domestic products and for imports.[4]

Decrease in Brazilian demand for domestic products causes transference of some Brazilian output from sale in the internal market to sale in the export market -- which increases export earnings. With a floating exchange rate this transference will be less than with a pegged rate because as export earnings increase, the floating exchange rate appreciates (i.e. the foreign exchange price of cruzeiros rises) -- thus making Brazilian exports less attractive in terms of foreign exchange prices.

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4. Actually monetary demand is still rising but at increasingly slower rates so that demand can be thought of as decreasing relatively. For ease of exposition the following discussion in this part of the text concerning changes omits the term(s) relative(ly). The same conclusions are obtained from analysis of conditions containing either relative or absolute changes.

Appreciation of the floating exchange rate also occurs (further limiting export increase) because of the decreased Brazilian demand for imports. Therefore in the process of reducing inflation at any income level more is imported and less is exported with a floating exchange rate than with a pegged rate. For any given effort to reduce inflation, the resulting reduction is faster and greater with a floating exchange rate than with a pegged exchange rate because with the former rate, induced monetary injections (from exporters' sale of their foreign exchange earnings) are less while induced monetary leakages (from importers' purchase of foreign exchange) are more than with a pegged exchange rate.

In summary, we can conclude that use of a floating exchange rate, in comparison with a pegged exchange rate, facilitates governmental efforts to decrease inflation and/or to stimulate economic recovery.

B. <u>Direct Governmental Intervention To Influence The Exchange Rate Should Be Limited To Minimizing The Impact Of Sudden, Unanticipated Rate Changes And Should Never Be Used To Impede Basic General Trends In The Foreign Exchange Market.</u>

A Short-Term Exchange Rate Stabilization (STERS) fund should be created and administered by the Brazilian Central Bank. The STERS fund would contain foreign exchange and cruzeiros which would be placed for sale in the foreign exchange market according to a predetermined formula.

The STERS fund and its method of use would comprise the only system by which the government participates in the foreign exchange market for the purpose of influencing the rate of foreign exchange. The automatic functioning of this system almost eliminates need for personal discretion, possibility of mismanagement, and inducement to corruption.

The system is designed to remove sharp, short-term fluctuations of the exchange rate while not interferring with free operation of the foreign exchange market (as described in Note 1) or with the general trends of that market. The system functions as follows:

1. Monetary Composition Of The Fund

The STERS fund should be formed with 30 million dollars worth of foreign exchange plus an equal value of cruzeiros. Later the values of foreign exchange and cruzeiro holdings can be modified when the fund's requirements become apparent from actual operation of the system being proposed.

2. Operation Of The Fund

In order to reduce undesirable exchange rate fluctuations, the STERS fund should be employed according to the following formula. This formula is based on the degree and pattern of exchange rate variations per unit of time[5] and is summarized in Table I.

If the exchange rate varies 1% within a four hour period, the fund supplies up to five million dollars worth of foreign exchange (or the cruzeiro equivalent) before the variation is extended in the same direction by an additional 1% in the specified hours following the initial variation of 1%, etc.

An example will help clarify this operation -- which is typical under the formula being presented. Suppose that one day at 8:00 hours the exchange rate is Cr$2.200 = US$1. Demand for foreign exchange increases. The cruzeiro price of foreign exchange rises. At 11:00 hours the same day the exchange rate reaches Cr$2.222=US$1.

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5. The fund is used to counteract the direction of exchange rate variation. Therefore when the exchange rate depreciates (i.e. the cruzeiro price of foreign exchange increases) the fund sells foreign exchange for cruzeiros in the foreign exchange market. On the other hand when the exchange rate appreciates (i.e. the cruzeiro price of foreign exchange decreases) the fund buys foreign exchange with cruzeiros.

which means that the exchange rate has depreciated 1% within a four hour period. Now foreign exchange becomes available from the STERS fund in order to prevent the exchange rate from rising to Cr$2.244.2-US$1.00 (that is, 1% above the rate of Cr$2.222-US$1.00) in Stage II (See: Table I).

Because the initial depreciation occurred within 4 hours of Stage I, the time periods of Part a in Stage II are to be considered next. The first task is to prevent the additional 1% depreciation before 1500 hours (i.e. within the first time period of Part a which covers the first four hours after the exchange rate enters Stage II). For this task 2 million dollars[6] worth of foreign exchange are available from the STERS fund (see: line 1 of column B_2).

If the 1% depreciation limit of Stage II is not reached by 1500 hours, then the time limit is extended 2 hours to make a total of 6 hours for which a total of 3 million dollars is now available. This sum includes the 2 million dollars allotted for the 4 hour period. For example, suppose that by 1500 hours the exchange rate is Cr$2.235-US$1.00 and that 1 million dollars has already been supplied from the STERS fund (since 11:00 hours). Now an additional 2 million dollars becomes available for use in preventing the exchange rate from reaching Cr$2.244.2-US$1.00 (that is the upper limit of Stage II) before 1700 hours (i.e. 6 hours after the exchange rate enters Stage II).

The time limit is next extended to 8 hours and an additional 1 million dollars is added to the unused reserves available in Stage II, if the exchange rate has been contained within

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6. For convenience, the foreign exchange reserves of the STERS fund will be defined in terms of US dollars.

The amounts of money being cited here as stabilizing reserves are employed primarily to illustrate functioning of the proposed system and do not specify necessarily the exact size of these reserves to be used.

TABLE I

EXCHANGE RATE STABILITIZATION FLOWS FOR USE WITH THE STERS FUND

Stage I (1%)	Stage II (1%)		Stage III (2%)		Stage IV (3%)		Stage V (5%)	
A_1	A_2	B_2	A_3	B_3	A_4	B_4	A_5	B_5
4	a 4	2	4	4	4	6	4	8
	6	3	8	6	8	8	8	10
	8	4	12	8	12	10	12	12
	12	5						
6	b 6	2						
	8	3						
	12	4						
8	c 8	1						
	12	2						
12	d 12	1						
12 or over	-	0						

Key:

A_1 = The length in terms of hours of the inicial stage during which the exchange rate moves in one direction by one percent.

A_2, A_3, A_4, and A_5 = The lengths in terms of hours of Stages II, III, IV, and V during which related amounts of moneys (Columns $B_2 \ldots B_5$) are available for stabilizing the exchange rate within variations of 1%, 2%, 3% and 5% respectively.

B_2, B_3, B_4, and B_5 = The amounts of foreign exchange in terms of millions of U.S. dollars - or the cruzeiro equivalents which are available for exchange rate stabilization.

the six hour time limit. If the eight hour time limit is held, then the time limit is extended to 12 hours with the related increase in available reserves.

After the exchange rate has been in Stage II for 12 hours -- indicating that the additional 1% depreciation has not occurred -- the exchange rate reverts to Stage I.

If however in spite of the foreign exchange injection into the market the rate depreciates more than 1% during Stage II, then the exchange rate enters Stage III. Regardless of the time limit being considered in Stage II, as soon as the 1% depreciation occurs, the exchange enters Stage III.

In Stage III the depreciation level is 2% (or Cr$2.289-=US$1.00) for time limits of 4, 8 and 12 hours (Column A_3), with the related available reserves (Column B_3). When depreciation of 2% occurs in Stage III, the exchange rate passes to Stage IV (which allows a 3% depreciation) and then possibly to Stage V. The method for using the STERS fund for dampening depreciation in each of these stages is the same as was explained for Stage II.

If in Stage I the exchange rate depreciates by 1% between 4 and 6 hours, then Part b is used for Stage II. Similarly, when in Stage I the exchange rate depreciates 1% between 6 and 8 hours or 1% between 8 and 12 hours Parts c and d, respectively, of Stage II are employed. When the exchange rate passes to Stage III and numerically higher stages the same sets of time periods and available reserves are used for all situations regardless of which part of Stage II was last operative.

The preceding explanation has described operation of the STERS fund during depreciation of the exchange rate. The same operation should occur when the exchange rate appreciates (i.e. when the cruzeiro price of foreign exchange declines) --

however, instead of selling foreign exchange for cruzeiros (as with depreciation) the fund sells cruzeiros for foreign exchange.

Whenever an exchange rate fails to pass to a numerically higher stage, the exchange rate reverts to Stage I. This means that after an exchange rate has remained 12 hours in any one stage the exchange rate, if not already there, is next placed in Stage I. Moreover, with change in direction of an exchange rate movement, the exchange rate is placed in Stage I. For example, if first the exchange rate is depreciating and then starts to appreciate, the exchange rate moves to Stage I.

The STERS fund is inoperative when the exchange rate is in Stage I. This means that in Stage I the exchange rate can vary by any rate less than 1% per 12 hours without governmental intervention.

It is possible that in an extreme situation, variation of the exchange rate exceeds the limits of Stage V. In this case use of the fund is halted until the rate of variation declines sufficiently to permit continuance with the stabilizing process according to the formula just described.

3. Administration Of The System

Administrative responsibilities for operating this system consist of: 1) observing variations of the exchange rate, 2) acting according to the formula, and 3) supplying stabilizing reserves in the proper degree within the specified limits. These activities should be relatively simple and in time be reduced to a pattern of almost automatic reaction to changes in the foreign exchange market.

Observation of the foreign exchange market can be maintained through frequent telephonic contact with several of

the banks and offices most active in foreign exchange transactions. Arbitrage by such institutions and private dealers will keep the exchange rate (with possibly some differences of buying and selling spreads) the same throughout the country, and in conformity with exchange rates in markets outside Brazil.

The cruzeiro should be measured simultaneously against several leading foreign currencies: U.S. dollar, West German mark, English pound, and the Swiss franc; in order to insure that stabilizing is consistent with all of these basic currencies. In other words, an independent change in the value of one foreign currency should not require an offsetting use of the STERS fund. For example, if the English pound is devalued, the new exchange rates between the US dollar, German mark, etc. and the English pound will determine the new cruzeiro-pound rate of exchange. Disparate cross rates will be eliminated automatically by arbitrage and the government need not concern itself directly with this activity.

The previously described formula provides the outline for governmental stabilization of the exchange rate. An administrator needs only control the flow of stabilizing reserves within any set of the relevant limits provided under the formula.

Probably, the government will not be required to enter into stabilizing activity often or to a substantial degree. It is unlikely that the exchange rate will vary at a rate equal to or higher than 1% per 12 hours. Knowledge that governmental stabilization would begin when variation reaches such a level will by itself induce speculators to act in a manner which tends to reduce the rate of variation to less than this level.

NOTE - 3 - ESTABLISHMENT AND FEASIBILITY OF A BRAZILIAN MARKET FOR FORWARD EXCHANGE TRANSACTIONS

Acceptance of a free market for foreign exchange, as described in Note 1, implies acceptance of non-restricted forward exchange transactions. Availability of a market for forward exchange transactions in Brazil would provide an important part of the proposed system based on a floating exchange rate in a free foreign exchange market.

A. Formation of a Forward Exchange Market

The government need take no specific action in order to secure establishment of a forward exchange market. Such a market should develop naturally after formation of the fully free foreign exchange market. Banks and exchange houses operating as dealers in spot foreign exchange would also be dealing in forward exchange. Actually there would be only one general market in which all moneys are traded freely without governmental restrictions on transactions related to time (i. e. purchase and sale of forward exchange).

B. Advantages of Forward Exchange

Forward exchange provides reduced risk related to international trade. Importers can insure against unexpected rises in future costs of foreign exchange required to pay for imports. When decision to import is made, an importer can secure forward exchange - that is, enter into a contractual relationship which guarantees delivery to the importer of a stated quantity of foreign exchange at a specified future time for a given sum of domestic money. Similarly, exporters

can insure against unexpected declines in future prices of foreign exchange by agreeing to sell their future export receipts in foreign exchange at given prices. Thus it can be seen that a great advantage provided by forward exchange is improved predictability. Costs and receipts associated with international trade can be determined at one time in terms of the same unit of account.

Availability of forward exchange also encourages international financial movements. A forward exchange market in Brazil should stimulate net inflow of loanable funds for two reasons.

First, "flight capital" has left and can leave Brazil under present "unofficial" arrangements. Much of this wealth retention in terms of foreign moneys (held both outside and inside Brazil) results from uncertainty about future Brazilian policies respecting capital outflow and the exchange rate. A forward exchange market overcomes such uncertainty by providing means of insuring in the present the conditions for future money conversion. Therefore, it is believed that a forward exchange market would cause a net capital inflow into Brazil by providing the possibility for guaranteeing capital outflow at a pre-determined rate of exchange.

Second, with the suggested removal of interest rate ceilings, the interest rate differential between Brazil and principal international capital markets should be sufficiently large to attract foreign held loanable funds to Brazil. Forward exchanges provides possibility to lower the cost of such transactions by eliminating the risk associated with future conversion from cruzeiros to foreign exchange and this will encourage a net capital inflow.

C. Use of Forward Exchange in the Foreign Exchange Market

It is of value to examine the relationship among the spot (foreign exhange) rate, the forward (foreign exchange) rate, and interest rates. For example, an importer has three basic possibilities of action. He can make a forward exchange contract and thereby be certain of his cruzeiro cost of imports. If however, the importer thinks that the forward rate is "too high" he can either 1) buy spot foreign exchange which he holds or invests until time when payment of imports is required, or 2) wait, holding or investing his cruzeiros, and then buy spot foreign exchange, when import payment is due. The term "too high" refers to the relationship between the cost of forward exchange and the cost(s) of one or both of the alternatives just described.

Interest from several markets may be readily available to the importer. He can either loan his funds in the home market, or in the market of the country from which he imports, or in a third market. Loans to the first and third markets require later conversion to the foreign exchange needed to pay for the imports.

The following two cases illustrate the basic considerations confronting the importer.

First, suppose that a Brazilian importer owes an American exporter US$100 in one month and that the spot and one month forward rates are US$1.00 = Cr$2,000 and US$1.00 = Cr$2,050, respectively. Furthermore, suppose that the interest rate in Brazil is 3% a month and in the United States is 1/2% a month. The importer can buy now US$99.50 which when invested in the United States will be worth $100 in one month. At the spot rate this will cost Cr$199,000.

If the spot rate is also US$1.00 = Cr$2,000 in the future,

then the importer need invest in Brazil only Cr$194,175, which in one month will grow to Cr$200,000 - or enough to buy the needed $100. Obviously in this case the importer would choose to invest in Brazil and not contract for forward exchange but wait and buy at the future spot rate. However, the importer does not know in advance what the future spot rate will be.

Suppose, for the second case, that the future spot rate is US$1.00 = Cr$2,055. Although the importer can gain 3% interest from investing in Brazil, he will also lose 2 1/4% during the same time because of depreciation of the spot exchange rate. Now the importer must invest Cr$199,515 in Brazil in order to gain the quantity of cruzeiros required to buy $100 at time of import payment.

In this second case, the importer has two possibilities which are better than investing in Brazil and waiting to buy foreign exchange at the future spot rate. He can: 1) buy spot dollars which he invests (as in the first case) at the cost of Cr$199,000 or 2) contract to buy forward exchange and invest in Brazil. For this second possibility, the importer's cost equals that amount of cruzeiros which when invested for one month will grow to Cr$205,000, which is the price of $100 under the forward exchange contract. This cost equals Cr$199,029 - which is slightly higher than the cost of buying spot foreign exchange, etc.

Many importers and exporters have neither time nor inclination to examine carefully all opportunities for obtaining maximum remuneration from use of their funds under such conditions, as described in the foregoing examples. Normally, it is unnecessary for them to do so. There is a strong market force acting to equalize the returns from available opportunities. This equilibrating force is arbitrage. Specialists in the Brazilian foreign exchange market (i. e.

dealers and speculators), motivated by incentive for personal profit, will conduct arbitraging activities in a manner which tends to hold the interest rate differentials between Brazil and other countries equal to the differences between the spot and forward exchange rates for the moneys of these other countries.

Let us now examine the nature of this adjustment mechanism and see how through arbitrage profits from the various possibilities of action are equalized.

Suppose that the monthly interest rates are 3% in Brazil and 1/2% in the United States and that both the spot and forward rates of exchange are US$1.00 = Cr$2,000. Holders of dollars will sell spot dollars for cruzeiros and contract to buy forward dollars with cruzeiros. Because of the interest rate differential loanable funds are moved from the United States to Brazil (or from dollar investments to cruzeiro investments). As a result, the interest rate in Brazil falls and corresponding upward pressure is applied to the interest rate in the United States. The gap between the interest rates narrows.

In addition, the increased demand for spot cruzeiros depresses the spot cruzeiro price of the dollar. Similarly, the forward exchange rate of cruzeiros for dollars is increased.

Continuing with our example, suppose that (because of the flow of funds) the interest rate rises to 1% in the United States and falls to 2% in Brazil while the spot rate declines to US$1.00 = Cr$1,990 and the forward rate rises to US$1.00 = Cr$2,020. This means that in one month $100 can earn $1 in the United States or can be exchanged for 199,000 cruzeiros which will earn Cr$3,980 in Brazil. Under forward exchange contracts, now available, the $100 worth of cruzeiros plus related earnings of one month in Brazil can be reconverted into US$101.47, which represent 47 cents more than could be obtained in

the United States during this time. The flow of loanable funds to Brazil will continue until the profit differential between the two markets is eliminated - by decreasing the interest rate spread and increasing the spread between the spot and forward exchange rates.

This example is simplified by assumption of equal lending opportunities in both markets and lack of transaction costs. Nevertheless the automaticity of the adjustment process should be evident. There is no need for (and in fact there should not be) governmental intervention. Brazilian exporters and importers gain a stable relationship among profit possibilities which easily enables them to utilize forward exchange for improving the predictability of their trading activities. In addition, for the reasons expressed earlier, the adjustment process through use of forward exchange will make an increased supply of loanable funds available to the Brazilian capital market.

NOTE 4 - EFFECTIVE EXPORT EXCHANGE RATE

(Alternative to Recommendation 2)

This note explains operation of an alternative exchange rate policy which should only be considered if the recommended floating exchange rate policy (Recommendation 2) is not adopted.

It was explained in Note 2 that one important advantage of the floating exchange rate is automatic adjustment for maintaining internal purchasing power of foreign earned revenue (given constant demand conditions). However with Brazil's continued use of a pegged exchange rate and until Brazilian inflation is almost eliminated, another method is required to preserve the domestic purchasing power of export revenue in a predictable and consistent manner.

When the policy of a pegged exchange rate must be perpetuated, it is suggested that monetary adjustments be made for relating export earnings to changes of internal production costs. These adjustments would permit continuence of export derived profits in real cruzeiro terms. Basically, the system being proposed here provides that one U.S. dollar earned from exports, when converted into cruzeiros, would be able to buy (in Brazil) approximately the same quantity of production goods and services from one period to the next - in spite of Brazilian inflation. In other words, the purchasing power for production inputs in Brazil of export earned foreign exchange be held (fairly) constant.[7]

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7. Some allowance might be made for changes in the real value (or purchasing power) of foreign exchange. If desired, the suggested system can be modified to include such an adjustment. However for at least the near future, domestic purchasing power of foreign exchange will be influenced predominately by variations of internal Brazilian costs and it is here that attention to adjustment should be concentrated.

This condition means greatly increased predictability of export earnings which in turn should stimulate exports (as is explained in Note 2).

The method of providing this increased predictability consists of varying the effective export exchange rates in conformity with cost conditions of domestic production. Effective exchange rate equals the monetary rate used for conversion of foreign exchange to cruzeiros plus adjustments for special export taxes and benefits, etc. (i.e. the number of cruzeiros actually obtained from each dollar's worth of exports).

It is suggested that an export bonus or tax be placed on exports in order to equate the cost of production[8] and the effective exchange rate according to a base ratio. For example, if December 1965 is taken as the base period, then the effective exchange rate and production cost are each assigned the index number of 100.

Let us suppose that between December 1965 and July 1966 the effective export exchange rate remains at 2,200 cruzeiros per US dollar, while during the same period production costs rise 20% making the index number 120. For this situation a bonus of 440 cruzeiros is given for each dollar's worth exported in July 1966. In other words, this means that the effective exchange rate for exports rises to 2,640 cruzeiros per US dollar[9].

If in the foregoing example, the effective exchange rate were Cr$ 2 500/dollar in July 1966, then the bonus would equal Cr$ 140/dollar in order to raise the effective rate to Cr$ 2 640/

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8. A cost of production index can be constructed either on a general basis or for individual sectors, i.e.; agriculture, industry, and extraction.

9. The original effective exchange rate is Cr$ 2,200/dollar which is

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dollar - for compensating fully (in terms of percentage increases) for the rise in production costs. However, if on the other hand the exchange rate had been raised to Cr$ 2 800/dollar there would be a tax of Cr$ 160 for each dollar's worth of exports.

If a producer's cost varies in conformity with the general cost of production index then his export profit in real terms remains constant for any given level of exportation.[10]

If the producer reduces his production cost relative to the general cost of production index, his profit in real terms is increased. Because no individual producer can significantly influence by his actions alone the cost of production index, any cost savings achieved by one producer will be rewarded by an increase in that producer's real profit.

It is important to remember that the purpose of equating relative variations between the effective exchange rate and production costs is to preserve a set of conditions (that is, relative prices) which will enable producers and exporters to plan for long term exports - a condition which should permit greatly increased export earnings on a continuing basis.

The effective exchange rate system, which is proposed here,

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multiplied by the ratio of index numbers (of production costs and exchange rate i.e. 120/100 = 1.2) to obtain the new effective exchange rate of Cr$ 2,640/dollar in July 1965.

10. For example, suppose that a producer exports a certain quantity at the unit price of one US dollar. The monetary exchange rate remains Cr$ 2.200 per US$ while the unit cost the producer-exporter rises from Cr$ 2.000 in January to Cr$ 2.500 in July. If the cost of production index rises by 25% (as did the individual producers' cost) in this period, then the adjusted effective exchange rate would be raised to Cr$ 2.750 (i.e. 125% x 2200).
The producer's unit profit is Cr$ 200 (i.e. 2200 - 2000) in January

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satisfactorily substitutes for the floating exchange rate system in providing the desired degree of profit predictability for exports. However, use of the effective exchange rate system has the disadvantage of necessitating administrative control - thereby limiting the desirable characteristics of simplicity and automaticity. Value of each export shipment would have to be ascertained accurately in order to insure proper reimbursement for export earned foreign exchange. Administrative machinery presently exists (in CACEX) for verifying declared export values. Unfortunately, application of this machinery entails complicating paperwork, loss of time, and possibility for individual discretion to distort the neutrality of the system.

It is felt that great improvement of export profit predictability is sorely needed. Although system of effective export exchange rates adequatety provides for attainment of this objective, there is a related cost (as pointed out) of administrative involvment.

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and Cr$ 250 (i.e. 2750 - 2500) in July. In terms of January prices, the July unit profit equals Cr$ 200. Therefore in real terms, the producer's incentive to export remains constant.

NOTE - 5 - BI-LATERAL TRADING AGREEMENTS SHOULD BE DETERMINED INDIVIDUALLY AND USED SPARINGLY

Bi-lateral trading agreements can be employed in conjunction with the proposed system for exchange rate conversion and export promotion. Such agreements arise from inter-governmental negotiation or sanction and therefore it is ultimately the duty of each government to fulfill its part of an agreement. The responsible representatives of a government should attempt not only to negotiate the most favorable agreements for their country but also should shape these agreements for their efficient operation in conjunction with the general policies regulating the economy.

A. Value to Brazil of Bi-lateral Agreements

In relation to the government's first task it cannot be said that bi-lateral agreements in general are either good or bad. Each one must be evaluated separately. Based exclusively on economic criteria, a bi-lateral trading agreement, like any other form of international trade, is good for Brazil when the following objective is achieved: Brazil in exchange for exports acquires imports (including services, etc. which within Brazil are of greater value than any result obtainable from alternative use of the exports or from alternative employment of the inpu used to produce those exports. In other words, a bi-lateral agreement should be undertaken by Brazil if there is a positive difference between the resulting net benefit to Brazil and the net benefit derivable from the best alternative action(s) which includes alternative use of the same resources.

Unfortunately it is difficult (if not impossible) to calculate accurately the present value of the future stream of all net benefits obtainable from a specific trading agreement - let alone from all

objectives of businessmen, etc. In this situation, reliance upon an existing set of market prices may not provide a satisfactory basis for determining the desirability (in global political-economic terms) of a given trading agreement. Lacking an objective standard of measurement by which such a decision can be evaluated, one might be forced to rely upon judgment of authorities responsible for the agreements. Nevertheless for each agreement, technicians should endeavor to establish the related economic costs and benefits which are to be weigh in conjunction with any political, etc. considerations.

Brazilian bi-lateral agreements are formed on the basis of credit swaping. Under this system, Brazil provides a fund for financing exports to the participating country while that country establishes a similar fund for financing exports to Brazil. Such an agreement specifies sizes of these funds and, when applicable, the exports to which use of these funds are limited. At expiration of a bi-lateral agreement, compensation is paid to the country with the larger unused balance in its fund. Sometimes penalties can be assessed for unused balances.

Brazil grants preferential treatment for imports under bi-lateral agreements. Almost every import requires a non-interest earning deposit with the Bank of Brazil at least 120 days before sale of the foreign exchange used to pay for the import. Normally, this advance deposit equals the full cruzeiro equivalent of the foreign exchange value of the import.[11]

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11. There are a few exceptions to this general rule. For example, advanced deposits are reduced for: newsprint (10%); fertilizers, insecticides, and seeds (20%); and petroleum products (50%).

However importation under a bi-lateral agreement requires only a 20% advance deposit. This means that 80% of the cruzeiro cost of foreign exchange is deferred for 120 days. Import financing at commercial banks currently costs between 3% and 4 1/2% a month. Therefore reduction of advanced deposits for imports under bi-lateral agreements is equivalent to depreciation of the exchange rate from 9% to 13%.

The question might well be asked: "Why should Brazil subsidize imports under bi-lateral agreements?" However what Brazil is really doing is subsidizing foreign exports to Brazil. This action can be justified if Brazilian exports are being sufficiently subsidized in compensation by the countries which participate with Brazil in these agreements.

Foreign subsidy of Brazilian exports can take various forms, e.g. special import credits, tax incentives to importers, payment of higher than international market prices for Brazilian exports, etc. The subsidy to Brazilian exports from all available forms should be calculated with respect to each bi-lateral agreement and matched with the cost to Brazil of the subsidy which it offers in order to determine Brazil's net benefit (if any).

Presently Brazil maintains bi-lateral agreements with 13 countries.[12] It seems highly unlikely that all of these countries are subsidizing Brazilian exports equally. Nevertheless, Brazil subsidizes their exports equally. Brazil might derive greater net benefit from each bi-lateral trading agreement if the degree and form of subsidy

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12. The countries with which Brazil has bi-lateral trading agreements are: Yugoslavia, East Germany, Czecoslovakia, Hungary, Romania, Poland, Bulgaria, U.S.S.R., People's Republic of China, Israel, Greec Denmark, and Iceland.

offerred by Brazil could be negotiated as a means for securing favored treatment from the participating country.

B. Revised Operation of Bi-lateral Agreements for Brazil

The government's second task, namely: efficient utilization of bi-lateral agreements necessitates operating these agreements in conformity with the government's exchange rate and other foreign trade policies and objectives.

Use of the fully free foreign exchange market, recommended in Note 1, eliminates the current stimulus to import (i. e. subsidize foreign exports) under bi-lateral agreements. If bi-lateral agreements are to continue they should harmonize with the proposed exchange rate system and therefore another type of stimulus must be employed.

If the stimulus is to be applied to imports, then it is suggested that an import discount rate be set for permitted imports within each bi-lateral agreement. The importer, upon proof that his imports have cleared Brazilian customs, is reimbursed an amount equal to the value of his imports multiplied by the discount rate.

Suppose that a Brazilian importer orders from Poland $1000 worth of butter, which is permitted according to the trade agreement of the two countries. The importer buys $1000 in the free foreign exchange market and deposits this sum with the designated governmental agency. The importer is credited with $1000 from the fund in Poland and, accordingly, the Polish exporter is paid. Brazil's credit in the Polish fund decreases by $1000. When the butter clears Brazilian customs, the importer presents the document certifying this fact and then receives partial reimbursement. If the import discount rate for Polish imports is 5%, the importer receives 5% of the import value, or in our example, $50.

In this way, the exact amount of subsidy is apparent and open to public review.

Exporters would receive their payments from funds established in Brazil in relation to the various bi-lateral agreements. Exporters would be paid at current rates of exchange.

Exports instead of, or in addition to, imports might be subsidized. Advantage of any such arrangement depends upon all relevant market conditions and in particular upon the actions of the participating countries.

In general, it would seem wise for Brazil to refrain from bi-lateral agreements in order to avoid governmental intervention, and to permit the free market forces to operate fully, and because of the difficulty often in determining actual net benefits to be gained by Brazil.

Full and free convertibility of moneys as envisaged for the proposed Brazilian foreign exchange market obviates justification of bi-lateral agreements as a mechanism for saving, so called, "scarce" international means of payment. However a country, desirous of trading with Brazil, may have limited convertability and therefore, with this excuse, seek to use this type of trading arrangement.

Actually, there are a number of reasons why a country might desire to use bi-lateral agreements - particularly when the government exercises strict control over the country's international trade. If a country insists on a bi-lateral trading agreement, then Brazil should extract compensation (in form of favorable trading terms) for the increased cost of administration and the resulting reduction in market freedom, which is a prime objective of the system being recommended in this report.

NOTE 6 - SIMPLIFICATION AND IMPROVEMENT OF EXPORT PROCEDURE

Brazilian exportation is presently being hindered by governmental control. Much of this control is inefficient - causing loss of time and money, and providing opportunity for curruption; without compensating benefits. Existing export control is exercised through different agencies and administrative processes - some of which although now unnecessary, have been preserved because of tradition, inertia, and/or political pressure. It is suggested that governmental control over Brazilian exports be reduced to a minimum; and this objective requires removing the unnecessary influences which presently restrict Brazilian exports.

A. Eliminate Export Licensing, Except For A Few Specified Products.

There appears to be no adequate reason for continuence of export licensing as now practiced in Brazil. There should be complete freedom to export almost all Brazilian products whenever, wherever, to whomever, and whatever price.

Exception to this general rule should be publicly specified by CONCEX together with the methods for obtaining the required export permission. It is envisaged that export restrictions will be applied to only a few items, such as: narcotics, national art treasures, atomic minerals, and weapons and munitions. Permission for exporting a restricted item should be granted by the related ministry.

A-1. Eliminate CACEX

CACEX should be eliminated. With removal of export licensing (except for the few items controlled by the relevant ministries), CACEX serves no useful function and only unnecessarily complicates the process of exportation.

Presently CACEX checks prices of most exports to see if these prices are: "in the national interest". An exporter can easily circumvent any potential limitation on his activity which this check

might impose. The exporter need only declare a false export price and purchase the difference between this and the actual price in the parallel market for reimbursing the foreign importer for his "apparent" payment of the false invoice.

If it is profitable to export, it is in the national interest; and it should be for the exporter to decide what price realizes his greatest profit.

It may be felt that checking export prices will help to determine income tax liability. However, income generated from exportation of most manufactured products is exempt from taxation. Furthermore, revenue from taxing income related to most other products exported is negligible. Anyway, income tax liability can and should be determined by other methods.

The danger of the present arrangement is that price checking represents another step in an over-complicated process and provides opportunity for personal, and perhaps arbitrary, administrative discretion. Thus a producer who wishes to practice dual pricing may be thwarted or at least inhibited in his effort to discriminate between the internal and external markets. Dual pricing (as described and analyzed in Note 12) should be encouraged and not exposed to the possible restraining effects of export price control.

Furthermore, there should be no need for CACEX, or any other governmental agency, to pass on the "paperwork" related to foreign exchange earnings and conversion arising from exports (see: Recommendation 1).

It is recommended that the present system of relying upon the price mechanism to determine the amount and composition of imports continue. The price mechanism provides the government with sufficient discretionary power over imports through adjustments of import taxes. Thus there should be no licensing of imports (except perhaps for

narcotics and weapons, etc.). However, import prices must be verified in order to insure proper payment of import taxes.

The responsibility for checking import prices should be taken away from CACEX and placed solely with the customs. This means that physical inspection and import price checking would occur at the same place and approximately at the same time, thereby simplifying the control process.

B. Use One Reporting Form For Exportation

Only one form should be required for most exportation. The export form should be self-explanatory and easy to complete. This form should be designed to provide information desired for the Brazilian national accounts and other statistical compilations.

Normally the export form would have four copies: three of which would be taken by the customs while the fourth copy would be returned to the exporter. Of the three copies taken by the customs, one each would be sent to the national statistical service and to the Ministry of Finance; while the third copy would be retained by the customs unit through which the exports passed.

Copies of the export form should be freely available at all customs units and post offices.

The export form should contain the names and addresses of the exporter and importer, and description of the merchandise according to: the customs classification, weight, quantity (where applicable), unit price, and value. Information presented in the form by the exporter should not normally be subject to verification by the Brazilian customs.

The only task of the customs with respect to exports should be to determine whether the type of good being exported appears on the list, published by CONCEX, of items requiring permission for exportation. If a good presented for exportation appears on this list, then a written copy of the required permission (obtain-

ed from the related ministry) must be presented with the export form. Otherwise, all other types of goods can be exported without any further governmental control.

An exporter may desire more copies of the export form and he should be able to add them as he wishes. These additional copies can be sent to importers as Certificates of Origin -- and be stamped by the customs to show date and place of customs clearance.

It is important to realize that the export form should not represent a barrier to exportation but should serve as a source of voluntary and un-verified information (except for determining the need for export permission). Aside from the relatively few cases where export permission is required, the export form will be the only document needed to export and therefore all the many documents now used, e.g. Guia de Embarque, Licença de Exportação, etc., should be eliminated.

C. Exportation As A Simple, Self Service Operation

There should be no legal obligation for an exporter (or importer) to employ services of an intermediary between himself and governmental agencies concerned with his transaction. This rule means, for example, that obligatory use of despachantes aduaneiros, as presently required, should be removed. Of course an exporter (or importer) would remain free to employ a customs agent or shipping broker, if he wishes.

However, the process should be so simple that anyone, with at least average intelligence, would be capable of easily understanding and fulfilling governmental requirements for exportation (and importation). It is anticipated that Brazilian banks -- with their increased influence in financing, servicing, and encouraging foreign trade -- will be able to provide adequate help and information for overcoming administrative or burocratic trade problems (see: Note 8)

Anyone should be entitled to export (and/or import). People dealing in foreign trade should not be licensed nor be required to obtain official sanction of any kind. Preservation of export standards, etc. should depend upon trade associations, etc. (see: Note 8, 10 and 11).

D. Improve Customs Administration

A serious, far-reaching reform of the Brazilian customs is required. Presently, exportation is being stifled by the often arbitrary, capricious, and exploitative control exercised by customs authorities.

Customs control over exports should be limited to a very simple operation of inspection. As indicated above, inspection should comprise two possible steps. In the First Step, customs authorities should check whether products destined for exportation are listed as requiring export permission. The great majority of products will not need export permission; and these products, after passing the First Step, are then free to be exported.

If some internal prices are to be controlled through export taxation (see: Recommendation 7), then the First Step should be extended to include checking whether each item for export requires payment of a tax. Such items would probably be limited to a few agricultural products and cheking should be a simple process. An export tax should be paid at time of customs clearance, as explained in Note 7.

The Second Step pertains only to those products requiring export permission. In this step, customs officials should verify that contents of such an export shipment conform to description of the products authorized for exportation, as stated in the related export permission.

Inspection should be made quickly, without charge to the exporter, and be available anytime during normal working hours. Inspection should occur when merchandise is delivered to the docks,

etc., in anticipation of exportation. Once a shipment clears inspection it can be helded in a guarded (or bonded) warehouse until time to be loaded for transport out of the country.

The caliber of personnel has been an important factor in customs discouraging legal exportation (and importation). Adoption of the suggested control method would reduce to a minimum the need for individual administrative discretion. Nevertheless someone must make each inspection; but he must not be allowed to abuse what little personal power remains.

The present Brazilian customs service does not seem to be the proper source for providing adequate personnel for performing even this rudimentary form of export control. Furthermore, it should be remembered that the same customs organization will also administer a somewhat more complicated and descretionary control over imports.

Within the present customs organization there apparently exist wide-spread dishonesty, capriciousness, and unnecessary complications which restrict Brazilian exports, deprive the government of revenue, distort any officially sought trade patterns and compositions, and corrupt governmental administrators and the citizenry. Lack of public confidence and extensive existence of extra-official personal working relationships in the customs administration necessitate removal of the present customs personnel.

In their place, it is suggested that the Brazilian army be utilized to administer and, in cooperation with the Brazilian navy and airforce, to police trade across Brazilian borders. The army can maintain discipline for insuring the proper adherence to customs regulations.

Soldiers can be trained to inspect merchandise moving into and out of Brazil. The simplified inspection system suggested for exports should make this task easy. Import inspection may be more

difficult, but it is preferable to risk having honestly made mistakes than to have results now obtained from the present method of administration.

In order to limit possibilities of social contact with and undesirable influence from exporters and importers, groups of soldiers should be rotated without prior notice, at irregular intervals no longer than three months, from one location in Brazil to another.

At each location, soldiers should be moved from one tipe of job to another, e.g. inspection of exports, guard duty, inspection of imports, and inspection of luggage arriving with travelers. Movement among jobs also should occur unannounced and at irregular intervals. Furthermore, composition of each work group should be varied. A unit of soldiers, say of company size, can provide a labor pool from which are formed every few days new work groups for the different operations assigned to that company.

The army has sufficient control over its personnel to enforce this system of variation (i.e. in location, job, etc.) which in turn greatly reduces opportunity for corruption of army personnel. The cost of using part of the army in this manner, including related costs of training and movement, should be no greater than the cost of paying for the present corps of customs administrators. However, with use of the army there should be a substantial increase in tariff receipts so that in monetary terms the government would thereby realize a considerable increase in net revenue.

There should be eliminated the present system of dividing a penalty between customs inspectors and the government. This system has not provided the intended incentive for better enforcement, but instead has been subverted for the personal profit of customs officials.

Too often an exporter (or importer), who is charged (falsely or not) with infraction of a rule, is offerred the choice of paying either the entire penalty or an amount to the customs official

sufficient to compensate him for his share of the penalty. In other words, penalty-sharing now sets a floor under the bribe prices paid to customs officials. Penalty-sharing places customs officials in a better bargaining position with exporters and importers and to this extent strengthens the incentive for officials to exploit illegally their positions.

Part of the cost of exportation (or importation) is now composed of the bribes, etc. which must be paid in order to receive customs clearance. This cost represents an unauthorized barrier to trade and a loss of potential revenue for the government. Utilization of Brazilian military forces to administer and police customs could rectify this situation. Recent introduction of the army to control exportation over isolated land borders is said to have reduced illegal coffee exports by one-half. Opportunity for improved enforcement at conventional border crossings and ports is even greater. The military should be used to restore confidence and honesty in the governments' administration of its customs regulations. Perhaps later, a new group of civilian employees can be trained and properly controlled so that administration of Brazilian customs might eventually revert to a civilian operation.

NOTE 7 - REGULATION OF INTERNAL PRICES THROUGH EXPORT CONTROL

A. Introduction

This recommendation in no way implies approbation of internal price regulation by the government or the use of export controls as a mechanism for implementing such regulations. If, however, the policy of controlling internal prices of some agricultural products is to be maintained through export restriction, then the method of executing this policy should be changed in order to improve marketing efficiency, reduce burocratic control, and provide opportunity for increased foreign exchange earnings.

In the present method, reliance is placed on quantitative restrictions of exports. Such a restriction is calculated to equal the difference between current production (plus stocks) and related future demand -- supposedly at a politically acceptable price. The authorities, thereby, try to maintain a market price ceiling by ensuring that a pre-determined minimum quantity is available exclusively for the domestic market.

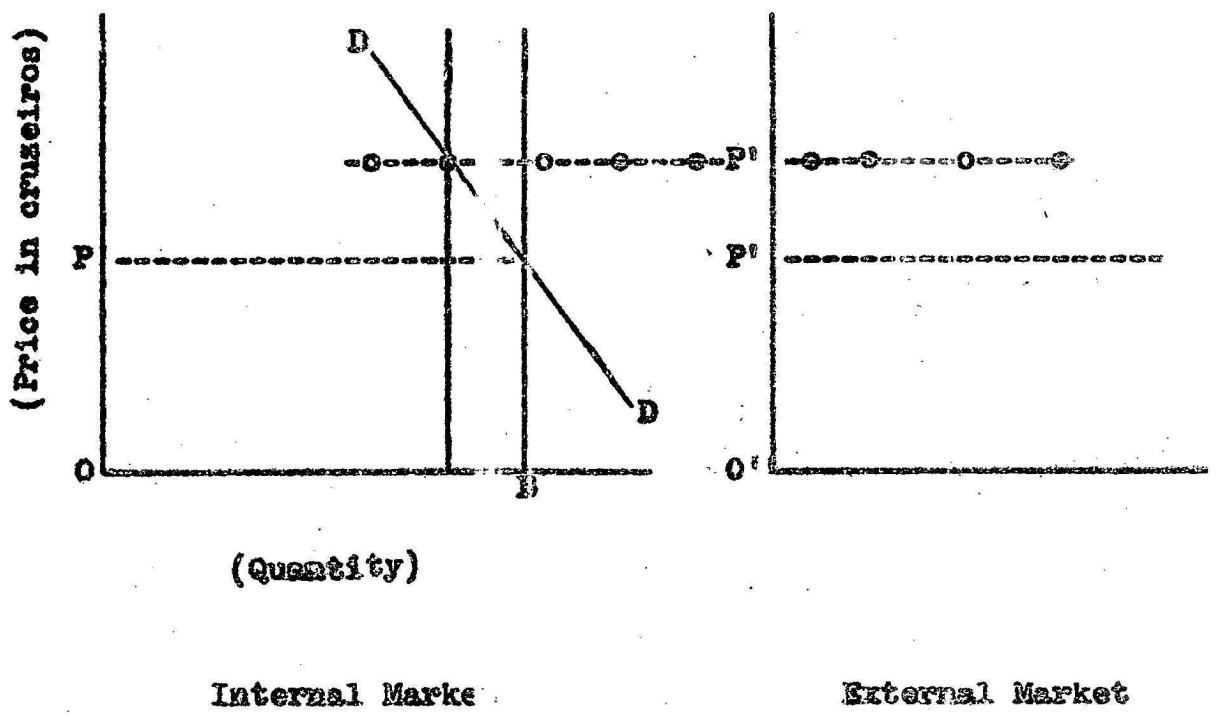
Instead of limiting exports by quantitative restrictions, the same objective can be obtained by use of price restrictions -- namely export taxes. Thus an export tax can limit the outflow of a product to the degree which permits retention in the internal market of any desired quantity.

B. Model

Figure I illustrates the simple procedure for determining the appropriate export tax rate. Demand in the internal market is represented by line DD. The domestic price ceiling equals the vertical distance OP. The export price (when converted to cruzeiros) equals O'P'.

With freedom of exportation, quantity OA would be retain-

FIGURE 1


(Price in cruzeiros)
D
P'
P
P'
D
O
B
O'
(Quantity)
Internal Marke
External Market

ed internally while the remainder of the country's supply would be exported. In this situation, the export price O'P' becomes the domestic price.

However, the government desires a lower internal price, namely OP, which requires quantity OB to be retained internally. In order to achieve this objective, there should be imposed an export tax (P'P) which equals the difference between the export price and the desired internal price.

There exist in the world well developed forward and future markets for those agricultural products likely to be subject to export control by Brazil. Such prices provide a basis for determining future export prices from which can then be calculated the export tax rates needed to preserve the desired internal prices.

C. Operation And Advantages Of The Proposed System

Under the present system, the quantity to be retained in the internal market (i.e. OB in Figure I) is pre-determined and only the excess over this amount can be exported. With a price higher in the export market than in the internal market, it is more profitable to export than to sell for internal consumption (which export control implies). Use of quantitative restrictions thus imposes need of a rationing device in order to determine who has access to the more profitable market.

In constrast, the proposed system, utilizing export taxes, functions more automatically -- requiring no rationing device or estimation of internal demand.

Furthermore, employment of export taxes has an additional advantage which could be of particular importance to Brazil. Harvests of many agricultural products with related low prices occur in Brazil at times when many other countries are between harvests and are

experiencing correspondingly high prices. Full advantage should be taken of this situation. With seasonal production out of phase between Brazil and much of the rest of the world (e.g. corn) there may be possibility of profit by exporting during the period of peak supply and importing during the period of relatively short supply.

It is therefore suggested that export taxes be refunded when imports occur 320 days after exportation of the same product. This system will prove profitable to Brazilian exporters-importers when the FOB export price (plus related interest) is higher than the CIF import price (at a later date); or when the internal storage cost exceeds the difference between the CIF import price and the FOB export price (plus related interest).

There is a net increase of foreign exchange from the operation when the FOB export price is higher than the CIF import price. There is a net foreign exchange decrease when the CIF import price is higher than the FOB export price. However this decrease (minus interest) must be valued less than the alternative cost of internal storage or otherwise the operation should not have been undertaken.

In a closed economy, the domestic consumer price of a product should vary by the cost of storage between one harvest and the next. A similar situation occurs in Brazil with use of quantitative restrictions to control exports. The proposed system of exporting-importing, as was mentioned, allows reduction in storage requirements while providing the same yearly supply to the internal market which is now available with quantitative export restrictions. With profitable employment of the proposed system, the cost of making available this yearly supply is reduced and therefore average yearly prices to the Brazilian consumer also are reduced.

The mechanics of the proposed system can be kept simple. No licensing of exports is necessary. The exporter fills out the export declaration (described in Note 6) and pays the required export tax, at time of customs clearance. The tax receipt should contain the following information: classification of the product, quantity exported, unit price, export tax rate, total tax amount, paid, and the date.

Tax receipts should be freely and fully negotiable. Anyone in possession of a valid tax receipt can by importing the product specified on that receipt obtain refund of the export tax previously paid. Refund should equal the imported quantity multiplied by the export tax rate. Refund cannot exceed the total tax paid.

If greater certainty is desired that importation will equal a given quantity of exports, then the authorities can require that exporters purchase and deposit forward contracts (plus related insurance and freight costs) sufficient to cover the quantities exported.

The President of the Republic should determine and announce publicly for which products internal prices are to be controlled. The appropriate Ministry should establish the desired internal price ceilings and recommend the export tax rates required to insure that the related internal prices do not exceed these ceilings. Quantity control should be eliminated. SUNAB should also be eliminated.

The fundamental objective of this proposal for use of export taxes with refund for imports is to provide a system by which Brazil can profit more extensively from having patterns of production and market prices which are phased differently from much of the rest of the world. The mechanism should at least be

available so that differences in markets can be exploited profitably. Profit incentive to export and import will determine the most efficient operation of the proposed system, within the limitations imposed by maintenance of internal price ceilings.

D. Taxation Of Exports And Imports Of The Same Product

When there is exportation there will be no importation if the internal price would otherwise be less than the external price without exportation.[13] Under this condition an import tax would have no effect.

It may occur that between one domestic harvest and the next the external price would vary from above to below what the internal price would be for the same product without trade. Governmental authorities may not wish importation to depress internal production incentive, while at the same time the authorities may not wish to allow exportation to reduce internal supply and thus raise the internal price. Therefore it could arise that both an import and an export tax are imposed on the same product.

The suggested plan for allowing export tax refunds for imports would not conflict with the situation described in the preceding paragraph. The plan does provide a wider range of choice than presently exists for efficient storing of production between harvests. In order for the plan to be fully effective, imports which offset exports (according to export tax receipts) should be free of import taxes.

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13. Exportation in itself does not automatically imply that the internal price without exportation would be lower than the external price, as for example may be the situation with dual-pricing (see: Note 13b).

NOTE 8 - EXPORT CREDIT AND BANKING

It is not recommended that there be established a special government sponsored export bank.

Instead, it is suggested that exports be encouraged by improving the export financing and service capabilities of the commercial banking system in Brazil.

Commercial banks should be provided with facilities for stimulating exportation in three areas of activity: 1) export credits, 2) export capacity loans, and 3) extended international contacts.

A. Export Credits

A special Export Credit Fund should be created in the Central Bank. This fund should be employed for re-discounting at low rates export contracts which previously were purchased by commercial banks from Brazilian exporters.

With the possibility of cheap and easy re-discounting, commercial banks will be stumulated to provide low discount rates for export contracts. Exporters can then offer more favorable terms of payment to foreign importers of Brazilian products.

It is envisaged that export credit extended in this manner would be of relatively short duration - covering the time between dates of sale by exporter and payment by the importer.

Exporters would be encouraged by:

1) early reimbursement at low cost
2) opportunity for increasing profits from foreign sales because of the reduced cost of those sales
3) establishment of exporter and importer credit reliability

which permits reduced time of credit clearance and the continuance of commercial relationships on a repetitive and protracted basis.

The system of the Export Credit Fund would function in the following manner. Exporters would sell their export contracts to commercial banks at a low rate of discount. At least two types of contract sale should be considered: 1) full transference of responsibility to the bank, i.e., the exporter has no further obligation and 2) nominal transfer, which means that the bank can hold the exporter responsible for payment of the contract if the importer defaults.

Under the first method of contract sale (i.e. full transference of responsibility) a commercial bank would be responsible for validating shipment (in conformity with the contract) and for establishing credit reliability of the foreign importer. Credit reliability is obtainable from international credit references (e.g. Dun & Bradstreet) and hopefully from related international banks (as is explained in part C of this note).

The second method of contract sale (i.e. nominal transfer) would require the commercial banks only to verify the financial reliability of the Brazilian exporter, so that the bank could be assured of restitution for that part of the contract not fulfilled by the importer.

Export contracts held by the commercial banks could then be rediscounted at the Central Bank. Commercial banks would be liable to the Central Bank for collection and covering of all export contracts (regardless of their type) held by the Central Bank. Thus the Central Bank's function would be to hold export generated debt for commercial banks. With competition among these banks, charges for discounting export contracts should equal the difference between the re-discount

rate at the Central Bank and the sum of related administrative and risk costs.

The re-discount rate would probably more than cover the Central Bank's related administrative and risk costs - both of which should be relatively slight. Risks to the Central Bank depend on solvency of the commercial banks.

Capacity of the Export Credit Fund determines the upper limit of the export volume which can be stimulated by this means. The re-discount rate can be raised or lowered until any given capacity of the Export Credit Fund is just exhausted.

It is suggested that allocation of the fund's re-discounting privileges be made purely by price (that is, the rate of re-discount). This means that no administrative intervention should be permitted to determine re-discounting on basis of product, exporter, importer, commercial bank, etc. Use of the fund in this way will assure the most efficient allocation of export credits for any given size of the fund.

B. Export Capacity Loans

An Export Capacity Fund should be established for inexpensive discounting of loans granted by commercial banks for the purpose of increasing export capacity. Such loans would be used mainly to finance conversion and expansion of present sources of production in conformity with competitive requirements in international markets. In addition, these loans could be used to finance establishment of new businesses dedicated to exportation.

It is felt that many Brazilian products require modification before they can comply with the different tastes, rules, and conditions of foreign markets. Low cost loans designed specifically to finance such modifications can stimulate exports considerably. For example, these "export capacity loans" could be used to pay for special processing machinery, re-design of containers and labels, surveys of foreign markets, external advertising campaigns etc.

Operation of this proposed system would be similar to that which was just described for re-discounting export credits. Availability of related inexpensive discounting will encourage commercial banks to grant export capacity loans. The Export Capacity Fund can be administered by the BNDE which can verify that the loans are being employed for the purposes intended.

C. Extended International Contacts

Brazilian banks should be encouraged to expand their international contacts. Strengthening of these contacts will increase: foreign confidence in Brazilian banking and institutions, availability of foreign credit, and flow of knowledge concerning foreign operations and changes in foreign market conditions.

Use of export credits (as envisaged in part A of this note) induces as well as in facilitated by improved relationships between Brazilian banks and foreign banking and financial institutions. Brazilian banks should be encouraged to promote exports not only by supplying credit but also by channeling information concerning export opportunities. Such information can be obtained through branches abroad or from "partner" foreign banks which realize and try to promote favorable trading opportunities.

Once effective and trusted working relationships are developed between Brazilian and foreign banks, costs and uncertainty of exportations will be reduced. For this reason, governmental regulations and control should not restrict international banking operations. Absence of such restrictions will provide a favorable climate and promote confidence that system will endure - thereby encouraging long-term trading relationships with improved export earning opportunities for Brazil.

NOTE - 9 - LONG TERM EXPORT AGREEMENTS

Increased foreign exchange earnings may be obtainable on a predictable and long term basis through use of government sponsored export agreements. Such an agreement would tie a specified quantity of Brazilian production to foreign markets through foreign controlled distribution.

An export marketing agreement would be composed of a specified marketing arrangement accepted by three parties: Brazilian producers, a foreign distributor, and the Government of Brazil. Brazilian producers of a particular product could be guaranteed, either collectively through their association or by individual contracts, a net price for a specified quality and/or quantity of output.

The foreign distributor would gain a dependable source of supply The distributor would be guaranteed a regular or pre-determined pattern of product flow for a predictable price. An agent of the distributor could inspect the product before exportation, with the right of rejection. Once the product is accepted by the agent, Brazilian producers would be absolved from all further responsibility.

The foreign distributor should provide detailed information concerning production methods required to realize his desired quality conditions. In addition to technical advice, the distributor might supply investment capital for improving and augmenting production. Reimbursement to the distributor could be made through the agreed upon method of payment for production.

Distribution in consuming countries often is that part of the total marketing process most subject to specialized (and perhaps monopolistic) control. Foreign producers usually face a decided disadvantage when they endeavor to compete with well entrenched local

distributors. In order for Brazilian products to enter effectively into foreign markets, it may be necessary to collaborate with established local distributors.

It is suggested that possibilities for long term export agreements be investigated for each major exportable product (or product group). When such a possibility exists, related international distributors should be invited to discuss their terms and requirements.

The foreign trade council (CONCEX) could establish a committee to represent the Brazilian Government in negotiations with foreign distributors. The government might offer tax concessions, underwrite loans, provide investments in related infrastructure, etc, and should offer to provide information and help for evaluating existing productive capacity, storage and transport facilities.

Brazil should invite many international distributors to negotiate marketing of a product in order to obtain a wide range of choice for selecting the most profitable arrangements. It may occur that for some products, no distributer offers satisfactory participation for Brazil. Such a result from negotiations need not be completely negative because Brazil gains exposure to outside ideas and information. This information can assist Brazilian officials in determining possibilities for independent export marketing or the desirability of concentrating on exportation of other products. Moreover such information might indicate those aspects of the productive and internal distributive processes needing improvement.

It is further suggested that initial contact and subsequent negotiations with foreign distributors be conducted in a manner which conveys the impression that the Government of Brazil - at the top level - is interested in promoting the marketing agreements and is ready to provide its full cooperation in all branches of government.

Example of an introductory letter for negotiations is presented following this note.

Use of export marketing agreements provide a mechanism for organizing domestic production on a large scale with the possibility of entering into and maintaining important shares in foreign markets. Brazilian producers and suppliers can gain important information and marketing "know-how" through technical assistance provided by foreign distributors. The Brazilian Government gains not only new sources of foreign exchange but also an extended and predictable flow of foreign exchange for the future.

Export marketing agreements can provide entry for Brazilian products into new foreign markets and with time and growing consumer acceptance of these products the climate will be improved for introduction of other Brazilian products. After Brazilian products are established firmly in foreign markets, it should be easier to negotiate more advantageous export agreements and/or practise independent export marketing.

Dear Mr. .....

We wish to inform you of a new Brazilian export policy which we believe can be advantageous to your company and to our country.

This new policy provides for establishment of long-term export marketing agreements between the Government of Brazil and important international marketing organizations. We should like to explore with you possibilities for Brazil to supply (include here the company's name) with (include here the name of the product(s)) on an extended basis. The Brazilian Government is ready to cooperate in the fullest for providing information on production potentials, internal processing, transportation, and warehousing facilities, etc.

We should appreciate learning your view concerning joining us in examining possibilities for a long range marketing arrangement between (include here the company's name) and the Brazilian Government.

Coordination of Brazilian participation in such a joint program is administered by:

_____

_____

_____

to whom all related correspondence should be sent.

Thank you for your kind attention to our proposal.

Sincerely yours,

NOTE 10 - FOREIGN PROMOTION OF BRAZILIAN EXPORTS

Foreign promotion of Brazilian exports should combine the active participation of exporters, trade and producer associations, and the Brazilian government.

A. Trade Fairs

Greater use should be made of international trade fairs as a means of opening new markets for Brazilian exports. Sponsorship of Brazilian representation in such fairs should continue under direction of "Dipree" (in Itamarati).

In the past, trade fairs have provided good initial exposure for Brazilian products. However, there has been a serious lack of "follow-up". After a fair ends, potential purchasers often have been unable to secure adequate information concerning importation of products they saw exhibited at the fair. Therefore it is suggested that, in conjunction with arranging Brazilian participation at a trade fair, diproc be responsible for providing an adequate local source of information for a reasonable time after the fair.

This source of information may consist of adequately trained personnel in Brazilian embassies and consulates or may be composed of a group of representatives supplied or trained by Brazilian trade and producer associations.

Information should be made available concerning general trading conditions (i.e. shipping, customs regulations, duties, paperwork, financing, etc) between Brazil and the country or countries supplying most of the interested visitors at the fair. Also available should be price lists, names and addresses of exporters, and brochures of Brazilian products - particularily for those products displayed at the fair.

Preceding a fair, likely purchasers of Brazilian products should be specially invited to attend the Brazilian display. After the fair, these persons should be contacted together with all other persons who showed interest during the fair. Such a contact might provide the fillip required for securing an export commitment in addition to the opportunity for receiving evaluation of the Brazilian products and their presentation. Information obtained from these contacts should be transmitted to Diproe and to related trade associations, etc, in Brazil. In other words, the trade representatives following the fair should not act passively but should seek to exploit any initial advantages gained from the fair.

B. Trade Ship

A Brazilian ship could be converted into a mobile trade fair. This trade ship would permit easy movement of the display of Brazilian products from one port to another.

Each voyage of the trade ship could be devoted to a particular group of countries (e.g. ALALC, African, European, etc.). For each such voyage there could be a special selection of products with brochures in the languages of the countries to be visited. Accompanyred the ship could be salesmen conversant with the customs and languages of these countries, and the technical aspects of the merchandise. At each foreign port, the local Brazilian commercial representative should provide a staff to answer questions related to the mechanics of trading with Brazil. As with trade fairs, there should be advanced promotion and post-visit contacts by trained personnel.

C. Functions of Foreign-Based Commercial Offices

Apparently the commercial offices maintained abroad by the Brazilian government have contributed little toward stimulating Brazilian exports. In particular, criticism primarily seems to be

directed toward employment in these offices of persons unskilled and not motivated for promoting trade.

The principle of these offices (now called Sepro) is good, but their continuance would only seem justified by staffing them with properly trained and effective people. Functions to be performed by the commercial offices should be similar - though on an expanded basis - to those of a commercial attaché section.

One function of the commercial office should be to record and verify local trade data related to Brazil. Effort should be made to determine reasons for any unusual differences between Brazilian data of trade with a country and that country's record of the same trade. By this means undervaluations and/or smuggling of imports into Brazil might be better controlled.

The commercial office should attempt to discover what new local markets are available to Brazilian products and how sale of traditional products can be strengthened. An important method of securing this information can be through interviews. Local purchasers can be interviewed to ascertain their reactions to Brazilian made products. Particularly, these purchasers should be encouraged to offer constructive criticism and suggestions for modification of the product and better means of commercialization, etc. In addition, representatives of the commercial offices should introduce new Brazilian products to both old customers and potential new purchasers.

All such information obtained should be sent to Dipros and to Brazilian trade, etc. associations.

It should be made known that commercial offices serve to receive complaints from local traders, etc. dealing with Brazil. Complaints may represent claims about non-fulfillment of trade agreements by Brazilian exporters, defective merchandise, etc.

The commercial office, together with Diproc and the related producer and/or trade association should investigate every such complaint coming from a reliable source. A Brazilian exporter or producer should be punished by his association for any dishonesty. Part of the punishment may be a fine which can be used to reimburse the foreign importer. Under certain circumstances the association may decide to compensate out of its general fund a foreign importer who suffers a loss from having trated with Brazil.

Prompt and interested attention to a complaint will stimulate greatly foreign willingness to purchase Brazilian products. Action of this kind would reduce the foreign customer's dependence upon the expensive and time-consuming means of restitution presently available through international commercial arbitration.

Another task of the commercial office should be to investigate possibilities and to assist in preparation of bi-lateral and complementarity agreements. Also, it may be that collectively - through coordination of the commercial office - pressure can be effectively applied for a country to increase its Brazilian imports in consideration for maintaining its favorable trade balance with Brazil.