ATTACHMENT I

Brasília, December 2, 2002

Dear Mr. Köhler:

1. In the period since Board approval of the new Stand-By Arrangement, financial markets have remained unsettled, owing both to an unfavorable international environment, and to concerns about the continuity of macroeconomic policies following the change in government next January. Market sentiment has improved since the presidential elections, but the full restoration of confidence has not yet occurred, and the exchange rate and interest rates have yet to recover to levels consistent with fundamentals.

2. The macroeconomic outlook has been strengthened by a remarkable adjustment in the external accounts: for 2002, the trade balance is expected to show a surplus of at least US$ 12 billion, twice the level projected in the program. The rapid turnaround in exports has been a key driver of this improvement, reflecting not just the impact of the depreciation, but also productivity growth and the opening of new markets. As a result, the current account deficit is expected to fall by more than half this year as a percentage of GDP, from 4½ percent last year to below 2 percent in 2002 and 2003. Real output growth is expected to reach 1½ percent in 2002 and to recover to 2½ percent in 2003.

3. All end-September performance criteria and structural benchmarks under the program were met. The consolidated public sector primary surplus for the period January-September 2002 exceeded the performance criterion by a wide margin, which will allow us to achieve the annual target comfortably. Nevertheless, because of the depreciation of the currency the public sector net debt exceeded the program's indicative target. The 12-month rate of inflation in September was below the midpoint of the program's consultation bands, but inflation expectations have recently increased. Accordingly, consistent with a forward-looking inflation targeting framework, monetary policy has been tightened. The SELIC overnight interest rate has been raised by a cumulative 400 basis points since mid-October and reserve requirements have also been increased. Monetary policy is committed to meet the 2003 inflation target of up to 6.5%. Given the carry-over of 2002 inflation, we propose that the central points of the program's consultation bands on inflation—and the associated limits for the inner and outer consulation bands—be adjusted upwards by 2 percentage points to 8.5 percent for December 2002 and 8.0, 7.5 and 7.0 percent for March, June and September 2003.

4. The maintenance of sound economic policies and continued progress in the structural reform agenda will ensure the full restoration of market confidence in the coming months. But for the depreciation of the *real*, the debt-to-GDP ratio would already have started to decline. Without the restoration of market confidence, macroeconomic policies would need to be revised. For example, were exchange rate weakness to persist, an adjustment of fiscal policies in 2003 would be appropriate. This issue will best be addressed during the next program review, after the new administration has taken office and has had the opportunity to develop its fiscal strategy. Accordingly, no changes are proposed to the fiscal performance criteria outlined in the Technical Memorandum of Understanding that accompanied our request for the Fund program. However, the indicative debt ceilings are being adjusted in line with the updated macroeconomic scenario as follows: R$895 billion for end-December 2002; R$915

billion for end-March 2003; R$905 billion for end-June 2003; and R$930 billion for end-September 2003.

5. During the remainder of its mandate, the current administration is committed to working with congress and the incoming administration to make progress toward the approval of key structural reforms, including (i) the constitutional amendment clearing the way for a new law establishing operational autonomy for the central bank; (ii) the remaining legislation for the establishment of complementary pension funds for civil servants; and (iii) the provisional measure converting the social contribution for the Programa de Integração Social (PIS) into a value-added tax (enactment of which is an end-December performance criterion under the program). The new tax base for the PIS will be legally effective as of December 1, 2002 on a provisional basis until congress formally approves the provisional measure issued by the government last August.

6. The incoming administration has reiterated its support for the program. In his first speech to the nation following the election, the president-elect stressed that any reorientation of expenditure must respect the need for continued fiscal discipline; emphasized the importance of maintaining low inflation to protect the real incomes of the poor; and highlighted the significance of further progress in the structural reform agenda, giving particular prominence to tax and pension reform. Subsequent statements by spokesmen for the president-elect have repeated these themes, and have also noted the importance of developing the institutional framework for operational autonomy of the central bank. In the immediate future, the incoming authorities have indicated that they will work with the government to achieve passage of the reforms identified in paragraph 5.

7. The Brazilian authorities believe that the policies described in this letter, as well as in the previous Memorandum of Economic Policies, are sufficient to ensure the achievement of the program's objectives, but stand ready to take additional policy measures as needed. The authorities will maintain the usual close policy dialogue with the Fund.

Yours sincerely,

Pedro Sampaio Malan
Minister of Finance

Armínio Fraga Neto
President, Central Bank of Brazil

Mr. Horst Köhler
Managing Director, International Monetary Fund
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