512-22-910-317
Loan 512-L-086

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DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C. 20523

CAPITAL ASSISTANCE PAPER

Proposal and Recommendations
For the Review of the
Development Loan Committee

BRAZIL - CAPITAL MARKETS DEVELOPMENT FUND

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512-L-086

AID-DLC/P-981

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AID-DLC/P-981

June 10, 1971

MEMORANDUM FOR THE DEVELOPMENT LOAN COMMITTEE

SUBJECT: Brazil - Capital Markets Development Fund

Attached for your review are the recommendations for authorization of a loan in an amount not to exceed $15,000,000 to the Banco Central do Brasil to finance the dollar and local currency costs of carrying out the Borrower's program to assist long-term private sector financing through the development of Brazil's Capital Market institutions and instruments.

This loan proposal is scheduled for consideration by the Development Loan Staff Committee at a meeting on Wednesday, June 16, 1971.

Rachel R. Agee
Secretary
Development Loan Committee

Attachments:
Summary and Recommendations
Project Analysis
ANNEXES I-VIII

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AID-DLC/P-981
June 10, 1971

TABLE OF CONTENTS

CAPITAL MARKETS DEVELOPMENT FUND

ANNEXES

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AID-DLC/P-981

June 10, 1971

BRAZIL: CAPITAL MARKET DEVELOPMENT FUND

SUMMARY AND RECOMMENDATIONS

1. BORROWER AND EXECUTING AGENCIES: The Borrower will be the Central Bank of Brazil, which will also be the principal executing agency. Other executing agencies are the National Development Bank (BNDE) and the Federal Savings Bank (Caixa Economica).

2. AMOUNT OF LOAN:

Not to exceed $15.0 million, with a 40-year repayment schedule including a 10-year grace period, at 2% during the grace period and 3% thereafter. The entire amount of the loan, with the exception of a portion of the technical assistance component, will be for local currency. (See Annex IV, Exhibit A, for justification of the local currency portion of the loan.)

3. PURPOSE:

The purpose of the proposed program is to assist the GOB in its effort to provide reasonably priced long-term financing to the private sector, through the development of Brazil's Capital Market instruments and institutions.

4. OBJECTIVES:

The objectives of the proposed program are to provide incentives (1) to investment banks to perform the function of underwriting corporate securities at a fair price and in a responsible manner, (2) to the Brazilian firm to refinance itself at competitive costs and in a rational manner by selling its securities in

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CRUZEIRO-DOLLAR CONVERSION TABLE

(Weighted average annual exchange rates)

1964	NCr$ 1.067/$
1965	NCr$ 1.908/$
1966	NCr$ 2.200/$
1967	NCr$ 2.658/$
1968	NCr$ 3.39 /$
1969	NCr$ 4.08 /$
1970	Cr$ 4.67 /$
1971 (Jan. 1-May 3)	Cr$ 5.11 /$

Source: Getulio Vargas Foundation, Conjuntura Economica

Brazil's Capital Market, and finally (3) to Brazil's individual and institutional investors to buy long-term debt and equity securities, placed in Brazil's Capital Market, that merit investor confidence and are tailored to his needs.

5. DESCRIPTION OF PROJECT:

The local currency equivalent to $12.5 million of the AID loan will be utilized to assist the Government of Brazil in establishing a revolving Capital Market Development Fund (FUMCAP) within the Central Bank of Brazil. The Fund will have an initial cruzeiro capital input equivalent to U.S. $50 million. The funds of FUMCAP will be repassed by the BNDE and the "Caixa Economica" to authorized investment banks. In addition, a technical assistance program of up to $2.5 million is proposed to develop and strengthen the private and public institutions in Brazil's capital markets.

Under the proposed program FUMCAP will provide reasonably priced credits to investment banks to assist them in financing the "firm offer" underwriting 1/ of long-term industrial bonds and shares, so as to enable Brazilian Corporations to finance their expansion with optimal amounts of reasonably priced long-term debt and equity funds. In order to minimize the risk of "firm offer" underwriting for the investment bank, FUMCAP will also provide credit for "price stabilization" operations. These credits will be available to support the price of shares underwritten with FUMCAP credits but only up to the level of the "offering price". Such credits should have the effect of offsetting speculative trading activities during the placement of new issue and shortly after. Lastly, FUMCAP will provide credits to assist investment banks in developing a stable and active secondary market for corporate bonds, in order to assure a reasonable degree of liquidity for these instruments.

Special regulations, to be administered by the Capital Markets Division (GEMEC) of the Central Bank, will apply to the corporate issues financed through FUMCAP. Such regulations will require improveddisclosure on the part of issuing companies and establish certain controls over the distribution and trading of the securities, thus providing increased protection to the buying public. The GOB will also adopt the necessary financial and regulatory incentives to assure an individual, as well as an institutional market for such issues.

1/ "Firm Offer" underwriting entails the purchase by an underwriter at sight and at an agreed upon price of a firm's securities, and the assumption of the risk of public placement of such securities by the underwriter.

6. FINANCIAL PLAN:

The total cost of the proposed FUMCAP program is equivalent of $60 million. This includes the $50 million Fund for Capital Market Development (FUMCAP) which will be capitalized 50% by the GOB ($12.5 million from the BNDE and $12.5 from the National Savings Bank) and 50% by the AID and World Bank loans. In addition it includes an allocation of the equivalent of $7.5 million from the "two-step principal" funds, for "price stabilization" and "liquidity" credits, in support of the FUMCAP operations. Finally, it includes a technical assistance program of up to $2.5 million, financed under the AID loan. With the exception of the latter program, which is expected to be a dollar cost program almost entirely, the AID loan will be disbursed in cruzeiros. The resulting financial plan is as follows:

FINANCIAL PLAN
(In Millions of US$)

	SOURCES				
USES	AID	IBRD	GOB 2-step	Principal Agents	Total
Underwriting Credits	12.5	12.5		25.0	50.0
Price Stabilization and Liquidity Credits			7.5		7.5
Technical Assistance	2.5				2.5
	15.0	12.5	7.5	25.0	60.0

7. OTHER SOURCES OF FUNDS:

With the exception of the IBRD, which has a loan of US$12.5 million under consideration, no other international lending agencies have expressed an interest in this project. Due to the nature of this project, no other US or free world financing is believed to be available for this project.

8. STATUTORY CRITERIA:

All statutory criteria have been met. See Annex III.

9. VIEWS OF COUNTRY TEAM:

One of the four "Great Priorities" listed in the GOB's Triannual Plan is the strengthening of the Competitive Power of the Nation's Industry". 1/

1/ "Metas e Bases para a Açao do Governo", September 1970.
The other three "Great Priorities" were (1) Education and Health (2) Agriculture and (3) Science and Technology

The Plan provides for specific actions in pursuance of these priorities, which - for the industrial sector - includes: "The perfection of the rules governing the opening of corporate capital, with the double objective of improving the financial structure of the business system and of intensifying the public's participation in the capital market".

The Country Team feels that the FUMCAP program will assist the GOB in improving the capital structure of the Brazilian firm by providing reasonably priced long-term debt and equity financing to the private sector. The development of an efficient Capital Market will also allow the public to participate increasingly in a growing industrial sector. Such participation should in turn have the positive effect of improving corporate management and widening public acceptance of private enterprise.

The proposed FUMCAP program is considered timely and opportune. The GOB has, since 1964, indicated a strong interest in developing the capital market as a means of stimulating industrial growth. It has adopted a number of fiscal and regulatory measures and brought about several institutional reforms in recent years, in pursuit of this objective. It has already succeeded in creating confidence and considerable public interest in its present system. The Country Team views the FUMCAP proposal as a logical sequel to AID's previous assistance through Brazil's intermediate credit institutions, which provided substantial sums of medium and long-term credit to Brazilian industry.

10. LOAN ADMINISTRATION:

With respect to the portion of the loan ($12.5 million) reserved for FUMCAP, AID will reimburse the Central Bank for disbursements made by the BNDE and the Caixa Economica in accordance with the program criteria. The Mission will also consider direct disbursements to the Central Bank rather than the reimbursement approach if the Central Bank so requests. AID disbursements to the Central Bank will be made on a pari passu basis with the GOB contributions and, if possible, on a matching basis with the IBRD. The disbursement procedures applicable to the portion of the loan reserved for technical assistance will be worked out after the program is negotiated in detail, and before loan funds are expended for this purpose.

11. RECOMMENDATIONS:

On the basis of the conclusions of the Capital Assistance Committee that the project is technically, economically and financially justified, it is recommended that a loan to the Central Bank of Brazil in an amount not to exceed $15 million be authorized subject to the following terms and conditions:

a. Interest and Repayment Terms

The Borrower shall repay the loan to AID in U.S. dollars within forty (40) years from the first disbursement under the loan, including a grace period of not to exceed ten (10) years. The Borrower shall pay to A.I.D. in U.S. dollars on the disbursed balance of the loan interest of two (2) percent per annum during the grace period and three (3) percent per annum thereafter.

b. Other Terms and Conditions

(i) Prior to the execution of the loan:

(a) Borrower and AID to agree on a time-phased implementation plan for technical assistance, to be included in the Project Description of the Loan Agreement.

(b) If the International Bank for Reconstruction and Development has not executed an agreement with the Borrower, satisfactory to AID prior to the date when AID and Borrower are prepared to execute a Loan Agreement, said Loan Agreement not to be executed without the prior written approval of the Deputy United States Coordinator of the Alliance for Progress.

(ii) Prior to disbursement to the Capital Market Development Fund, Borrower shall:

(a) Provide evidence of the establishment of FUMCAP pursuant to a decree signed by the President.

(b) Submit a completed Operational Manual for FUMCAP, satisfactory to A.I.D.

(c) Provide a time-phased operational plan for the implementation of the FUMCAP program, together with evidence of the administrative and technical capability of the divisions in each of the executing agencies to perform its assigned functions, satisfactory to A.I.D.

(c) Develop (a) a list of regulatory measures, including a minimum set of accounting principles and auditing standards, adequate rules relating to bona fide distributions, and appropriate requirements of disclosure, and (b) a time-phased plan for further study of additional regulations needed for the development of a sound capital market in Brazil, said list and plan to be approved by A.I.D.

(iii) Prior to disbursement for Technical Assistance Program

Borrower to furnish a detailed time-phased implementation plan for the execution of the technical assistance portion of the loan. Such plan to include (a) a plan for the overall administration and coordination of the program; (b) a description of each major element of the TA program; (c) a description of the agency or entity responsible for the execution of each major element of the program; (e) evidence of the organizational and technical capability of such agency or entity to carry out its responsibilities and function under the program, and (e) a financial plan, showing breakdown by dollar and local currency costs.

<u>Capital Assistance Committee</u>

Chairman	Donald Pearson, CDLS
Economists	K.Fedor, J.Braga, N.Silva, PREP
Financial Analysts	T.McMahon, A.Mulholland, CONT
Legal Advisor	E.Seiff, LGS
Advisors	J.King, L.Fish, B.Meca, CDLS

<u>Project Coordinator</u>

G. Reginald Van Raalte
Dep. Assistant Director for
Capital Development & Industry

<u>APPROVED:</u>

Dwight B. Johnson, Asst. Director for Capital Development & Ind.

William A. Ellis, Director of Mission

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AID-DLC/P-981

June 10, 1971

SECTION I: NATURE OF THE PROJECT

A. Description of Activity

1. Description of the Project

The local currency equivalent to $12.5 million of the A.I.D. loan will be utilized to assist the Government of Brazil (GOB) in establishing a revolving Capital Market Development Fund within the Central Bank of Brazil. The Fund (hereafter called FUMCAP) will have an initial cruzeiro capital input equivalent to US $50 million, including a proposed IBRD loan of $12.5 million, and a matching contribution of the equivalent of $25 million from the GOB. The remaining portion of the A.I.D. Loan (up to $2.5 million) is set aside to finance a technical assistance program related to the objective of developing and strengthening the private and public institutions in Brazil's capital market. This latter program is described in Section I.A.4 below.

Under the proposed program, FUMCAP will provide reasonably priced credits to eligible investment banks, to assist them in financing the "firm offer" underwriting of long-term corporate bonds and shares. The "firm offer" underwriting of securities entails the purchase at sight of such securities at an agreed upon price, and the assumption of the risk of public placement by the underwriter. The FUMCAP credits will enable the investment banks to make a firm offer for such securities at a fair price to the issuing firm without feeling the pressure to "underprice" them for a quick placement. To further reduce the risk of "firm offer" underwriting to the investment banks, FUMCAP will make available lines of credit for limited price support during and for a reasonable period after placement (in the case of shares) and lines of credit to create an active secondary market (in the case of bonds). The differences and rationale for the three kinds of credits are explained in more detail below.

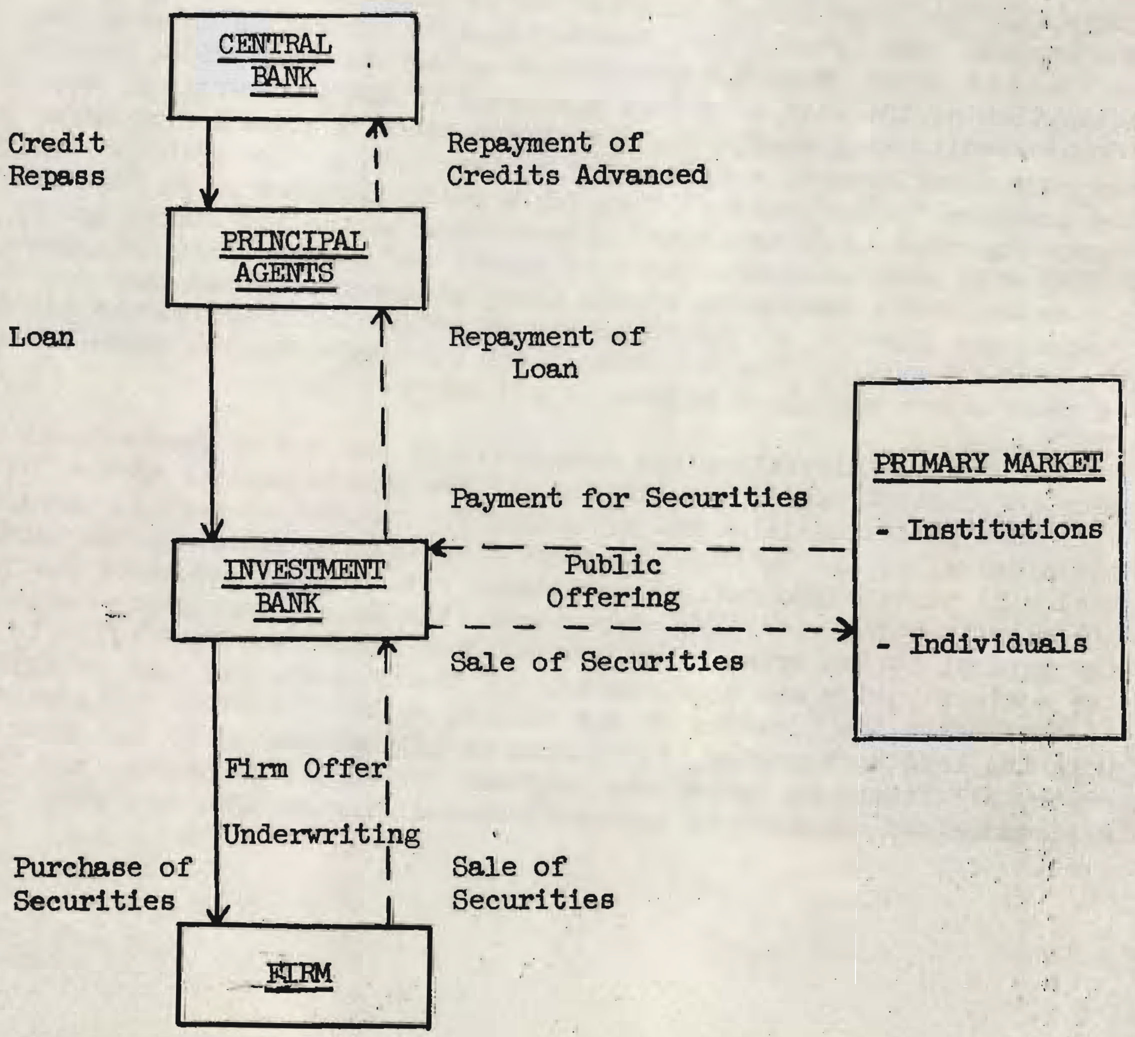
The administration and management of the FUMCAP program will lie with the Central Bank. The Director of the Bank's Capital Market Division will have policy decision making authority, subject in certain cases to the approval of the National Monetary Council. In addition, the Central Bank will provide centralized management for the Fund, probably but not necessarily within its GEMEC department (the Bank's regulatory organ for the capital market area). The Central Bank's FUMCAP office will (1) provide the administration and coordination for the project, (2) make policy recommendations to the Director of the Capital Market Division, (3) provide liaison with the lending agencies, (4) during an initial period to be agreed upon, review all financing operations proposed for FUMCAP financing, and (5) provide assistance and guidance to underwriters desiring to utilize FUMCAP lines of credit.

The GOB contribution to FUMCAP will be provided by the Special Agency for Industrial Financing of the National Development Bank (FINAME) and by the National Savings Bank (Caixa Economica). These two entities will function as the Principal Agents for the repassing of FUMCAP funds from the Central Bank to the investment banks. The Principal Agents will be responsible essentially for checking the eligibility of the issuing firm and the investment bank to receive FUMCAP assistance and for reviewing the underwriting proposal against the operational criteria established for the program.

The eligibility and operational criteria for the program, including the relationships between the Central Bank, the Principal Agents and the investment banks will be set forth in an Operational Manual, which now exists in draft only, and which will be completed before loan funds are disbursed. (A summary of these criteria appears in Section I, A.3, below).

Step-by-Step Description

"FIRM OFFER" UNDERWRITING CREDITS



The above diagram graphically presents the relationships between the entities and institutions participating in the FUMCAP project. The following are the principal steps involved in the process:

(1) A qualifying Brazilian firm, desiring to place its corporate securities with the public, seeks the assistance of an eligible investment bank. 1/ The investment bank evaluates market conditions for the securities, and the value of the firm's shares (or the ability of the firm to safely meet its debt service obligations, in the case of bonds) before agreeing to a preliminary contract for the "firm offer" underwriting of the client's securities. Once a preliminary contract is agreed to by the investment bank and its client, the investment bank assists the firm with the filing of a registration at the Central Bank.

(2) The investment bank applies to one of the Principal Agents for a loan in accordance with the terms set forth in the FUMCAP Operational Manual. Under the terms as presently proposed the loan can be for up to 24 months, at an annual cost of 6% plus monetary correction for the first 18 months, increasing by 1% per annum every month thereafter. The investment bank can borrow up to 70% of the underwriting, financing the remainder from its own or other sources. The application, together with the preliminary contract between itself and the issuing firm and a copy of the prospectus is sent to the Principal Agent.

(3) The Principal Agent reviews the documents and contracts against the eligibility and operational criteria contained in the FUMCAP Operational Manual, and forwards the papers to the Central Bank. Essentially, the FUMCAP staff at the Central Bank will review the registration documents, in addition to the prospectus, to determine that all pertinent information has been fully disclosed and that all financial statements were duly certified by independent auditors. The FUMCAP staff will also review the qualifications of the investment bank and the results and practices associated with any previous underwriting the investment bank has led or participated in.

(4) Upon approval of the proposed operation by the Central Bank, FUMCAP will release funds to be repassed by the Principal Agent to the investment bank. The Principal Agent will release the funds to the investment bank pursuant to a loan agreement signed between it and the Principal Agent. Upon receipt of the loan funds by the investment bank, the underwriting contract between it and the issuing firm is finalized. The underwriter purchases its client's securities on a "firm offer" basis, charging a subscription and placement fee for this service, and accepting the risk of placing the securities with the public.

1/ The eligibility of the issuing firm and investment bank will be determined in accordance with the criteria set forth in Section I, A.3.

The procedure for the release of "price stabilization" credits (for shares) and the "liquidity credits" (for bonds) is essentially the same, except that the purposes of these credits are different, as will be shown in the next subsection.

Rationale for FUMCAP Credits

The essential purpose of the FUMCAP program is to assist the GOB in its effort to develop its capital markets so as to enable it to better perform its function of providing reasonably priced long-term financing to the private sector. The present program seeks to obtain this objective by providing a series of related incentives, specifically (1) to encourage investment banks to underwrite corporate securities at a fair price and on a "firm offer" basis; (2) to encourage the Brazilian firm to open up its capital and sell its securities to the public; and (3) to encourage the Brazilian investor to purchase long-term debt and equity instruments tailored to his investment objectives. The Economic Analysis 1/ section of this paper contains a more elaborate analysis of the project, as it affects the investment bank, the issuing firm, and the investor. The following is a brief overview of the anticipated impact and implications of the proposed program.

(1) The Investment Bank

The investment bank is a relative newcomer on the capital market scene. Until recently, it has been engaged principally in the profitable business of guaranteeing the short term promissory notes of Brazilian industry. These promissory notes, called "Lêtras de Cambio", are sold to the public in order to provide the firm with what is, in effect, short-term and expensive working capital credit. The small amount of long-term financing provided to industry through Brazil's capital market has been both expensive and highly risky for the corporate firm. This capital market financing has been channeled to the firm through a limited number of underwritings, most of which were characterized by underpricing of the firm's shares, in order to assure their rapid public placement. Under this form of "best effort" underwriting, whereby the risk of public placement is assumed by the issuing firm, the latter has no certainty as to the price it will receive for its shares. In the case of long-term debt financing, Brazil's investment banks have not, in recent years, underwritten corporate debentures. As a result of their practices and limited activities, Brazil's Investment Banks have not performed their important role of advising Brazilian industry in the area of financial management.

1/ See Section II, B.

Under the FUMCAP program, the investment bank will be provided with financial incentives to engage in underwriting corporate debt and equity securities at terms attractive to the Brazilian firm. The provision of reasonably priced FUMCAP credits will lower the risk for the investment bank to underwrite a firm's securities at a fair price and on a "firm offer" basis. FUMCAP credits should not only lower the cost of underwriting but should give the underwriter more time to successfully place a security launched at a fair price to the issuing firm. 1/ In addition, the investment bank will be in a better position to effectuate a wider distribution and placement, which is in the interest of the investor in that it provides better secondary market liquidity for his securities.

The FUMCAP "Price Stabilization" credits will be limited to support the price of shares during placement and for a reasonable period thereafter, and only up to the level of the "offering price". The FUMCAP "Liquidity Credits" are designed to support the launching of debentures in the Brazilian Capital Market. Medium to long-term debt instruments have been virtually non-existent on the Brazilian scene. As will be demonstrated in the Economic Analysis Section, such instruments should enjoy a high degree of public confidence and liquidity in order to compete with other short-term financial instruments currently being offered to the public. Thus, in order to create an active secondary market for corporate debentures in Brazil, FUMCAP will permit traders in such instruments (which may include brokerage houses) to draw on FUMCAP for "liquidity" credits.

These credits should also represent a stabilizing factor in terms of supporting the face value of the instrument during the placement period. While price fluctuations should occur only within a relatively narrow range, in the case of fixed yield securities 2/, the fact that the debenture is a relatively new instrument increases the risk for the investment banks which agree to a "firm offer" underwriting of bonds in Brazil.

1/ In the absence of the FUMCAP credits, a "firm offer" underwriting would have been financed out of an investment bank's own capital. This capital has a real opportunity cost for the Brazilian investment bank of approximately 40%. When the investment bank uses its own capital for this purpose, it is encouraged to underprice the issuing firm's securities to assure rapid market placement, and to charge and excessive fee to the firm in order to justify the real, plus opportunity cost of financing the underwriting.

2/ Assuming the issuing firm remains financially sound, debenture prices should fluctuate only in accordance with changes in the prevailing interest rate.

(2) The Firm

The Brazilian firm, in recent years, has had to depend almost exclusively on its retained earnings and reserves for depreciation to finance its growth. Financing from sources external to the firm, when available, is both short-term and expensive. While Brazil's Capital Market now represents a potential source for long-term financing for the Brazilian firm, the investment banks have not fulfilled their normal function of educating the firm on how and why it should finance its expansion by selling its securities in the capital market. The firms themselves have lacked managerial talent in corporate finance and financial analysis to be aware of this potential, and to negotiate effectively with the investment banks. The FUMCAP program will provide an important incentive for theinvestment banks to go to industry and "educate it" as to the advantages of going public. The present loan proposal contains a complementary technical assistance and training component which would emphasize the areas of accounting, corporate finance and financial analysis. See Section I, A.4. Finally, the increased availability of long-term financing at reasonable rates of interest will provide Brazilian firms with increased opportunities to engage in capital projects with extended gestation periods. This is particularly relevant in Brazil at this time because the Brazilian economy can no longer grow by a higher utilization of excess capacity.

The availability of FUMCAP financing will also enable an increased number of investment banks to enter the field of "underwriting". As a result, corporate clients will be in a position to request competitive bidding from various banks. In addition to stimulating the investment bank to underwrite corporate securities on a "firm offer" basis and thus making it more attractive for the firm to consider the possibility of placing its securities with the public, the investment banks can, with FUMCAP credits, offer to underwrite for the firm an optimal mix of its long-term debentures and shares. The leveraging of a firm's equity with reasonably priced long-term debt should lower the cost of an equity placement for the firm, or stated differently, it should increase the return on the firm's equity capital.

By providing the financial incentives necessary for a firm to agree to open-up its capital to public participation, the FUMCAP program should have a positive effect on corporate management practices in Brazil. Firms underwritten with FUMCAP credits will have to provide periodic and independently audited financial statements to their shareholders, which should substantially improve the financial management of Brazilian firms. The feasibility study undertaken by the underwriter to value a firm's shares and determine its future financial needs should also prove to be an important and useful reference point for the corporation's management in planning for and directing the firm's continued expansion.

(3) The Investor

In order to create a public market for corporate shares and debentures, the Brazilian investing public must have confidence in the reported value of the securities they purchase and in the practices of the financial community. One of the objectives of the FUMCAP program is to improve the practices of investment banks and the quality of the securities they underwrite. This result is expected to follow naturally from the "firm offer" underwriting concept, since it is in the interest of the investment bank to minimize its risk by carefully analyzing the real value of the securities it agrees to purchase.

The FUMCAP program also improves the probability of the investor being able to sell his securities quickly and at a fair price, by providing incentives to the underwriters to widely distribute newly issued securities. Both the "firm offer" underwriting concept and availability of "price stabilization" and "liquidity" credits should improve the secondary market liquidity for securities underwritten with FUMCAP funds.

The Government of Brazil, in its efforts to create an institutional market for Capital Market securities, has encouraged the development of mutual funds and recently liberalized the legislation permitting commercial banks and insurance companies to hold a part of their compulsory and technical reserves respectively in corporate securities. These official measures should improve the prospects for an active primary and secondary market for newly issued securities and also bring into the market a group of knowledgeable institutional investors who are traditionally discriminating in their purchases of securities.

The individual investor likewise should become more discriminating, as a result of the FUMCAP program. In the first place, the program calls for additional disclosure and regulations relating to underwriting practices 1/, which will increase the availability of accurate information on different issues. Secondly, the program is expected to broaden the base of Brazil's securities market, by increasing the number new issues placed on the market. 2/ This effect, in turn, should have a stabilizing influence on the recent price rise in Brazil's secondary market, which has been due to a great extent to the large influx of savings into a relatively narrow market.

1/ See Regulatory Analysis, Section II, C

2/ See Financial Analysis, Section II, D

2. Limits on A.I.D. Financing

The A.I.D. loan of $15 million consists of $12.5 million for underwriting credits and $2.5 million for technical assistance. The loan is supplemented by an allocation of $7.5 million for price support and market stabilization credits, as described in the previous section, from two-step principal funds 1/. The portion of the loan reserved for underwriting credits will be disbursed entirely in cruzeiros. The technical assistance program described below in Section I. A.5, is expected to be a dollar cost program almost entirely, except for incidental cruzeiro costs.

The A.I.D. loan for underwriter credits ($12.5 million) will be matched by an IBRD loan, now under study, for the same amount. The $25 million of external resources thus raised for FUMCAP is, in turn, matched by a $25 million (cruzeiro equivalent) contribution from the GOB, derived from the Social Integration Plan Fund (PIS) of the National Savings Bank (Caixa) and from the BNDE. The financial capacity of these organizations to provide the matching funds is discussed in Section II, D.2.

The financial plan, accordingly is as follows:

TABLE : FINANCIAL PLAN
(in millions of US$)

	SOURCES				
	AID	IBRD	GOB 2-Step(1)	Principal Agents	Total 2/
Underwriting Credits	12.5	12.5		25.0	50.0
Price Support and Liquidity Credits			7.5		7.5
Technical Assistance	2.5				2.5
	15.0	12.5	7.5	25.0	60.0

1/ There are 28 signed "Two-Step" AID loan agreements in Brazil requiring repayments in Cruzeiros from borrowers in fewer years and with shorter grace periods than the corresponding requirement for dollar repayments by the GOB. The excess amount of each cruzeiro payment over the then required GOB dollar payment is deposited in a "Special Account". The "Two-Step" funds are available for lending for development purposes upon mutual agreement by USAID and the GOB. At April 30, 1971, the balance of the Two-Step Special Account was the cruzeiro equivalent of US$9.3 million.

2/ The terms applicable to the funds repassed by the Central Bank to the Principal Agents, and the financing procedures to be followed in extending loans to underwriters and utilizing repayments and earnings are treated in Section III,C of this paper.

3. Operating Criteria

Dr. Ernane Galvêas, President of the Central Bank of Brazil, organized a Work Group 1/ to draft an operational manual for the FUMCAP Program (hereafter called "Operational Manual" or simply "Manual") in July of 1970. At the end of March 1971, the first complete draft of the Operation Manual was sent to AID and the World Bank for their review and comments . The Manual is still under review and a number of suggested alterations are now being prepared for discussions by the FUMCAP Work Group. The GOB has indicated that it will seek AID and IBRD approval of the Manual before submitting it to the Monetary Council which also has to approve it. The loan agreement will provide for the submission of a complete Manual as a condition precedent to disbursement.

The Manual, as it now stands, incorporates among others the following documents, in addition to pertinent legislation and appendices:

- a. Proposed Presidential Decree establishing FUMCAP.
- b. Central Bank Regulations for FUMCAP (summarized below).
- c. Investment Bank's Application to Principal Agent.
- d. Form Contract between Investment Bank and Issuing Firm.
- e. Criteria for Audits of Investment Banks.
- f. Prospectus for Use of Issuing Firm (see Annex VII, Exhibit B.
- g. Form Report by Principal Agent and Central Bank.

The principal criteria, as they appear in the proposed Central Bank regulations are summarized in this section.

1/ This Work Group was composed of one representative of the "Caixa Economica", one representative of the BNDE, two representatives from the Central Bank, one representative from the Finance Ministry, one representative from AID and initially two representatives from the World Bank.

a. <u>Eligibility Requirements</u>

(i) <u>Firms</u>

To have their securities underwritten with FUMCAP credits firms will have to meet the following eligibility criteria:

(a) Type - only national <u>1</u>/ firms, registered in Brazil as corporations or public/private corporation ("economia mixta").

(b) Minimum Capital Requirement - a minimum of Cr$2.5 million or approximately US$500,000.

(c) Minimum Profitability - 10% return on capital.

(d) External Auditing Requirement for the Firm - already have contracted or be prepared to contract an independent audit for at least five years. <u>2</u>/

(ii) <u>Investment Banks</u>

The investment banks eligible to act as Financial Agents for FUMCAP will be selected by the Central Bank of Brazil, based on the recommendations submitted by the Principal Agents of FUMCAP, the National Economic Development Bank (BNDE) and the Federal Savings Bank (Caixa Economica). To qualify as Financial Agents of FUMCAP investment banks will also have to meet the following criteria:

(a) Minimum Capital Requirement - Cr$15 million or approximately $3 million, ~~which is~~ the new minimum capital requirement being established for investment banks licensed to operate in all the states and territories of Brazil.

<u>1</u>/ National Firms - this definition includes foreign firms registered in Brazil.

<u>2</u>/ This requirement should be changed in favor of a requirement to have independent audits performed annually, without requiring a contract to be executed.

(b) Minimum Underwriting Experience - The experience of underwriting two placements of securities in the secondary market, as a leader or a co-leader of an underwriting consortium.

(c) To have the technical capability to analyze projects - (criteria for this determination have not been established as yet).

(iii) Operational Criteria

(a) Investment Bank

1. The investment bank acting as a Financial Agent of FUMCAP can contract a line of credit with the Principal Agent for up to Cr$5 million (US$1 million). A line of credit requested by a Financial Agent in excess of Cr$5 million would have to be revised and approved by both the Principal Agent and the FUMCAP staff at the Central Bank. 1/

2. "Firm Offer" Underwriting Credits will be provided to the investment bank by the Principal Agent within a maximum of 30 days after the receipt of a request from the investment bank is made unless denied within this time period by either the FUMCAP staff at the Central Bank or the Principal Agent for failure to meet eligibility or other criteria of the Program.

3. Lines of credit granted to the investment bank to finance a "firm offer" underwriting of a firm's securities will not exceed 70% of the value of the underwriting.

4. If the line of credit is made available to finance the "firm offer" underwriting of shares an annual interest of 6% 2/ will be charged for the first 18 months and starting on the 19th month the rate will be increased every month by 1% per annum until the maximum term of 24 months is reached. In addition, the investment bank will be charged 1% annually for the unused balance of this line of credit, starting on the 61st day after the opening of the line of credit.

5. If the line of credit is made avaiable to finance the "firm offer" underwriting of a firm's debentures, the charge for this line of credit will be equal to the annual coupon plus the monetary correction applicable to the bond. This line of credit can be extended for a period equal to the life of the debenture 3/ which must have a minimum term of 3 years.

1/ The proposed "free limit" of Cr$5 million is to be removed. The Central Bank has agreed to review all underwriting proposals regardless of size, at least during an initial period to be agreed upon (probably one year).

2/ Plus monetary correction tied to the index for Treasury Bills (ORTNs)

3/ Some limitation on the term of such credits should be imposed in order to provide an incentive for placement.

6. The investment bank that has financed a "firm offer" underwriting of a firm's shares with FUMCAP credits, can also draw on FUMCAP for "price stabilization" credits in an amount not to exceed 15% of the value of the overall issue.

7. "Price stabilization" credits can only be applied in support of the offering price of issues financed with FUMCAP credits. The cost of these credits are still under study and to be determined by the Central Bank of Brazil.

8. "Liquidity" credits will also be made available to investment banks 1/ under the FUMCAP Program. These credits will be used to create a secondary market for debentures underwritten with FUMCAP credits. The cost of this line of credit, at any given time, will be equal to the market rate of interest plus monetary correction. These credits can be used to finance the trading activities in a given bond until 12 months before it matures.

(b) Principal Agents

1. The Principal Agents of FUMCAP will limit the repass of credits for the "firm offer" underwriting of any single firm's securities to 10% of the overall value of the FUMCAP fund.

2. The Principal Agent may at its option guaranty debentures underwritten with FUMCAP credits. This guaranty would be for the repayment of the debenture's monetarily corrected face value at maturity. The charge for this guaranty will be determined by the Principal Agent.

b. Reporting Criteria 2/

(i) Between the Investment Bank and the Firm

(a) A form contract will be developed between the investment bank and the issuing firm, stating the amount that the investment bank is willing to pay for the firm's securities and the types of securities that would be issued by the firm. A copy of this contract must be sent to the Principal Agent.

1/ At a later date qualified or brokerage houses ("corretoras") might be allowed to participate in this part of the FUMCAP Program.

2/ The documents that will be used for reporting purposes, with some exceptions, are still being prepared by the FUMCAP Work Group.

(b) The firm will also be required to register its Prospectus with the Central Bank. A tentative draft of the Prospectus is attached as Annex VII, Exhibit B.

(ii) Between the Investment Bank and the Principal Agent - The investment bank requesting a FUMCAP loan will be required to prepare and submit the following documents to the Principal Agent:

(a) A complete financial analysis of the firm. This analysis will include the financial statements of the firm, a "Source and Use of Funds" statement, the financial information required by the Central Bank in Resolution 88 1/, a statement on how the issue is being financed, a description of the proposed placement strategy, the name of the underwriter(s) and the price being offered for the firm's securities 2/.

(b) A copy of the registration document required by the Central Bank. The registration document, for the most past, contains the information required under Resolution 88.

(c) A copy of the tentative contract between the investment bank and the firm.

(d) Before funds are released to the investment bank, the firm must send copies of its Prospectus to the Principal Agent and the Central Bank. Once approved, the Prospectus must be made available, upon request, to all investors interested in purchasing the firm's securities.

(e) When the investment bank requests the release of funds by the Principal Agent, to support trading or price stabilization activities, contracts relating to the amount of these credits, their use, interest rates charged and the terms of repayment will have to be signed between the investment bank and the Principal Agents. Form contracts have been prepared in draft.

(iii) Between the Principal Agents and the Central Bank

(a) Each semester the Principal Agents of FUMCAP will be required to report on their activities to the FUMCAP staff at the Central Bank. This report will contain: (1) the names of the investment banks which contracted underwriting operations financed with FUMCAP credits; (2) the number of operations contracted by each investment bank; (3) the name of the Principal Agent that repassed the FUMCAP credits; (4) a breakdown of the source of funds used to finance the underwritings between the Principal Agent, the Central Bank and the investment banks; (5) a "Source and Use of Funds" statement resulting from the contracted underwriting.

1/ Resolution 88 requires a detailed financial analysis of the firm and a description of the securities being issued, as well as the terms and financial characteristics of these securities.

2/ A more detailed outline of what will be required is contained in the draft Operational Manual.

(6) a breakdown of the credits used in financing the underwriting: between the application of funds accruing from foreign loans, those originating from the resources of the Central Bank, the Principal Agents and the investment banks.

(b) Price stabilization or trading operations financed with FUMCAP credits will have to be reported to the FUMCAP staff at the Central Bank in accordance with the outline set forth in Annex IX in the Operational Manual. Essentially this document will show: (1) the amount of the credit; (2) the name of the investment bank employing the credit; (3) the value of the entire issue; (4) the type of security; (5) the amounts of the issue bought; (6) the amounts of the issue sold; (7) profits from the operations.

(c) The Central Bank will review for approval rejection the Prospectus of the firm being underwritten. The Prospectus will be forwarded to the Central Bank by the Principal Agent.

(iv) Between the Central Bank and USAID

(a) All information received by the Central Bank regarding FUMCAP will be available for review by USAID.

(b) Semiannual statements will be sent to USAID regarding the application of funds derived from the USAID loan.

4. Technical Assistance Program

The proposed A.I.D. loan includes up to $2.5 million for technical assistance (TA) in the area of capital market development. It has not been feasible, during intensive review, to identify all of the needs and priorities of assistance in this sector, and to finally negotiate a detailed program with the GOB. In the absence, therefore, of a fully elaborated program, this section will be limited to a brief analysis of the most important needs for TA in the private and public sectors, followed by a proposed TA program 1/.

It should be noted that the needs for technical assistance identified in this analysis go well beyond the immediate TA requirements of the FUMCAP proposal. As this section will attempt to show, technical assistance is urgently needed in a number of specific areas, if the GOB's immediate and long-term objectives of capital market development are to be attained. Such assistance would be related to, and definitely complement the FUMCAP project. Furthermore, it is apparent that all of the executing agencies for the FUMCAP program (i.e. the Central Bank and the two Principal Agents) could absorb and benefit from external TA directed at both their present and prospective roles and responsibilities. We are not prepared to say, however, that the requisite expertise cannot be found and mobilized internally within Brazil or in ways other than those suggested in the proposal which follows. Our approach, therefore, has been to require a demonstration of technical capacity on the part of the public and private entities participating in the FUMCAP program, as a condition precedent to loan disbursements, and to offer any technical assistance under the loan which may be required to develop the requisite expertise.

In this context, it is expected that a substantial TA program will be negotiated with the GOB, considering (1) that both the public and private sectors have eagerly sought such assistance in the past (see Section I, B, 1) and (2) discussions during intensive review with both public and private sector representatives have indicated a definite interest in several aspects of the program outlined below.

a. Need for Technical Assistance

The real pressure point, in terms of where TA appears to have the greatest potential benefit, appears to lie in industry, and more particularly in the management and reporting of its financial activities. One problem is the limited recognition of what are generally referred to as "internationally accepted" accounting principles and auditing standards. The second problem is the relative dearth, both in the private and in the public sector, of financial analysts and corporate finance expertise.

1/ The analysis is based in large part on the report of a team of consultants contracted by USAID to make a survey of TA needs in the area of capital markets in Brazil. The study included numerous interviews with public officials and private sector representatives during several weeks. It took into the account the specific requirements of the FUMCAP program but was not limited to such needs. The team was composed of Mr. Lyell Ritchie (Porter International), Mr. John Fowler (International Executive Services Corp.) and Dr. Walter Krause (Univ. of Iowa).

From these two deficiencies arise two parallel problems. One is that industry is handicapped in terms of capital budgeting, financial forecasting, assets management and related corporate finance disciplines. The other is that government agencies that may be called on to review financial statements are handicapped in terms of the value that can be derived from them.

These problems are likely to worsen as the existing institutional structure of the capital market expands. Until recently, for example, only a relatively small number of investment banks were actively involved in underwritings - perhaps 6 to 8 of the 30 currently authorized. However, a number of others, including some of those affiliated with the largest financial groups, are moving in that direction. Some of the larger brokerage firms are in the process of establishing research departments with a view toward becoming more involved in underwritings. Commercial banks are becoming directly and indirectly involved in the field, by affiliating with investment banks and/or brokerage firms, by their involvement in fund management and by the very recent establishment of portfolio management as a financial community service. 1/

The implications for the proposed FUMCAP program is that industry is presently at a disadvantage during the negotiation of an underwriting. This is in part due to the tradition of valuing a company on the basis of its fixed assets rather than earnings power or other criteria. In part, it is because the concept of going public is not yet related directly to capital requirements. And in part it is due to some of the underwriter practices identified earlier, including the practices of pricing an initial issue well below the level it will be selling for only a short time later.

These conditions suggest that the critical needs for the long-term development of the Capital Markets in Brazil are: (a) accounting in every aspect, (b) corporate financial management, and (c) more sophisticated financial analysis.

A second major area in which technical assistance could profitably be utilized is the area of regulation. As outlined in more detail the regulatory analysis sections of this paper (Sections II, C and Annex VII, Exhibit A) there are a number of weaknesses in the

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1/ One consequence has been to make investment analysts (typically young economists or engineers with some analytical training) highly sought after, and highly paid. Their resources materials are, however, very circumscribed, limited largely to the financial statements which companies file with the stock exchanges plus such interim reports as the companies may publish.

government regulatory system, and also as regards self-regulation by individual firms and by the stock exchanges, which could be strengthened with the aid of training and external TA.

The following technical assistance proposal addresses both of these major problems, the private sector's need for TA in the area of accounting, financial analysis and corporate finance, and the public sector's deficiencies in the regulatory area.

b. Proposed TA Program

The following program has been prepared on the basis of the needs just delineated. Parts of the proposal have been discussed in some detail with the entities that would be involved in its execution. Some of these potential executing agencies (e.g. the Getulio Vargas Foundation in Sao Paulo) have expressed a strong interest in parts of the program. With respect to the recommendations for the public sector, the proposal is considered realistic in terms of the GOB's past and present receptivity to external technical assistance. However, it should be emphasized that the proposal is illustrative, in the sense that it has been discussed but not finally accepted by the GOB. The loan agreement will provide, however, that a fully developed program be negotiated and approved by the GOB and USAID before funds are released from this portion of the loan.

The objective of the proposed technical assistance program is twofold: a) to begin a long-range program which, over the course of the next several years, will better equip the country to deal with problems as they arise within a Brazilian context; and b) to deal with the immediate problems and deficiencies that have been identified.

(i) Long-Term Proposal

It is proposed that the longer range objectives be approached in two separate but parallel ways: (a) a continuing program designed to adapt the experience of older capital markets to the specific needs of Brazil, and (b) a flexible, highly responsive program to bring external expertise immediately to bear on new and/or unexpected needs as they emerge. It is possible that both approaches could be handled by and in a single entity but a separation would permit the programs to reach broader and more varied audiences.

The first approach would involve establishing a program of external study in the areas of accounting, corporate finance and financial analysis to, in turn, develop competent sources of training in those fields in Brazil. In other words, the objective is to train teachers in these areas. In the accounting area the focus would be on (a) management accounting - concepts, systems and procedures, cost accounting, product pricing, principles of consolidation, financial reporting and (b) auditing - fundamental concepts and principles, reporting standards and auditor responsibilities.

On the finance side the stress would be on (a) corporate financial management - sources and uses of funds, least-cost methods of financing, management of current assets, selection of alternative investments, cost of capital, optimum capital structures, dividend policy; (b) security analysis - analytical methods and theory underlying the appraisal of corporate equity and debt securities for both short-term and long-term performance and (c) investment management - investment policy, portfolio selection and evaluation, securities pricing, trading operations, mergers and acquisitions.

One academic years of study abroad would be made available to eight or more Brazilians for each of the next five years. The recipients should have a degree in areas such as economics, or business administration and some university teaching experience. These should not become rigid criteria, however, since the program should be adaptable enough to include capable personnel irrespective of background. Upon their return to Brazil, it would be expected that these trainees would enter into university and graduate level teaching in these areas at selected Brazilian educational institutions.

A program of this nature, selecting the recipients, arranging for their education abroad etc., is expensive and time-consuming. It is the type of program that would best be administered through an existing institution with experience in such areas. The most logical institution to manage the program is the Vargas Foundation's School of Business Administration in Sao Paulo and this institution has indicated its interest to administer such a program.

Of the Business School's fulltime staff, 15 have degrees (7 PhDs) in finance or accounting. Of the 15, the school has expressed the view that two or three could be released annually for study abroad in specialized areas of the capital markets. Additional staff members, at the pre-masters' degree level, would also be available to receive specialized training. The balance of the participants would be identified, screened, selected and monitored by the Business School, keeping in mind the national character of the program and the need to maximize impact.

The objective in recommending that a program of this nature be placed under the leadership of the Business School is, as noted, to create local sources of training in capital markets that are particularly relevant to the Brazilian experience. At the end of the suggested five-year period, this program would hopefully be carrying the major burden for training areas such as corporate finance financial analysis and accounting.

It should be emphasized again, however, that the identity of the program manager or managers, and exact structure of such a program has not been finally decided. In this respect, the GOB has merely indicated its interest in a long-term program designed to create in Brazil areas of competence in accounting, corporate finance and analysis adapted to Brazilian needs.

The second and parallel approach is designed to be implemented rapidly and, hopefully, can be adopted to any and all levels of industry and finance. IBMEC 1/ appears best suited to manage this technical assistance component. Admittedly IBMEC has, at present, some limitations. It is new, untested and relatively unknown. But IBMEC's strengths, its strong orientation toward capital market research and training, and its resources which should enable it to establish and maintain a highly professional staff, should more than offset such concerns.

The IBMEC program could be developed to maximize flexibility and impact. In that context, the program would begin by concentrating first on corporate finance, second on accounting and third on financial analysis. Two specialists, one in corporate finance and one in accounting would be required to with IBMEC to develop curricula, course content and training materials.

The seminar approach could be expanded by IBMEC to address any urgent problem that may arise suddenly or unexpectedly. If, for example, a need developed involving the analysis, pricing and marketing of corporate debentures, IBMEC should be able to organize seminars using foreign experts in a relatively short period of time and to develop an internal staff capacity to offer training soon thereafter. Similarly, IBMEC could conduct short "senior seminars" on selected topics, to reach the owners, directors and managers in the private sector.

(ii) Short-Term Proposal

There are four specific programs suggested in this category.

(a) The Rio and Sao Paulo Stock Exchanges

There may not be another pressure point where a modest investment in the services of one specialist could result in comparable benefits. The area of need is not so much abstractions such as the rules

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1/ IBMEC: The Brazilian Institution for Capital Markets, created by the Rio Stock Exchange to provide information, training and research services to the entire sector.

of a stock exchange or the need to rationalize differences among the rules set out by the various exchanges. It is in the very practical aspects of helping the exchanges organize their current operations and plan for the future. Decisions involving very substantial sums of money have to be made regarding physical facilities, internally, between the exchanges and their member firms, and possibly as among the exchanges or to the public at large. Decisions must be made regarding new clearing procedures and conversion to a computerized share certificate. There are also the questions about 1) training of the exchanges operating personnel; 2) the training of floor brokers, and 3) the development of specialist operations. One exchange expert for one year is suggested, dividing his time primarily between the Rio and Sao Paulo exchanges, but also to be available to the regional exchanges if they so desire, to address these and other urgent questions.

(b) Auditing Accreditation

Steps toward creating a system of accrediting independent auditors should be taken. As a beginning, a qualified specialist - probably a professor of accounting at the outset should be brought in to develop curricula, and course content for academic training at the graduate level.

A parallel or sequential step would be to develop the procedures for, and contents of, the qualifying examinations themselves. Qualification could be based upon a one-time examination, or it could be attained in phases and/or it could require a minimum period of practical experience over and above the requisite academic training.

A total of 15 man-months of specialist time over the five year period is suggested. (Even if the training and qualification procedures were to be set up over the near term. occasionals visits by an independent expert to monitor the program would be valuable).

(c) GEMEC and ISMEC 1/

The service of a specialist in the regulation of new issues of securities should be available to GEMEC and in the regulations of broker trading in ISMEC. These would be specialists with long operational experience in their respective areas of regulation. Their initial periods of assignment should be a year, with a second year by mutual agreement. Ideally, the technical assistance program in these areas of regulation should be for at least two years' duration.

1/ GEMEC and ISMEC - The regulatory divisions of the Central Bank for the Capital Market Sector. See Section II, C

To assure effective utilization, it would seem advisable, first, to enlist briefly the services of an expert, on the level of an ex-head of the SEC to work with the government in diagnosing the exact requirements.

(d) FUMCAP Administration

At this time, the most logical approach would seem to be to offer to the National Savings Bank (Caixa Economica) assistance in planning and organization in connection with both the PIS 1/ and FUMCAP programs, as it appears that in the very near future there will be need for a rapid build-up of staff capabilities. Given the urgency and magnitude of the problem, technical assistance could be budgeted for at least the next three years.

The Special Operations Department of FINAME 2/ is also in need of technical assistance. FINAME would require no less than the assistance available to the Caixa (over the short run, FINAME could presumably draw upon the skills present within the BNDE, but that is no long term solution to its responsibilities vis-a-vis FUNCAP). 3/

c. Financial Plan

The estimated cost of the above illustrative TA proposal would range between US$2,640,000 and $2,940,000, as shown in the following table:

1/ PIS: GOB's Social Integration Plan. See Section IIB for a discription and implications for FUMCAP.

2/ FINAME: BNDE's Special Agency for Industrial Financing.

3/ For an analysis of the present capabilities of the Caixa and FINAME to perform their roles as Principal Agents for the FUMCAP program, see Section II, A, 2 of this paper.

Table: Illustrative Technical Assistance Program - Estimated Cost

AREA	TIME FRAME	APPROXIMATE COST (In US $)
Private Sector		
School of Business	5 years	$1,250,000
IBMEC	5 years	850,000
Stock Exchange	1 year	75,000
Accounting	5 years	100,000
	Sub-Total	2,275,000
Public Sector		
Government	1 month	15,000
GEMEC	2 years	175,000
ISMEC	2 years	175,000
PIS	3 years	150,000
FINAME	up to 3 years	150,000
	Sub-Total	665,000
	Total	$2,940,000

B. Background of Project

1. Past A.I.D. Assistance

The largest single program for the support of private industrial development in Brazil between 1964-1968 was based on the repassing of medium and long-term credits to industry through official intermediate credit funds. These funds were initially capitalized, to a large degree, by A.I.D. counterpart funds released under a series of program loans granted to Brazil between 1964-1968. During this period approximately Cr$2.8 billion of medium and long-term industrial credit was repassed to Brazil's private industrial sector. During the same period, the official intermediate credit funds (either wholly or partially capitalized by USAID) provided approximately Cr$2.3 billion in medium and long-term financing to Brazil's private industrial sector or approximately 83% of all long-term credit to Brazilian industry. USAID was responsible for providing approximately 41% of these intermediate credit funds or US$339.2 million between 1964-1968. The total amount of official intermediate credit extended between 1964-1968 participated in the financing of approximately Cr$6 billion of new industrial investment in Brazil 1/. In addition to providing industrial financing through intermediate credit institutions, USAID/Brazil has an existing portfolio of 12 loans made to various industries throughout Brazil.

By the late 1960's it became clear to the GOB and most international financing agencies that continued economic and specifically industrial development in Brazil had to be complemented by a responsive and efficient Capital Market. After the Revolution of 1964, the GOB recognized that it could no longer depend on a policy of foreign borrowing and inflation to support the rational and efficient growth of Brazilian industry and the overall economy.

It was at this point that the international agencies and specifically A.I.D. altered its former policy of project financing through the repassing of official intermediate credit to industry, to one of complementing the institutional development of Brazil's Capital Markets. A.I.D.'s first response to this new approach consisted of a markedly increased technical assistance program to this area.

1/ Montor Montreal Industrial Financing Study (1969).

The first initiative came in 1965 in the form of a request by the National Development Bank (BNDE) to assist in the strengthening of governmental institutions concerned with the capital market. USAID agreed to conduct one program for the BNDE, on the understanding that attendance to future programs would be extended to the Central Bank and Brazilian private firms, and that arrangements were to be made to institutionalize the program. The Getulio Vargas Foundation (GVF) was the Brazilian institution selected, and six professors from its staff received advanced, one-year training at the Graduate School of Business Administration of the University of New York. In addition, over 300 high-level public officials and representatives of the private sector were trained at Getulio Vargas Foundation. Another 100 who completed this training proceeded to advanced training at New York University for a period of 4 months. The program with New York University lasted for 4 years and is now being continued by the GVF in Rio.

The GVF/NYU program was followed, at the request of the Central Bank by a special program, mostly for the benefit of the GEMEC staff, under a contract between A.I.D. and the Practising Law Institute of New York. Several U.S. experts, including two former SEC chairmen, conducted a seminar on the experience of the U.S. in the area of capital markets control and regulations. Six senior employees of the Central Bank underwent further theoretical-practical work in the U.S. for approximately 3 months.

Following this course, the ADECIF (Brazilian Association of Financeiras) requested A.I.D.'s assistance in conducting a similar course for the private sector. For this purpose, several prominent members of the U.S. financial community were contracted, through the Investment Bankers Association of America, to lecture on a series of topics of interest to the 200 registrants in the course.

As a result of this assistance, there are now a substantial number of "alumni" of these courses in the financial community, and with the GOB entities involved in the capital markets sector. Of these, a number hold responsible positions in their respective institutions. This fact has been of considerable assistance in developing the FUMCAP project to its present stage and should be of valuable help in its future execution.

2. Loan Preparation

Upon the request of USAID/Brazil, Fordham University Professor David T. Kleinman was invited to come to Brazil in 1967 in order to review the possibility of USAID assisting the GOB in its efforts to develop a viable Capital Market. In January of 1968, Mr. Kleinman submitted a report in which he recommended that USAID assist in capitalizing a "Special Fund" for financing underwritings 1/. At that time, however, USAID postponed any decision regarding assistance to Brazil's Capital Markets.

1/ "The Private Investment Banks and the Development of Brazil's Capital Market". Prof. Kleinman's report had a catalytic effect on USAID programs in the capital market and many of his recommendations are incorporated in the present proposal.

In the early part of 1969, the Mission decided to update and re-study the possibility of assisting the GOB in its efforts to develop the Brazilian capital market. An IRR was prepared and presented in AID/W in September 1969. The CAEC did not approve the IRR at that time, since it felt that additional research had to be done, and the project should be reviewed by recognized experts in the area of Capital Markets. At this time also, the World Bank agreed to send a Mission to Brazil to review the possibility of joining A.I.D. in a possible loan to support the development of Brazil's Capital Market.

In the fall of 1969, Professor Dwight Brothers, Professor of International Finance at the Harvard Business School, spent two weeks in Brazil at the Mission's request to review a proposal for loan assistance in this area. After additional study and research, the Mission presented a second IRR to AID/W in September of 1970; the IRR was approved with a number of comments (See Annex II Exhibit B).

In December 1970, World Bank and USAID representatives met with the President of Brazil's Central Bank and agreed to participate in a Work Group with the objective of developing a document to be used as a basis for loan assistance from the World Bank and A.I.D. in support of a Capital Market Development Fund (FUMCAP). The first draft of this document, the proposed FUMCAP Operational Manual, was sent to the World Bank and A.I.D. in March 1971.

Based in part on the issues raised at the CAEC meeting a number of consultants were contracted to come to Brazil, and several studies were contracted with Brazilian consultant firms to assist USAID/Brazil in its intensive review of Brazil's Capital Market. In January and May of 1971, Mr. Richard Phillips 1/ came to Brazil to review the regulatory needs and objectives of the proposed FUMCAP program. In March 1971, Professor Charles Williams, Professor of Finance at the Harvard Business School, spent a week in Brazil reviewing the proposal in relation to the problems and possibilies of launching a bond market in Brazil. Three studies on industrial financing in Brazil were contracted by USAID/Brazil. The first of these studies was the "Montor-Montreal" study of the official industrial intermediate credit funds referred to above, which was concluded in late 1969. The second and third studies 2/ reviewed existing industrial financing practices and instruments in Brazil; one of these also made a survey of the capital structure of a profile of 100 firms representing potential candidates for underwritings financed under the FUMCAP program.

The reports and recommendations resulting from these consultants and studies have been carefully considered and addressed in this paper.

1/ Partner, Hill, Christopher & Phillips, Washington, D.C. Formerly Assistant General Counsel, U.S. Securities & Exchange Commission.

2/ Undertaken by "Paulding Associates" and "INDICE", Brazilian consulting firms.

3. GOB Application

By letter dated January 8, 1971 to the USAID/Brazil Mission Director, Finance Minister Antonio Delfim Netto applied for an A.I.D. loan of up to $30 million, to assist the GOB in establishing a Capital Market Development Fund, with the following objectives:

a) to activate the market for securities;

b) to facilitate the financial restructuring of national corporations, with the objective of developing the ideal level of efficiency and increasing their borrowing capacity levels, compatible with their development needs;

c) to create a medium and long-term financing system to support the implementation of projects involving the installation, expansion or reequipment of national enterprises, facilitating the flow of the national production of machines and equipment and, if the need arises, the purchase of commodities abroad;

d) to stimulate the mobilization of private savings to promote the opening up of the capital of these enterprises.

The letter further states that such a program "should represent an important contribution for the expansion and definite consolidation of the Brazilian Capital Market, especially in the area of placement of stocks and debentures."

At the time the letter was received the World Bank and A.I.D. were discussing a total loan of $27.5 million, divided into $15 million from A.I.D. and $12.5 million from the IBRD, with a matching contribution of $25 million in cruzeiros from the GOB. As noted in the Financial Analysis Section, the proposed $50 million Fund for Capital Market Development is believed to be adequate, considering the pilot nature of the proposed Fund.

4. Status of IBRD Loan

As noted previously, the International Bank for Reconstruction and Development is considering a loan of $12.5 million as its part in the establishment of the proposed Fund for Capital Market Development. Bank representatives have had a number of discussions with GOB and USAID/Brazil representatives in Rio de Janeiro, and again in Washington prior to the presentation of this loan proposal. The IBRD is now preparing to send an "appraisal mission" to Brazil in the middle of June 1971. Assuming favorable findings, the Bank would be in a position to execute a loan agreement before the end of the current calendar year.

In earlier correspondence to the Central Bank, the IBRD listed a number of questions and concerns, which the GOB subsequently attempted to address in the draft Operational Manual submitted to the IBRD and USAID/Brazil in March of this year. The Manual deals with some of the questions posed by the IBRD, but leaves others to be discussed during the "appraisal mission".

As a result of their meetings and discussions, the World Bank and A.I.D. agree that a number of the operational details contained in the draft Manual will have to be modified and that others, such as the Bnak's disbursement procedures, remain to be worked out. There is general agreement, however, on the overall objectives and broad outlines of the program, as between the GOB, the World Bank and A.I.D. 1/

At this point in time, it is very likely that the World Bank will participate in this project. Bank representatives have emphasized, however, that there is no absolute certainty at this time that the Bank will make a loan to the FUMCAP program. Should the IBRD decide not to make the proposed loan, however, this would not mean that the GOB/AID project would be jeopardized. The FUMCAP program is, in any case, a pilot project which will meet only a part of the global needs for funds and a program reduced in size could still have a significant impact.

1/ One specific concern expressed by the IBRD in the course of its discussion with A.I.D. representatives relates to the proposed management of FUMCAP. This point is discussed in Section II,A.1 of this paper.

SECTION II - PROJECT ANALYSIS

A. Participating Agencies

As noted in the project description, the principal entities participating in the organization and execution of the FUMCAP project are (1) the Central Bank; (2) the Principal Agents, viz. the Special Agency for Industrial Financing (FINAME) and the National Savings Bank (Caixa Economica) and (3) the investment banks. This section discusses the functions of each of these institutions, their organization and staffs, and concludes with an appraisal of the overall adequacy of the proposed FUMCAP administrative and operational structure. 1/

1. The Central Bank of Brazil

a. Functions Under FUMCAP Program

In a letter to the Central Bank earlier this year, the World Bank expressed its concern that the divided responsibilities of the two Principal Agents could result in a lack of coordination in the administration of the program. USAID/Brazil discussed this problem with the Central Bank, which agreed to provide centralized management for the program within the Bank itself. Accordingly, the Central Bank's functions in connection with the FUMCAP program will include: (a) overall management and direction of the program; (b) policy formulation and policy decisions, (subject to the authority of the Monetary Council in certain cases); (c) coordination among the Principal Agents, and liaison with the lending agencies; and (d) administrative and regulatory responsibilities. The main administrative functions will include the following: (a) receiving and evaluating reports on the utilization of FUMCAP funds in all financing operations; (b) promotion and assistance to underwriters desiring to utilize FUMCAP credits; (c) during an initial phase of the program to be determined, review applications for firm offer underwriter credits, including underwriter's contract with issuing firm and with the Principal Agents, prospectus, compliance with accounting and auditing standards, etc.

b. Organization

The Central Bank of Brazil (CB) was instituted by Law 4595 of December 1964. The same law also instituted the National Monetary Council and established th so-called National Financial system which is composed of the following institutions: The National Monetary Council (NMC), the CB, the Bank of Brazil (BOB), the National Bank for Economic Development (BNDE), and all other government and private financial institutions in the country.

1/ A description of the role of the investment banks and their activities is contained in the Economic Analysis (Section II, B).

The NMC, whose chairman is the Minister of Finance, is the top Federal policy-making entity in the area of money and credit. Its membership includes, besides the Finance Minister, the Ministers of Planning, Industry and Commerce, and Interior, the Presidents of the CB, the BOB, the BNDE and six (6) additional members appointed by the President of Brazil. The latter are persons of generally acknowledged capacity in the fields of economics and finance. The NMC is assisted by four Consulting Committees whose functions are advisory: the Banking Committee, the Capital Markets Committee, the Rural Credit Committee and the Industrial Credit Committee. The membership of these committees is representative both of government and private organizations.

The CB is basically an implementing and regulatory entity subordinate to the NMC's policies and guidelines (see Annex V, Exhibit A for details of functions of both these entities). In actual practice, the CB and the NMC maintain a close working relationship. The Resolutions usually originate within the CB where they are drafted and informally discussed with the NMC and its advisory committees before the Council's formal approval. The CB also issues circulars on its own authority but which are based on Resolutions. Thus, the CB has an important and authoritative role.

The legislation addressing itself specifically to the capital market is to be found in Law 4728 of July 1965 known as the "Capital Markets Law". The functions of the NMC and the CB regarding the financial market as set forth in this law are summarized in Annex V, Exhibit B.

The CB is organized on the basis of its major activities. Its principal organizational units, called "Areas", are headed by a director reporting to the Bank's president. The CB's Areas are Foreign Exchange (including the registration and control of foreign investment), Banks (i.e., commercial banks), Administration and Credit, and Capital Markets (see Annex V, Exhibit C for the Central Bank's organization chart). The Capital Markets Area is subdivided into GEMEC (Gerencia de Mercado de Capitalis) and ISMEC (Inspectoria do Mercado de Capitalis). GEMEC concerns itself with the registration of financial institutions, corporations and security issues, while ISMEC is the inspection counterpart of GEMEC. A summary of the functions and capabilities of GEMEC and ISMEC is contained in the section on Regulatory Analysis, below (Section II, C). A more detailed description of their organization and staffs is included in Annex V, Exhibit G.

c. Conclusion

As a result of its existing responsibilities in the area of capital market regulation, the CB has accumulated very substantial experience in this field. It is considered to be the most logical focal point for the FUMCAP program. The CB, through its President, has expressed a willingness to assume the responsibilities inherent in the administration of the program. The Bank has determined that these functions come within its Capital Market

"Area", but has not finally decided where the FUMCAP administration will be lodged (it will probably be within GEMEC). Regardless, however, of where these functions will be, the CB could mobilize the necessary staff to meet its responsibilities to FUMCAP. It will be required to demonstrate this capacity before loan funds are released.

2. Principal Agents

The two institutions designated by the Government to act as Principal Agents for the FUMCAP program are FINAME, the Special Agency for Industrial Financing, and the Caixa Economica, the National Savings Bank.

a. Functions

The principal functions of the Principal Agent in connection with the Program, will entail (a) review the contract between the underwriter and the issuing firm, as well as the prospectus (also to be reviewed by CB); (b) check eligibility of investment and issuing firm to receive assistance under FUMCAP program; (c) review firm offer underwriting credits (subject also to review of CB) and make final determination on eligibility for price stabilization and liquidity credits (however, reports on the utilization of these credits are subject to review by CB).

b. FINAME Organization

FINAME (Special Agency for Industrial Financing) was established in 1964 by federal decree as a fund within the National Development Bank (BNDE). The legal status of the agency was changed by decree in 1966 to give it somewhat greater autonomy. At the present time, its only relationship with BNDE is that both organizations have the same President. A bill now pending in Congress would reconstitute FINAME as a publicly held corporation.

The objectives of FINAME, as defined in the original decree, were to finance the purchase and sale of Brazilian-made machinery and equipment; to finance projects for the establishment of small-size new industries; and to finance resources permitting expansion of presently installed plants. In practice, FINAME has been providing medium-term financing (3-5 years) for industrial machinery and equipment made in Brazil; tractors and farm machinery; heavy vehicles, including road building equipment; and the importation of industrial machinery and equipment. During its 6 years of operation, FINAME has granted a total of over 30,000 loans, of which 8,000 were approved in 1970 for a total value of Cr362,000,000 or US$80,000,000.

FINAME operates through financial agents who repass funds to the end borrower. These financial agents are private or public investment and commercial banks and finance companies. In 1970, 76% of FINAME's financing was provided through private investment and commercial banks, and finance companies. The function of the agents, who earn a commission of 4%, is to take care of the details of financing and to guarantee the loans; FINAME's role is limited to checking if the loans are eligible and to supplying the funds.

Refinancing and financing terms vary from 2-5 years according to the type of equipment. FINAME participation varies from 30% to 90%. Maturities vary from 2 to 5 years. Interest rate is 12% plus monetary correction of 10% to the ultimate borrower.

FINAME's organization chart appears in Annex V, Exhibit D. Recently, a new Division for Special Operations was created within FINAME, to commence longer-term financing operations (8-10 years). This Division will also be in charge of the FUMCAP operations. Headed by a Deputy Executive Secretary, the staff of this Division presently includes economists (7), lawyers (3), an engineer and supporting personnel.

FINAME has no underwriting experience. Its staff, however, through their handling of several thousand lending operations has acquired a respectable experience in the area of industrial credit and a feeling for the financial-operational capability and soundness of business firms which could be utilized in connection with FUMCAP.

The BNDE, on the other hand, has conducted three underwriting operations (with the participation of 6 private banks) which were quite successful. Their combined total reached Cr$30,500,000 or approximately $6,250,000. There is, therefore, a nucleus of personnel within the BNDE who are familiar with financial analysis, pricing and distribution, as a result of having worked jointly on these operations with the issuers and the investment banks. According to the Chief of this BNDE Department (the Department of Resources), the experience gained in these operations is fully available to FINAME. As a matter of fact, there is active participation of the BNDE Department of Resources in the formulation of the proposed basic rules for FUMCAP's operations. However, it is unlikely that any personnel will be transferred from BNDE to FINAME.

c. Caixa Economica Federal (National Savings Bank)

The Brazilian savings banks first came into being in 1831, organized as private institutions. In 1860, the "Caixas" (savings banks) were given the basic features which they were to keep for about 110 years. This law established the maximum deposits that could be guaranteed by the GOB, established interest rates, and basic operations the "Caixas" could perform. Each State capital was to have one "Caixa", autonomous or attached to the agency of the Ministry of Finance in that town, but in any case owned by the Federal Government.

In 1915 new types of operations and regulations were established which remained in force until 1934. In that year the Higher Council for Savings Banks was established in an effort to coordinate and give some uniformity to the 21 "Caixas" in operation. However, these "Caixas" operated independently of each other, having their own Board of Directors.

On August 12, 1969 the GOB decided to merge the 22 "Caixas" and to dismiss the Higher Council for Savings Banks (effective December 31, 1970) 1/. This step meant the dismissal of the boards of directors of the former State "Caixas". A single national Board of Directors with a Chairman and 4 Directors 2/ was installed in March 1970. The organization chart of the new "Caixa" appears as Exhibit E in Annex V.

The important changes effected by this recent legislation can be summarized as follows:

(1) establishment of one institution with a central administration and philosophy, but operationally decentralized;

(2) organization as a public enterprise, under the aegis of the Ministry of Finance, subject to the policy of the National Monetary Council and the inspection of the Central Bank;

(3) change in the legal status of its employees, from government to private (therefore subject to Brazilian labor law).

The functions of the new "Caixa", as established in 1969, are: (1) to receive savings deposit and provide a GOB guaranty within certain limits; (2) make personal loans; (3) operate as a credit institution and principal agent of the National Housing Bank; (4) to administer the federal and sports lotteries; (5) to conduct pawn operations, on an exclusive basis; (6) to operate in the capital markets, under conditions established by the National Monetary Council. As of September 1970, the Caixa is also charged with the administration of the social integration fund (PIS), which is described elsewhere in this paper.

Both the PIS program, and the proposed FUMCAP operation were placed under the responsibility of the Director for Special Operations. The present functions of this Department are: (1) to administer consumer direct credit; (2) to refinance consumer hard goods; (3) to conduct personal

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1/ The new Caixa was capitalized in the amount of the combined net worth of the 22 Caixas and the Council. This amounted to Cr$353,000,000 on March, 1970

2/ Directors in the Brazilian context is equivalent to the officers of the enterprise in U.S. terminology. With respect to the "Caixa", the chairman and directors are appointed by Presidential decree and may be dismissed at will. The chairman has 2 votes: one as a member, another as chairman, and also the power to veto. The chairman is the legal representative of the Caixa.

loan operations; (4) to collect federal taxes and (5) to handle traveler's checks activities. The Department's staff includes lawyers (3), accountants (5), one economist and one business administration graduate. The Department plans to hire two additional lawyers and two additional economists.

As noted, the integrated Caixa, operating with headquarters in Rio and branches in 22 States, is less than two years old. In spite of the tremendous volume of funds handled with great efficiency every day in the course of its normal operations (almost $1.8 million per day) it is quite clear that the "Caixa" does not now have the staff or capability, in its Department of Special Operations or elsewhere, to perform the specialized functions that will be necessary in connection with both the PIS fund, and a full-fledged FUMCAP operation. However, the "Caixa" has considerable flexibility in hiring additional staff, and in retaining specialized or consultant services. It has already accumulated considerable expertise in its FIPIS division, the department concerned with the creation and structuring of the PIS fund, including personnel familiar with the capital markets and investment banking operations. It also has several of its staff on leave of absence and in training with various investment banks. As a result, the "Caixa's" acting president, Dr. Sebastião F. dos Anjos, expressed confidence that the "Caixa" can assemble such internal and external expertise as it may need to perform the functions required by FUMCAP.

d. Conclusion

Neither of the divisions designated by the Principal Agents to be in charge of the FUMCAP Program appears to have the orientation or significant present expertise in the field of underwriting. However, a number of possible approaches to a solution of this problem were tentatively identified: (1) both institutions expressed the confidence that they could gear up to their responsibility with relative ease and speed; (2) the necessary technical assistance is available to these institutions and is provided for under the proposed TA program described above (Section I, A, 4); and (3) the World Bank and USAID/Brazil has requested, and the GOB has agreed as stated above, that FUMCAP would be endowed with a centralized administration within the Central Bank, which would provide overall supervision for the program, and review individual underwriting proposals, before they would be financed.

Regardless of which approach or combination of solution, the GOB chooses to pursue, the conditions precedent will call for evidence to be furnished that the requisite technical capacity exists or has been established within each responsible division of the Principal Agents before loan funds are released (see Section III, D, below).

B. ECONOMIC ANALYSIS

The basic economic justification for the FUMCAP program can be summarized as follows:

The Government of Brazil has an objective of sustaining an overall economic growth rate of 10% per year. Two significant methods of inducing real growth are by increasing the size of the nation's capital stock and by improving the composition of a given amount of capital stock via a more efficient allocation of available savings. The financial system is one important determinant of both the rate of growth of the capital stock (investment) and the efficiency by which the nation's

The principal purpose of the financial markets is to transfer resources from savers to those firms who can most efficiently use these savings for productive purposes (e.g. purchase of machinery, building of factories, etc.). The focus of this section is to show how the FUMCAP program should improve the efficiency by which the Brazilian financial system serves this purpose.

Although the FUMCAP program will not change all aspects of the financial system, its goals are to improve that aspect of the system which is not functioning properly at this time, namely, the provision of long-term financing to the private enterprise sector of the Brazilian economy. This section will begin by describing the financial structure of the Brazilian economy and the activities of its principal financial institutions. The examination of the lending operations of these institutions clearly shows the emphasis placed on short-term loans in Brazil. This phenomenon is explained by the inflationary environment in which these institutions have been forced to operate during the 1960's. The sucess of the Brazilian government's anti-inflationary program began to have a significant impact on the financial markets in the last several years. The reduction in the rate of inflation coupled with the widespread adoption of the monetary correction clause has increased the percentage of total savings flowing into a variety of financial instruments. The analysis of the characteristics of those financial instruments which the Brazilian public is buying clearly exhibits the ability of the financial market to capture a rising volume of savings. One of the basic objectives of the FUMCAP program is to channel a larger proportion of these savings into Brazilian private firms.

The analysis also discusses the position of the Brazilian firms and how they have captured the funds necessary to finance their long-term needs. The principal conclusion is that these firms have been forced to rely almost exclusively on their own internal sources of funds to meet their long-term financing needs. The reliance on internal funds was not an insurmountable obstacle to the impressive growth of the Brazilian private sector in the late 1960's because of the widespread existence of excess capacity. These favorable conditions no longer exist in the Brazilian economy. Consequently, the capital requirements, and concomitant demand for long-term financing, which will be necessary to achieve similar growth rates in the 1970's will be significantly higher.

1. FINANCIAL STRUCTURE OF THE BRAZILIAN ECONOMY

a. The Structure of the Financial System

The Brazilian financial system is composed of the Central Bank, commercial banks, the Bank of Brazil, credit and finance companies, official development banks, private investment banks, official savings banks, the National Housing Bank, and several specialized entities such as FINAME (Fund for Financing the Acquisition of Industrial Machinery and Equipment), credit cooperatives, social welfare institutes, real estate finance companies, and so on. Several types of financial intermediaries also exist in the capital market such as mutual funds and companies specializing in the distribution of stocks, bills and acceptances.

The commercial banks operate almost exclusively in the field of short-term loans, principally in the form of discounts of trade acceptances, which are seldom for more than 120 days. The credit and finance companies extend loans for terms that vary from six months to two years, generally on the basis of acceptances of Letras de Câmbio (real bills of exchange). The Bank of Brazil combines operations of a commercial bank with those of an agricultural bank, with the major part of its activities falling into the latter category. The most important of the development banks is the National Bank for Economic Development (BNDE), the principal function of which is to finance fixed capital investment in the basic sectors of the economy (FINAME is an entity within the BNDE). The National Housing Bank (BNH) regulates and refinances housing credit. The funds for real estate financing are not lent directly by the BNH to ultimate borrowers, but are repassed through such institutions as real estate credit companies and savings banks. Savings banks attract lower and middle - income savings in addition to public resources (principally from the BNH), and, in turn, grant personal, commercial, and mortgage loans.

The private investment banks were authorized in 1966 with the primary objective of extending long-term financing to industry. They have not, to date, made a great deal of progress in achieving this objective. Beginning in 1966, investment banks were involved almost exclusively in short-term operations of less than one year. They have made some progress over the last five years in the sense that the average maturity of their loans has been extended from less than one year to approximately 18 months in addition to the fact that they have increased their underwriting activities. A more detailed examination of the investment banking community will be given below.

Table 1[1/] shows the distribution of loans and financing by the principal Brazilian financial institutions to the private sector from 1964 to September 1970. A number of important characteristics of the Brazilian financial system are reflected in this table. First, the preponderance of short-term (less than 2 years) lending which was more than 5 times long-term lending in 1964 but fell to only 3 times long-term lending in 1969. The reduction in the rate of inflation and the more widespread use of monetary correction (to be explained below) would seem to account for this absolute and relative expansion of long-term loans. Secondly, long-term loans are almost exclusively available from government institutions. About 40% of all long-term loans in 1969 went into industry (BNDE, Bank of Brazil, and investment banks), another 17% into agriculture (Bank of Brazil), and about 40% into real estate (BNH and savings banks) with the latter expanding rapidly while long-term industrial and agricultural credit basically maintained their own relative positions.

The relevance of this general picture of the financial system in terms of the FUMCAP program is twofold: (1) The success of the FUMCAP program, especially on the debt side, will add further inducement to the absolute and relative growth of long-term financing vis-a-vis short-term financing. In particular, a greater percentage of total financing will be made available to industry on a long-term basis. This is particularly important in view of the fact that even in 1969, only about 8.5% of total financing was available to industry on a long-term basis. (2) FUMCAP will provide the first significant source of long-term private debt financing to industry.

Before discussing the reasons for the almost complete lack of private long-term, debt financing, it may be useful to point out some of the drawbacks of having Brazilian firms so dependent on government sources for long-term financing. First development banks function only as a conduit of funds, making little real contribution to the development of local capital markets and having little if any effect on the generation of local savings. Secondly, there exists a considerable opportunity cost when development funds are tied to individual projects for periods of many years, particularly when they are committed for beyond the time when they could have been replaced by private funds; this prevents their redeployment when projects of greater priority develop.

1/ Annex VI, Exhibit J

Finally, state development banks must, because of the fact that public funds are involved, justify all development loans with extensive technical and economic analys.s which are only really necessary for larger projects. With their limited staff, such banks tend to become bottlenecks in the development process and are unable to fully meet the demand for funds from private industry.

This is not to say that Development Banks do not have a large and important role to play in industrial development. Obviously, using the Brazilian National Development Bank (BNDE) as an example, they have an enormous role not only in financing projects, but in rationalizing and structuring investment programs. However, the limitations discussed above clearly limit the impact which development banks can have on industrial financing.

Given the limitations of development bank financing, a favorable economic climate in Brazil, and the emergence of financial instruments and institutions capable of mobilizing private savings and channeling them into long-term industrial financing, it is a propitious time for USAID to assist the Brazilian government in creating the conditions under which the private investment banks can assume a larger responsibility for evaluating projects and assuming the risks of mobilizing private savings in order to finance industrial development.

In this regard, it may be useful at this time to take a closer look at the institution which USAID proposes to support in order to bring about this change in the nature and volume of long-term financing, namely, the investment banks.

b. Analysis of Investment Banking Activities

In February of 1967, 21 investment banks were registered in Brazil and operational by December of that same year. This number grew to 30 by the end of 1970. Ten more investment banks will be permitted to register and become operational by the end of 1971. As of May 1971 eight of the ten have already registered with the Central Bank of Brazil and have become operational.

In 1967 the minimum capital requirement for an investment bank ranged from Cr$5 million to Cr$15 million, for investment banks operating in Rio de Janeiro and São Paulo. In 1969, Resolution Nº 117 was passed raising the minimum capital requirement for all Investment Banks to Cr$15 million and at the same time allowing them to operate in all the states of Brazil.

The capital base of the investment banks grew from Cr$961 million at the end of 1967 to Cr$7,631.4 million as of Dec. 1970. This represents a rate of growth of 795%, during a period in which wholesale prices in Brazil rose by 140% 1/. During this period the ratio of third party resources vis-a-vis the Investment Banks own capital grew from 6 times capital to 7.7 times capital.

A review the Investment Banks Sources and Uses of Funds Statement for 1969 and 1970 shows the absolute growth in Investment funds which reveals the important growth in the different operations of the Investment Banks.

TABLE A

Investment Bank Resources (Sources)

Cr$ (million)

Balances at the End of 1969 and 1970 1/

Sources of Funds	Dec./69 A	Dec./70 B	% C= B/A
Equity	552,2	718,3	
Reserves	160,5	307,0	
Revaluation of Assets	61,6	168,0	
Capital (sub-total)	774,3	1,193,3	54,1
Acceptances	1,633,4	1,774,1	8,6
Official Intermediate Credit Funds	206,6	285,9	38,4
Time Deposits	1,202,2	2,784,5	131,6
Repass of Foreign Credits	357,1	672,8	88,4
Other Accounts	341,3	920,8	169,8
Third Party Funds (sub-total)	3,748,6	6,438,1	72,1
	4,514,9	7,631,4	69,0

Source:
Boletim da ANBID Nº 28
Ano III - Number 28, 2/71

1/ *Conjuntura Econômica*, Getulio Vargas Foundation, Nº 125, p.84.

The figures above show that in 1970 investment bank resources grew by 69% and that the capital base of the investment banks expanded by 54%. The growth in the capital base of the Investment Bank was complemented by a 72% increase, in 1970, of the funds captured by the Investment Bank from third parties.

TABLE B

Investment Bank (Uses of Funds)

Cr$ (Million)

Balance at the Close of

Uses of Funds	Dec./69 A	Dec./70 B	% C=B/A
Cash	203.1	262.3	29.1
Loans	1.292.3	2.941.4	127.6
Acceptances	1.637.7	1.802.3	10.5
Official Intermediate Credit Funds	214.1	313.0	46.2
Foreign Repass Operations	356.6	674.7	89.2
Securities	525.8	1.011.2	93.3
Fixed Assets	45.3	73.6	62.5
Others	240.0	545.9	127.4
TOTAL	4.514.9	7.631.4	69.0

The most noticeable changes in the source and use of funds has been the slow-down in the acceptance business (uses of funds) which grew 10.5% in 1970 while time deposits, the principal source of working capital loans, grew by 131.6%. Foreign Repass Operation, another important source of working capital financing expanded by 89.2% in 1970.

Table C shows the breakdown of actual loans from investment banks to the private sector from their first year of operation (1966) to the end of 1970 by the maturity of the loan. The first important trend to be noted is the gradual change in their short-term (less than 2 years) operations from acceptance financing (a significant percentage of which is used for consumer credit) to straight working capital financing as represented by the relative growth of the entry "loans and financing". This change was brought about by the increasing pressure on investment banks to terminate their acceptance operations. In fact, the GOB will not allow investment banks to engage in acceptance financing at all after February, 1972.

TABLE C

Loans from Investment Banks to the Private Sector

Balances at the end of the period

In millions of cruzeiros at current prices

	Dec/'66	Dec/'67	Dec/'68	Dec/'69	Dec/'70
Number of Banks	6	20	22	29	30
Loans & Financing	43.4	131.5	576.0	1.293.3	2.833.2
Acceptances	85.6	563.0	865.8	1.637.8	1.809.3
Sub-Total(short-term)	129.0	694.5	1.441.8	2.930.1	4.642.5
FINAME	13.5	44.1	93.7	214.1	313.0
External Funds	-	11.1	214.6	356.6	674.7
Sub-Total(long-term)	13.5	55.2	308.3	570.7	987.7
TOTAL	142.5	749.7	1.850.1	3.500.8	5.630.2

The other distinct trend shown in Table C is the relative increase in long-term financing as a percentage of total financing. Long-term lending by investment banks grew from about 7% to almost 18% of total financing between 1967 and 1970. The entry for FINAME represents the amount of their own resources that the investment banks supply to private firms for the purchase of machinery and equipment, with an average of 60% being provided by the BNDE and 15% by the firm itself. The maturity of these loans averages about 30 months.

The entry for external funds represents the amount of money lent by investment banks to Brazilian firms for a period of 28 months, as required by Central Bank Resolution 63. The investment banks capture these funds by issuing their own promissory notes which are negotiated in the international markets, principally the New York and Euro dollar markets. The amount of money the investment banks could raise from this source, and consequently repass to Brazilian firms, is considerably higher than the amount they currently are capturing. The reason they cannot capture more is that the Central Bank has restricted the amount of foreign capital coming into Brazil through these and other sources in order to keep Brazil's foreign debts obligations consonant with its repayment capacity.

Those operations practiced by the investment banks that have been related to Capital Market long-term financing are the Investment Bank Mutual Fund and Underwriting operations.

The mutual funds directed by Brazil's investment banks invest the major part of their resources in shares being traded on the secondary market of Brazil's security exchanges. Because these funds represent one of the principal sources of funds being channeled into Brazil's stock exchanges they have been largely responsible for the spectacular price rises in many of the issues now being traded. Price rises have been a function of the large inflow of funds into a market that offers mutual fund managers very little selection for the investment of their funds. The present trading activity and high prices being offered for shares on Brazil's secondary market has, however, represented an important incentive for firms to agree to open up their capital to public participation by selling their shares on Brazil's primary market.

In terms of underwritings, or the process of providing a firm with permanent long-term financing by the sale of its securities, the mutual funds can act as an important buyer of newly underwriten securities. In this regard, the growth and activities of the mutual funds have played an important role in stimulating the development of Brazil's primary market for corporate securities.

Investment Banks have played the leading role in developing Brazil's primary market for corporate securities. While, at first, sight the underwriting operations of the investment banks (US$55 million in 1970) appear small in comparison to the long-term financial needs of Brazilian industry, they were very relevant to total underwriting operations and the gradual development of Brazil's securities market over the last three and one-half years. In fact the value of underwritings for the first five months of 1971 are approximately equal to the total underwritings undertaken by Investment Banks in 1970.

6. Reasons for the Scarcity of Private Long-term Lending

Long-term loans have been virtually unavailable from private sources in Brazil basically because of the uncertainty about the future rhythm of inflation. In an inflationary environment, the rate of interest that would be established in a free market depend on expectations about the future velocity of price increases.

The velocity of price increases over any long period of time has been almost totally unpredictable in Brazil, with the possible exception of the last few years. An interest rate based on a projected price increase of 3 percent a month in a ten-year operation can be disastrous for the borrower if prices stabilize, or disastrous for the lender if inflation explodes.

One important result of this long-term credit impasse is the weakness of the Brazilian bond market in which long-term, fixed yield, securities have been sold. Although corporate law allows companies to issue debentures up to the total of stockholders' equity, few firms do so.

Table E - Debentures Issues

Year	Value (millions Cr$)	Percent of GNP
1956	0.29	0.03
1957	0.11	0.01
1958	0.54	0.04
1959	0.88	0.05
1960	1.20	0.05
1961	0.60	0.01
1962	2.4	0.04
1963	2.2	0.02
1964	11.0	0.06
1965	31.6	0.11
1966	29.1	0.06
1967	2.6	0.04
1968	145.1	1.46
1969	5.0	0.04
1970	67.5	0.39

Table E shows corporate bonds issued in the period 1956-1970, in total value and as a percentage of GNP. The market is very small when compared, for example, with the size of the market for such short-term instruments as the Letras de Câmbio (commercial acceptances used primarily for consumer financing). Many of the debentures issued in recent years have been short-term instruments (generally one year), sold at a discount in the manner of Letras de Câmbio.

The natural remedy for a shortage of long-term credit during a violent inflation is the adoption of an inflation clause-adjusting payments and unpaid balances in accordance with price indices previously agreed on. Until 1964, such readjustments were illegal in Brazil. Since 1964, several laws have been promulgated authorizing the issuance of credit instruments and the extension of loans with a monetary-correction clause.

Before we discuss the current use of the system of monetary correction in Brazil, it should be pointed out that Table E does not show two other sources of long-term financing available to private firms, namely, the issuance of new equity and foreign capital. Although the amount of financing received through the issue of new stock is very small (approximately 1% of total financing and 4% of long-term financing in 1969), foreign capital represents a very significant source of financing (over 20% of total financing in 1969). We will discuss both of these sources of financing in a later part of the paper as viewed from the point of view of the industrial sector.

d. Monetary Correction

Monetary Correction (MC) is a mechanism by which the nominal value of a claim is adjusted to compensate for the loss in the purchasing power of the currency in which that value was originally expressed.

The application of MC in Brazil can be traced as far back as 1951, when firms were first authorized to correct the historical value of their fixed assets. This device, which came to be known as "revaluation of assets" was in 1958 authorized to be applied on a regular basis and the legislation that followed extended the application of MC to current assets. This legislation also established special treatment for the public utility companies for the use of MC.

The authorization for firms to correct the value of their assets came to be made in Brazil as a result of the growing concern by business, and ultimate recognition by Government, that inflation was eroding the book value of the firms' assets, so that nominal profits, and consequently corporate income tax, were very high, but real profits were low, and in many instances even negative.

Starting in 1964 the field of application of MC has been considerably expanded. By the end of 1970, practically any claim could legally have its value monetarily corrected. Of particular relevance for this study was the extension of MC to the financial sector through either existing financial instruments or the creation of new instruments with the MC clause. Legislation enacted since 1964 created the ORTNS (Readjustable government bonds) and the housing bonds ("letras imobiliárias") both with MC, and authorized MC to be charged against private credit instruments, such as debentures, time deposits, and bills of exchange.

The principal objectives of the government in extending MC to financial instruments was to improve its own ability to borrow long-term and to develop a private long-term financial market in Brazil. One of the worse effects of the long-time Brazilian inflation was the practical elimination of the demand for long-term securities. While the impact of inflation and the limitations posed by the so-called usury law (the 12% interest ceiling) could to some extent be circumvented in the short and medium term credit markets by means of such banking expedients as "interest on the outside" and "surcharge of commissions", or the discounting mechanism in the bills of exchange, none of these could work in the case of long-term instruments because of the unpredictability of inflation in longer periods. This in part explains the preference of the Brazilian wealth holders for short term instruments. In the light of the undesirability of adopting strong methods to curb inflation, as viewed by the Brazilian monetary authorities - with overwhelming support from the Brazilian public opinion - the MC device appeared as the best way to conciliate the need for long-term financing with uncertainty about inflation in the long-run.

Another factor that determined the adoption of the MC in Brazil relates to the role of expectations in an inflationary environment vis-a-vis the implementation of a price-stabilization program. Influenced by the behavior of prices, holders of financial assets may tend to overestimate the future rate of inflation and thus to underprice the present value of securities. Consequently the real rate of interest may be raised much more than otherwise would be the case, a fact that would unnecessarily strengthen the recessionary effects of a price-stabilization program. In 1965, the monetary authorities were very concerned with avoiding, to the maximum extent possible, these effects of their anti-inflationary program. Beginning in 1965, the real rate of interest, though still negative, began to rise considerably. This rise was expected to continue in the future, eventually beyond acceptable levels, and was interpreted as being caused, to a large extent, by the rigidity of price expectations associated with the discounting practices followed in the securities markets. a/

To the extent that this was so, a mechanism such as MC could help to overcome the situation since it could substitute an a posteriori verification of inflation for the a priori estimation of it, which is the case when a security is bought at a discount. When a security is bought at a discount, the discount includes the interest rate and a margin allowing for the future unknown increase in the prices of goods and services.

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a/ Actual annual discount rates for bills of exchange of six month maturity were on the average -50% in 1964, -25% in 1965, -8% in 1966, +2% in 1967 and +6% in 1968.

When, on the contrary, MC is tied to a coupon yielding bond, then the issuing price and the coupon are no longer fixed; they vary according to the actual amount of inflation that takes place between the issuing and the redemption dates. The advantage of adopting such a mechanism is that, on the one hand, it protects the lender as interest and the final amount collected are expressed in a currency of a constant purchasing power; on the other hand, it avoids the possibility that the borrower is hurt if prices stabilize faster than originally expected.

A detailed discussion of the method used to derive the monetary correction coefficient and the methods by which it is applied to various financial instruments can be found in Annex VI, Exhibit A.

e. Financial Instruments

Another aspect of the structure of the Brazilian financial system that is relevant for this project is the change in the flow of funds going into the various types of financial instruments in which the private Brazilian saver can hold part of his wealth. Although a detailed discussion of the characteristics of these instruments and the volume of money flowing into them can be found in Annex VI (Exhibits C, D and E), the description of the Brazilian financial system would be incomplete without noting some of the conclusions drawn in this Annex.

The financial instruments available to the public in Brazil are almost entirely short-term. The largest volume of funds were captured by financial acceptances (Letras de Cambio, used primarily for consumer finance) and time deposits, both of which have maturities ranging from 6 to 24 months. The volume of funds flowing into these instruments increased by about 80% in real terms during the 1960's. It is particularly interesting to note, however, that money flowing into longer term, fixed interest securities (Letras Immobiarias and savings accounts, both of which are used primarily for real estate financing) showed a much larger relative increase since 1968. This implies that the Brazilian saver is becoming more interested in the higher yields offered by these latter instruments than his previous preference for the more highly liquid short-term instruments. This recent change in saver preferences exhibits the market's greater receptivity for the new type of instrument which will be introduced to the public by the FUMCAP program, namely, long-term private bonds. If the public does accept this new instrument, one can expect a relative shift of resources from consumer & real estate financing to industrial financing.

A second important phenomenom is the fantastic increase in the amount of money flowing into the stock exchanges. The Rio Stock Exchange, for example, increased the real volume of monetary transactions by a factor of 8 from 1968 to 1970. This reflects the growing receptivity of equity as a form in which the Brazilian saver wants to hold his wealth. Once again, however, the increase in the volume of money flowing into this instrument (stocks) has not directly effected the large majority of Brazilian firms since the money is being spent to purchase stocks in the secondary market. Moreover, only about 80 issues are actively traded.

The development of an active secondary market is, of course, a prerequisite for the expansion of the primary ma.'ket wherein firms initially sell their new equity and thereby receive funds for long-term financing. The renewed interest in the stock traded in the secondary market does appear to make this a highly opportune time for Brazilian firms to launch new securities at reasonable prices through the FUMCAP program.

2. Sources of Long-Term Financing Available to Brazilian Firms

a. The Current availability of Funds

This section analyses the sources of long-term financing upon which the types of Brazilian firms which are likely to benefit from the FUMCAP program have had to rely in the recent past. This section will attempt to show that these sources have not adequately served the needs of these firms for long-term financing in the past, and that they can not be expected to provide the financing required for the private sector to grow at the rates projected by the Brazilian government.

In order to get a clear idea of the sources of funds used by firms who will be the potential users of the underwriting services being financed under FUMCAP, USAID/B commissioned the services of two Brazilian consulting firms to collect data on the financial activities of these firms.

INDICE, a private "data bank", collected and analysed data on sources of long-term financing (which they define as having a maturity of one year or more) for the private business sector as a whole and for firms with a capital base exceeding Cr$10 million. An in-depth analysis of the balance sheets of 100 of these firms as well as an extensive interview of 50 of these 100 was conducted by Paulding Associates, a Brazilian consulting firm specializing in financial research and analysis. The conclusions and results of these surveys are reported below.

The data collected by INDICE firmly supports one of the basic propositions underlying the need for the FUMCAP program, namely, that Brazilian firms are forced to rely heavily on their own resources for the financing of their long-term needs. Table 3* shows the flow of long-term funds and their sources for all firms in Brazil. The first group represents sources of funds internal to the firm, while the last three groups represent external sources, broken down into official sources, private sources and foreign sources.

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* Annex VI
Exhibit J

The most important observation to be made on the basis of these flow of funds data is the high percentage of long-term financing which have been generated from the firms' own resources (the average over the period is more than 50%). In addition, the variation in this percentage is very high from year to year. The uncertainty and limited size of the flow of funds into the firm is not, to say the least, characteristic of an efficiently functioning capital market. In this regard, one should note the extremely small amount of funds flowing into the firms through the private capital markets. This source of funds has, however, been growing rapidly in the last few years.

Presented in Tables 4-7 * are data on Brazilian firms with a capital base of at least $2 million (Cr$10 million) in 1970. The first table shows the total capital base of these firms, broken down by sector, in order to give a general picture of the potential clients of the FUMCAP program. As could be expected, the sector which will benefit most from the FUMCAP program is the industrial sector, although the service sector has been growing rapidly and also represents another important sector to be affected by FUMCAP.

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*Annex VI, Exhibit J

Table 5 shows the sectoral pattern of retained earnings during the 1964-1969 period. Two interesting aspects of the data in this table should be noted. First, the cyclical nature of retained earnings in the various sectors, particularly in steel and metalurgy. Secondly, some sectors, such as commerce and services, have been plowing back a relatively large amount of their profits into retained earnings

Table 6 shows the amount of new equity raised by the firms from all sources (i.e.) current owners, and sales of new issues to the public, and fiscal funds. This table verifies the recent (1968) substantial growth of new resources being made available to Brazilian firms. Once again, the industrial (especially automobile) and service sectors have been the chief beneficiaries.

Table 7 shows the sectoral breakdown of long-term loans supplied by the principal, official, lending agency, the National Bank for Economic Development (FINAME). Once again, industry (especially steel and metalurgy) and the service sector are the primary beneficiaries of the long-term financing available.

A slightly different method of analyzing the Brazilian firms' sources of long-term financing was done by the Paulding Associates. In addition to interviewing firms, they did an in-depth analysis of the balance sheets of 100 firms which resulted in the flow of funds table shown in Table 8, Annex VI, Exhibit J.

In order to analyze the significance of these data, let us examine the averages for the medium size industry, a prime candidate to participate in the FUMCAP program.

Grouping the entries shown in the table, it can be seen that the net primary sources and uses of funds were:

Uses	
Increase in current assets	44.5
Increase in fixed assets	48.3
Dividends	3.2
	96.0
Sources	
Increase in long-term liabilities	7.7
Increase in short-term liabilities	17.6
Profits (before depreciation)	46.3
Increase in capital or re-evaluation of assets	24.4
	96.0

Assuming that the difference between the increases in current assets and current liabilities was working capital, the following picture emerges:

Uses	
Increase in Working Capital	26.9
Increase in Fixed Assets	48.3
Increase in Dividends	3.2
	78.4

Sources	
Increase in Long Term Liabilities	7.7
Increase in Profit	46.3
Increase in Capital or Reevaluation of Assets	24.4
	78.4

It is impossible to determine how the last item breaks down between increases in capital and reevaluation of assets because of the manner in which balance sheets are drawn up in Brazil. Let us make the reasonable assumption that it breaks down 50-50. Since the reevaluation of assets is done to correct for the erosion of monetary values in an inflationary situation, then the final, perhaps most accurate picture that emerges, is:

Uses	
Increase in Working Capital	26.9
Increase in Fixed Assets (Investment)	36.1
Increase in Dividends	3.2
	66.2

Sources	
Long-Term Financing	7.7
Profits	46.3
New Equity	12.2
	66.2

No matter how one looks at the data, the same general conclusions emerge: namely, that the typical Brazilian firm is forced to finance an inordinately large percentage of its needs from sources internal to the firm and that long-term debt financing (and therefore leverage) is extremely limited.

b. Attitudes of owners/managers regarding new long term financing of operations through the public offerings of debentures and equities

In order to insure that there would be a sufficient number of Brazilian firms interested in launching new securities under the FUNCAP program, USAID hired a Brazilian consulting firm to interview 50 Brazilian firms who would be potential candidates for new underwritings. These 50 firms represented a reasonably good cross section of the Brazilian private sector which have the size and profitability necessary to consider a new public offering. Only a very small percentage of the firms have any equity held by the general public. The most relevant aspects of the results of this survey are reported below.

In terms of the demand for new underwritings, a large majority of the firms interviewed are considering launching new securities in the near future (about 40% within the coming year). It is, however, interesting to note that almost all of these firms are thinking only in terms of new equity issues.

The survey revealed that the type of long-term planning required to make rational decisions about the proper use of long-term external financing was quite inadequate. Only about 2/3 of the firms interviewed had financial plans which projected future profits and/or cash flows. Those that did have financial plans generally limited their projections to 3 years at the most. Less than 1/2 of the firms had made projections of the future market demand for their products. Those that did, once again, limited their projections to 3 years.

Another salient characteristic of the firms interviewed was the limited understanding and knowledge of financial markets. This was especially true with reference to long-term debt instruments. For example, more than 1/2 of the firms had absolutely no idea how much it would cost to receive financing through the capital market.

Those who thought they knew seriously over-estimated the cost. For example, about 2/3 of this latter group thought that they would have to pay 14% or more plus monetary correction in order to sell their convertible debentures on the market.

This lack of knowledge and/or inaccurate information probably explains the fact that only 1/3 of the firms wanted to substitute long-term debt for short-term debt, even through their balance sheets showed that long-term debt represented only about 11% of their total assets (short-term debt was about 25%.)

The attitudes of the firms interviewed regarding the major advantages and disadvantages of issuing new securities breaks down as follows:

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1) Major advantages of new equity issues (listed in order of importance) :

a) Improve the possibilities for future expansion, including mergers with other companies via the use of stocks.

b) Decrease the financial costs of the firm.

c) Receive the fiscal benefits offered by the GOB to "open capital" companies.

d) Increase the liquidity of the shares held by the current owners.

e) Improve the ability of the firm to launch an expansion program whose pay-offs would not be realized for a relatively long period of time.

2) Major advantages of new long-term debt issues.

a) Decrease the financial costs of the firm (One should note the contradiction here with their response to other questions about long-term debt).

b) Substitute long-term debt for short-term debt (Another contradiction)

c) Increase fiscal benefits because interest payments can be deducted from profits before taxes are computed.

3) Major disadvantages of new securities issues (both debt and equity)

The only important disadvantage seen by a majority of the firms was that launching a long-term debt instrument today requires the payment of a rather high rate of interest over a long period of time. They think this is a disadvantage because they expect interest rates to fall in the future.

It is interesting to note some of the factors that they did not think were important disadvantages of launching new securities. First, only 16% thought that divulging information that was now confidential was an important disadvantage. Second, only 27% viewed annual audits by independents auditors as an important disadvantage. Finally, although not asked directly, they were given more than ample opportunity to express their concern that new equity issues might dilute the control and/or earnings of their present stock holders. No one mentioned this at all.

/...

The final relevant result of the survey was the apparent attitude of firms toward investment bankers who could underwrite their new securities. Almost 1/2 of the firms interviewed thought that investment bankers could provide useful information about the capital market, but they did not feel that the investment bankers could provide useful advice on how to improve the financial structure of their firm.

Another 1/3 of the firms felt that the investment banks could provide useful advice and information on both of the topics mentioned above, but that they would not place a great deal of confidence in the advice of any one investment bank, implying that they would consult a variety of investment banks. Only 17% of the firms interviewed seemed to have a high degree of confidence in the ability of any one investment bank to provide them with useful advice and information on both the capital market and the financial structure of their firm.

It is obvious from this survey that the Brazilian investment banking community has both a necessity and the opportunity to improve significantly the service it is currently providing to the business sector. The basic reason why the service they are providing is inadequate today is probably best explained by the fact that investment banking is a new institution in Brazil (the first investment banks were launched in 1966). There is, however, a real need at this time for Brazilian firms to improve their financial management. The investment bankers are in a prime position to induce improvements in these practices. The FUNCAP program, both through its credits and technical assistance, should aid the investment bankers in improving the services they provide to issuing firms.

3. Economic Benefits of FUMCAP

a. Economic Benefits of FUMCAP for the Brazilian Firm

A recent survey by Paulding Associates of 100 Brazilian firms 1/ shows that the average return on monetarily corrected assets after taxes is approximately 16.5% 2/. The average debt/equity ratio of these same firms is 17% debt to 83% equity 3/.

These data have pointed out two important factors.

First, the Brazilian firm depends heavily on retained earnings as its principal source of funds for financing expansion, while long-term debt has been used to a very limited degree as an important source of investment funds for the firm. Not only does the almost exclusive dependence on retained earnings limit the expansion possibilities for the Brazilian firm, but the benefits of leveraging the firm's equity capital with long-term debt have not been exploited to any significant extent. The following table demonstrates the clear advantage to the shareholder of a firm that leverages its equity with an optimal amount of long-term corporate debt.

1/ (79) Industrial, (17) Service, (8) Commercial. The minimum capital base of the firms sampled was Cr$10 million; their minimum return on equity was 20%.

2/ See Annex VI, Exhibit J, Table 9

3/ See Annex VI, Exhibit J, Table 10

Exhibit A: Financial Leverage

Financial Data for Brazilian Firm

- Average Debt/Equity Ratio of FUMCAP's Potential Clients 17/83
- Maximum Debt/Equity Ratio allowed for a Brazilian Firm 50/50 1/
- Profit Margin on Sales 20%
- Brazilian Corporate Income Tax 30%
- Interest Payout on Bond 12%

	Firm (X) Debt/Equity = 17/83	Firm (Y) Debt/Equity=50/50
Sales:	$1,000,000	$1,000,000
Net Income Before Taxes and Interest:	200,000	200,000
Interest at 12%:	9,500	28,000
Net Income Before Taxes:	190,500	172,000
Taxes at 30%:	57,150	51,600
Profits After Taxes:	133,350	120,400
Total Assets:	500,000	500,000
Total Debt (Long-term):	85,000 (17%)	250,000(50%)
Owners' Investment:	415,000 (83%)	250,000(50%)
Return on Assets (Profits)/(Assets):	26.8%	24.2%
Return on Owners' Investment (Profits)/(Owners' Investment):	32.6%	47.0%

1/ We also assume that, on the average, this amount of debt can be safely serviced by the firm on a long-term basis. A 50%/50% debt equity ratio is considered the average for U.S. manufacturing companies.

The much higher return on ownership funds in Firm Y (47%) versus (32.6%) for Firm X, reflects the fact that long-term credits were the source of much of the funds used in the business. The degree to which the return on total assets and the return on owners' investment differ from one company to another will hinge on the relative mix of ownership and creditor's funds in the business. Thus, the figure for return on ownership funds reflects the financial policies of the firm as well as its effectiveness in employing assets. The economic impact of this increase in profits is difficult to predict because firms can do one of 3 things with extra profit: plow it back into the firm, lower prices and/or raise dividends.

The Importance of Financial Leverage to the Shareholder

The price that an investor is willing to pay for a firm's securities is dependent on the earning power of the firm. More significantly, the common shareholder is only interested in earnings per share (related to the owners' investment) and would be willing to pay a substantially higher price for the shares of Firm (Y) than for Firm (X) because of the higher return on the investment for the firm's owners (common shareholders). This is, of course, very important for the firm that plans on raising new equity and the subsequent value that the firm will receive for its shares.

Using the example of the above table, Firm (Y) required only 60% of the initial investment of Firm (X). Said differently, Firm (Y) would have only had to issue 60% as many shares to receive the same amount of initial capital as Firm (X) 1/. The table below demonstrates the effect that the return on the equity investment should have on the market price of the firm's shares. In preparing this table the following assumptions were made.

- The price earnings ratio for both Firms (X) and (Y) is .... 15 x
- Nº of shares outstanding of Firm (X) 100,000
- Nº of shares outstanding of Firm (Y) 60,000
- Asset Base for Firms (X) and (Y) $500,000
- Brazilian Corporate Tax 30%

1/ Assuming that the shares were sold to the initial shareholders at the same price for both Firm (X) and (Y) are in the same business.

Table

Earnings Before Interest and Income Tax (EBIT):	$200,000	$200,000
Deduct: Bond Interest:	9,500	28,000
Net Earnings Before Taxes:	190,500	172,000
Federal Taxes (30%):	57,150	51,600
Net Earnings on Total Common Stock:	133,350	120,400
Dividends:	- 0 -	- 0 -
Nº of Common Shares Outstanding:	100,000	60,000
Net Earnings per Common Shares (E.P.S.):	1.33	2.00
Price Earnings Ratio P/E:	15 x	15 x
Resulting Market Price per Share:	$19.95	$30.00

As the example points out Firm (Y), benefiting from greater financial leverage than Firm (X), enjoys a marketprice of $30 per share while the shares of Firm (X) are trading at only $19.95 per share. This relationship between financial leverage and the market price of a firm's shares is clearly of great importance to the firm that chooses to increase its equity through the public placement of its common share.

In addition to the specific advantages mentioned above, there are a number of general benefits which should be enjoyed by firms who participate in the FUMCAP program. Planning for future expansion on the basis of retained earnings and short-term credit is a highly uncertain and risky activity. Expansion often requires the purchase of capital equipment which will not begin to pay for itself for at least 3-4 years. In the face of limited sources of long-term financing, firms are less likely to expand their capacity than if they could rely on lending which would finance them during the gestation period. Although we cannot make a quantifiable prediction about the extent to which the greater availability of long-term financing will induce greater output, common sense leads to us to the conclusion that the firm will be in a better position to increase output and take advantage of profitable opportunities.

Another benefit of FUMCAP will be the provision of "firm offer" underwritings in the place of the current widespread practice of "best efforts" underwriting. The principle advantage of a "firm offer" underwriting stems from the fact that the risk of placement is shifted from the firm to the underwriter. This assures the issuing firm of receiving a predetermined amount of money at some designated date. The uncertainty concerning both the real cost of the new security as well as the time when this new money will be available is reduced considerably.

The provision of FUMCAP credits to the underwriter to assume this added risk of a "firm offer" underwriting should also increase the price the firm receives for its new securities because the underwriter will not be under the same pressure to place the new issue in as short a time as possible. Since the opportunity cost of tying up their capital for long periods of time is very high, the Brazilian underwriter has had an incentive to underprice new issues for almost immediate placement. The FUMCAP credits should significantly reduce this incentive.*

Finally, to the extent that the FUMCAP program improves and expands the general practices of the underwriting services available to firms, this also will benefit the typical Brazilian firm which is in need of a great deal of additional financial advice and information.

Debt Service

Exhibit I, taken from the Paulding Associates studies, indicates that the average after tax return on monetarily corrected assets is 16.5%. Assuming a payout by the firm of 12% interest per year on the monetarily corrected face value of the bond and the fact that interest is tax deductable 1/, the actual after tax cost to the firm issuing debentures at 12% is approximately 9.4%.

The analysis of 100 industrial firms by Paulding Associates shows that, with an average after tax return on corrected assets of 16.5%, the majority of the firms sampled would be able to safely service the interest on debentures offering a "real" 2/ coupon of 12%.

It is felt that the industrial firm in Brazil will have to offer a "real" 10%-12% return on medium to long-term debentures in order to attract the savings of the private investor, who is now receiving "real" returns of between 6% - 8% on current, highly liquid, short-term, financial instruments that also carry third party guarantees.

1/ Corporate income tax = 30%

2/ The monetary correction factor which is tied to the Treasury Bills Index (ORTN) would be paid at the maturity of the bond. In the meantime the bonds should trade at a premium reflecting the cumulative effect of monetary correction.

* For a more detailed discussion of current underwriting practices in Brazil, see Annex VII, Exhibit A, pp. 1-4.

b. Improvements in the Market

While the spectacular rise in share prices in Brazil's securities market over the last two years has averaged over 150% per year and over 100% in the first five months of 1971, the Brazilian securities market is more stable than it may appear to be. In fact, it appears that the current prices for shares are not excessively high but rather that the sales price of industrial shares to the public has been excessively low.

A review of the price/earnings ratios of the 100 most actively traded shares on the Rio Stock Exchange on May 18, (which was the most active trading day in the history of both the São Paulo and Rio Stock Exchanges - amounting to US$51 million) shows that the average price/earnings ratio was 22.3. On Friday, May 14 the Dow Jones industrial average was 18.3 times the $51.02 per share earning of the 30 component stocks, for the 12 months period ended last December 1/.

In Brazil the highest price/earnings ratios are not enjoyed by the new issues but rather by the state owned banks (e.g. Bank of Brazil), the oil industry (e.g. Petrobrás) and the utility companies. All these firms are substantial in size, have shown impressive profits, and are expanding rapidly. For example, the most widely owned stock by Brazilians is the Bank of Brazil, whose profits for the last two years has exceeded both the bank's capital and reserves of the previous year. Unlike New York, where the high price/earnings ratios in late 1968 were associated with "hot" or "new" issues, just the opposite phenomena has taken place in Brazil. This factor, of course, has, in part, supported to date the public confidence in the stock market.

If the high price/earnings ratios enjoyed by the above mentioned sectors (primarily government controlled) were not included in averaging the 100 most actively shares, the average price/earnings ratio would fall to approximately 17.3. This price/earnings ratio is applicable to many firms that were underwritten during the last 6 to

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1/ Wall Street Journal - May 17, page 27.

24 months and have averaged price increases of over 100% per year. This would imply that the average price/earning of newly issued securities in Brazil have been underwritten at relatively low price/earnings ratios. Said differently, the Brazilian firm is benefiting far less from the recent huge flow of funds into Brazil's securities market than has the average Brazilian investor. While it could be argued that this sequence was essential to activating the securities market; it could also be argued, now that stock investment has been widely accepted by the Brazilian public, that underwriters should now tap a greater proportion of these savings for industrial investment by underwriting securities at higher price/earnings ratios, something that the Brazilian public is clearly prepared to accept.

The shift to "firm offer" underwriting under the FUMCAP program should also provide benefits to the market as a whole. A prerequisite for any mature securities market is the existence of a mechanism for the distribution of high quality securities. Since "firm offer" underwriting places the risk of placement on the underwriter, he can be expected to conduct much more thorough investigations of issuing firms than when underwriting is done on a "best efforts" basis. By so doing, the Brazilian underwriter will more properly perform his function of screening and selecting only the highest quality issues to be distributed. Investor confidence will also be boosted by the fact that FUMCAP provides funds to support any issue at the offering price, thereby eliminating the risks of loss during the placement period.

One final benefit to be derived from the availability of FUMCAP credits, which is particularly relevant within the Brazilian context of a limited supply of money being available to give the market any real depth, is that underwriters can be much more cautious in the timing of the placements of new issues. Any new issue coming into this thin market will represent a much higher volume of the monetary transactions than it does in the United States. With FUMCAP funds available for inventoring new issues, the Brazilian underwriter can place much more emphasis on the ability of the market to digest new issues over a longer period of time.

c. <u>Increased Opportunities for the Investor</u>

The direct benefits accruing to investors under the FUMCAP program are not related to the availability of new instruments in the market, since debentures and equity underwritings are already in practice, although the number of debentures currently available for public purchase is very limited.

Under the FUMCAP program, however, the characteristics of those instruments will be altered and it is from these changes that increased opportunities to investors will result.

On the bond side, investors will have at their disposal a fixed income, long-term instrument issued by private industrial firms, which will provide them with:

(1) a higher interest rate (estimated to be between 10-12% in average real terms) than rates paid on presently available instruments.

(2) an interest rate determined by and allowed to fluctuate according to market conditions.

The debentures will compete with the existing Housing Bonds (Letras Imobiliárias) which carry interests arbitrarily set at 8% in real terms. At the present time, "Letras Imobiliárias" receive large fiscal incentives which will, however, be completely eliminated by 1972. Therefore, real returns on FUMCAP bonds will be higher than those of "Letras Imobiliárias". Furthermore, the interest rate on the Letras is not sensitive to changes in market interest rates, whereas FUMCAP bonds will have a rate freely determined by market forces. An active market for bonds is expected to emerge as a result of the liquidity mechanism introduced by this loan. This market could then repurchase FUMCAP bonds at a discount, therefore the real interest rate on all bonds (outstanding and new) will be the same.

On the equity side, investors will have access to new issues at an earlier stage than they do under present circumstances. This means that they be able to get better (lower) prices than is the case now. Under present withholding practices, the issuing price of new stocks is very low. They are, to a large extent, privately placed at this low price. By the time they reach the public, however, their price has risen substantially. By changing present underwriting practices from "best effort" to "firm offer" basis and by having the underwriters (Investment Bank) disclose the amount of issues being withheld, the FUMCAP program should have a positive impact on both the price received by the issuing firms and the price the public has to pay to purchase new issues. As explained above, the quality of the new issues will also be improved under the FUMCAP program.

In order to qualify for FUMCAP, firms willing to issue new equity must provide the underwriters with information regarding their financial position that is reflective of their actual situation. To the public this is a significant improvement over the present system of receiving information on firms issuing equity.

Also, since the number of firms issuing equity has grown at fast rate in the last two years, and is likely to continue to grow, the investment opportunities available to the public are improved because investors will have a larger list of firms to choose from. In addition, firms under FUMCAP will be thoroughly analyzed to to improve the chances of investors having better options, therefore, reducing their risks.

Finally, another advantage offered to investors by FUMCAP is its price support mechanism. FUMCAP credits will be given to the Investment Banks to prevent the prices of issues from falling below the offering price. These credits will be available for a period of up to 18 months. This means that investors will have the minimum offering price guaranteed for a period beyond the placement period, thus having some liquidity on the stocks they buy. In the form in which underwritings are being made now, investors receive no such guarantee.

A discussion of the macroeconomic implications of the FUMCAP program can be found in Annex VI, Exhibit H.

C. Regulatory Analysis

A sound regulatory framework is essential to the capital market process. In Brazil, the basis for the regulatory system originated with the enactment in 1965 of Law 4728, commonly known as the "Capital Markets Law", which gave the Central Bank of Brazil responsibility for the development and implementation of national securities regulation. Under this law the Central Bank was delegated responsibility for (1) supervising the operations of stock exchanges, members of stock exchanges and investment companies; (2) authorizing and regulating the operations of financial institutions; (3) registering public corporations and issues of securities distributed in the capital markets and traded on stock exchanges, and (4) regulating the use of inside information, in securities trading.

These functions are exercised by two divisions of the Central Bank. One division, GEMEC, concerns itself with the administration of disclosure requirements in the registration of public corporations and the issues of securities for distribution and trading. The other division, ISMEC, is primarily responsible for the inspection and monitoring of financial institutions to determine compliance with applicable legislation, checking their accounts and reports for supporting documentation and evaluating internal controls and accounting organization.

GEMEC has three major divisions: a financial institution division which reviews the registration statements and reports of financial institutions, a corporation and securities registration division and a study and analysis division with miscellaneous functions. GEMEC administers rules adopted by the Central Bank. It has no independent rule making power. The branch or subdivision of GEMEC with responsibility for administering the registration of corporations and issues of securities has a total of 15 employees including 11 analysts, of whom all but one are economists. The analysts are largely young graduates, since experienced personnel tend to leave the organization for employment at substantially increased salaries with the private financial community. The registration statements received by GEMEC are distributed among the various analysts with no attempt at specialization. The review process consists basically of determining whether all the required information and documents have been submitted and whether the information is internally consistent and appears to be reasonably complete, current and reliable.

In form, this examination process is comparable to that conducted by the SEC with respect to registration statements for public offerings in the United States. An analysis of the workload of GEMEC with respect to corporate and new issue registrations indicates that each analyst must examine between 20 and 25 registration statements per year and therefore an analyst can spend personally on the average two weeks on each registration statement. The workload appears reasonable.

ISMEC is organized into three sub-divisions which have responsibility for the supervision of (1) stock brokers, exchanges and distributors of securities; (2) finance companies; (3) investment banks and special assignments. The sub-divisions are supported by a group of 70 experienced inspectors who operate in accordance with reasonably detailed and professionally designed written audit programs for each type of institution.

Although ISMEC appears to have competent personnel and operates under well conceived regulatory programs, it appears to be understaffed. Its actual activities are largely limited to routine review of reports filed with it and the inspection and supervision of those institutions subject to its jurisdiction believed to be in serious difficulty. ISMEC is unable to perform all the auditing functions required of it, much less the regulation and supervision reasonably expected of the governmental authority governing the operations of broker-dealers, stock exchanges and investment companies. For this reason it does not purport to exercise regulatory functions comparable to that exercised by the SEC over broker dealers, stock exchanges and investment companies.

Annex VII, Exhibit A contains a detailed analysis of the existing Brazilian framework, and a comparison of the pertinent aspects of this system with the regulatory structure existing in the U.S. This section contains a brief review of the approach taken in the analysis, and of the principal conclusions and recommendations for regulatory modifications. 1/

The annexed analysis of the Brazilian regulatory system does, to some extent, compare and contrast the Brazilian system with the regulations and enforcement existing in the U.S., noting the principal differences. For example, in contrast to SEC requirements, the Brazilian registration requirements do not include disclosure of salaries, bonuses and other remuneration received by management, or information relating to transactions between the company and its management, and other insiders or affiliated persons. The analysis also notes that the effectiveness of financial reporting and independent auditing is largely impaired due to the limited acceptance in Brazil of what are generally referred to as "internationally accepted"accounting principles and auditing standards. The prospectuses, as known in the U.S., are not mandatory in Brazil; however, detailed information on new issues must be filed with the Central Bank.

The analysis notes that in Brazil continuing disclosure requirements are presently imposed only by the stock exchanges, which, as in the U.S., are reluctant to apply the remedies of

1/ For the Regulatory Analysis attached in the Annex, we are indebted to Richard M. Phillips, Esq. who visited Brazil on two occasions during the development of this project. Mr. Phillips is former Assistant General Counsel of the U.S. Securities and Exchange Commission, now partner of Hill, Christopher & Phillips, Washington, D.C.

suspension. It cites the difficulty of defining "manipulative" trading practices, and the problem existing in both countries of assembling the staff and the expertise required to inspect and survey on a continuing basis the trading practices of broker-dealers. Finally, the analysis of the regulatory system in Brazil disclosed that private enforcement of the securities laws, such as exists in the United States through shareholder voting rights and shareholder derivative actions, does not exist in Brazil as an effective supplement to government regulations.

While this comparison of the Brazilian and U.S. regulatory systems is helpful to provide a frame of reference, it should be kept in mind that both the origins and present requirements of the two systems are quite different.

The regulation prevailing in the United States has developed on the federal level since the early 1930's. The contents of U.S. securities regulation, including the specific requirements for disclosure, the definition and delineation of manipulative, fraudulent and unfair practices, the accounting principles and auditing standards, the pattern of administration and enforcement, and the existence of effective private remedies for violations, evolved over a period of almost forty years in response to specific problems arising from the development of the U.S. capital markets.

In contrast, the regulatory system in Brazil was enacted much more recently, not as a political reaction to financial crisis, as was the case in the United States and other countries, but because of farsighted recognition that adequate security regulation is essential to the development of a viable capital market.

In shaping Brazilian securities regulation the Brazilian government has had the benefit of the A.I.D. technical assistance program which has brought its staff in contact with U.S. securities regulation and has enabled it to borrow in its discretion those components of the system which seems most suitable for Brazil in the context of its present economic and capital market development. Care must be taken not to attempt to impose on the Brazilian capital market a patternof regulation which, however well it might operate in the context for which it was shaped, may be ill-suited to Brazilian needs. Accordingly, the resulting recommendations were limited in the area of securities regulations to those conditions which were considered important prerequisities to the proper administration of the loan fund and theeffective development of the capital markets as a source of long-term capital financing. The recommendations encompass three primary areas as follows:

-- The establishment of generally accepted accounting principles and auditing standards and standards of professional competency and independence for the preparation and certification of financial statements of publicly held companies by public accountants.

-- The development of disclosure requirements with respect to management remuneration and transactions between management or other insiders and publicly held companies.

-- The adoption of disclosure and reporting requirements and certain restrictions to insure fair pricing and a bona-fide distribution of those issues and to guard against manipulative activity by underwriters of issues financed with loan funds.

1. Adoption of Generally Accepted Accounting Principles and Auditing Standards

(a) The Central Bank will be asked to adopt, with the assistance of the Brazilian accounting profession and subject to the approval of A.I.D. or its designee, a basic set of generally accepted accounting principles and auditing standards to which independent public accountants should adhere in preparing and certifying financial statements of companies whose securities will be offered through FUMCAP. The accounting principles and auditing standards to be adopted by the Central Bank need not be identical to those generally accepted in the United States. Indeed, in some areas a significant departure from those principles may well be justified, as, for example, in the area of price level accounting, which is particularly important in Brazil which has experienced a high rate of inflation.1/

(b) The Central Bank should define in writing the concept of "independent" public accountant. A suggested definition is included in the Regulatory Analysis annexed (Annex VII, Exhibit A).

1/ Attached as Annex VII, Exhibit C to this paper is a set of accounting principles and auditing standards which could serve as a framework in which the Central Bank, with the assistance and advice of the Brazilian accounting profession, may formulate principles and standards best suited to the needs of the Brazilian industry and the capital markets.

(c) The Central Bank should disqualify any public accountant who cannot demonstrate what it deems the professional competence necessary for preparing and certifying financial statements of a company whose securities will be underwritten through FUMCAP.

(d) Subject only to Central Bank waiver in specified situations, registration statements for securities of companies being underwritten through FUMCAP will have to include certified financial statements, including balance sheets and income statements, for each of the last three fiscal years prior to filing of the registration statement and such financial statements will be prepared by independent, professionally competent accountants in accordance with the generally accepted accounting principles and auditing standards adopted by the Central Bank.

(e) Companies whose securities have been underwritten through FUMCAP will be required to file with the Central Bank and with all exchanges on which their securities are traded, annual financial statements certified by independent professionally competent public accountants in accordance with the generally accepted accounting principles and auditing standards adopted by the Central Bank.

2. Restraints against Management Remuneration and Insider Transactions with Publicly Held Companies

In this area, companies whose securities are underwritten through FUMCAP should be required to disclose, in their registration statements and in their annual reports filed with the Central Bank, certain aspects of management compensation and insider dealings.1/ These recommendations remain to be negotiated with the GOB.

3. Underwriting Practices

The third area of critical deficiency in existing Brazilian securities regulation relates to practices in connection with underwritings of securities. In this regard, a number of recommendations are proposed. They are designed to insure that a bona-fide effort is made by the underwriters to distribute securities to the investing public, by limiting the amount of any issue that may be placed (a) with underwriters or brokers participating in the underwriting, or any

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1/ For detailed recommendations, see Annex VII, Exhibit A.

related, controlled or affiliated persons or companies; (b) in the account of affiliated mutual funds. In addition, an overall limitation should be placed on the percentage of any issue that may be sold to mutual funds as a group, whether or not affiliated with the underwriter and/or participating broker-dealer. Registration statements for securities to be underwritten through FUMCAP should disclose the underwriters' intent with respect to compliance with these restrictions and reports should be required with regard to securities acquired by such persons.

With respect to the use of FUMCAP credits used for price stabilization purposes, the Central Bank will be asked to adopt a rule which would provide that to the extent FUMCAP funds are outstanding for use by an underwriter to finance purchases of stock in support of the market, the underwriter will not be permitted directly or indirectly to purchase securities in the market at a price above the offering price except to the extent necessary to fill customer orders.

4. Conclusions

Each of the foregoing recommendations is considered important to varying degrees to the FUMCAP program. Some of the proposed rules could be agreed upon immediately, or as soon as defined (e.g. the proposed rule against the use of liquidity credits for price support above the offering price level). Most of the suggested rules should be discussed at some length with representatives of both the public and private sectors, to determine their probable acceptance, and the effect of a dual system of regulations on the use of FUMCAP. Even then, rules should be left subject to change, depending on experience. Still other recommendations, while extremely important (e.g. the proposed announcement of a minimum set of accounting principles and auditing standards) may have to be adjusted, in substance and/or time-wise, with existing efforts of the GOB and the profession to develop such principles and standards. All of the suggested measures need to be carefully formulated and defined before being adopted (e.g. the rules on insider transactions).

Our conclusion is that in every area cited above, USAID/Brazil and the GOB (aided by such external expert assistance as may be needed) should develop prior to the disbursement of AID loan funds (a) a list of such rules as are considered essential to the project and must be adopted prior to loan disbursement and (b) a time-phased plan for the further consideration and/or study of additional regulations needed for the development of a sound capital market in Brazil.

D. Financial Analysis

1. Sources of Financing

The initial capital of FUMCAP will be the cruzeiro equivalent of $50 million, as reflected in the financial plan included in Section I, A.2 above. The status of the proposed World Bank loan is discussed in Section I, B.4. The GOB, through the Minister of Finance, has agreed to match the amount of the foreign loans with an equal amount of cruzeiros, which--assuming both the World Bank and AID loans are authorized -- will amount to the equivalent of $25 million in cruzeiros. The GOB has stated that the source of these funds will be the two principal agents, viz. the BNDE's Special Agency for Industrial Financing (FINAME) and the National Savings Bank (Caixa Economica).

a. Caixa Economica

The contribution of the latter is to be derived from the funds of the National Integration Plan (PIS). In 1971 alone, the PIS is expected to collect the equivalent of US$47 million. The sources of funds of the PIS, and additional projections, are contained in the Annex VI, G. There is no question of the Caixa's ability to make the requisite contribution of the equivalent of $12.5 million at any time.

b. FINAME

FINAME's source of funds are the BNDE and the Central Bank of Brazil. The BNDE funds are made available to FINAME in the form of advances, i.e. there is no term for repayment which is at FINAME's discretion. The Agency pays 10% monetary correction plus interest at 6% on these advances. The funds provided by these advances must be used for financing locally-manufactured equipment. The first advance was made by the BNDE in 1966 in the amount of Cr$20,000 (or Cr$46,000 at 1970 prices) and was intended as a capital contribution. It is shown on FINAME's financial statements as "capital advanced". The reason is that FINAME, being a federal government agency, cannot have capital stock.

The funds supplied by the Central Bank have different applications according to the Bank's own sources of these funds:

a) USAID program loan funds (Loans 512-L-055/064/073) for financing imported equipment;

b) Two-step principal transferred to the GOB by USAID borrowers for financing locally manufactured equipment;

c) Funds made available by the Central Bank's GECRI (Rural and Industrial Credit) department for financing agricultural equipment.

The AID Funds, i.e. program loan and two-step principal, are lent to FINAME on the same terms as the GOB terms i.e. 40 years with 10 years grace, but the Central Bank charges 10% monetary correction plus 3% interest and a service fee of 1/2%. The interest on these funds is capitalized, and FINAME only pays the monetary correction and service fee.

In the case of the GECRI funds, FINAME is not a borrower, but simply a financial agent. On loans made with these funds, FINAME earns a commission of 3%.

Funds received from these several sources are shown in Annex VIII, Exhibit C.

FINAME's financial statements are shown in Annex VIII , Exhibits A and B. The income statements which have significance are those for the past 3 years: in 1965, FINAME was no more than a fund within the BNDE, while during 1966 it was still in the throes of becoming an independent organization. In fact, FINAME ceased to operate for a number of months in 1966. In 1967, FINAME's operations were still rather limited by the funds available, since it was only in 1968 that the BNDE started making substantial advances.

The Agency's major source of revenue is its financing of local equipment accounting for some 90% of its revenues. Imported equipment financing is being phased out as the AID program loans near completion, despite the fact that demand has exceeded the supply of funds. Other revenues from long-term loans includes the 3% commission earned on agricultural loans funded by GECRI and repassed by FINAME.

Revenue from short-term loans has been the second major source of earnings, because of the high turnover of funds invested, but is on a downtrend in real terms.

The growth of financial expenses is the evident result of FINAME's borrowings. Administrative expense has remained stable, perhaps because FINAME is a small and tightly-run organization. The standard of personnel as high as the BNDE's from which FINAME originated.

FINAME has been somewhat laggard in implementing its budgeting. The first attempts made in 1970 have proved to be inadequate, and currently a group is engaged in developing a sound projection for the next few years. Among other things, new sources of funds and their costs are being evaluated.

2. Projected Funding Requirements 1/

There are currently 37 investment banks operating in Brazil. Of the 37 it is estimated by Central Bank officials that approximately 8 will qualify for FUMCAP assistance in 1971. It is projected that the FUMCAP staff will qualify two additional investment banks at the beginning of 1972 and that this number will increase by another 5 in 1973 and remain constant for 1974-1975.

The average value of new issues underwritten by investment banks in 1970 was approximately $2 million. This increased to approximately $4 million during the first quarter of 1971.2/ It is assumed for this analysis that the average value of an underwriting financed with FUMCAP credits will be approximately $4.3 million for the second half of 1971, growing to $5.7 million for 1972, remaining constant at 1972 level for 1973-75.

It is estimated that the average credit extended for the financing of "firm offer" underwritings under the FUMCAP program will be extended for six months, implying the Fund would revolve twice annually.

1/ The projected underwritings and cash flow analysis presented in this section are meant to be illustrative of the development of the FUMCAP program based on what are considered to be realistic assumptions.

2/ S-N Financial Bulletin -- May, 1971; Rio de Janeiro.

FUMCAP (Table A)

PROJECTED FUMCAP UNDERWRITINGS

YEAR	TOTAL AVERAGE VALUE OF UNDER-WRITINGS ($ Millions)	70% OF UNDERWRITINGS FINANCED WITH FUMCAP CREDITS ($ Million)	NO. OF FUMCAP ELIGIBLE INVESTMENT BANKS	NO. OF UNDERWRITINGS/ INVESTMENT BANKS	TOTAL UNDERWRITINGS/ YEAR	TOTAL VALUE OF ISSUES UNDERWRITTE ($ Million
1971	$4.3	$3	8	2	16	$ 68.8
1972	5.7	4	10	2	20	114.0
1973	5.7	4	15	2	30	171.0
1974	5.7	4	15	2	30	171.0
1975	5.7	4	15	2	30	171.0
					TOTAL	$ 695.8

Currently, the shares of approximately 80 firms are actively traded on the Brazilian securities exchange. According to the projections in Table , the securities of newly issued firms would increase the number of actively traded issues by approximately 20% per year for the period 1971-75. It is assumed, however, that both the size and quality of the issues financed under the FUMCAP program will be above average, thus implying that the projected growth will be substantive in nature.

In terms of absolute values, investment banks were responsible for $55 million in underwritings in 1970. As demonstrated in Table above, it is projected that eligible investment banks will increase the value of underwritings by over 100% during 1972 and in excess of 200% in 1973, for a total value of $695.8 million for the first five years of FUMCAP operations.

3. Cash Flow Projections

It is the current plans of the GOB to launch the FUMCAP program in July or Aug. 1971. At this time FINAME and the Caixa Economica will each advance the equivalent in cruzeiros $12.5 million to the FUMCAP account at the Central Bank. Based on the current assumptions, previously stated, all but $1 million would be loaned to investment banks during the first six months of its operations (July-December 1971).

At the beginning of 1972 USAID and the IBRD should be prepared to start disbursement of their combined financial commitment of $25 million. It is estimated that approximately $40 million of the $50 million FUMCAP credits will be employed in 1972. However, this situation should reverse itself during 1973, when it is anticipated that there will be an estimated $8.2 million shortfall in underwriting credits. This shortfall could be covered by a GOB advance or FUMCAP could elect to limit itself to meeting only 83% of the projected demand for underwriting credits. If it is assumed that after the advance of $8.2 million by the GOB to FUMCAP in 1973 the demand for underwriting credits remains constant at 1973 levels (for both 1974 and 1975), FUMCAP should require only very modest GOB advances for 1974 and 1975.

CASH FLOW

FUMCAP

($US Million)

SOURCES	Dec. '71 (6 mos.)	Dec. '72	Dec. '73	Dec. '74	Dec. '75
CASH ON HAND		2.01	11.31		
DEPOSITS:					
- AID		12.50			
- IBRD		12.50			
- CAIXA	12.50				
- BNDE	12.50				
REPLACEMENTS:					
- Principal		24.00	40.00	60.00	60.00
- Interest	1.44	2.40	4.00	4.00	4.00
TOTAL	26.44	53.41	55.31	64.00	64.00

USES					
Underwriting Credits	24.00	40.00	60.00	60.00	60.00
Central Bank Fees	.06	.20	.30	.30	.30
Interest Payments:					
-AID		.25	.25	.25	.25
-Principal Agents	.37	.75	.96	1.00	1.00
-IBRD		.90	.90	1.95	1.88
TOTAL	24.43	42.10	62.41	63.50	63.43

DIFFERENCE + (-)	+2.01	+11.31	(7.10)	+.50	+.57
Unused Balances	(1.00)	(10.00)	-0-	-0-	-0-
Net Inflow (Outflow)	1.01	1.31	-0-	-0-	-0-
Advances	-0-	-0-	7.10	.10	.03

The Assumptions supporting the above cash flow analysis are:

1. The projections outlined in Table A.

2. The average interest rate charged for FUMCAP credits will be 6%.

3. Lump-sum repayments every six months.

4. The terms of repaying the AID loan will be ten-year grace period with an annual interest charge to FUMCAP of 2% and a ten-year repayment schedule carrying an annual interest charge of 3%.

5. The terms of the IBRD loan will be: a 15 year 7-1/4% loan with a 3 year grace period.

6. The Principal Agents will charge FUMCAP 3%/year for the funds they have advanced.

SECTION III. LOAN ADMINISTRATION

A. Execution Plan

The GOB has indicated that it wishes to establish the proposed Fund for Capital Market Development in July or August 1971. The World Bank has indicated to the GOB that its loan could be executed before the end of CY 1971, assuming a favorable report from the appraisal mission in June 1971. On these assumptions, the following time table is submitted:

June - July 1971: Arrival of IBRD appraisal Mission in Brazil — Joint GOB/IBRD/USAID/Brazil discussions of project — Completion of IBRD Mission.

August - September 1971: Presidential Decree establishing FUMCAP — Revision of FUMCAP Operational Manual by GOB Working Group with AID assistance - AID/GOB negotiation of principal conditions precedent to be incorporated in loan agreement.

October 1971: Completion of revised draft of Operational Manual and submission to AID and IBRD for approval - AID/GOB negotiation of draft loan agreement.

November 1971: Completion of review of Operational Manual by USAID/Brazil and consultants - AID approval of Manual - Completion of negotiations of loan agreement.

December 1971: AID loan agreement signed - IBRD approval of Operational Manual - Manual submitted to Monetary Council for approval.

January - February: IBRD loan signed - Operational Manual approved by Monetary Council.

March 1, 1972: Initial disbursement of AID and IBRD loans.

As has been the procedure to date, it is expected that the revisions of the Operational Manual will be assigned to a Working Group consisting of representatives of the Central Bank, each of the Principal Agents, the investment banking community and USAID/Brazil. Once a final draft has been worked out, it will be submitted to AID and IBRD for approval. The step thereafter is approval by the Monetary Council 1/.

1/ The Monetary Council will approve the basic framework for the FUMCAP program, but is expected to leave sufficient flexibility to the Central Bank to change or modify operational rules and criteria from time to time as needed.

As in the past, USAID/Brazil will continue to provide every assistance requested by the GOB in the preparation of a final Operational Manual for FUMCAP. However, the Mission expects to retain the services of consultants in the technical areas (e.g. Regulations) to assist in the final negotiations and approval of the Operational Manual. Funds are available within USAID/Brazil for this purpose.

B. USAID Monitoring Responsibilities

This being a loan to an intermediate credit institution (the Central Bank), AID will not review individual underwriting proposals. Instead, the loan proposal is predicated upon (a) the present capacity and existing responsibilities of the Central Bank in the area of Capital Markets; (b) the condition precedent that the Central Bank and the Principal Agents demonstrate that they have acquired the additional administrative and technical capacity required to carry out their respective functions and responsibilities under the program; and (c) the additional condition precedent that a full set of operating criteria be developed for the project and approved by AID, in the form of a revised Operational Manual.

Nevertheless, AID will retain certain continuing monitoring responsibilities over the program. The Central Bank has agreed to provide centralized management for the FUMCAP Program, and this group will also provide liaison with AID and the IBRD. USAID/Brazil will receive reports from the Central Bank concerning the application of loan funds. In addition, USAID/Brazil will have access to all documentation related to the project which the Central Bank will be required to maintain. (See Section I, A.3 for reporting requirements.)

As implied throughout this paper, USAID/Brazil has been intensively involved in the development of the project to its present stage, and expects its close participation to continue throughout the final negotiations and early implementation of the program. The Mission has, within its capital development office, a number of officers familiar with corporate finance and underwriting. The USAID Controller's division has a strong financial analysis staff.

The existing USAID/Brazil staff is believed to be sufficient to adequately monitor an on-going program. To the extent additional expertise is required, in the initial stages before the program becomes operative, to review specific aspects of the program (e.g. the regulatory system), or to meet specific requests for assistance (e.g. in reviewing the Operational Manual), the Mission will retain specialized consultants for these purposes.

G. Disbursement Procedures

a. For "Firm Offer" Underwriting Credits

The Central Bank plans to establish a revolving fund consisting of the foreign credits extended by AID and IBRD. These funds will be repassed through the principal agents in amounts equal to those provided from the resources of the principal agents for bond and share underwritings by qualified investment banks. The principal agent will disburse these funds, i.e. the Central Bank's share and its share, to the investment banks under lines of credit for which the principal agent will charge a one percent per annum administrative commission on the unused balance beginning with the 61st. day after the opening of the line of credit. These lines of credit will not exceed 70% of the total individual underwriting. Such funds will be disbursed to the investment banks with the following terms, according to the draft Operational Manual:

(1) Shares

Repayment must be made upon receipt of proceeds from placement but within the maximum term of 24 months. Interest will accrue at 6% per annum for 18 months with a 1% per annum increase applicable to the balance outstanding in each month thereafter until the maximum loan period of 24 months is reached. Monetary correction will be applied to the unpaid balance trimestrally according to the Treasury Bill (ORTN) index.

(2) Bonds

Under the terms of the draft Operational Manual, repayment must be made upon receipt of proceeds from placement, but repayment may follow the repayment schedule of the debentures for the period during which the investment bank continues to hold the bonds. 1/ Interest will accrue at the coupon rate of the bond and monetary correction will be applied in the same manner as described above for shares.

(3) Repayments

As securities are placed on the market, the underwriting investment bank will apply the proceeds to repayment of the loan from the principal agent before any other parties

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1/ Some limitations on the terms of such credits are now being discussed with the Central Bank in order to provide an incentive for placement.

receive payments or commissions. The Principal Agent will deduct from the repayment of funds to the FUMCAP account at the Central Bank, an amount equivalent to monetary correction plus the cost of the funds to the Principal Agent. The loan's principal, plus the difference between the cost of funds to the Principal Agent and the rates charged to the investment bank, will revert to FUMCAP. The Principal Agent will also be allowed to deduct from repayments its administrative fee. The FUMCAP revolving fund will also receive the 50% portion of loan repayments financed from the foreign credits (and earnings) plus interest and monetary correction thereon less a 1% administrative commission charged by both the principal agent and the Central Bank.

b. For Price Stabilization and Liquidity Credits:

The Central Bank plans to establish a "price stabilization" and "Liquidity credit" fund to: (1) provide credits to investment banks to support the price of shares being underwritten at their offering price to the public; and (2) provide liquidity credits to traders to enable them to create a secondary market in debentures. Funds will be repassed through principal agents under contracts between the principal agents and investment banks. Such funds will include the following terms:

(1) Shares

The amount will be limited to 15% of the value of the issue underwritten with FUMCAP credits. The Operational Manual provides that the first 5% will be free of interest and monetary correction and that the remaining 10% will be made available free of interest but with monetary correction based on the ORTN index 1/. Credits will be available for a period not to exceed 18 months after the shares are offered to the public.

1/ The price support and liquidity fund will be financed from 2-step principal funds as discussed in the Financial Plan, Section I, A,3. Discussions are being held with the Central Bank concerning the rates at which these funds will be made available to underwriters and traders. The Mission favors attaching interest and monetary correction to such credits.

(2) Bonds

The Manual provides for a finance charge based on "the coupon rate of the debentures" plus monetary correction 1/. Credits will be available upon request until 12 months before the maturity of the debentures.

The price support and liquidity funds will be repaid to the Central Bank with monetary correction to the extent that monetary correction is applied as described above.

c. AID Disbursement Procedure:

The Mission prefers to reimburse the Central Bank for disbursements made pursuant to the project until repayments from principal agents bring the revolving fund to an amount which is sufficient to meet the existing demand for additional disbursements. While it is theoretically possible that underwritings would be so few and credits provided for such short periods as to provide a self-sustaining revolving fund of less than that required for the AID and IBRD loans, the Mission believes that demand will more than exceed the funds made available by the two loans 2/. The Mission prefers to disburse loan funds on a matching basis with the IBRD but will provide funds independently if this proves to be procedurally more expedient. The Mission will also consider direct disbursements to the Central Bank rather than the reimbursement approach if the Central Bank so requests.

1/ The method of arriving at this rate remains to be worked out.

2/ See Section II, D.

D. Conditions and Covenants

The loan agreement will contain the standard conditions and covenants, to the extent applicable to this loan. In addition, certain non-standard conditions will be negotiated with the GOB, as follows:

1. Prior to Loan Execution

a. Borrower and A.I.D. to agree to a time-phased implementation plan for technical assistance which shall, in substance, be included in the Project description of the Loan Agreement.

b. If the International Bank for Reconstruction and Development has not executed an agreement with the Borrower, satisfactory to A.I.D. prior to the date when A.I.D. and Borrower are prepared to execute a Loan Agreement, said Loan Agreement shall not be executed without the prior written approval of the Deputy United States Coordinator of the Alliance for Progress.

2. Prior to Disbursement to FUMCAP

a. Provide evidence of the establishment of FUMCAP pursuant to a decree signed by the President.

b. Submit a completed Operational Manual for FUMCAP, satisfactory to A.I.D.

c. Provide a time-phased operational plan for the implementation of the FUMCAP program, together with evidence of the administrative and technical capability of the divisions in each of the executing agencies to perform its assigned functions, satisfactory to A.I.D.

d. Develop (a) a list of regulatory measures, including a minimum set of accounting principles and auditing standards, adequate rules relating to bona fide distributions, and appropriate requirements of disclosure, and (b) a time-phased plan for further study of additional regulations needed for the development of a sound capital market in Brazil, said list and plan to be approved by A.I.D.

3. Prior to Disbursement for Technical Assistance Program

Central Bank to furnish a detailed time-phased implementation plan for the execution of the technical assistance portion of the loan. Such plan to include (a) a plan for the overall administration and coordination of the program; (b) a description of each major element of the TA program; (c) a description of the agency or entity responsible for the execution of each major element of the program; (d) evidence of the organizational and technical capability of such agency or entity to carry out its respective responsibilities and function under the program and (e) a financial plan, showing breakdown by dollar and local currency costs.

In addition to these conditions, the following covenants will be negotiated with the GOB:

3. Covenants

1. Central Bank to submit to USAID/B for approval in writing any changes in the FUMCAP operational Manual.

2. Central Bank not to effect major changes in the management or operation of FUMCAP without prior AID approval.

3. Central Bank to conduct periodic reviews of the FUMCAP program, with the participation of the principal agents, and USAID. Such reviews to be held 3, 6 and 12 months after the commencement of operations, and annually thereafter.

DRAFT LOAN AUTHORIZATION

Provided from: Alliance for Progress Funds
BRAZIL: Capital Markets Development Fund

Pursuant to the authority vested in the Administrator, Agency for International Development by the Foreign Assistance Act of 1961, as amended, and the delegations of authority issued thereunder, I hereby authorize the establishment of a loan ("Loan") pursuant to Part I, Chapter 2, Title VI, Alliance for Progress to the Banco Central do Brasil ("Borrower") of not to exceed fifteen million dollars ($15,000,000) to finance the dollar and local currency costs of carrying out the Borrower's program ("Program") to assist long-term private sector financing through the development of Brazil's Capital Market institutions and instruments. The Loan shall provide up to twelve and one half million dollars ($12,500,000) to assist the Borrower in developing a revolving Capital Market Development Fund and up to two and one half million ($2,500,000) for technical assistance, subject to the following terms:

1. Interest and Repayment

Borrower shall repay the Loan in United States dollars within forth (40) years from the date of the first disbursement under the Loan, including a grace period of not to exceed ten (10) years. Borrower shall pay interest in United States dollars on the disbursed balance of the Loan of two percent (2%) per annum during the grace period and three percent (3%) thereafter.

2. Other Terms and Conditions

(a) Except for marine insurance and ocean shipping, goods and services financed under the loan shall have their source and origin in Brazil and in countries included in A.I.D. Geographic Code 941. Marine insurance financed under the loan shall have its source and origin in Brazil or in any country included in A.I.D. Geographic Code 941, provided, however, that such insurance may be financed under the loan only if it is obtained on a competitive basis and any claims thereunder are payable in convertible currencies. Ocean shipping financed under the loan shall be procured in any country included in A.I.D. Geographic Code 941.

(b) As a condition precedent to the execution of the Loan Agreement, Borrower and A.I.D. shall agree to a time-phased implementation plan for technical assistance which shall, in substance, be included in the Project Description of the Loan Agreement.

(c) The Loan shall be guaranteed by the Government of Brazil in form and substance satisfactory to A.I.D.

(d) If the International Bank for Reconstruction and Development has not executed an agreement with the Borrower, satisfactory to A.I.D. prior to the date when A.I.D. and Borrower are prepared to execute a Loan Agreement, said Loan Agreement shall not be executed without the prior written approval of the Deputy United States Coordinator of the Alliance for Progress.

(e) Prior to any disbursement to the Capital Market Development Fund (FUMCAP), Borrower shall:

(i) Provide evidence of the establishment of FUMCAP pursuant to a decree signed by the President;

(ii) Submit a completed Operational Manual for FUMCAP, satisfactory to A.I.D.;

(iii) Provide a time-phased operational plan for the implementation of the FUMCAP program, together with evidence of the administrative and technical capability of the divisions in each of the executing agencies to perform its assigned functions, satisfactory to A.I.D.;

(iv) Develop (a) a list of regulatory measures, including a minimum set of accounting principles and auditing standards, adequate rules relating to <u>bona fide</u> distributions, and appropriate requirements of disclosure, and (b) a time-phased plan for further study of additional regulations needed for the development of a sound capital market in Brazil, said list and plan to be approved by A.I.D.

(f) United States dollars utilized under the loan to finance local currency costs shall be made available pursuant to procedures satisfactory to A.I.D.

(g) The Loan shall be subject to such other terms and conditions as A.I.D. may deem advisable.

____
Administrator

____
Date

CERTIFICATION PURSUANT TO SECTION 611 (e)

OF THE FOREIGN ASSISTANCE ACT OF 1961, AS

AMENDED.

Subject: BRAZIL - Capital Assistance - Capital Markets Loan.

Having taken into account, among other things, the maintenance and utilization of projects in Brazil previously financed or assisted by the United States, I certify that in my judgement Brazil has the financial capability and the human resources to maintain and utilize effectively the proposed Capital Markets Loan.

This judgement is based primarily on the facts developed in the Capital Assistance Paper for the proposed loan of US$12,500.000 (twelve and one half million dollars), which discusses in detail the capabilities of the Central Bank and various entities and finds that they will possess adequate financial and human resource capability (supported by technical assistance and training where appropriate) to maintain and utilize the project effectively. The relationship between the proposed loan and prior U.S. assistance to the Brazilian Capital Markets sector is discussed in detail in the Capital Assistance Paper.

William Ellis
Director

May 24, 1971
Date

TELEGRAM Foreign Service of the United States of America

10/5 INCOMING AMEMBASSY RIO PROPOSAL LOAN: CAPITAL MARKET

UNCLASSIFIED
Classification

Control: 9034

ACTION:
USAID

INFO:
CHARGE
AIDE
MINECON
FILE

R 282349Z SEP 70
FM SECSTATE WASHDC
TO AMEMBASSY RIO DE JANEIRO
BT
UNCLAS STATE 159791

Recd: SEP 29, 1970
7:49

RECVD'MGCR 9/29
10:30

AIDAC

SUBJECT: IRR - CAPITAL MARKETS LOAN

SUBJECT IRR HAS BEEN APPROVED BY CAEC. THE FOLLOWING ISSUES, HOWEVER, MUST BE TREATED IN DETAIL DURING INTENSIVE REVIEW:

ACTION
ADCD-5

INFO
DDOM
CDII-2
LGS
CONT-2
ADPR
CHRON

1. LOAN PAPER SHOULD ANALYZE REASONS WHY EXISTING FINANCIAL INTERMEDIARIES ARE NOT ADEQUATE TO PERFORM FUNCIONS ENVISAGED FOR CAPITAL MARKET DEVELOPMENT FUND. IN PARTICULAR WE NOTE QUOTE CAPITAL MARKETS LAW OF 1965 UNQUOTE AND IDENTIFICATION OF INVESIMENT BANK AS PRIMARILY RESPONSIBLE FOR DEVELOPMENT OF INDUSTRIAL SECURITIES MARKET. ANY GAPS IN LAW/FUNCTIONS OF EXISTING FINANCIAL INTERMEDIARIES SHOULD BE PRESENTED IN LOAN PAPER SO AS BETTER JUSTIFY CMDF; PAPER SHOULD CONTAIN ADEQUATE DISCUSSION OF THE ROLE OF OTHER DEVELOPMENT FINANCING INSTITUTIONS IN BRAZIL AND THEIR RELATION TO AND PARTICIPATION IN THE PROPOSED NEW FUND.

2. LOAN PAPER SHOULD DESCRIBE WHY USAID FEELS THAT UNDERWRITERS FUND AND TIEING MEDIUM/LONG TERM CREDIT TO ISSUANCE OF SHARES BY BORROWING COMPANIES REPRESENTS IMPORTANT INSTRUMENT FOR GENERATING DOMESTIC SAVINGS AND INVESTMENT IN CONTRAST OTHR ALTERNATIVES (I.E- FURTHER CAPITALIZATION FINANCIAL INTERMEDIARIES).

3. GIVEN RELATIVE INEXPERIENCE BRAZILIAN UNDERWRITERS QUOTE PROJECT ASSEMBLY AND EVALUATION UNQUOTE LOAN PAPER SHOULD CONTAIN CLEAR DESCRIPTION HOW THESE FUNCTIONS WILL BE CARRIED OUT EFFECTIVELY UNDER PROPOSED FUND. WILL TECHNICAL ASSISTANCE BE REQUIRED?

4. LOAN PAPER SHOULD GIVE DETAILED DESCRIPTION OF GOVERNMENT REGULATIONS THAT WILL APPLY TO CAPITAL AND MONEY MARKET. AMONG OTHER MATTERS WE ARE CONCERNED WITH PROVISIONS OF LAW THAT WILL ALLOW GOVERNMENT TO MINIMIZE EXTREME PRICE MOVEMENTS IN SECURITIES MARKET IF SUCH MOVEMENTS ARE UNCALLED FOR BY UNDERLYING REAL FACTORS.

IRR POINTS OUT SPECULATION AND PRICE INCREASES IN PRESENT QUOTE THIN UNQUOTE MARKET WITH POSSIBILITY OF MAJOR QUOTE BREAK UNQUOTE IN MARKET WHEN PROFIT-TAKING OCCURS; AND COMPOUNDING OF THIS POSSIBILITY BY INCREASED INFLOW OF VOLUNTARY SAVINGS, ETC. UNDER CIRCUMSTANCES UNDER-WRITERS RECEIVING FINANCE FROM CMDF MUST BE SUBJECTED TO APPROPRIATE GUIDANCE SO AS MINIMIZE EXTREME PRICE MOVEMENTS. LOAN PAPER SHOULD FOCUS ATTENTION ON WHOLE PROBLEM OF MAINTAINING INTEGRITY AND STABILITY OF MARKET.

5. PAPER SHOULD CONTAIN JUSTIFICATION FOR SIZE OF LOAN AS WELL AS DISCUSSION ALTERNATIVE SOURCES OF FINANCING. SIZE OF LOAN SHOULD BE CONSISTENT WITH PILOT NATURE OF PROJECT.

6. PAPER SHOULD REFER ITSELF TO THOSE MONETARY AND FISCAL DISINCENTIVES WHICH NOW INHIBIT FLOW OF CAPITAL INTO INVESTMENTS AND THE EFFECT THAT THE PROPOSED LOAN AND FUTURE GOB POLICIES WILL HAVE ON REVERSING THIS TREND.

7. HIGHLY DESIRABLE THAT WORLD BANK GROUP, IFC IN PARTICULAR, PARTICIPATE IN THIS PROJECT. UNDERSTAND PROJECT WILL BE DEVELOPED ON BASIS JOINT USAID-IBRD/IFC-BRAZILIAN DISCUSSIONS.

8. EXPECT THAT RLA WILL BE ESPECIALLY INVOLVED IN TECHNICAL ASSISTANCE/SEMINARS RELATING TO REGULATORY ASPECTS OF MARKET.

9. 620(D) POLICY QUESTIONS RAISED IN ISSUES SECTION CURRENTLY UNDER REVIEW. AID/W WILL ADVISE OUTCOME. IRWIN

UNOFFICIAL TRANSLATION of letter from Minister of Finance to USAID/Brazil Mission Director

AVISO GB-Nº 5   JAN 8, 1971

Dear Mr. Minister,

As you know, the GOB has been studying together with the USAID/B and the IBRD, the creation of a Capital Market Development Fund to permit the use of financial resources to fulfill the following basic objectives:

a) to dynamize the market for securities;

b) to facilitate the financial restructuring of national corporations, with the objective of developing the ideal level of efficiency and increasing their borrowing capacity levels, compatible with their development needs;

c) to create a medium and long-term financing system to support the implementation of projects involving the installation, expansion or reequipment of national enterprises, facilitating the flow of the national production of machines and equipment and, if the need arises, the purchase of commodities abroad;

d) to stimulate the mobilization of private savings to promote the opening up of the capital of these enterprises.

2. By virtue of its characteristics the program that we have in mind should represent an important contribution for the expansion and definite consolidation of the Brazilian Capital Markets, especially in area of placement of stocks and debentures.

Minister William A. Ellis
Director Agency for International Development

3. This Fund, which would be administered by the Central Bank of Brazil with the participation of the BNDE and the Caixa Econômica Federal, aims at providing private investment banks with the resources needed to finance securities underwritings (shares, debentures or debentures convertible into shares) through "firm offer" underwritings, conducted on the basis of a project showing the economic-financial feasibility of the proposed undertaking.

4. Therefore, and considering that the GOB is ready to offer counterpart Cruzeiros to the foreign lendings, which would constitute the basis of the Fund for the Development of the Capital Markets, I consult your Excellency on the possibility of there being extended to the Central Bank by the USA through your Agency a loan of up to $30 million to be applied in the above program.

I take this opportunity to renew to your Excellency the expression of my high esteem and consideration.

(Sgd) Antonio Delfim Netto
Minister of Finance

CHECKLIST OF STATUTORY CRITERIA

(Alliance for Progress)

The following abbreviations are used:

FAA - Foreign Assistance Act of 1961, as amended by the Foreign Assistance Act of 1971.

App. - Foreign Assistance and Related Agencies Appropriations Act, 1971.

MMA - Merchant Marine Act of 1936, as amended.

COUNTRY PERFORMANCE

Progress Towards Country Goals

1. FAA §. 208; §. 251 (b)

A. Describe extent to which country is:

1. Making appropriate efforts to increase food production and improve means for food storage and distribution.

Expanding food production and improving the means for food storage and distribution is one of the major goals of Brazil and a great many steps have been taken to achieve this goal. For further details see CIAP/377, especially pages 124-142.

2. Creating a favorable climate for foreign and domestic private enterprise and investments.

Brazil has done a great deal to encourage private enterprise, both domestic and foreign and has not in general placed any special obstacles in the way of foreign investors except in a few "national security" areas. For specifics see IBRD Report WH-195-a, December 19, 1969, "Industrial Policies and the Manufacturing Industries in Brazil," and IBRD Report WH-203, November 4, 1970.

3. Increasing the public's role in the developmental process.

Brazil has encouraged an increased public role in the developmental process by its very successful tax incentive programs to encourage private savings and investments.

4. a. Allocating available budgetary resources to development.

Brazil is allocating large amounts of budget resources to development.

b. Diverting such resources for unnecessary military expenditure and intervention in affairs of other free and independent nations. (See also Item No.16).

Brazil is spending about 2.4 percent of its GNP for defense. In 1970 this was about $1 billion. This is a substantial amount but not excessive in view of the special defense burdens created by long borders (4,600 miles coast and 8,700 miles of land frontier) and a vast sparsely populated interior. Defense Agency budgets include expenditures of a non-military nature for such things as subsidies to civilian airlines, civilian airport construction, maintenance of flight control and communications and mail delivery to remote areas. Identifiable items of this kind approach 10 percent of defense agency budgets. Brazil is not intervening in the affairs of other nations.

5. Willing to contribute funds to the project or program.

The GOB is contributing funds to the program, as described in the Financial Analysis section of the paper (Section II, D).

6. Making economic, social, and political reforms such as tax collection improvements and changes in land arrangements, and making progress toward respect for the rule of law, freedom of expression and of the press, and recognizing the importance of individual freedom, initiative, and private enterprise.

Although progress toward a return to democratic government still is hindered by the Military's determination to hold on to Revolutionary leadership, state legislatures elected Governors from among candidates either selected or approved by the President. Elections for the national Congress and Senate were held in November after preliminary screening process. Cassations, the stripping of political rights for ten years and the firing from government jobs or deprivation of elected office, continue sporadically. All the State legislatures have been reopened, membership altered, of course, by cassations. Municipal elections continue to be held. In October 1969 the Federal Congress reopened after having been closed by former President Costa e Silva for ten months. At the same time the Constitution was amended, with Congressional ratification, to strengthen the President's powers. Although censorship still exists and new laws precensoring for pornography have been issued, a certain latitude in the press and in expression is allowed insofar as fundamental concepts of the Revolution are not challenged nor articles published which lend support to subversives. On the other hand, there has been a continued incidence of police intimidation of individual journalists.

The last 6 months have seen continued allegations of brutal treatment and tortures of accused subversives by GOB security officials. The GOB continues to deny the incidence of officially sanctioned torture.

The GOB appears convinced that private enterprise with government assistance will keep the economy growing at the same rapid rate of the last two years. Outside the government there is some concern expressed at the extent of U.S. investment in certain sectors and at the amount of foreign profit remittances.

7. Adhering to the principles of the Act of Bogota and Charter of Punta del Este.

Brazil is adhering to these principles.

8. Attempting to repatriate capital invested in other countries by its own citizens.

   Brazil's efforts to encourage investment, promote rapid economic growth and reduce the rate of inflation contribute to the return of capital invested in other countries by its citizens.

9. Otherwise responding to the vital economic, political, and social concerns of its people, and demonstrating a clear determination to take effective self-help measures.

   Since assuming power President Medici has voiced concern for the disequilibrium in standards of living among Brazilians of different regions and classes. The GOB has undertaken to build 600,000 houses for workers and is placing increased emphasis on strengthening its educational system. It has not yet embarked significantly on needed land reform. With most political power concentrated at the top, there is political apathy on the part of the vast majority and the danger of continued isolated acts of terrorism on the part of extreme-left elements. (See 6 supra).

B. Are above factors taken into account in the furnishing of the subject assistance?

   The above factors have been taken into account in recommending approval of this loan.

Treatment of U.S. Citizens

2. FAA §. 620 (c). If assistance is to government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or servides furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) debt is not denied or contested by such government?

Brazil is not known to be so indebted.

3. FAA §. 620 (e) (1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing-ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

No such action has been taken.

4. FAA §. 620 (o); Fishermen's Protective Act. §. 5. If country has seized, or imposed any penalty or sanction against, any U.S. fishing vessel on account of its fishing activities in international waters.

No case of seizure, penalty or sanction against U.S. fishing vessel is known to exist.

a. has any deduction required by Fisherman's Protective Act been made?

Not applicable.

b. has complete denial of assistance been considered by A.I.D. Administrator?

Not applicable.

Relations with U.S. Government and Other Nations

5. FAA §. 620 (d). If assistance is for any productive enterprise which will compete in the U.S. with U.S. enterprise, is there an agreement by the recipient country to prevent export to the U.S. of more than 20% of the enterprise's annual production during the life of the loan?

Not applicable. The loan will go to the development of the capital market. It is not known which underwriters will use the funds provided. Nor is it known what kinds of companies will be the clients of those underwriters utilizing credits and funds stimulated by the loan.

6. FAA §. 620 (j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction by mob action, of U.S. property?

   Brazil has not permitted such acts.

7. FAA §. 620 (l). If the country has failed to institute the investment guaranty program for the specific risks of expropriation, in convertibility or confiscation, has the A.I.D. administration within the past year considered denying assistance to such government for this reason?

   Brazil has actively instituted a guaranty program.

8. FAA §. 620 (q). Is the government of the recipient country in default on interest or principal of any A.I.D. loan to the country?

   No such default exists.

9. FAA §. 620 (t). Has the country severed diplomatic relations with U.S.? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

   Brazil has not severed relations with the U.S.

10. FAA §. 620 (u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearage taken into account by the A.I.D. Administrator in determining the current A.I.D. Operating Year Budget?

    Brazil is meeting its U.N. obligation.

11. FAA §. 620 (a). Does recipient country furnish assistance to Cuba or fail to take appropriate steps to prevent ships or aircraft under its flag from carrying cargoes to or from Cuba?

Brazil does not furnish assistance to the present Government of Cuba. Brazil has taken appropriate steps to prevent ships or aircraft under its registry from engaging in any Cuban trade.

12. FAA §. 620 (b). If assistance is to a government, has Secretary of State determined that it is not controlled by the international Communist movement.

The Secretary of State has determined that Brazil is not controlled by the international Communist movement.

13. FAA §. 620 (f). Is recipient country a Communist country?

No.

14. FAA §. 620 (i). Is recipient country in any way involved in (a) subversion of, or military aggression against, the U.S. or any country receiving U.S. assistance, or (b) the planning of such subversion or aggression.

No.

15. FAA §. 620 (p). Does recipient country furnish goods to North Viet-Nam or permit ships or aircraft under its flag to carry cargoes to or from North Viet-Nam?

Brazil does not traffic or knowingly permit trafficking with North Viet-Nam.

Military Expenditures

16. FAA §. 620 (s). What percentage of country budget is for military expenditures? How much of foreign exchange resources spent on

military equipment? How much spent for the purchase of sophisticated weapons systems? (Consideration of these points to be coordinated with PPC/MAS).

Expenditures for military purposes are about 18 percent of total central government or about 9 percent of total public sector expenditures including states and municipal governments.

Brazil's foreign exchange disbursements for military equipment are projected to increase from $20 million in 1967 to $58 million in 1973. These expenditures would range from 1.19% of total imports (defined as goods plus net services) in 1967 to 1.85% in 1973. Brazil's foreign exchange reserves were at about $510 million at the end of 1969. For about 10 years (1955-1965) Brazil bought little military equipment. A re-equipment and modernization program now underway to improve efficiency in the defense establishment by replacing aged and obsolete equipment will increase expenditures for equipment, but will increase overall military expenditures only slightly.

CONDITIONS OF THE LOAN

General Soundness

17. FAA §. 201 (d). Information and conclusion on reasonableness and legality (under laws of country and U.S.) of lending and relending terms of the loan.

The terms of the proposed loan are legal under both U.S. and Brazilian laws, and are considered reasonable.

18. FAA §.251 (b) (2): §.251 (c).

Information and conclusion on activity's economic and technical soundness. If loan is not made pursuant to a multilateral plan, and the amount of the loan exceeds $100,000, has country submitted to A.I.D. an application for such funds together with assurances to indicate that funds will be used in an economically and technically sound manner.

The project is considered economically and technically sound. See Economic (Section II, B) and Financial Analysis (Section II,D) in this paper. The Minister of Finance submitted a loan application to USAID on January 8, 1971. Assurances have been given by the Central Bank that the funds will be used in an economically and technically sound manner.

19. FAA §.251 (b). Information and conclusion on capacity of the country to repay the loan, including reasonableness of repayment prospects.

Brazil is considered able to repay the proposed loan.

20. FAA §.611 (a) (1). Prior to signing of loan will there be (a) engineering, financial, and other plans necessary to carry out the assistance and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?

Yes.

21. FAA §.611 (a) (2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purposes of loan?

No legislation is required.

22. FAA §.611(e). If loan is for capital assistance, and all U.S. assistance to project now exceeds $1 million, has Mission Director certified the country's capability effectively to maintain and utilize the project?

Yes. (See Director's Certification in ANNEX II, Exhibit A).

23. FAA §.251 (b). Information and conclusion on availability of financing from other free-world sources, including private source within the United States.

IBRD is expected to participate in the program. See Summary and Recommendations, Financial Plan and Financial Analysis in the paper. EXIM and IDB have expressed no interest in financing this project. No other free world sources are known to exist.

Loan's Relationship to Achievement of Country and Regional Goals.

24. FAA §.207: §.251 (a). Extent to which assistance reflects appropriate emphasis on: (a) encouraging development of democratic economic, political and social institutions; (b) self-help in meeting the country's food needs; (c) improving availability of trained manpower in the country; (d) programs designed to meet the country's health needs, or (e) other important areas of economic, political, and social development including industry; free labor unions, cooperatives, and voluntary agencies; transportation and communications; planning and public administration; urban development; and modernization of existing laws.

(a) While the development of democratic economic, political and social institutions is not the primary objective of the loan, the program is nevertheless expected to result in broader ownership of private industrial enterprises (by encouraging more companies to go public) and in a greater participation on the part of the public in industrial finance and growth by the creation of newly created long-term debt instruments hitherto little used in Brazil.

(b) Not applicable.

(c) Not applicable.

(d) Not applicable.

(e) The program has a basic significance for industry in Brazil, in that it seeks to improve the institutional and regulatory framework of the country's financial sector. In so doing, the program will enable the financial community more effectively to mobilize and rechannel internal savings to industry, on more reasonable terms. (See Economic Analysis, Section II, B). A number of regulations applicable to the financial sector will be modified in connection with this program. See Regulatory Criteria (Section II, C).

25. <u>FAA §.209.</u> Is project susceptible of execution as part of regional project? If so why is project not so executed?

No.

26. <u>FAA §.251 (b) (3).</u> Information and conclusion on activity's relationship to, and consistency with, other development activities, and its contribution, to realizable long-range objectives.

Although primarily aimed at long-range financial and industrial development, the Program will, in achieving these objectives, indirectly benefit the remaining sectors which are served by industry. As such, the activity is fully consistent, and of basic significance, to Brazil's development objectives and activities.

27. FAA §. 251 (b) (7). Information and conclusion of whether or not the activity to be financed will contribute to the achievement of self- sustained growth.

The Program will contribute to the achievement of self-sustaining growth by creating a mechanism and financial instruments capable of mobilizing and channelling Brazilian savings into industry, lessening the country's reliance, in a relative sense, on external financing for industry.

28. FAA §. 281 (a). Describe extent to which the loan will contribute to the objective of assuring maximum participation in the task of economic development on the part of the people of the country, through the encouragement of democratic, private, and local governmental institutions.

The strengthening of the financial and regulatory institutions in Brazil, and the promotion of attractive new financial instruments, will encourage greater participation on the part of individual investors, in the ownership and growth of Brazilian industry. For institution building aspects, see Section I, C. 3.

29. FAA §. 281 (b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

The program capitalizes on recent GOB initiatives to develop Brazil's capital markets, and the resulting interest of the Brazilian public in financial instruments as a means of investment. The Program has been conceived and developed by the Brazil's leading specialists in finance, from both the public and private sectors. A large technical assistance program is contemplated, to provide for training of additional personnel in the field of corporate finance and financial analysis, and to strengthen the government regulatory agencies in charge of overseeing the financial sector.

30. FAA §. 601 (a). Information and conclusions whether loan will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competitions; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

(a) There is no direct relationship between the Program and Brazil's foreign trade. There is, however, an indirect relationship in the sense that any improvement in the efficiency of the private sector brought about by improvements in its financial structure will be reflected in the ability of Brazilian firms to be more competitive world markets.

(b) By increasing the availability of long-term industrial financing, the growth and expansion of industry, through private initiative, will be encouraged. Competition will be fostered among financial institutions, by strengthening those who previously did not have the financial or technical means of competing in the field of underwriting.

(c) Not applicable.

(d) Monopolistic practices among a few financial institutions will be discouraged by the entrance into the field of additional institutions (see (c) above).

(e) The industrial sector is expected to benefit significantly from the increased efficiency of the capital market, and the intermediary institutions, in attending to industry's long-term financing needs on reasonable terms.

(f) Not applicable.

31. FAA §.619. If assistance is for newly independent country; is it furnished through multilateral organizations or plans to the maximum extent appropriate?

Not Applicable.

32. FAA §. 251 (h). Information and conclusion on whether the activity is consistent with the findings and recommendations of the Inter-American Committee for the Alliance for Progress in its annual review of national development activities.

In a section entitled "Capital Markets", the 1971 CIAP report to the Special Committee for Consultation and Negotiation (CECON) notes that in "most country reviews the need to increase and improve domestic capital formation was found to be one of the most important topics. "The Committee restated its feeling that financial and technical assistance from abroad would be essential for the solution of this problem.

33. FAA §.251 (g). Information and conclusion on use of loan to assist in promoting the cooperative movement in Latin America.

Not applicable.

34. FAA §.209; §.251(h) (8).
Information and conclusion whether assistance will encourage regional development programs, and contribute to the economic and political integration of Latin America.

The Program is not intended to be regional in scope or impact. It may, however, encourage the interaction and exchange of ideas in Latin America in the field of capital markets, to the extent that the program is successful. An international conference on Capital Markets and development has already been schedule in Rio for September 1971.

Loan's Effect on U.S. and A.I.D. Program

35. FAA §.251 (b) (4); §.102
Information and conclusion on possible effects of loan on U.S. economy, with special reference to areas of substantial labor surplus, and extent to which U.S. commodities and assistance are furnished in a manner consistent with improving the U.S. balance of payments position.

There are no perceivable effects of this loan on the U.S. economy.

36. FAA §.601 (b). Information and conclusion on how the loan will encourage U.S. private trade and investment abroad and how it will encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

To the extent that Brazilian firms which are partially or fully owned by American interests choose to participate in the FUMCAP program, the Program should have a favorable effect on US investment abroad by allowing these firms greater access to the Brazilian financial market.

37. FAA §. 601 (d). If a capital project, are engineering and professional services of U.S. firms and their affiliates used to the maximum extent consistent with the national interest?

This is not a capital project. A portion of the proposed Technical Assistance program, however, will be furnished by US professional services. See description in Section I, A.5.

38. FAA §. 602. Information and conclusion whether U.S. small business will participate equitably in the furnishing of goods and services financed by the loan.

Not Applicable.

39. FAA §. 620 (h). Will the loan promote or assist the foreign aid projects or activities of the Communist-Bloc countries?

No.

40. FAA §. 621. If technical assistance is financed by the loan, information and conclusion whether such assistance will be furnished to the fullest extent practicable as goods and professional and other services from private enterprise on a contract basis. If the facilities of other Federal agencies will be utilized, information and conclusion on whether they are particularly suitable, are not competitive with private enterprise, and can be made available without undue interference with domestic programs.

Technical assistance will be provided to the maximum extent possible from private enterprise on a contract basis. It is contemplated, however, that experts from the Securities and Exchange Commission may be sought to provide advice and assistance to the GOB's regulatory agencies. Such services would not be competitive with private enterprise, and could be made available without undue interference with domestic programs. See description of Technical Assistance program in Section I,A.5.).

41. FAA §.252 (a). Total amount of money under loan which is going directly to private enterprise, is going to intermediate credit institutions or other borrowers for use by private enterprise, is being used to finance imports from private sources, or is otherwise being used to finance procurements from private sources.

The largest portion of the loan to the Central Bank will be channeled through the National Savings and the National Development Banks, to private financial intermediary institutions. The latter will use the funds to finance underwritings of corporate security issues, while the Program will thus enable companies to raise funds in the capital market which may result in procurement or imports from the private sector, but loan funds will not be used directly for this end.

Loan's Compliance with Specific Requirements

42. FAA §.201 (d). Is interest rate of loan at least 2% per annum during grace period and at least 3% per annum thereafter?

Yes.

43. FAA §. 608 (a). Information on measures to be taken to utilize U.S. Government excess personal property in lieu of the procurement of new items.

Not Applicable.

44. FAA §. 604 (a). Will all commodity procurement financed under the loan be from United States except as otherwise determined by the President?

Not Applicable.

45. FAA §. 604 (b). What provision is made to prevent financing commodity procurement in bulk at prices higher than adjusted U.S. market price?

Not Applicable.

46. FAA §. 604 (d). If the host country discriminates against U.S. marine insurance companies, will loan agreement require that marine insurance be placed in the U.S. on commodities financed by the loan?

A recent law appears to discriminate against certain non-Brazilian insurance companies, but the loan agreement will require that marine risk coverage be obtained from U.S. insurance companies, in the event such discrimination affects procurement under this loan.

47. FAA §. 604 (e). If off-shore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity?

Not Applicable.

48. FAA §. 611 (b): App. §. 101. If loan finances water or water-related land resource construction project or program, is there a benefit-cost computation made, insofar as practicable, in accordance with the procedures set forth in the Memorandum of the President dated May 15, 1962?

Not Applicable.

49. FAA §. 611 (c). If contracts for construction are to be financed, what provision will be made that they be let on a competitive basis to maximum extent practicable?

Not Applicable.

50. FAA §. 620 (g). What provision is there against use of subject assistance to compensate owners for expropriated or nationalized property?

The Loan Agreement will not permit such use.

51. FAA §. 612 (b): §. 636 (b). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized to meet the cost of contractual and other services.

The GOB is contributing an amount of local currency matching the AID and proposed IBRD loans. The GOB's allocation of internal resources is discussed in Annex IV, Exhibit A. The availability of US owned cruzeiros is discussed in Section II,D,2.

52. App. §. 104. Will any loan funds be used to pay pensions for military personnel?

No.

53. App. §.106. If loan is for capital project, is there provision for A.I.D. approval of all contractors and contract terms.

The loan is not for a capital project. However, contracts for technical assistance will be subject to A.I.D. review and approval, as to contractors and contract terms.

54. App. §.108. Will any loan funds be used to pay U.N. assessments?

No.

55. App. §. 109. Compliance with regulations on employment of U.S. and local personnel for funds obligated after April 30, 1964 (Regulation 7).

Not Applicable.

56. FAA §. 636 (i). Will any loan funds be used to finance purchase, long-term lease, or exchange of motor vehicle manufactured outside the United States, or any guaranty of such a transaction?

No.

57. App. §. 401. Will any loan funds be used for publicity or propaganda purposes within U.S. not authorized by the Congress?

No.

58. <u>FAA §. 620 (k)</u>. If construction of productive enterprise, will aggregate value of assistance to be furnished by U.S. exceed $100 million?

No.

59. <u>FAA §. 612 (d)</u>. Does the U.S. own excess foreign currency and, if so, what arrangements have been made for its release?

Not Applicable.

60. <u>MMA § 901.b.</u> Compliance with requirement that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed with funds made available under this loan shall be transported on privately owned U.S.-flag commercial vessels to the extent that such vessels are available at fair and reasonable rates.

The Loan Agreement will so provide.

INTERNAL ALLOCATION OF RESOURCES IN BRAZIL

While there are no widely agreed upon or universally applicable criteria for evaluating a country's allocation of resources, one can judge proper allocation by its results in growth, stabilization, and distribution of welfare. In these terms, Brazil's past record and stated future intentions are encouraging.

In many important respects Brazil's recent economic record has been excellent. The growth of GDP recovered in 1966 and 1967 from the economic crisis of the early 60's, when growth dipped below 2% and per capita GDP actually declined. The 1966/67 expansion was largely a result of the reform policies of the revolutionary government and accelerated in 1969 and 1970, when GDP grew at an estimated 9.2% rate. Exports have risen very rapidly since 1964, especially during the past two years when the GOB's new system of mini-devaluations of the cruzeiro enabled Brazil to benefit greatly from the boom in world trade. The rate of inflation, although still high, was reduced sharply in the period 1964-67 from a former peak of over 80%, and further gradual progress has been achieved the last two years (20.1% in 1969 and 19.3% in 1970) as the relative weight of priority in national economic policy has shifted from stabilization back to growth. The government deficit has been gradually but decisively reduced from a very inflationary level to only about 0.4% of GDP in 1970.

Federal tax receipts grew from 7.8% of GNP in 1961 to 10.2% in 1970. Recently an IMF study ranked Brazil first in tax effort among the developing countries. The overall tax rate in Brazil is a very high 24% of GNP.

A system of fiscal incentives for rebating income tax receipts for private investment in special areas or sectors including agro-industry has been remarkably successful particularly in promoting industrial expansion in the poor Northeast.

Total savings and investment have recovered from a low of 14.2% of GNP in 1963 to 15.8% in 1969 and 16.9% in 1970.

An important question is whether the recent economic growth has resulted in increased welfare for the average Brazilian. At least for the non-agricultural work force this appears to be the case. During the 1960's, although the official real minimum wage declined, average earnings increased. Of the non-agricultural work force, workers who earned less than half the minimum wage dropped from 37% to 22% of the work force and

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those earning at or above the minimum wage increased from 45% to 59% of the work force. Furthermore, the non-agriculture work-force grew at close to 5% a year.

Thus, the internal allocation of resources has been high enough and sufficiently effective to promote overall rapid economic growth and a somewhat better distribution of income. The GOB's stated priority for education, health and agriculture has been generally well reflected in resource allocations and policy measures affecting those sectors, which also are AID's priorities.

The agricultural sector has benefited from a wide number of programs encouraging modernization. Recently tax incentives have been created to promote investment. Exemptions from the value-added tax have ended previous disincentives to use modern inputs and to sell in the export market. Government spending on agriculture is a less significant indicator but it also increased 31% from 1961 to 1969.

Public expenditures on education jumped 11% a year during the 1960's. The Government plans for a continued rapid increase and ultimately the attainment of universal primary education. From 1966 to 1970, enrollments increased at the annual rates of 6% at the primary level and 14% at the secondary level. Educational opportunities are rapidly widening for the average urban and small-town Brazilian.

Public spending in health and sanitation grew at close to 10% a year in the 1960's with major emphasis on campaigns against malaria, tuberculosis and other specific debilitating diseases.

The Government of Brazil has said its goals for the early 1970's will be an increase in GNP between 7% and 9% per year. The major emphasis in the public sector will continue to be on expanding educational and health services. Within a macro-economic policy framework aimed at rapid growth, continued gradual reduction in the rate of inflation, and a continued rapid rise in exports, the GOB's private sector development priorities will continue to feature the modernization of agriculture.

UTILIZATION OF COUNTERPART RESOURCES FROM PL 480 WHEAT SALES AGREEMENT FROM 1966 TO PRESENT
(VI, VII, VIII, AND IX WHEAT AGREEMENTS)
(Figures in parenthesis are non-additive)
(Cr$ Millions)

	VI WHEAT AGREEM. APRIL 1966	VII WHEAT AGREEM. OCTOBER 1967	VIII WHEAT AGREEM. DECEMBER 1969	IX WHEAT AGREEM. MAY 1970 (programmed)
Rio-São Paulo Road	50.0	-	-	-
Southern States Highway Maintenance Loan Supplement	14.6 1/	-	-	-
Agricultural Research (EPE)	-	4.0	8.1	-
Meteorological Service	-	0.4	1.0	-
National Research Council (CNPq)	-	0.6	2.0	-
SUNAB	-	3.0	4.0	-
FUNFERTIL	-	4.0	-	-
ABCAR	-	3.0	-	-
Cooperatives	-	16.8	-	-
Credit: Agriculture-(21.5)) Fertilizer -(17.6))	-	30.1	-	-
Seeds	-	2.5	-	-
SUVALE	-	2.7	6.0	-
Agric.Marketing Roads-(8.0)) Supply Centers -(7.2)) Milk Plants -(0.3))	-	15.5	-	-
Irrigation-Ministry of Interior	-	-	6.4	-
IBGE Foundation	-	-	7.1	-
ETA - Mogiana	-	-	0.9	-
GERAN	-	-	2.2	-

(Cont.)

	VI WHEAT AGREEM. APRIL 1966	VII WHEAT AGREEM. OCTOBER 1967	VIII WHEAT AGREEM. DECEMBER 1969	IX WHEAT AGREEM MAY 1970 (programmed)
Budget Support: (many of separate items listed above now included under general categories below)	-	-	67.82	75.15
a. Agricultural Credit	-	-	(34.92)	(32.50)
b. Agricultural Production	-	-	(6.55)	(16.15)
c. Agricultural Marketing	-	-	(17.35)	(18.15)
d. Rural Roads	-	-	(9.0)	(.85)
e. Agricultural Research (of which EPE received Cr$4.2 and CNPq Cr$8 million)	-	-	-	(7.50)
TOTALS	64.6	91.6	88.22	75.15

1/ Central Bank transferred "temporarily" to DNER on instruction of Ministry of Finance, 9-12-69

Functions of the National Monetary Council and Central Bank*

A. National Monetary Council

"The Council's policies should seek:

1. To maintain the volume means of payment at a level adequate for the actual needs of the national economy and its development;

2. To control the internal value of the country's currency by preventing or correcting inflationary or deflationary processes of internal or external origin, economic recessions and other kinds of macroeconomic disequilibrium;

3. To control the foreign exchange rate of the currency and the balance of payments position with a view to an optimum use of foreign currency owned by the country;

4. To orient the use of funds by government or private financial institutions to insure conditions favoring the balanced growth of the economy and the country's different regions;

5. To promote the improvement of financial institutions and instruments with a view to increasing the efficiency of the system for making payments and mobilizing funds;

6. To insure the liquidity and solvency of financial institutions;

7. To coordinate monetary, credit, budget, tax and public debt policies."

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* Translated from Law No. 4595 (December 1964)

B. <u>Central Bank of Brazil</u>

"1. To control credit in all its forms;

2. To control foreign investment;

3. To control the operations of financial institutions and apply the required penalties;

4. To authorize financial institutions to operate;

5. To buy and sell Federal securities as an instrument of monetary policy."

Functions of the National Monetary Council and Central Bank Related to Financial Markets*

1. The money market and the capital market are regulated by the National Monetary Council and controlled by the Central Bank.

2. The National Monetary Council and the Central Bank should exercise their legal powers in the money and capital markers so as to:

   a. facilitate public access to information about marketable securities distributed in the market and the companies issuing them;

   b. protect investors against illegal or fraudulent issues;

   c. prevent fraudulent and manipulatory practices aimed at creating artificial conditions for the demand, supply or price of securities distributed in the market;

   d. insure that equitable business practices are followed by all those who are professional intermediaries in the distribution or trading of marketable securities;

   e. regulate the use of credit in the securities market;

   f. regulate the activities of stock and foreign exchange brokers.

3. The Central Bank is responsible for:

   a. authorizing and inspecting the operation of Stock Exchanges;

   b. authorizing and inspecting the operations of members of Stock Exchanges and of investment companies;

   c. authorize and inspect the operations of financial institutions or individuals engaged in the underwriting and distribution of securities;

   d. maintaining a register of and inspecting the operations of companies and individuals acting as intermediaries in the distribution of securities or which, for whatever purpose, mobilize savings in the capital market;

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* Summarized from the Capital Markets Law No. 4728 (July 65)

e. register securities to be traded on the stock exchange;

f. register security issues to be distributed in the capital market;

g. monitoring the compliance by companies issuing securities traded on the stock exchange with laws and regulations concerning (1) disclosure of the company's economic and financial position, its management and the utilization of its net income, and (2) protection of the interests of investors in securities distributed on the money and capital market;

h. monitoring the compliance with laws and regulations concerning the issue, underwriting, subscription and distribution of securities placed on the capital market;

i. to monitor the use of information not disclosed to the public for personal benefit or the benefit of other individuals, by shareholders or persons who, because of the positions they occupy, have access to such information.

CENTRAL BANK OF BRAZIL

ORGANIZATION CHART

PRESIDENT

Foreign Exchange Area | Banking Area | Admin. and Credit Area | Capital Markets Area

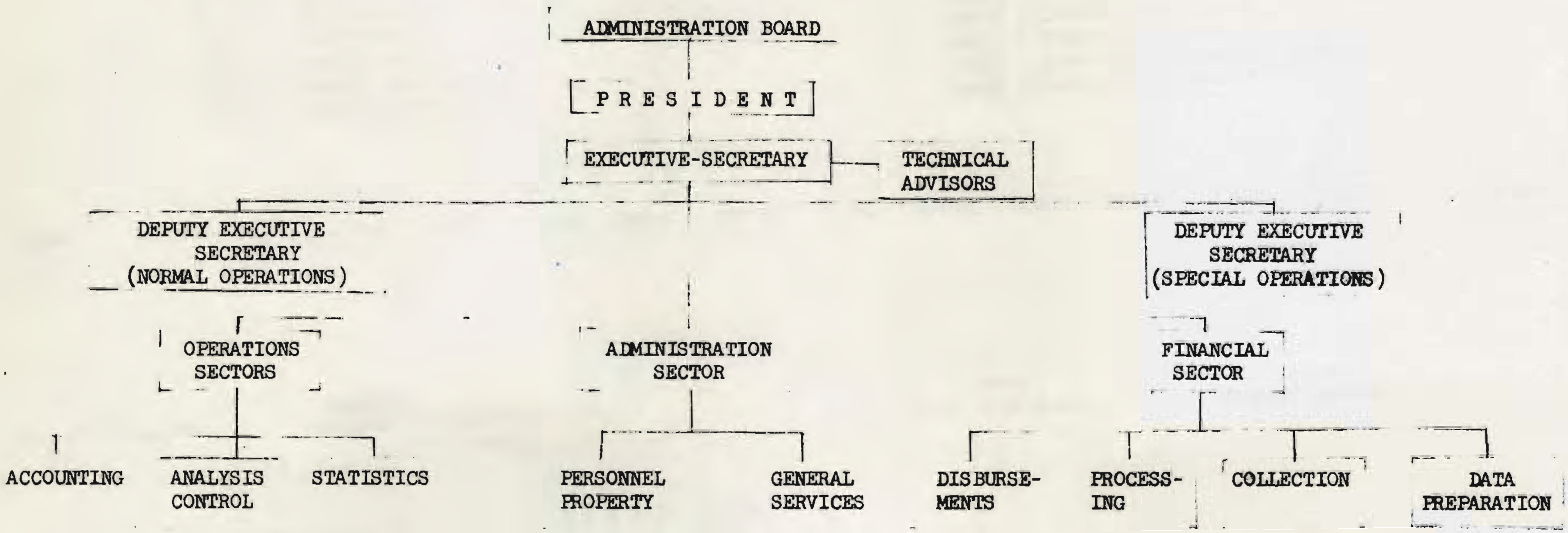
GECAM | FIRCE | GEBAM | ISBAN | CEPRO | GEDIP | DEPEC | DEJUR | GECRI | MECIR | CONGE | DEPAD | GEMEC | ISMEC | 3 REGIONAL OFFICES

GECAM - Exchange Operations
FIRCE - Foreign Investment
GEBAN - Bank Operations
ISBAN - Bank Inspection
CEPRO - Data Processing
GEDIP - Public Debt
DEPEC - Economic Department

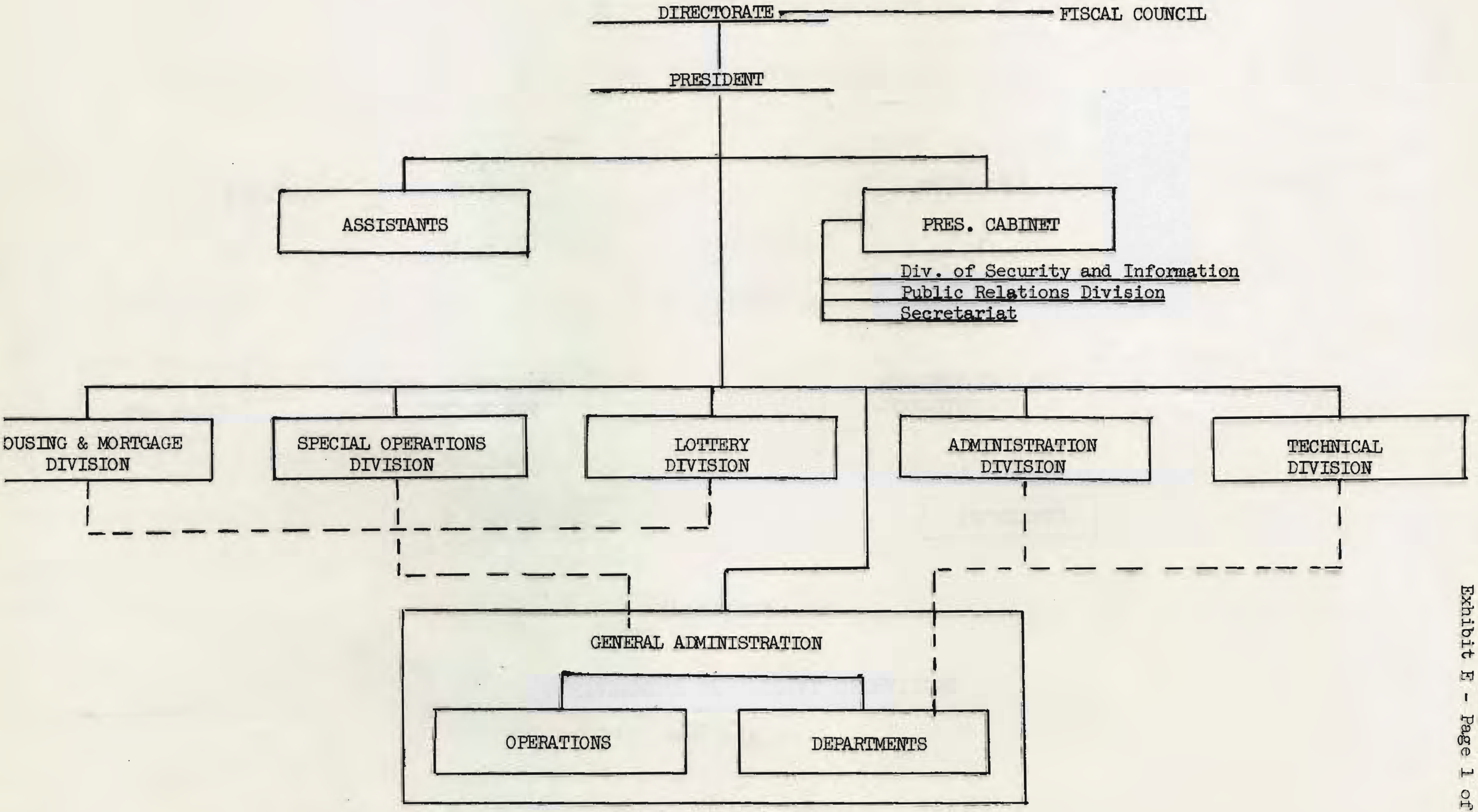
DEJUR - Legal Department
GECRI - Rural and Industrial Credit
MECIR - Currency Issues
CONGE - General Accounting
DEPAD - Administration
GEMEC - Capital Markets
ISMEC - Capital Markets Inspection

FINAME ORGANIZATION CHART

(Special Agency for Industrial Financing)



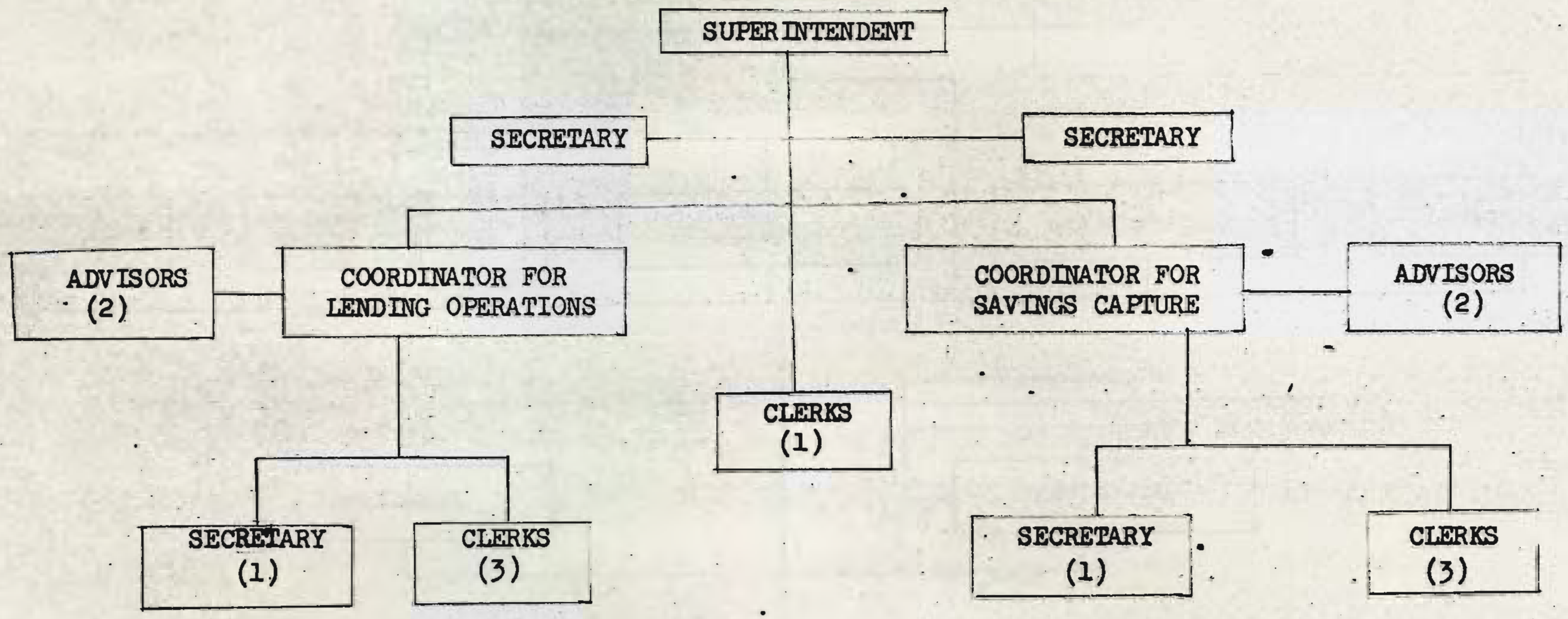
ORGANIZATION CHART
NATIONAL SAVINGS BANK
(Caixa Economica Federal)



REGIONAL ADMINISTRATIONS

"CAIXA"

DEPARTMENT OF SPECIAL OPERATIONS



GEMEC and ISMEC
(Organization and Staff)

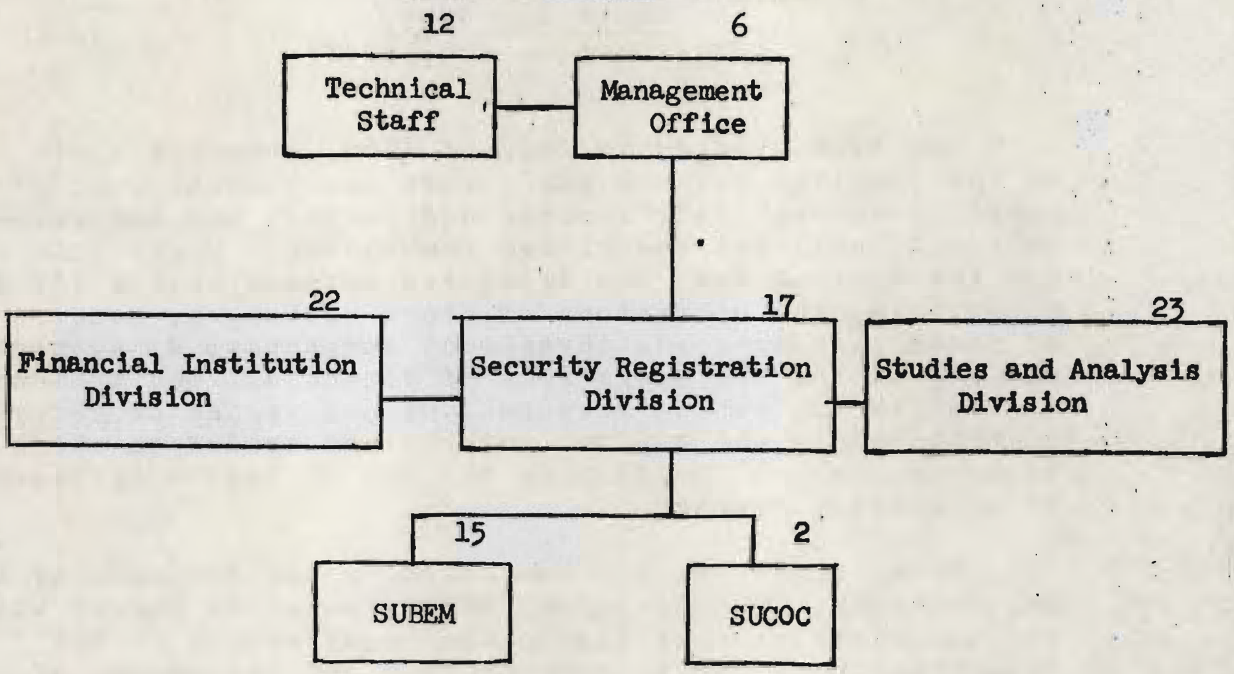
Law 4728 enacted in July of 1965, commonly known as the "Capital Markets Law", gave the Central Bank of Brazil responsibility for the development and implementation of national securities regulation. Under this law the Central Bank was delegated responsibility for 1) supervising the operations of stock exchanges, members of stock exchanges and investment companies; 2) authorizing and regulating the operations of financial institutions; 3) registering public corporations and issues of securities distributed in the capital markets and traded on stock exchanges, and 4) regulating the use of inside information, in securities trading.

These functions are exercised by two division of the Central Bank. One division, GEMEC, concerns itself with the administration of disclosure requirements in the registration of public corporations and the issues of securities for distribution and trading. The other division, ISMEC, is primarily responsible for the inspection and monitoring of financial institutions to determine compliance with applicable legislation, checking their accounts and reports for supporting documentation and evaluating internal controls and accounting organizations. This Annex described the internal organization of these two entities.

a. GEMEC

GEMEC is headed by a manager reporting to the Area Director and has three major divisions: a Financial Institution Division where these institutions register and file reports and other documentation required by law; a Securities Registration Division (DIVEP) where securities and corporations are registered; and a Study and Analysis Division with miscellaneous functions. Organization Chart is as follows:

GEMEC ORGANIZATION CHART



Note: Only the Security Registration Division is shown in detail. Numbers indicate staff in each organizational unit.

There are 4 types of registration: a) corporate registration for those companies wishing to have their securities listed on the stock exchanges; b) new issue registration for public offerings of securities; c) registration for companies wishing to make use of fiscal benefit funds provided for under Law 157, commonly called "Law 157 registration"; and d) open-capital registration for companies wishing to enjoy the fiscal and other benefits provided to open-capital companies. The corporate and new issue registration are the major types of registration, and are discussed in detail elsewhere in this paper.[1/] The other two registrations apply only to specific cases, and must be preceded by at least corporate registration.

DIVEP/GEMEC is the division responsible for the above registrations, and is further subdivided into the SUCOC subdivision which takes care of open capital registrations, and the SUBEM subdivision which handles the remaining types of registration. SUBEM is

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1/ See Annex VII, Exhibit A, p. 6.

subdivided into 3 groups called "sectors". In addition to the sub-division chief and the 3 sector chiefs, there are 11 analysts. The analysts are all economists, except for one accountant. However, academic qualifications are of a relatively secondary importance since the review of registration statements is largely a matter of exercising one's judgment based on experience. The analysts are mostly young graduates, and would undoubtedly benefit from additional training of the practical type.

The sectors are not in any way specialized. Some attempts were made in the past towards this, but were defeated by the substantial fluctuations in workload. The registration statements received by SUBEM are distributed equally among the sectors and assigned by the sector chief to one of his analysts who conducts the review under his direct supervision. The review consists basically in checking out if all the required information and documentation has been submitted. The information is also checked out for internal consistency. 1/

There were a total of 585 registrations in 1969 and 1970. However, the registration requirements for new issues and corporations overlap to a great extent, and often a corporation makes both simultaneously. Therefore, if it is assumed that all new issue registrations were simultaneous with corporate registrations, an average of 20 registration statements would be reviewed per analyst per year. Thus, registrations average out to between 20-25 per analyst, i.e., on the average each analyst spent about 2 weeks on each registration. This is considered a reasonable worklaod.

b. ISMEC

ISMEC is headed by an inspector general reporting to the Capital Markets director. It is responsible for the inspecting or monitoring side of the Central Bank's functions with regard to the capital market. It is not responsible for inspecting commercial banks which is a function of ISBAN of the Banking Area, nor does it inspect real estate finance companies which is

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1/ As noted elsewhere in this paper, the absence of generally accepted accounting principles and auditing standards renders a meaningful analysis difficult. See Section II, C and Annex VII, Exhibit A.

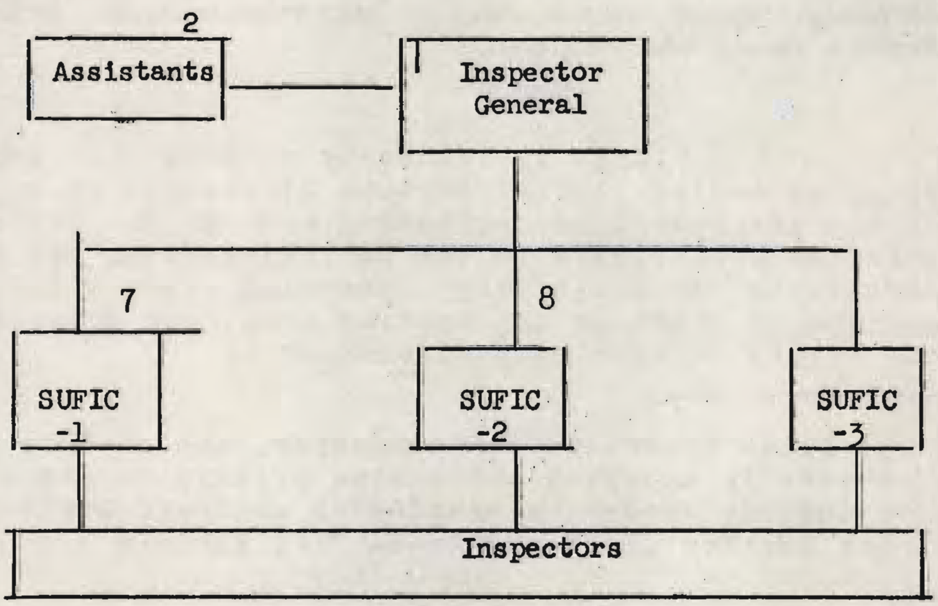
the responsibility of the National Housing Bank. ISMEC's major function, as it actually exists in practice, is to conduct audits of financial institutions for the following purposes: a) to determine compliance with applicable legislation; b) to check if the financial institutions' accounts are supported by appropriate documentation; c) to evaluate internal controls and accounting organization in general; and d) to evaluate the institution's financial position by reviewing financial statement data and preparation of cash flows.

ISMEC is organized into 3 subdivisions called SUFIC plus a separate group of inspectors who perform the field work. The SUFICs work is purely internal and they are responsible for reviewing reports received from financial institutions. These reports include monthly as well as annual financial statements, and reports listing transactions and investments in other companies. Special reports are required for mutual funds. The SUFICs are specialized as follows:

SUFIC-1: Stock exchanges, brokers and distributors
SUFIC-2: Finance companies
SUFIC-3: Investment Banks and special assignments

Each SUFIC is headed by a Deputy Inspector General and has a basic structure of: 2 senior clerks, 2 or 3 analysts and 2 office clerks. Mutual funds are the responsibility of the junior of the Inspector General's two Administrative Assistants. An organization chart follows:

ISMEC ORGANIZATION CHART



Note: Numbers indicate Staff in each organization unit

The inspectors form a separate group within the organization, although they submit their reports to the appropriate SUFIC. They number a total of 70, of which 51 are located in Rio de Janeiro and São Paulo where the great majority of institutions are established, the remaining inspectors being distributed throughout the Central Bank's regional offices in other States. Like many of the Central Bank's employees, these inspectors are former Bank of Brazil employees with 20 to 25 years' service with the two banks in most cases.

ISMEC has written audit programs for each type of institution. They are reasonably detailed and professional, and the scope is that indicated in the first paragraph of this section. Audit standards are high, and the inspectors are required to examine documentation, prepare working papers, and give an opinion. However, the audit is limited because of the lack of generally accepted accounting principles in Brazil.

Although ISMEC appears to have a competent staff, it has two major weaknesses as an organization: a) it is understaffed, and b) it does not perform all of the monitoring functions which it is authorized to perform by law of the Central Bank nor other functions which it might perform as the monitoring staff of the regulatory authority (see Annex VII, Exhibit A, p. 5).

At the end of last year, ISMEC was required to inspect finance companies (215), investment banks (30), brokers (404), stock exchanges (19) and distributors (594), or a total of 1,262 persons and institutions, not counting 265 mutual funds. There figures in themselves clearly indicate that ISMEC does not have sufficient staff to monitor these institutions. In addition, some 30 inspectors are engaged full time or nearly full time in following up the liquidation of certain finance companies, the mergers of other and the conversion of some finance companies into investment banks. This leaves only 40 inspectors to do the auditing. Since an audit of a finance company or investment bank requires about one man-month, just a once yearly audit would require at least 23 inspectors, leaving only 17 out of the 40 available for audits to handle the remaining 1017 institutions. Because of this shortage of staff, instead of using an audit schedule, ISMEC has to operate on a priority list of firms, the priority being based on a combination of the size of the firm, how long ago was it last audited and the existence of problems. The volume of reports received by ISMEC is also beyond the capacity of its internal staff for more than superficial review and analysis.

Periodic audits of institutions cannot be the sole monitoring tool of a regulatory body. Apart from the sheer magnitude of the task, it could be performed by private audit firms, thus allowing ISMEC to devote itself to the continuing and day-to-day monitoring activities typical of a regulatory body.

In sum, ISMEC appears to operate under acceptable and defined technical standards. On the whole it has been doing an excellent job with its limited resources, but its actual functions are very limited in scope. ISMEC's experience is perhaps the most valuable asset in the Central Bank's Capital Markets Area, and for this reason its activities should be developed along more realistic lines.

The Monetary Correction Coefficient

If inflation in a given period was "m", the corrected value at the end of the period of a sum of money "s", expressed in the currency of the beginning of the period, is s'=(1+m), where (1+m) is the monetary correction coefficient and "m" is the percent change in the period of some price indicator. 1/ Since MC was first applied in Brazil, three indicators have been used for this purpose: The Getulio Vargas Foundation general wholesale price index (excluding coffee), the exchange rate and the highest official minimum salary.

Of the three, the wholesale price index is the most widely used price indicator for the purpose of MC. It is used to correct the value of the ORTNs (Treasury Bonds) which in turn serve to correct the value of other claims, since these are expressed in terms of the ORTN.

The MC of an ORTN is based on a quarterly moving average of the wholesale price index with the average for the second quarter of 1964 as 1 and is applied with a lag of one quarter. The ORTNs were issued with the face value of Cr$10,00 as of the second quarter of 1964. Thus, the first change in its value was in effect on Jan. 1st 1965, reflecting a 13% change in the WPI (Wholesale Price Index) from the second to the third quarter of 1964 (actually as a result of this lag and the fact that inflation in 1965 was almost half that in 1964, the ORTNs in 1965 yielded a very high return in real terms).

The exchange rate is used as an alternative to the WPI for correcting the value of the ORTN (in the case that the instrument was issued with a foreign exchange clause) and as the implicit monetary correction factor in the cases of external borrowing by Brazilian firms.

The minimum salary is used in the case of adjusting the value of the installments of mortgages negociated under the system led by the National Housing Bank (in the Plano de Equivalência Salarial) and in rental adjustments.

Table 1 below shows the values of the ORTN corrected on the basis of the WPI since these bonds were first issued. Table 2 contains the percent changes on an annual basis of the values of the ORTNs and the other MC indicators.

1/ If the sum "s" had been lent at the beginning of the period, at the interest rate "i", the monetarily corrected amount received by the lender at the end of the period would be (A'=s'(1+i)=s[i+m+mi]).

TABLE 1

Values of ORTNs a/
Cr$

	1964	1965	1966	1967	1968	1969	1970	1971
Jan	-	11.30	16.60	23.23	28.48	35.62	42.35	50.51
Feb	-	-	17.05	23.78	28.98	36.27	43.30	51.44
Mar	-	-	17.30	24.28	29.40	36.91	44.17	52.12
Apr	-	13.40	17.60	24.68	29.83	37.43	44.67	52.64
May	-	-	18.28	25.01	30.39	38.01	45.08	53.25
Jun	-	-	19.09	25.46	31.20	38.48	45.50	54.01
Jul	-	15.20	19.87	26.18	32.09	39.00	46.20	55.08
Aug	-	-	20.43	26.84	32.81	39.27	46.61	
Sep	-	15.70	21.01	27.25	33.41	39.56	47.05	
Oct	10.00	15.90	21.61	27.38	33.88	39.92	47.61	
Nov	-	16.05	22.18	27.57	34.39	40.57	48.51	
Dez	-	16.30	22.69	27.96	34.95	41.42	49.54	

Source: Ministry of Planning

a/ ORTN of one or two year with monthly MC and ORTN of 5 years with MC quarterly. The monthly MC ORTN started in September 1965.

TABLE 2

Percent Change in the Value of the ORTNs,
Wholesale Index, the Exchange Rate and the Minimum Salary

	ORTN Dec/Dec	WPI (Internal Supply) Dec/Dec	Sale Exchange Rate (as of December)	Minimum Salary (as of the data it became effective)
1965	63.0	31.4	57.1	57.0
1966	39.2	41.4	-	27.3
1967	23.2	22.0	22.7	25.0
1968	25.0	24.2	41.9	23.4
1969	18.5	19.2	13.6	20.9
1970	19.6	18.5	13.8	20.0

Source: Conjuntura Econômica,
and IBGE.

MC and the Various Financial Instruments

Bills of Exchange (letras de câmbio)

These securities have, since 1969, been sold at a discount, in a way similar to the practices followed before 1966 when the Government attempted to apply MC to them (a Cr$100 "letra" of six-month maturity sold at a 10% discount costs Cr$90 and yields a return of 11.1% in the semester, or 23.4% a year). The discount rates, however, are no longer entirely determined by the market, but are set by the Financeiras in a sort of a "gentlemen's agreement" based on informal approval by the Government (investment banks deal with "letras" and therefore participate in this process also). In 1970 the annual nominal rate to the holder of a six-month bill was 28.7% or a 7.4% real return.

The income tax on bills of exchange is paid at source and is levied upon the full nominal return. The tax rates are regressive in terms of maturity so as to incentivate longer-term bills. The tax rates go from 10% in the case of a six-month bill to 4% in the case of a 24-month or longer-term bill. This tax treatment is practically the sole incentive to hold a longer-term bill.

ORTNs

The readjustable treasury bonds (ORTN) were issued with the MC clause, which can be based on the wholesale price index or on the exchange rate. The latter is an option offered to the buyer of an ORTN who does not want the MC calculated by means of the wholesale price index 1/. The official value of an ORTN, however, is the one that results of correcting its value by means of the wholesale index.

1/ Example: In December 1968 the value of an ORTN was Cr$34.95. The total amount collected in December 1969 by the buyer of an one-year 4% interest bond can be exemplified for MC calculated on the basis of the WPI or of the exchange rate.

MC based on the WPI

- value of the ORTN in Dec. 1968	Cr$34.95
- value of the ORTN in Dec. 1969	Cr$41.42
- 4% interest over Cr$41.42	Cr$ 1.66
- Amounted collected	Cr$43.08

MC based on the Exchange Rate

- Value of the ORTN in Dec. 1968	Cr$34.95
- Value of the ORTN in Dec. 1968 in dollar at the Dec. 1968 exchange rate of Cr$3.816 /$1	$ 9.158
- Value in Cr$ in Dec. 1969 of the $9.158 sum (rate of exchange of Cr$4.350 /$1	Cr$39.84
- 4% interest over Cr$39.84	Cr$ 1.59
- Amount collected	Cr$41.43

The preference for the exchange rate correction was particularly great before the Government had adopted, in 1968, the adjustable exchange rate. During that time it was possible to increase the return on the ORTN by buying it prior to a cruzeiro devaluation and selling it soon after.

Interest on an ORTN is calculated over the corrected value of the bond and is paid semestrally or annually. MC, however, is paid at redemption.

Currently in the market there are three types of ORTN which are the following:

- One-year term: yields 4% annual interest, paid at maturity. MC calculated monthly and paid with interest at maturity.
- Two-year bond: 5% annual interest paid semestrally. MC calculated monthly and paid at maturity.
- Five-year bond: 7% annual interest paid semestrally. MC calculated on a quarterly basis and paid at maturity.

The income tax on the ORTNs is not levied upon the MC part. On the interest received there is a tax of 6% withheld at source, which may be exempted if the holder is identified.

Housing Bonds (Letras Imobiliárias)

The housing bonds are securities issued by the National Housing Bank and the real-estate credit companies (companhias de crédito imobiliário) which issue bonds, receive savings accounts and make mortgage credit available. The housing bonds have maturity of one, three, five or 20 years and yield an annual interest of 8% plus monetary correction. This is done by expressing the value of a "letra" in terms of the value of one ORTN. In the case of the one-year bond, interest on the corrected value and MC is paid at maturity. For the 3-year bond interest on the issuing price plus MC are paid quarterly (example: if the value of the ORTNs in the last quarter rose 6% the return on the housing bond will be calculated as 8% of the issuing price). For bonds with maturities of 5 years or more, interest is paid monthly on the corrected value of the bond and MC is paid at maturity.

As to income tax, interest and MC are exempted in amounts up to Cr$792,00 as of 1970.

DCM - Bank Deposits with MC

Commercial and investment banks can receive time-deposits held for a minimum of six-months to which monetary correction can be applied. This and the interest rate are set in advance in a similar fashion as in the case of the "letras de câmbio". Thus what is relevant is the full nominal amount paid, although the heading "Monetary Correction" is required in order to circumvent the usury law. In November 1966 the Central Bank approved an agreement among bankers to set the full return on time-deposits on the range of 18-21% per year. In April 1969 these rates were permitted to increase and in 1970 they have reached the range of 25-30%. The nominal return of time deposits may be paid at maturity or on a quarterly basis.

DCMs of more than 12 months can be received against the issuance of a deposit certificate, which has the advantage of being negotiable.

Income tax on DCMs can be charged in a similar way as for the bills of exchange - (tax on the full amount according to a regressive schedule in terms of maturity) or on the basis of the real return only, with MC being verified a posteriori according to the value of the ORTNs. (Example: if the nominal return on a DCM happens to be 30% annually and the ORTN rose 20%, only the 10% part is taxable). The tax rates are 25% for DCMs less than 2 years and 15% for DCMs longer than that.

Debentures

These are corporation bonds of a minimum term of one year in the case of straight debentures and 3-year in the case of convertible debentures. Existing legislation authorizes the issuing of these bonds with the MC clause based on the value of the ORTNs. The MC is to be calculated at least on a quarterly basis, but it is not yet clear whether it can be paid periodically with interest or only at maturity. The MC of debentures is exempted from the income tax and for the interest the tax correspond to 25% in the case of debentures of up to 2 years and 15% in the case of longer-term bonds.

Savings Accounts

These accounts, which are held in the savings banks, real estate credit companies and savings and loans associations, yield a 6% annual interest and are subject to MC based on the value of the ORTNs. The MC is calculated quarterly but paid only at maturity. Interest is calculated over the corrected value of the account balance.

Monetary Correction of Fixed and Current Assets

Firms in Brazil have, since 1958, been authorized, and since 1964 required, to correct the value of their fixed assets. In 1964 the authorization to apply MC was extended to current assets. Fixed assets refers basically to machinery, equipment and buildings. Current assets includes cash plus accounts receivable (excluding credits already subject to MC) minus accounts payable (excluding debts already subject to MC).

The advantage to the firm of applying MC to their assets is principally one of reducing illusory profits. In the case of fixed assets, the MC provides a more realistic basis, in terms of constant price values, for calculating capital depreciation allowances. In the case of current assets, it permits the maintenance of a real basis for the firm's working capital needs by deducting from current profits the reduction of current assets on account of currency depreciation. Under current legislation, however, the latter advantage is not fully enjoyed because only 20% of the MC of current assets can be deducted from current profits.

The MC of current and fixed assets is calculated annually and is based on the straightforward change in the period concerned of the general wholesale price index (domestic supply). The amount resulting from the MC of fixed assets is fully incorporated into the firm's equity capital. Currently, this amount is tax exempted but until 1967 it was subject to a 10% income tax.

Reluctance of Borrowers to Accept MC

Despite the fact that in an inflationary environment the application of MC to loans is aimed at protecting both the lender and the borrower (a nominal interest rate can be disastrous to the lender if inflation explodes or to the borrower if prices stabilize) borrowers, especially businessmen, seem considerably reluctant in borrowing money through contracts with the MC clause. One important factor determining this reluctance is that business calculations traditionally are based on nominal values, and once a given value is finally accepted, all the risk involved has already been taken into account. When, however, a nominal value is split into a real component and the MC component, the latter is immediately associated with future inflation which, even in the short run, tends to be considered in the business community as unpredictable. Furthermore, even if inflation could be predicted with reasonable accuracy, entrepreneurs are reluctant to commit themselves in the short run to a variable amount such as MC, when in this period they feel unable to increase proportionately the value of their accounts receivable.

This explains the failure of the extension of MC to the "letras de câmbio" in 1965. These "letras" were issued against the certificates (duplicatas) representative of a firm's invoicing during a certain period. Those certificates, however, have a nominal fixed value which could not be altered to match the increase represented by the MC to be paid on the "letra".

In the case of long-term borrowing, the reluctance to accept MC is associated with market uncertainties. Although the value of business assets can be monetarily corrected and the prices of their products can theoretically be raised as other prices go up, it is not certain that the market for a particular product or group of products will allow the price to be increased in the required proportion to permit the servicing of a loan with MC.

FOREIGN SOURCES OF PRIVATE INVESTMENT FINANCING

In addition to borrowing in the domestic market, Brazilian and foreign firms operating in Brazil have been able to finance part of their working and fixed capital needs through borrowing abroad. This borrowing has taken place in the form of credit tied to imports (supplier's credit) and of loans granted by international and foreign government agencies (principally IDB, IBRD, AID, EXIMBANK), and through certain legal mechanisms such as those set under Law 4131 of 1962, SUMOC Instruction 289 of 1965 and Central Bank Resolution 63 of 1967. In this section the movement of loanable funds from the private external market through these legal mechanism and supplier's credits are analysed.

Borrowing Through Legal Mechanisms

Most of the money entering the country under the mechanisms of Law 4131, Inst. 289 and Res. 63 may be considered as short-term money. The costs of these resources to the borrower have usually been lower than in the internal market. Although the Res. 63 system seems to be an instrument open to all forms, the borrowing through Law 4131 and Inst. 289 has been made primarily by foreign firms.

The size of the flow of funds under these legal mechanisms has been considerably large. As shown by data in Table below, the balance of loans outstanding at the end of 1964 reached some Cr$10 billion, or about 25% of the overall balance of loans granted by domestic lenders to the private sector in Brazil.

However, the net flow of 4131, 289 and 63 money has fluctuated substantially. From Cr$886 million in 1965 it rose four fold to reach Cr$4,155 million in 1966. In 1967 there was a net outflow of almost Cr$100 million followed by a net inflow of Cr$1,336 million in 1968 and Cr$3,303 million in 1969.

The lack of detailed data on the flow of these funds precludes a conclusive analysis of the way they have fluctuated. Most of this fluctuation, however, can be attributed to speculation in the foreign exchange market motivated by the system of currency devaluation in force until late in 1968. This system was based on changes in the external value of the cruzeiro undertaken in periods seldom exceeding one year. In the period preceding an anticipated change there was a huge outflow of resources followed by a proportionately large inflow after the devaluation was made. Thus the huge inflow of resources in 1966 may include speculative balances that entered Brazil following the November 1965 cruzeiro devaluation. Since the cruzeiro value relative to the dollar did not change in 1966, these balances may have been allowed to stay in the country, especially in view of the credit restriction that took place in 1966 on account of the on-going price-stabilization program. In 1967 there was an outflow of resources of roughly Cr$100 million which probably took place because of the huge outflows at the end of the year in anticipation of the change in the exchange rate that was decreed on January 4, 1968. Later that year there was another cruzeiro devaluation but the outflow that would have preceded it may have been offset by the inflow following the January devaluation.

In addition to making the foreign funds an erratic source of financing for the firms operating in Brazil, the exchange speculation introduced considerable disturbances in the implementation of the government's monetary policy by forcing an increase in the demand for credit during the times preceding a currency devaluation and pushing up the money supply in the period immediately following the devaluation. With the adoption by the Brazilian Government of a more flexible exchange-rate system in August 1968, the operation of the legal instruments seems to have become more stable, although one lacks data for ascertaining the performance of the system in the more recent past.

What follows is a presentation of the principal characteristics of each of these mechanisms of external borrowing.

Law 4131 Funds

With the passing of Law 4131 in September 1962, regulating the inflow and outflow of foreign capital in Brazil, the long-time, on-going credit operations between a parent company abroad and its affiliated in Brazil were required to be registered in the Central Bank. Since then, the money flowing into the country from a foreign company to its associate became known and accounted as Law 4131 funds. Later, these came to include any direct borrowing in the international market by either a Brazilian or a foreign firm operating in Brazil. Most of this borrowing, however, continues to represent a transaction between two associated companies.

Law 4131 funds can theoretically be either short, medium or long-term money, but the indications are that they are mostly short-term. In some Central Bank statistics, loans registered under that denomination are considered as being for working capital, of the short-term type. Data on the debt position of Brazil indicate, however, some long-term borrowing. The position as of September 30, 1970 (Central Bank Bulletin, January, 1971, pg.110) shows that for 4131 funds, about 28% of the outstanding debt falls due before 15 months from that date; some 23% between 15 and 39 months and about 10% falls due after 39 months representing therefore long-term borrowing (as of September 30, 1970, about 39% of all 4131 funds had not yet been classified as per the due date).

The costs to the borrower of 4131 money include an 8-9% interest rate on the remmittance of which the borrowing company has to pay the Brazilian Government a 33% income tax, which amounts to a 2.6-3.0% cost on the loan. As a 4131 loan has to be paid back in foreign currency, there is an exchange risk involved, the cost of which is represented by the cruzeiro devaluation that has taken place during the term of the loan. On the basis of the 1970 exchange situation and the values of the current selling exchange rate, the exchange cost of a loan due in the beginning of 1971 would be of the order of 13.8%. An additional cost may be incurred by the firm in case a guarantee is required. The cost of securing such a guarantee (usually from a bank) is about 2.5-3.0% of the value of the loan.

Thus, on the basis of these numbers, the total cost for the borrower of Law 4131 funds may be considered to be, as of this writing, 27-29% per year. In comparison with the other two mechanisms discussed below, loans under Law 4131 have the lowest terms, even though the cost differential seems to be small (see Table).

As to the size of 4131 flows, it may be seen in Table below, that they went from Cr$643 million in 1965 to Cr$3,792 in 1966. In 1967 and 1968 there was an outflow and in 1969 a sizeable inflow of Cr$2,304, which brought the outstanding balance of 4131 loans up to Cr$6,796 or 68% of the total for 4131-289-63 loans.

Instruction 289

In January 1965 SUMOC (Superintendency of Money and Credit), the entity that preceded the Central Bank, issued Instruction 289, the principal element of which was the guarantee granted to the seller of foreign exchange by the Brazilian Government that he would be able to buy back this exchange for the purpose of paying for imports or for amortization loans. Included in this guarantee were the amounts representing interest on the loan obtained. The provision of the foreign exchange guarantee represented a considerable incentive for foreign savers to lend to Brazilian firms, especially those that could not borrow under the conditions of Law 4131. The provision was also relevant primarily in light of the precarious position of Brazil in 1965 regarding the availability of foreign exchange.

The amount of money channelled from abroad through Instruction 289 has not been significant. In the first year of operation of this mechanism some Cr$243 million entered the country and by the end of 1969 the outstanding balance of Instruction 289 money was Cr$1,141 million.

The costs of 289 funds are close to the costs of 4131 funds: in the range of 29-31% per year.

Resolution 63

In August 21, 1967 the Central Bank of Brazil issued Resolution 63 authorizing investment and commercial banks dealing in exchange to borrow money in the international market up to two times equity capital and reserves, for purpose of lending this money to firms in Brazil. This authorization aimed on the one hand at boosting the operations of the investment banks and on the other at exploring the borrowing capacity of banks associated with foreign credit institutions.

Under current conditions, Resolution 63 funds are used for loans up to 28 months.

The costs for the Brazilian firm of Resolution 63 funds include the following: variable interest rate payable quarterly and calculated as 2.5 percent points above the London interbank rate (case of Euro-dollar money) or the prime rate in New York (case of American money). As of this writing, the interbank rate was 7.5% per year, and the prime rate was 7.0% per year. The exchange risk in 1970 was 13.8%. A repassing commission, of 3.5-4.0%, is also charged by the bank to repass Resolution 63 funds. This commission is similar to a guarantee commission since the actual borrowing in the international market is done by the Bank. A 33% income tax on the interest is also paid by the borrowing firm. Finally, a one percent tax is paid on financial operations. Thus the over-all cost to the ultimate borrower of Resolution 63 loans is 30-32%, or slightly above the rates for resources under the other two mechanisms.

The operations with Resolution 63 resources may be considered to have been reasonably successful for the outstanding volume at the end of 1969 reached Cr$1.98 billion (almost double of 1968's), 20% of the total for the 3 mechanisms and almost double that of Instruction 289. According to data for the investment banks, external borrowing under Resolution 63 recorded an almost 90% increase in 1969.

TABLE

INFLOW OF EXTERNAL RESOURCES UNDER LAW 4131, INST. 289 AND RES. 63

Cr$ Millions
(Current Prices)

	Law 4131		Inst. 289		Res. 63		Total 4131-289-63 Funds		Total Private Financing from Domestic Sources	
	Stock	Flow	Stock	Flow	Stock	Flow	Stock	Flow	Stock	Flow
1964	-333	N.A.	-		-		333	-	4,345	-
1965	976	643	243	243	-		1,219	886	7,310	2,965
1966	4,768	3,792	606	363	-		5,374	4,155	10,920	2,980
1967	4,656	- 112	593	-13	29	29	5,278	-96	16,740	6,450
1968	4,492	- 164	1,092	499	1,030	1,001	6,614	1,336	28,545	11,805
1969	6,796	2,304	1,141	49	1,980	950	9,917	3,303	41,512	12,969
Estimated Costs to the Borrower (As of beg. 1971) %	27-29		29-31		30-32					

Source: Central Bank

Supplier's Credit

Lack of detailed data precludes an analysis of this type of credit. On the basis of the data that is available, it may be said that supplier's credit finance about one-third of financed imports in Brazil, which represented in 1969 about 12% of total CIF imports of goods. Thus in 1969, a little over US$91 million, or Cr$373 million, was made available to Brazilian firms to pay for their imports. We estimate that in 1968 the amount of supplier's credits available was US$82 million (Cr$278 million).

Regarding costs and terms, supplier's credit are considered as medium and long-term credit. The rate of interest closely corresponds to the rates prevailing in the international market. As of the beginning of 1971, these rates were 8-9% per year. In addition to interest the borrower has to incur the exchange-risk costs, but is not subject to the other charges that are levied upon the instruments discussed in the preceding section.

Returns, risks and security of currently available financial instruments.

Almost all instruments available to the public in the financial market in Brazil are short-term. The only exceptions to this rule are government bonds (Treasury Bonds and Housing Bonds). Fixed income instruments carry a monetary correction clause, which may either be prefixed according to official coefficients, or implicit in the discount rates.

Tax incentives granted by the GOB are large, and together with considerations related to interest rates, liquidity and personal income tax bracket, define investors' options for various types of securities.

A brief description of the financial instruments as they are presently defined is presented below.

1) Fixed Income Instruments:

a) Letras Imobiliárias (Housing Bonds) are securities issued either by the Sociedades de Crédito Imobiliário (Private Real Estate Credit Institutions) or by the Housing Bank directly for the financing of the housing program. There are various types of Letras with maturity periods ranging from 1 to 10 years, the most common period being 3 years.

Income (interests and monetary correction) is either paid monthly, every three-months, or at maturity, depending on the specific type of Letra.

The risk element on these securities is non-existent: they are fully guaranteed by the Sociedades de Crédito Imobiliário and by the Housing Bank.

There is a market for resale of Letras Imobiliárias which operates on the basis of 24 hours advance notice, despite the theoretical need for 60 days advance notice.

Return on Letras Imobiliárias are approximately 8% per year plus monetary correction. In 1970, the nominal returns stayed within the range 28% - 30%. The letras imobiliárias receive sizeable tax incentives from the GOB; 30% of the amount spent in Letras in a given year can be deducted from taxable gross income. Monetary correction is tax exempt as well as interest payments up to Cr$ 792 in 1970 1/ provided the investor holds the Letra for at least 2 years.

b) Letras de câmbio (bills of exchange) are securities issued by private firms and accepted by the Investment Banks or the Sociedades Financeiras.* Approximately 75% of the outstanding volume of Letras de Câmbio represent consumer's credit financing of durable goods with the remaining 25% being used to finance working capital needs.

Consumer's credit financing is done mainly by the Financeiras in order to alleviate Commercial firms from the financing of their own sales. This credit can either be granted by the Financeira directly to an individual buyer of durable goods or to a Commercial Firm, which in turn finances its individual clients. In the first case, the Letras de Câmbio are issued by the Financeira based on the credit contracts with individuals. In the second case the Letras are issued by the Commercial Firm and accepted by the Financeira.

As a result of market specialization, financing of manufacturing firms working capital needs is done mainly by Investment Banks. The Letras are issued by the manufacturing firms, accepted by the Investment Banks, and resold to the public. Maturity period are from 6 months to two years, with the short term being the most common.

The Letras de Câmbio are guaranteed by both the issuing firm and the Investment Bank or Financeira, so that the risks involved in letra de câmbio operations are a function of the reliability of the issuing firm and the Financeira.

There is a very active market for Letras de Câmbio made by the Sociedades Distribuidoras, which in effect provides a high degree of liquidity before maturity.

Letras de Câmbio have a prefixed monetary correction, estimated by the Financeiras or Investment Banks themselves. Nominal returns in 1970 were about 28% - 30%. The variation depends on maturity periods, issuing firms and guaranteeing Financeiras/Investment Banks.

1/ The Cr$792 is the total exemption level for interest payments from all instruments allowed under personal income tax laws in the year 1970. (Including debentures, but excluding savings accounts)

* (Finance Companies)

There is no tax incentive as such to buying Letras de Câmbio. The tax schedule has a built-in incentive for longer term letras as shown bblow:

Maturity			Tax Rates
180 days	-	269 days	10%
270 days	-	359	9%
360 days	-	449	8%
450 days	-	539	7%
540 days	-	629	6%
630 days	-	719	5%
720 and over			4%

c) Cadernetas de Poupança are savings accounts held for a minimum period of 6 months. The resources raised through the savings accounts at the Caixa Econômicas,* Sociedades de Crédito Imobiliário and Associações de Poupança e Emprêstimo (private savings and loans banks) are used for the financing of the housing program. The final guarantor is the BNH.

The rate of return on these accounts is 6% per year plus monetary correction. In 1970, this corresponded to 26.59% in nominal terms. Income, interests and monetary correction, is paid every 3 months. Tax incentives to cadernetas de poupança are: exemption to monetary correction, exemption on interest payments up to Cr$1,142,64 and deduction of 15% of average balances from taxable gross income.

d) Obrigações Reajustáveis do Tesouro Nacional (OTRN) are Treasury Bonds issued for purposes of financing the federal government deficit. Maturity periods are of 1, 2 and 5 years. The Federal Government guarantees full payment of ORTNs at maturity.

ORTNs enjoy a high degree of liquidity because of its acceptability in payments of federal taxes, income tax inventives and federal guarantees, which make them an attractive instrument for large institutional investors.

The rates of return on ORTNs are:

1 year - 4% per year plus monetary correction
2 years - 5% per year plus monetary correction
5 years - 7% per year plus monetary correction

(Interests are computed on the basis of the ORTN corrected face value).

* (Public savings banks)

For 1 year ORTNs, interest is paid annually and monetary correction applied monthly. For 2 years ORTNs interest is paid each semester and monetary correction applied monthly. For 5 years ORTNs interest is paid each semester and monetary correction applied every 3 months. Monetary correction for ORTNs (all types) is paid at the end of the maturity period.

In 1970, yields from 1 year ORTNs were 24.26% in nominal terms. About 30% of the amount spent in ORTNs can be deducted from taxable gross income. Monetary correction is fully exempt as well as interests up to Cr$ 792 (all sources) in 1970. These incentives are part of the personal income tax system and as such are not applicable for ORTNs to the bearer. In this case, the tax on ORTNs is witheld at source at a rate of 6%.

(Treasury Bills)

e) Letras do Tesouro Nacional/(LTNs), created in August 1970, were devised especially to be the instrument for open-market operations in substitution for the ORTNs, which could not properly play that role in Brazil, because they are medium to long-term instruments. The LTNs are usually issued at maturity periods of 91 days and are guaranteed by the Federal Government, therefore involving no risks to the buyer. In order to simplify its operations and as a consequence, provide high liquidity, the LTNs are discount papers. This means that there is no uncertainty regarding future yields, as is the case with the ORTNs where monetary correction is prefixed only for 3 months. In 1970, the yearly discount rate was 18%. Considering that the rate of inflation was higher than the 18% return on these Letras, it becomes obvious that his is an instrument which attracts only large institutional investors who seek high liquidity and some protection against inflation for short periods of time. One further advantage of the LTNs is that they are totally tax exempt.

f) Depósitos a prazo (time deposits), are deposits accepted by Commercial and Investment Banks for periods of 6 months to two years. When made at Investment Banks, a certificate can be issued by the Bank allowing the deposits to be negotiable. These deposits are guaranteed by the Commercial and Investment Banks. The nominal rates of return in 1970 were about 24-28%. This instrument receives no tax incentives except for exemption for monetary correction.

g) Terms Operations at the Bolsa - These operations were started in January 1969 in order to allow investors in the stock market to buy on margin. They are usually 90 day operations although they may last as long as 180 days. The broker acts as an intermediary between the financer and the investor, and receives the regular commission fees.

The system is guaranteed essentially by the Stock Exchanges' Caixa de Liquidação* which controls all term operation contracts and determines the need for increases in the margins deposited. From the financer's point-of-view, this is a completely risk-safe free operation and the returns are high relative to other instruments (estimated to be 33% in nominal terms in 1970).

With respect to tax treatment, there is no understanding on how these operations should be treated. Since the mechanics of them involve both a purchase from and a sale of stocks to different individuals, there is a widespread tendency to consider the income from these operations as capital gains, and as such, tax exempt.

h) Debentures are bonds issued by private firms representing loans of a minimum of 1 year maturity period. They can be either straight or convertible debentures. They are guaranteed by the issuing firm's net assets and by the Investment Bank in charge of their placement. They can generally be sold only at the end of the maturity period because there is currently no active intermediary market for them. Debentures have been practically non-existent in the last few year because of the market preference for short term instruments. Mutual and Fiscal Funds are, however, beginning to buy them once again for their own portfolios. Returns on debentures are interests, monetary correction plus any eventual income that may result from their conversion into stocks.

In 1970, the rate of return on debentures was about 30%. Debentures do not receive any special fiscal treatment. The tax schedule is the same as that of the Letras de Câmbio, starting at 8% for 360 days debentures and going down to 4% for debentures of 720 days and above. However, when Debentures carry a monetary correction clause according to official coefficients (ORTNs), then monetary correction is tax exempt and the tax is collected on interest payments only at a rate of 15%.

2) Variable Income Instruments:

a) Investment Funds

Mutual Funds hold a diversified portfolio of securities, stock, debentures, letras de câmbio, and government bonds,

*(Liquidity Fund)

which minimize investment risks and at the same time can provide yields higher than those obtainable through fixed income instruments alone.

For this reason, mutual Funds have become an attractive investment for private savers who, for reasons related either to the small size of their savings or the high risks of investing in stocks or lack of information necessary to make stock-investments decisions, do not want to invest in stocks directly.

Mutual Funds, because of the large size they have reached, have become an important force in influencing Market prices, especially stock prices. In order to prevent manipulation they are subject to certain limitations regarding concentration in one single type of security or firm. These are:

- no more than 10% of the portfolio can be held in the securities of any one firm;

- the average investment per firm however, can not exceed 5% of total portfolio value; (e.g. 8% in one firm has to be offset by 3% in other.);

- investment in any single firm should not exceed 20% of the voting capital of the firm.

These limitations are not applicable to shares received in splits nor preferred stocks nor underwritings. They do, however, limit the earning capacity of the mutual funds under current market conditions in Brazil.

The guarantees offered by the Funds are related to their management capacity and to the securities held in the Fund's portfolio. Liquidity on the shares of Mutual Funds is high and immediate, since the administering firms (Investment Banks, Sociedades de Investimentos, Corretoras, etc) buy back their shares of Funds at a price based on the daily market value of the securities they hold.

Returns on shares of Mutual Funds correspond to income from fixed income securities and dividends plus increases in the value of stocks in the Stock Market. It is estimated that return from Mutual Funds in 1970 was 54% compared to 95.3% increase in the Rio Stock Exchange Index. Of the total amounts used for the purchase of shares of Investment Funds, 15% are income tax deductible. Interests from any source) up to Cr$792 in 1970 were tax exempt.

b) Fiscal Funds

Decree Law Nº 157 established a tax credit system under which 12% of personal income tax liabilities can be used in the purchase of "certificados de compras de ações" which are shares of Fiscal Funds. By regulation, the Fiscal Funds hold a portfolio of stocks and debentures composed of:

> a minimum of 2/3 in underwritings of new stock and debentures of "open capital" companies and maximum of 1/3 of existing stocks and debentures traded in the Stock Exchanges. By September 1971, 70% of their portfolio will have to be in the stocks and debentures of firms with a capital base of less than CR 15.7 million (approximately $3 million).

Unlike the Mutual Funds, investments in Fiscal Funds have a minimum maturity period of two years during which the investors (taxpayer's) monies must remain in the Fund.

Fiscal Funds operate in a manner similar to that of Mutual Funds, aside from the characteristics cited above regarding the form in which Fiscal Fund resources are raised, the requirement of a minimum 2 years maturity period 1/ and heavy concentration of portfolio in new issues.

Also, it should be emphasized, that they have quite successfully played their role as an indirect inducement to investment in the stock market, despite their limited size.

c) Stocks

Stocks are the most common type of variable income instrument. There are basically of two types: common and preferred. With respect to the form in which they are issued, stocks can be nominal, endorsable nominal and to the bearer, depending on whether the holder is identified or not.

Most of the stocks traded in Brazilian Stock Exchange are to the bearer. These are more easily traded because the transfer of property involves solely a physical transfer of stock certificates, whereas for nominal stocks there is a need for changes in the ownership records at the company (the entire process) usually takes several months.

1/ Complete pay out in 4 years according to recent legislation

Since stocks represent the ownership of a share of a firm's assets, there is no maturity period on them. Their guarantee is the firm's net worth. If the firm is listed in the Stock Exchange, liquidity is high. If not, liquidity may be non-existent. At the present time, about 80 stocks can be considered highly liquid. Returns on stocks are a function of the amount of dividends, splits, underwriting options that the firm offers and capital gains derived from their sale at a price higher than the purchasing price. Average returns on stocks as measured by the Rio Stock Exchange Index on stock prices were 95.3% in 1970. The tax legislation on stocks is very complex and provide a variety of tax incentives whose importance depends essentially on size of income. The tax incentives include tax deductions, tax credits and exemptions.

The deductions from gross income allowed under income tax laws for investments in stocks are:

- 30% of amounts invested in stocks of "open capital" companies as defined by the Central Bank;
- dividends and bonuses up to Cr$ 2.376 in 1971; and
- 100% of underwritings of nominal stocks of firms in the SUDENE/SUDAM area.

The tax credits correspond to portions of the tax liabilities which can be used for specific purposes as follows.

Personal income: 12% of tax liabilities for the purchase of shares of Fiscal Funds (DL 157);

25% of what to cover up to 50% of purchases of stocks of Banco da Amazonia and Banco do Nordeste.

Corporate income : 1% of tax liabilities for purchases of shares Fiscal Funds (DC 157) up to 25% of what to cover 50% of underwritings of shares of the Banco da Amazonia.

up to 50% of what for purchases of shares of fishing companies in the SUDENE/SUDAM area and 25% for SUDEPE projects outside SUDENE/SUDAM areas.

Complete Income tax exemptions are granted to all income earned via capital gains and stock splits. "Open capital" companies are exempt from the addition to Income tax on distributed dividends.

Volume of Funds Flowing Through the Various Financial Instruments

Tables I.a and I.b attached show the volume of funds flowing through the various financial instruments in the period 1959-1970, both in nominal and real terms.

Some interesting conclusions can be made from the figures on those tables.

In 1970, the most important instruments in terms of volume of funds were still the Letras de Câmbio and the time deposits. In the period 1959-1970 the volume of funds flowing through these instruments has increased about 80 times in real terms. For the most part this increase occurred since 1964. It is particularly interesting to note that the volume of funds flowing to Letras Imobiliárias and savings accounts showed the largest relative increases, mainly after 1968: for the Letras volume it increased one and a half times and for the savings accounts where it tripled in real terms.

In turn, the relative importance of the Letras de Câmbio as a market instrument has declined.

The growth of funds in underwriting operations in the last two years is also worth noting.

VOLUME OF FUNDS FLOWING THROUGH THE VARIOUS FINANCIAL INSTRUMENTS

In Cr$1,000,00

Year	Underwriting Operations2/	Fiscal Funds	Mutual Funds	Housing System		Government Bonds		Letras de Câmbio	Time Deposits	Reserves of Insur. Co.	Total
				Letras Imob.	Savings Acc.	ORTN	LTN				
1959										2,300	2,300
1960								5,190	16,700	3,000	24,890
1961	3,267	-	4,800	-	-	-	-	6,100	8,100	4,500	26,767
1962	4,170	-	8,600	-	-	-	-	34,900	6,100	6,700	60,470
1963	17,623	-	13,500	-	-	-	-	33,500	25,200	33,800	123,623
1964	28,670	-	....	-	-	41,000	-	156,300	63,000	45,900	334,870
1965	21,513	-	15,400	-	-	376,000	-	292,300	129,000	55,000	889,213
1966	....	-	6,100	7,000	-	882,000	-	177,000	96,000	44,200	1,212,300
1967	57,300	....	....	133,000	66,000	792,000	-	1,233,000	409,000	91,000	2,781,300
1968	116,900	70.445	19,343	321,000	276,000	335,000	-	2,443,000	706,000	114,374	4,402,062
1969	206,058	84,867	206,838	461,000	545,000	1,834,000	-	1,616,000	1,082,000	204,055	6,239,818
1970	317,490	27,143	269,990	808,000	1,219,000	891,100	684,600	2,100,000	1,747,000	229,000 1/	8,293,323

1/ Figures above are net yearly entries.

2/ Actual placements rather than registrations, private offers may also be included.

VOLUME OF FUNDS FLOWING THROUGH THE VARIOUS FINANCIAL INSTRUMENTS

In thousands of 1970 Cr$

Year	Underwriting Operations	Fiscal Funds	Mutual Funds	Housing System		Government Bonds		Letras de Câmbio	Time Deposits	Reserves of Insur. Co.	Total	Index
				Letras Imob.	Savings Acc.	ORTN	LTN					
1959	-	-	-	-	-	-	-	-	-	102,918	102,918	100.0
1960	-	-	-	-	-	-	-	179,774	578,464	103,916	862,154	837.7
1961	82,573	-	121,319	-	-	-	-	154,176	204,725	113,736	676,529	657.3
1962	69,500	-	143,333	-	-	-	-	581,667	101,667	111,667	1,007,834	979.2
1963	167,491	-	128,306	-	-	-	-	318,388	239,504	321,240	1,174,929	1,141.6
1964	143,039	-	...	-	-	204,555	-	779,804	314,317	229,002	1,670,717	1,623.3
1965	68,437	-	48,990	-	-	1,196,127	-	929,861	410,373	174,965	2,828,753	2,748.6
1966	-	-	14,058	16,132	-	2,032,665	-	407,916	221,242	101,864	2,793,877	2,714.7
1967	102,961	-	-	238,984	118,594	1,423,125	-	2,215,547	734,922	163,516	4,997,649	4,855.9
1968	169,101	101,901	27,980	464,340	399,245	484,591	-	3,533,899	1,021,258	165,447	6,367,762	6,187.2
1969	246,840	101,663	247,775	552,239	652,865	2,196,979		1,935,833	1,296,146	244,441	7,474,781	7,262.8
1970	317,490	27,143	269,990	808,000	1,219,000	891,100	684,600	2,100,000	1,747,000	229,000	8,293,323	8,058.2

The market for new financial instruments

As demonstrated earlier, financial instruments available to the public in Brazil are almost entirely short-term. It was also mentioned that market preferences are changing towards longer term instruments such as savings deposits, Letras Imobiliárias, Treasury Bonds, Stocks and Mutual Funds. Of these, the first three are instruments issued for the financing of the housing program and of the federal deficit. The volume of savings flowing to the housing instruments more than doubled between 1968 and 1970 in real terms, with the major increase occurring in 1970. In the same period, Treasury Bonds show a substantial increase and then a sharp drop in real terms, mainly as a result of the appearance of Letras do Tesouro (open market instrument).

The money volume of operations at the Stock Exchange has also grown fantastically in the last few years. For the Rio Stock Exchange, the volume of monetary transactions in real terms increased about 8 times in the last two years. For the same period, the Rio Stock Exchange price index registered an increase of about 370%.

The overall volume of funds flowing through other financial instruments has grown as well. This is shown in tables Ia and Ib

The point we find important to make here is that in addition to the overall increase in the amount of savings flowing through the financial markets, a marked shift towards longer term instruments has also occurred in the recent past. These instruments were, however, either directed towards governmental programs (savings accounts, housing and Treasury Bonds) or, on the equity side, served to increase stock prices in the secondary market with little direct benefit to industrial investment.

The point we find important to make here is that in addition to the overall increase in savings, a marked shift towards longer term instruments has also occurred in the recent past. These instruments were, however, either directed towards governmental programs (savings accounts, housing and Treasury Bonds) or, on the equity side, served to increase stock prices skyhigh with little benefit to industrial investment.

The facts related above indicate the existence of a potencial market for new instruments, such as the ones proposed under the FUMCAP program, both on the bond and the equity sides. The specific instruments we are proposing under FUMCAP are further justified by the fact that at the present time industrial firms finance their expansion plans out of retained earnings, because of the lack of sources of financing external to the firm.

Summarizing, the argument that there is a potential market for new financial instruments in Brazil and furthermore instruments of the types proposed under FUMCAP, is supported by the following:

a) there is evidence that national savings have grown in the recent past and that the portion of national savings flowing through the instruments has grown even faster.1/

1/ The portion of private savings flowing through the instruments was about 10% in 1964 and reached about 50% in 1970.

b) a change in market preferences towards longer term instruments of both bond and equity has occurred;

c) on the investment side, industrial investments have been limited primarily to financing available at sources internal to the firm. Figures available on placement of new equity in recent years show the following growth pattern:

	1967	1968	1969	1970
			in current Cr$ million	
Fiscal Funds	54.7	114.6	283.3	105.4
Public offers	-	105.3	143.1	341.8
Total Registered	54.7	219.9	426.4	447.2

Most of the issues above were underwritten on a "best effort" basis. Although the figures used here are registrations, there is reason to believe that all issues were placed in a short period of time.

Data available on debentures registrations also show impressive increases in the amounts issued, particularly in 1970:

	1967	1968	1969	1970
			in current Cr$ million	
Fiscal Funds	2.6	3.7	2.0	3.8
Public offers	0	0	3.0	63.8
Total Registered	2.6	3.7	5.0	67.6

According to an analysis made by the World Bank on the market for new securities, most of the recent issues were placed with institutional investors. Data from balance sheets of these institutions show the following with respect to the importance of securities in their portfolio:

	NCr$ Million			
	Total Assets		Increment in Portfolio of Corporate Securities	
Financial Institutions	12/31/69	Securities	1968	1969
Commercial Banks	31,447	320	76	85
Investment Banks	4,748	550	50 3/	97 3/
Insurance Companies 1/	1,116	160	45	36
Federal Savings Banks 2/	2,234	27	8	6
State Savings Banks 2/	1,140	6	2	3
Private Savings Banks	42	12	1	3
Soc. Sec. Fund	3,829	86	13	53
Government Dev. Banks	7,040	210	57	67
	51,596	1,371	252	350

1/ September 30, 1969
2/ November 30, 1969
3/ Estimated on basis 1/3 of increment in securities portfolio.

On May 19, 1971 the Monetary Council issued a set of new resolutions increasing the market for new securities. In short, these are the main facts:

a) Effective July 1, 1971 Commercial Banks will be allowed to use part of their compulsory reserves for the purchase of new stocks and debentures of firms which have a capital base of less than Cr$15.7 million (Resolution 184). This represented approximately Cr$150 million when the resolution was passed.

b) Effective immediately, Fiscal Funds should increase the share of their portfolios in new equity and debentures to 70% in January 1972 (Resolution 185).

c) Insurance companies are now allowed to hold part of their reserves in debentures (Resolution 190).

Other potential buyers of securities issued under FUMCAP are Pension Funds. Assuming that FUMCAP can attract them, this will essentially occur on the bond side, given the nature of their operations.

Effects on the Brazilian Housing Construction Program of an Eventual Reduction in the Demand for Housing Bonds (Letras Imobiliárias)

The housing bond was created in 1964 for the purpose of helping the financing of the Brazilian housing program, whose objective is the gradual elimination of the deficit of houses in Brazil, which was in the order of 8,000,000 dwellings in 1964. The placement of housing bonds since then has been quite successful and by the end of 1969 the value of outstanding bills reached Cr$1.1 billion ($220 million) or 17% of the total loans made under the household finance system for housing projects in the 1964-69 period.

Because incentives to invest on competing instruments may be expected to increase as a result of FUMCAP, the money flowing into housing bonds will eventually diminish. A question then naturally emerges relating to the implications of FUMCAP for the Brazilian housing program. As is argued below, this impact may be expected to be minor.

In the first place it may be observed that the principal component of the Brazilian housing financial system is not made up by money coming from "letras imobiliárias" but by FGTS (Fundo de Garantia por Tempo de Serviço) money, which will not be affected by the development of a debentures market in Brazil. The FGTS is a guarantee fund for an employees time in service in a firm. FGTS funds are compulsory deposits made by firms on behalf of their employees and are administered by the BNH. In 1969 this money represented well over 80% of total BNH's loanable resources. Second, it can be argued that the implementation of the Brazilian housing program is affected much less by the lack of financial resources than by the high costs of houses and of mortgages under the household finance system.

Housing construction costs in Brazil have increased considerably. In Guanabara, for example, the cost of construction in 1970 was 145% higher than the average costs in 1965/67. The Guanabara cost of living index rose by 128% in the same period. The national index of wholesale prices of construction materials in the 1965/67-1970 period rose by 147% whereas the wholesale price index for industrial products increased by 129%. In addition to higher construction costs, the buyer of a house in Brazil is faced with the high costs of mortgages. All charges included in the final cost to the borrower in the beginning of 1971 of a 15-year mortgage was of the order of 12-13% per year on the principal plus monetary correction.

This may be compared to nominal rates in the US of 6-7% for much longer term financing such as 25-40 years. In terms of the installment that would amortize a loan of, say, Cr$100,000 ($20,000) the situation would be as follows (according to the French system of amortization): For a mortgage of 15 years at the 12% interest rate, the installment would be Cr$1.200 ($240). If the term is increased to 25 years, at the same interest rate, the installment would be Cr$1,053 ($211), but if the rate of interest is lowered to 7%, the installment drops to Cr$707 ($141).

The situation described above seems to be reflected in the shift from what the BNH calls popular loans (maximum of Cr$9.500 as of Sept. 70) to what is called middle class loans (average Cr$33.000 as of Sept. 70) that may be observed in the applications made by the Housing Bank in the 1965-69 period. (Central Bank Report, 1969, p. 72). Popular loans accounted for 93% of the total number of urban loans made in 1965 whereas in 1969 the share of these loans had declined to 37%. In the same period the middle type loan increased from zero to 12% and an intermediate type loan increased from 7% to 51%. In addition to this shift from low-cost house loans to loans for more expensive units, it may also be observed that the number of loans declined in 1969 relatively to 1968 (3% less) whereas until 1968 that number had increased steadily.

PIS - A New Source of Long-Term Financing

In 1970, President Medici announced an ambitious "plan for social integration" in Brazil, known as PIS (Programa de Integração Social). The basic objective of this plan is to set up a system in which the general Brazilian population can more fully participate in and enjoy the fruits of economic development. All Brazilian employees will participate in the program by being able, under specified conditions (retirement, permanent injury, home buying, marriage), to draw on the resources of a special fund to be set up by the national savings bank (Caixa Econômica) in accordance with the amount of time they have been employed and their salary. The sources of money going into the fund are twofold: (1) each company contributes a certain percentage of its sales (starting with .15% in 1971 and .50% in 1974 and thereafter) to the fund; and (2) each company will put a certain percentage of its income tax (2% in 1971 and 5% in 1973 and thereafter) due to the federal government into the fund. The latest estimate of the total receipts of the PIS fund are shown in table below:

Estimates of Receipts of PIS
(in Cr. 1000)

	1971	1972	1973	1974
January	-	41,000	85,000	173,000
February	-	42,000	100,000	181,000
March	-	48,000	107,000	196,000
April	-	51,000	106,000	192,000
May	-	54,000	114,000	207,000
June	-	53,000	110,000	200,000
July	39,000	90,000	183,000	276,000
August	39,000	91,000	186,000	279,000
September	40,000	89,000	181,000	271,000
October	39,000	92,000	187,000	281,000
November	40,000	90,000	184,000	275,000
December	40,000	95,000	194,000	290,000
TOTAL	237,000	836,000	1,737,000	2,821,000

Source: Institute of Economic Research, Federal University of São Paulo.

Since the government has pledged to increase each employee's portion of the fund by 3% per year plus monetary correction, the managers of PIS will be under pressure to invest this money in sources which will yield at least a real 3% per year. At the time that the present paper is being written, the government has not determined exactly how they will use this money. Since the amount of money PIS has available for long-term financing is very large, USAID met with the president of the Central Bank and the Minister of Finance in order to insure that the PIS program would not conflict with the FUMCAP program. The following statement was agreed to, in principle by these officials of the Brazilian Government:

"It is our (USAID) understanding that the objectives of the PIS are to provide medium to long-term financing at market rates of interest to those firms which, either because of their size or limited profitability, are unable to go to the Capital Markets to realize their long-term financing needs. It is also our understanding that the PIS will be allowed to act as an institutional buyer of capital market securities, which would include securities underwritten under the FUMCAP program. Regarding those firms that, both because of their size and profitability, represent logical candidates for selling their securities in Brazil's capital market in order to realize their long-term financing needs; these firms will not under normal market conditions be allowed to receive medium to long-term lines of credit under the PIS program. We anticipate that a mechanism will be set up to coordinate the activities of the PIS and FUMCAP probably in the form of a committee which would include a representative of the investment banks."

Possible Implications of the FUMCAP Program for Brazilian Economic Development

One readily observable characteristic of the process of economic development over time is that, in a market oriented economy, the amount of money flowing into financial instruments as a proportion of GNP, tends to rise. The causal nature of the relationship between financial development and economic growth has not, unfortunately, been fully explored either theoretically or empirically.

Although the primary justification for FUMCAP has been described above, we feel that there are a number of possible macro-economic implications of the program which should not be ignored. This section will provide some limited support to the hypotheses that the financial system plays an important role in determining the pace and pattern of economic growth.

There are two basic explanations of the relationship between financial development and economic growth which may be called "demand-following" and "supply-leading". In the former view, it is the financial system, a properly functioning financial system accommodates - or, to the extent that it malfunctions, restricts - the process of growth. W. Arthur Lewis has, for example, argued that the nature of the demand for financial services depends upon the growth of real output, and upon the commercialization and monetization of agriculture and other traditional subsistence sectors. The more rapid the growth rate of real national income, the greater will be the demand by enterprises for external funds (the saving of others) and therefore financial intermediation, since under most circumstances firms will be less able to finance expansion from internally generated depreciation allowances and retained profits. (The proportion of external funds in the total source of enterprise funds will rise). For the same reason, with a given aggregate growth rate, the greater the variance in the growth rates among different sectors or industries, the greater will be the need for financial intermediation to transfer saving to fast-growing industries from slow-growing industries and from individuals. The financial system can thus support and sustain the leading sectors in the process of growth.

The demand-following supply response of the growing financial system is presumed to come about more or less automatically. It is assumed that the supply of entrepreneurship in the financial sector is highly elastic relative to the growing opportunities for profit from provision of financial services. The result is that the number and diversity of types of financial institutions expands sufficiently within a favorable legal, institutional, and economic environment. The government's attitudes, economic goals, and economic policies, as well as the size and rate of increase of the government debt, are of course important influences in any economy on the nature of the economic environment. As a consequence of real economic growth, financial markets develop, widen, and become more perfect, thus increasing the opportunities for acquiring liquidity and for reducing risk, which in turn feeds back as stimulant to real growth 1/.

1/ This and other ideas presented in this section are more fully described in Hugh T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, Vol. XIV, Nº 2, January 1966. Some of the most original and complete writings on the subject in the literature of economics can be found in the works of Gurley and Shaw, especially in J.G. Gurley and E.S. Shaw, Money in a Theory of Finance, Brookings, 1960.

Although we fully agree with the importance of this phenomenon for successful real growth, the Brazilian case indicates that the required responsiveness of the financial system is not at all automatic and flexible. As we have argued above, the legacy of inflation and resulting attractiveness of short-term instruments has forced expansion minded firms to finance an inordinately large percentage of their investment needs with rolled over short-term credit and especially with retained earnings. To the extent that the FUMCAP program will at least partially provide firms with a more rational means of financing their long-term needs, it will improve the Brazilian financial system's ability to accommodate the process of economic growth.

The "supply-leading" explanation of the relationship between financial development and economic growth takes the opposite view of the nature of cause and effect. The proponents of this viewpoint argue that the creation and improvement of financial institutions and the supply of their financial assets, liabilities, and related financial services in advance of the demand for them has two positive effects on real growth: (1) it transfers resources from the traditional (non-growth) sectors to modern sectors, and (2) it promotes and stimulates an entrepreneurial response in these modern sectors. Yale economist Hugh Patrick states this arrangement as follows:

"New access to such supply-leading funds may in itself have substantial, favorable expectational and psychological effects on entrepreneurs. It opens new horizons as to possible alternatives, enabling the entrepreneur to "think big". This may be the most significant effect of all, particularly in countries where entrepreneurship is a major constraint on development. Moreover, the top management of financial institutions may also serve as entrepreneurs in industrial enterprises. They assist in the establishment of firms in new industries or in the merger of firms not only by underwriting a substantial portion of the capital, but more importantly by assuming the entrepreneurial initiative" 1/.

1/ Patrick, ibid., page 176

Although there are a number of Brazilians playing the dual role of managing financial institutions and acting as entrepreneurs of an industrial enterprise, this is not a general characteristic of the Brazilian economy. There is, however, one salient characteristic of the FUMCAP program which makes the above argument relevant. One glaring deficiency of the typical Brazilian industrial enterprise is the inadequacy of its financial structure in supporting future expansion. A cursory glance at the balance sheet data shown in Table 8, Exhibit 8 will confirm this assertion. Not only will the FUMCAP program provide firms with alternative sources of funds to rationalize their financial structure, but it will also improve the investment bankers' ability and knowledge to educate Brazilian entrepreneurs in the proper use of financial instruments. This is particularly necessary since Brazilian underwriters should act as financial consultants to firms, identifying the financial problems of the past and recommending the proper mix of financing needed in the future. The number of people qualified to conduct this type of sophisticated financial analysis is very limited in Brazil.

The Paulding survey of Brazilian firms who are potential candidates for new underwritings shows very clearly that little if any financial planning is currently being conducted by these firms. This absence of financial planning precludes any rational analysis of the costs and benefits of using different types of instruments to finance capital expenditures. The role of the underwriter as educator and advisor to firms becomes highly relevant in this context. The FUMCAP program should significantly improve this situation (1) through the inducement to the growth of underwriting as a widely available service to Brazilian firms; and (2) through the qualitative improvement in the art of underwritings, which will be accomplished through the technical assistance part of the loan as well as by the changes in the regulations imposed on underwriters.

Although it cannot be said that supply leading finance or the provision of financial services to firms under the FUMCAP program are necessary or sufficient conditions for the continuance of real growth in Brazil, it does represent an opportunity to induce some real growth through financial means.

One can get a fuller appreciation of the importance of the "supply-leading" argument by examining the relationship of the stock of financial assets and liabilities to the real capital stock of Brazil. If we can assume that the positive relationship between the stock of capital and real output is strong and direct, then the growth objective of the financial system is to achieve the structure and rate of growth of various financial assets and liabilities which are consonant with and even induce the optimal characteristics of the real capital stock. In other words, real growth can be brought about by either an increase in the size of the capital stock or by an improvement in the composition of the capital stock. Improvements in the financial system, in turn, can lead to increases or changes in the structure of this stock of capital.

The two major ways by which the financial system can induce real growth via this method are:

(1) By encouraging a more efficient allocation of wealth; and
(2) By increasing the rate of capital accumulation.

(1) Changes in the allocation of a given amount of tangible wealth

The composition of an individual's portfolio of asset holdings is largely determined by the nature of alternative investment opportunities that he perceives to be available to him. Not all holders of tangible wealth are capable of transforming their wealth into productive assets, i.e., holding their wealth in forms which will increase its size over time. In countries with poorly developed financial markets (equity markets in particular), the profitable use of wealth is normally limited to people who have the managerial or entrepreneurial ability to transform savings into productive investments. The improvements in the financial system which will result from the FUMCAP program will increase the opportunities of wealth holders to hold financial assets of superior characteristics to land, consumer durables and cash as a store of wealth. The creation of a virtually new instrument for public consumption, long-term debentures, as well as the expansion of the availability of stocks to be sold in the market under conditions much more favorable to the general public, provides a far better opportunity for holders of tangible wealth to trade their relatively less productive assets for relatively more productive financial assets, and for entrepreneurs to arrange the transformation of these freed, tangible assets into a more productive form namely, capital.

Another important service to be provided by a properly functioning financial system is one of allocating available resources to their more efficient uses. This is the function of a price system in any market. The interest rate structure in Brazil is in need of significant improvement. The legacy of inflation and somewhat arbitrary attempts by the government to keep interest rates low by decree (e.g. the imposition of maximum nominal rate changeable by commercial banks for various types of loans), has resulted to a very artificial set of interest rates which does not accurately reflect the profitable opportunities available. Although the FUMCAP program will not alter the entire interest rate structure it will significantly improve one important part of that structure by allowing firms to sell long-term bonds at rates of interest determined by the market. The agreement of the BOG to remove the arbitrary fiscal incentives from one other significant long-term debt instrument on the market (Letras Imobiliarias) is another important step in the direction of creating an efficient market for the allocation of long-term credit.

This crucial change in the composition of a given amount of wealth brought about by FUMCAP induced improvements in the financial system should result in a more efficient allocation of the economy's resources, moving it toward existing production frontiers. It is the result of, on the one hand, the provision of greater opportunities for private wealth holders to substitute financial assets for real assets in their portfolios and, on the other hand, the expanded ability of entrepreneurs to incur financial liabilities enabling them to hold a larger amount of productive assets than they could have otherwise.

(2) Increasing the rate of capital accumulation

Many economists have argued that the financial system stimulates additional savings by offering a wider array of financial assets. A number of studies of Asian countries have shown that there is a correlation between a higher, and rising, saving rate relative to GNP and an increase in the proportion of savings held in the form of financial assets relative to tangible assets. The theoretical argument supporting this relationship emphasizes the fact that greater savings is stimulated when the returns on savings are greater because of the provision of new assets having higher yields, lower risks, and/or other desirable characteristics. With the terms of trade (the exchange ratio) between savings and consumption becomes relatively more favorable to the former, individuals substitute increased saving for consumption out of current income.

The data required to test the relevance of this hypothesis for the Brazilian economy is, unfortunately, not available. Although a number of researchers have attempted to isolate the determinants of saving in Brazil, their findings do not allow us to come to any definitive conclusions about the impact of rates of return on the size of saving. We are, however, tempted to accept the argument on the basis of the <u>prima facie</u> evidence presented in these studies and on the basis of common sense. The historical ratio of domestic savings to GNP in Brazil is estimated to be approximately 15%. This ratio is not only relatively low when compared to similar ratios in less developed countries, but, contrary to expectations, marginal changes in this ratio do not correlate well with changes in income. Since Brazil has the unrealized potential for saving a greater percentage of its marginal income, we have adopted the tentative conclusion that the widening of the array of financial assets available to the public can increase the amount of savings in Brazil.

If we accept the validity of this presumption, one important macroeconomic benefit of the FUMCAP program will be the increased supply of funds to productive users who have been quite limited in their ability to receive required funds under highly imperfect market conditions and who would be willing to pay higher rates for the use of these funds in order to expand.

Loans & Financing to Private Sector 1/, 1964-1969 and 1970 (September)

Balance at End of Year - Cr$ millions

	1964		1965	1966	1967		1968	1969		1970
	Am't	% Total	Am't	Am't	Am't	% Total	Am't	Am't	% Total	End Sept
Total Loans & Financing	4,345	-	7,310	10,290	16,740	-	28,545	41,512	-	53,279
a) Index	-	-	168	141	163	-	171	145	-	128
A) Working Capital & other short term loans	3,690	84.9	6,207	8,375	13,560	81.0	22,390	31,256	75.3	38,157
a) Index	100	-	168	135	162	-	165	140	-	122
b) Financial Associations & Investment Banks	245	5.6	695	1,083	2,069	12.7	4,240	5,601	14.9	6,508
1 - Investment Banks	-	-	-	129	695	-	1,342	2,930*	-	4,642
2 - Financial Institutions	245	-	695	954	1,374	-	2,898	2,671	-	1,966
c) Commercial Banks 2/	2,226	51.2	3,914	4,821	7,931	47.4	12,573	17,158	42.0	21,735
1 - Loans 3/	2,226	-	3,914	4,821	7,931	-	12,573	16,941	-	21,035
2 - Bank of Northeast	-	-	-	-	-	-	398	517	-	700
3 - Amazon Bank	-	-	-	-	-	-	-	-	-	-
d) National Bank for Economic Development	-	-	-	-	-	-	-	- 5/	-	- 5/
e) National Cooperative Credit Bank	6	-	13	18	30	-	53	88	-	81
f) For South Development Regional Bank	-	-	-	-	-	-	10	10	-	10
g) Bank of Brazil	1,135	26.1	1,422	2,183	2,957	17.7	4,362	6,412	15.4	7,909
1 - Normal Transactions	-	-	-	-	-	-	4,304	6,315	-	7,711
1.1 - CREAI	340	-	415	691	1,019	-	1,650	2,333	-	1,884
1.2 - CREGE	795	-	1,005	1,469	1,919	-	2,654	3,982	-	5,827
2 - Specific Transactions	-	-	-	-	-	-	58	97	-	198
2.1 - CREAI	-	-	-	-	-	-	58	97	-	102
2.2 - CREGE	-	-	-	-	-	-	-	-	-	96
2.3 - CACEX	-	-	2	23	19	-	-	-	-	-
h) Savings Banks	78	1.8	163	270	519	3.1	834	1,116	2.7	926

Cont'd. Table

	1964		1965	1966	1967		1968	1969		1970
	Am't	% Total	Am't	Am't	Am't	% Total	Am't	Am't	% Total	End Sept
B) Long Term Capital Loans	655	15.1	1,103	1,915	3,180	19.0	6,155	10,256	24.7	15,122
a) Index	100	-	168	174	166	-	194	167	-	147
b) National Bank for Economic Development	303	6.9	572	858	1,927	11.5	1,921	3,002 6/	7.2	4,022 6/
c) National Housing Bank 7/	-	-	19	73	327	1.9	1,412	2,920	7.0	4,851
d) Northeast of Brazil Bank	-	-	-	-	-	-	379	551	-	575
e) Amazon Bank	-	-	-	-	-	-	-	-	-	-
f) FINAME	-	-	33	91	140	0.8	280	429	1.0	519
g) Far South Develop. Regional Bank	2	-	9	18	30	-	46	80	-	132
h) National Cooperative Credit Bank	1	-	7	13	18	0.1	30	42	0.1	44
i) CEPLAC	-	-	-	-	-	-	22	36	-	57
j) Bank of Brazil	274	6.3	530	595	912	5.4	1,373	2,077	5.0	2,616
1 - Normal Transactions	-	-	-	-	-	-	1,220	1,845	-	2,286
1.1 - CREAI	261	-	513	563	856	-	1,204	-1,820	-	2,179
1.2 - CREGE 4/	-	-	-	-	-	-	16	25	-	107
2 - Specific Transactions	-	-	-	-	-	-	155	252	-	330
2.1 - CREAI	-	-	-	-	-	-	153	[illegible]	-	32
2.2 - CREGE	-	-	-	-	-	-	2	4		298
2.3 - CACEX	11	-	17	32	57	-	-	-	-	-
k) Savings Banks 7/	76	1.7	154	268	326	1.9	690	1,159	2.7	2,308
l) Investment Banks	-	-	-	14	55	0.3	[illegible]	[illegible]	1.3	988 *
C) Other Bank of Brazil Accounts Not Classified Above	-	-	-	-	-	-	389	895	-	755
a) Wholesale Prices Indexes, excluding coffee	100	-	131	142	122	-	124	119	-	115

1/ Includes joint economy agencies.
2/ Includes Res. nº 5 and excludes financial agencies, FINAME (Commercial Banks) and BNB (Investments).
3/ Includes Bank of Amazon (working capital and investment) and BNB (Working capital and investment), the later until Dec. 1967.
4/ Values in item "CREGE", working capital, until Dec. 1966.
5/ Data included in BNDE investment.
6/ Includes FUNGIRO.
7/ Excludes BNH money.
Source: CENTRAL BANK REPORTS

* As of December 1970
May 20, 1971

REGISTRATION OF THE UNDERWRITINGS PLACED WITH THE PUBLIC OR WITH 157 FUNDS

Since 2/10/67

(In Cr$1,000)

Years	Public Offering					
	Shares		Debentures		Total	
	Cr$	No.	Cr$	No.	Cr$	No.
1967	-	-	-	-	-	-
1968	105,291	13	-	-	105,291	13
1969	143,046	51	3,000	1	146,046	52
1970	341,790	83	63,790	3	405,580	86

OPERATION HEADED BY INVESTMENT BANKS

Years	Cr$	No.	Cr$	No.	Cr$	No.
1967	-	-	-	-	-	-
1968	47,511	6	-	-	47,511	6
1969	47,945	13	3,000	1	50,945	14
1970	120,934	18	63,790	3	184,724	21

REGISTRATION OF THE UNDERWRITINGS PLACED WITH THE PUBLIC OR WITH 157 FUNDS

Since 2/10/67

(In Cr$1,000)

Years	Totals					
	Shares		Debentures		Total	
	Cr$	No.	Cr$	No.	Cr$	No.
1967	54,743	49	2,600	1	57,343	50
1968	219,855	122	3,700	2	223,555	124
1969	426,325	145	5,000	2	431,325	147
1970	447,205	127	67,540	4	515,165	131

OPERATION HEADED BY INVESTMENT BANKS

Years	Cr$	No.	Cr$	No.	Cr$	No.
1967	38,338	23	-	-	38,338	23
1968	120,424	55	-	-	120,424	55
1969	241,504	60	5,000	2	246,504	62
1970	208,727	45	67,540	4	276,267	49

The average underwritings placed with the public by the Investment Banks in 1970 was valued at about Cr$8.8 million whereas those underwritings undertaken by other financial institution (corretoras, etc.) amounted to approximately Cr$3.3 million. 1/ The Investment Banks are clearly bringing the larger and more important firms to the Capital Market for equity financing. The size of the underwritings and the characteristics of the firm are clearly important vis-a-vis the secondary-market liquidity of underwritten securities and the assurance that the investor will be investing in substantial enterprises.

1/ Editorial - "underwriting Operations", Boletim da ANBID, N° 26, Ano II (December, 1970)

REGISTRATION OF THE UNDERWRITINGS PLACED WITH THE PUBLIC OR WITH 157 FUNDS

Since 2/10/67

(In Cr$1,000)

Years	Decree Law No. 157					
	Shares		Debentures		Total	
	Cr$	No.	Cr$	No.	Cr$	No.
1967	54,743	49	2,600	1	57,343	50
1968	114,564	109	3,700	2	118,264	111
1969	283,279	94	2,000	1	285,279	95
1970	105,415	44	3,750	1	109,165	45

OPERATION HEADED BY INVESTMENT BANKS

Years	Cr$	No.	Cr$	No.	Cr$	No.
1967	38,338	23	-	-	38,338	23
1968	72,913	49	-	-	72,913	49
1969	193,559	47	2,000	1	195,559	48
1970	87,793	28	3,750	1	91,543	29

Flow of Long-Term Funds into the Private Business Sector

(in Cr$ Million)

		1965	1966	1967	1968	1969	1970
1)	New Companies	111.3	124.9	491.4	871.8	1,048.7	1,913.4
	Incorporation of Reserves	434.8	966.3	957.0	1,317.6	8,641.9	6,797.3
	New Money	1,133.8	1,644.5	2,428.9	3,911.4	5,070.5	5,599.6
	Sub Total	1,679.9	2,735.7	3,877.3	6,100.8	14,761.1	14,310.3
2)	National Development Bank (BNDE)	253.7	173.8	221.4	237.8	358.4	515.8
	Bank of the Northeast (BNB)	469.2	504.8	(-641.3)	513.0	278.9	403.3
	Bank of the Amazon (BASA)	8.0	9.4	57.3	300.7	121.7	56.3
	National Housing Bank (BNH)	18.9	69.6	359.3	1,528.6	1,756.2	2,648.1
	Bank of Brazil(BoB)	132.9	536.7	566.5	974.2	1,321.1	1,760.5
3)	Private Investment Banks	-	43.4	88.1	444.5	716.3	1,540.9
	New Equity(public offerings plus placement with 157 funds)	-	-	54.7	219.9	426.3	447.2
	Debentures (public offerings plus placement with 157 funds)	-	-	2.6	3.7	5.0	67.5
4)	Instruction 289	243.0	363.3	(-13.4)	499.5	48.3	-
	Law 4,131	643.5	3,791.6	(-112.2)	(-164.0)	2,305.0	-
	Resolution 63	-	-	28.6	1,001.3	950.1	-
	Inter-American Development Bank(IDB)	591.3	91.9	(-187.8)	440.1	727.7	-
	World Bank (IBRD)	-	378.6	19.2	207.4	349.0	-
	International Finance Corporation(IFC)	-	36.0	4.2	63.1	48.1	-
	A.I.D.	52.9	(-2.7)	171.9	(-95.0)	337.4	(-294.3)
	Total:-	4,093.3	8,732.1	4,496.4	12,275.6	24,510.6	
6)	Group 1 as a % of Total	41.0	31.3	86.2	49.7	60.2	

The Stock of Total Capital
Firms with a Capital Base of at least $2 million

(in Cr$ million)

Sectors		1964	1965	1966	1967	1968	1969
Commerce	No.	68	72	76	71	75	76
	Value	140.6	252.7	397.7	638.1	947.9	1,585.2
Industry	No.	449	482	500	494	525	542
	Value	1,821.9	3,839.1	5,424.5	9,046.2	12,598.8	18,314.9
Textiles	No.	42	44	46	42	45	46
	Value	137.9	271.8	526.1	595.4	777.6	1,164.4
Construction	No.	45	49	50	50	51	53
	V	92.1	156.1	220.5	338.8	569.1	992.0
Steel and Metalurgy	No.	42	45	46	44	48	51
	V	347.9	694.1	869.6	1,460.9	1,959.3	2,765.3
Chemicals	No.	47	50	51	43	47	50
	V	118.4	232.1	348.4	374.5	783.4	1,193.0
Food Processing	No.	73	83	85	80	88	92
	V	185.1	472.1	718.8	1,070.3	1,389.5	2,023.3
Machinery and Equipment	No.	36	37	40	43	43	45
	V	81.8	149.5	206.6	376.3	475.5	727.7
Automobile (including parts)	No.	26	27	26	27	29	29
	V	207.0	370.0	466.1	620.8	843.4	1,258.2
Others	No.	138	147	156	165	174	176
	V	651.6	1,493.4	2,068.3	4,209.1	5,800.1	8,191.1
Services	No.	62	61	66	61	65	68
	V	708.5	1,289.8	3,311.8	4,489.1	6,718.2	10,157.3
Others	No.	21	22	24	22	24	25
	V	40.0	76.0	108.3	154.4	196.8	404.0
Total:-	No.	600	637	666	648	689	711
	V	2,711.1	5,457.7	9,242.2	14,317.8	20,460.9	30,461.5

Retained Earnings

Firms with Capital Base of at least $2 million

(in Cr$ million)

Sectors		1964	1965	1966	1967	1968	1969
Commerce	No.	55	63	62	63	66	74
	V	33.3	81.8	91.5	196.6	255.1	263.9
Industry	No.	388	437	443	459	473	495
	V	723.0	989.1	1,144.0	1,043.3	1,819.9	2,427.8
Textiles	No.	38	38	37	39	43	41
	V	66.3	56.0	76.5	71.2	197.3	130.8
Construction	No.	40	46	44	48	50	46
	V	7.0	15.5	22.9	49.5	147.9	180.7
Steel and Metalurgy	No.	31	36	38	37	41	45
	V	60.1	94.3	43.7	-13.3	243.3	241.7
Chemicals	No.	41	46	52	40	46	46
	V	34.7	61.5	71.5	71.7	103.9	100.8
Food Processing	No.	62	77	73	70	77	81
	V	54.2	92.9	91.8	123.9	109.8	198.0
Machinery and Equipment	No.	29	35	32	42	41	43
	V	19.1	33.7	25.1	23.8	84.4	129.3
Automobile (including parts)	No.	24	26	27	26	25	29
	V	80.5	87.1	118.0	54.8	102.5	221.5
Others	No.	123	133	140	157	150	164
	V	401.0	548.5	694.4	661.5	820.6	1,224.9
Services	No.	56	49	54	58	56	61
	V	95.9	63.7	317.7	356.0	513.2	1,056.1
Others	No.	20	20	20	22	20	24
	V	1.8	4.9	4.6	9.0	12.1	27.5
Total: -	No.	519	569	579	602	615	654
	V	854.0	1,139.6	1,557.8	1,604.9	2,600.3	3,775.3

New Equity

Firms with Capital Base of at least $2 million

(in Cr$ million)

Sectors		1964	1965	1966	1967	1968	1969
Commerce	No.	68	72	76	71	75	76
	V	61.9	51.8	64.8	87.8	147.8	325.3
Industry	No.	449	482	500	494	525	542
	V	331.1	829.6	294.1	903.6	1,793.1	2,680.8
Textiles	No.	42	44	46	42	45	46
	V	24.4	30.8	77.6	82.4	244.2	333.9
Construction	No.	45	49	50	50	51	53
	V	21.7	28.6	40.2	54.4	146.3	232.0
Steel and Metalurgy	No.	42	45	46	44	48	51
	V	28.6	220.5	47.4	126.5	274.3	583.4
Chemicals	No.	47	50	51	43	47	50
	V	38.9	50.9	28.4	28.0	341.7	185.0
Food Processing	No.	73	83	85	80	88	92
	V	49.8	155.7	107.3	197.9	187.0	315.8
Machinery and Equipment	No.	36	37	40	43	43	45
	V	40.4	28.6	28.6	111.7	58.9	125.3
Automobile (including parts)	No.	26	27	27	27	29	29
	V	17.7	23.3	61.8	89.0	124.8	184.0
Others	No.	138	147	156	165	174	176
	V	109.5	291.1	224.0	338.0	424.9	721.2
Services	No.	62	61	66	61	65	68
	V	110.7	283.4	1,391.9	422.5	1,096.5	2,063.5
Others	No.	21	22	24	22	24	25
	V	26.1	21.8	16.5	41.3	30.9	166.3
Total:-	No.	600	637	666	648	689	611
	V	529.9	1,186.6	1,767.4	1,474.7	3,068.3	5,235.9

Sectoral Breakdown of BNDE Lending

(in Cr$ million)

Sectors	1964	1965	1966	1967	1968	1969	1970
Commerce	-	-	-	-	-	-	-
Industry	10.8	146.6	1,197.4	51.3	598.0	1,130.0	1,133.5
Textiles	-	1.0	-	5.0	10.5	13.6	19.7
Construction	-	-	-	1.7	1.4	33.6	-
Steel and Metalurgy	5.8	125.6	1,114.4	33.2	221.7	200.1	784.9
Chemicals	-	4.8	7.8	6.1	9.4	19.1	222.7
Food Processing	-	-	-	0.1	0.6	-	-
Machinery and Equipment	2.9	5.1	66.1	3.3	23.1	48.0	6.4
Automobile (including parts)	1.6	9.6	1.1	0.8	-	3.7	-
Others	0.5	0.5	8.0	1.1	93.3	213.9	99.8
Services	38.8	11.8	37.6	176.8	323.3	228.5	427.0
Others	0.03	-	-	9.9	139.4	112.3	-
Total:-	49.63	158.4	1,235.4	238.0	1,060.7	1,470.8	1,560.5

Flow of Funds Averages for Firms with a Capital Base of Cr$10 million or more and with a Rate of Return Exceeding 20%. (Numbers are Percentages)

	INDUSTRY			SERVICE			COMMERCE		
	Large	Medium	Small	Large	Medium	Small	Large	Medium	Small
Uses of Funds									
Increase in Current Assets	33.39	44.47	43.34	23.25	20.46	25.00	32.83	73.00	59.13
Increase in Fixed Assets	39.46	37.24	42.04	45.70	54.48	39.90	56.47	11.15	28.47
Decrease in Current Liabilities	2.28	1.85	0.45	1.35	6.64	-	-	-	5.67
Decrease in Long Term Liabilities	10.09	2.08	1.63	-	-	4.50	4.30	-	-
Depreciation	13.88	11.13	11.69	21.50	18.42	17.60	5.67	15.90	6.10
Dividends	-	3.22	0.86	8.20	-	13.0	-	-	0.63
Loss for the year	-	-	-	-	-	-	0.73	-	-
Total:-	99.99	100.00	100.00	91.80	-	-	100.00	100.00	99.37
Sources of Funds									
Increase in Current Liabilities	20.08	19.41	19.08	16.00	12.98	10.80	25.53	36.20	32.57
Increase in Long Term Liabilities	11.77	9.79	5.91	24.45	19.40	18.00	0.47	3.80	1.47
Decrease in Current Assets	1.08	-	0.57	-	6.12	-	18.60	-	-
Decrease in Long Term Assets	0.98	-	-	-	-	9.70	-	4.45	-
Depreciation	13.88	11.13	11.69	21.50	18.42	17.60	5.67	15.90	6.10
Profit for the year	23.08	35.27	40.64	27.40	18.78	20.10	24.00	28.10	47.43
Sub-Total:-	70.86	75.60	77.88	89.35	75.70	-	74.27	88.45	87.57
Increase in Capital or Reevaluation of Fixed Assets	29.14	24.40	22.13	10.65	24.30	23.80	25.73	11.55	12.43

Source: Paulding Associates

Table 9

PRELIMINARY FIGURES

- Firms with a net worth of Cr$10 million or more
- Firms with a return on equity of 20% or more

		RETURN ON EQUITY			RETURN ON ASSETS		
		Group	Overall	Overall/BT	Group	Overall	Overall/BT
Industry (79)	Large	13.4			9.4		
	Medium	25.1	25.3	36.1	15.9	17.0	24.3
	Small	31.2			21.5		
Service (13)	Large	19.2			7.8		
	Medium	41.6	32.8	46.8	13.8	14.0	20.0
	Small	30.0			16.3		
Commerce (8)	Large	25.7			13.3		
	Medium	31.1	33.1	47.3	15.7	16.7	23.8
	Small	41.9			20.8		
		Overall ...	26.9	38.4		16.5	23.7

% OF TOTAL ASSETS

		APPLICATIONS		LT FINANCING	
		Working Capital	Fixed Assets	LT Debt	Equity
Industry	Large	22.9	54.1	10.7	66.3
	Medium	26.7	47.5	9.2	65.0
	Small	26.5	50.5	8.7	68.4
Service	Large	0.2	52.6	6.2	46.5
	Medium	26.1	59.9	33.6	52.4
	Small	14.9	69.7	20.6	63.3
Commerce	Large........	23.6	41.6	6.8	58.5
	Medium	28.7	24.2	1.5	51.4
	Small	30.8	24.3	1.1	53.9
Average				10.9	58.6
Debt				17%	
Equity					83%

REGULATORY ANALYSIS

1. Capital Market Development and the Need for Effective Securities Regulation

The dramatic surge of interest in equity securities of Brazilian companies within the past few years has been reflected in substantial increases in trading volumes on the Rio, São Paulo and other smaller stock exchanges as well as in the number and value of underwritten public offerings of securities. It also has been accompanied by substantial increases in other significant indicia of capital market growth including increases in the number of brokerage firms, number of personnel employed by brokerage firms, number of mutual funds, and number of investors who participate directly in the market. This growth shows no signs of abatement.

As trading volume has increased so have the price levels of outstanding securities actively traded on the exchanges. The nature and extent of the stock market activity has led one prominent U.S. news periodical to characterize the Rio stock exchange as the "Samba Market", and, indeed, heavy trading for short term speculation has been the predominant tone in that market. Although precise figures are not available, the available evidence indicates a rapid turnover rate among many of the actively traded stocks and the overall impression is a climate in which investors calculate their gains by the day and the week, not years or even months. In such a market investment considerations tend to focus upon the market trends rather than the growth potential of the company issuing the securities.

Characterization of the Brazilian stock market as a "Samba Market" overlooks some significant facts. For example, the two securities which have attracted the greatest trading interest and by far the largest amont of investor money are the common stocks issued by Banco do Brasil and Petrobras, a government controlled bank and oil company respectively, which are substantial and (in the case of Banco do Brasil at least) highly profitable enterprises. Under Brazilian law, common stocks of banks and oil companies can be issued only as registered shares as opposed to bearer shares predominant and most favored in Brazil. Except for the original investor, a transfer of stock certificates issued in registered form may require up to six months, and for this period the purchaser is effectively locked into his investment. This relatively long holding period, however, has not precluded the most substantial investor interest in these stocks -- an indication that there may be greater interest in common stocks as long-term investments than has been generally recognized.

Nevertheless, the capital markets in Brazil are young and immature markets in which the ratio between short term speculation and long term investment is much too high in favor of speculation. Such markets do not serve as adequate sources and allocators of long term capital to meet the needs of Brazilian private enterprise. The lack of long term investor interest in the capital markets has impeded the development of a bond market to provide Brazilian industry with long-term credits as a substitute for the roll-over of short-term credits on which it now so heavily depends.

The propensity for short term speculation is reflected in the undesirable underwriting methods not uncommon to the Brazilian financial community. While it is difficult in the context of the short history and rapidly changing conditions of the Brazilian capital markets to characterize any practice as "typical", in many instances underwritings in Brazil are characterized by attempts to excite investor interest and to create the "hot issue", i.e., a security which shortly after its initial distribution trades in the open market at rapidly increasing premiums over the initial offering price.

Underwriters tend to believe that new securities can be successfully distributed only if they can attract speculative interest in the issue. Thus, in many underwritings the issue is deliberately priced at a level substantially below the price/earnings ratios at which outstanding securities of comparable companies are traded. The underwriter restricts the number of shares available for trading after completion of the distribution by placing a substantial amount of the issue in his own accounts, accounts of business associates, close friends and relatives and accounts of mutual funds controlled by it. The underwriter then seeks to excite interest in the stock by buying and selling shares in the trading market at increasing prices. The appearance of activity and rising prices in turn attracts more and more investors into the market for the stock at higher and higher prices. The underwriter then proceeds to feed into the market at substantial profits the large quantities of stock that have been placed in its affiliate accounts. Once this process is complete the underwriter has little incentive to continue support of the market and the price may then drop drastically, with consequent losses to the large numbers of the investing public who purchased the shares at the artificially inflated prices prevailing in the trading market. The effect of this process of underpricing, manipulation, sell-off and withdrawal of support is not only substantial losses to public investors but also a substantial reduction in the amount of proceeds from the offering that under realistic pricing practices would be available to the issuing company. The ultimate result is lack of confidence in the stock market by both public investors and companies that seek financing from such investors.

Such "hot issue" underwriting practices provide a poor base for the development of the Brazilian capital markets as an efficient source and allocator of long-term capital. As long as such practices are commonplace, much remains to be done to convert the capital markets in Brazil from an arena for short-term speculation into a channel for long-term investment.

Predominant use of the securities markets for short-term speculation tends to be encouraged by the existing income tax structure in Brazil. Capital gains, whether long or short term, are not subject to income tax but dividends are taxed at full rates. Changes in the tax laws to prove for taxation of short-term capital gains at full rates and for reductions in the tax on dividends on stock held as long-term investments would assist development of the market as a source of long-term capital and should be given consideration in the future.

But the conversion of the capital markets from a predominantly short-term to a long-term investment arena requires more than favorable tax incentives. It requires a firm underpinning of investor confidence in opportunities for long-term return on their capital. Such confidence is very different from the confidence required for short-term speculation where the investor looks mainly at the current market movements and depends for the success of his investment on his ability to buy and sell with correct timing. The confidence necessary for long-term investment must induce the investor to withdraw his savings from investments in his own business which he knows and controls, from investments in real and personal property which he can identify and appraise with a great deal of certainty, and from investments in short-term commercial paper guaranteed by banks of unquestioned financial stability or by the government. It must induce him to channel these savings into investments which are represented only by a piece of paper evidencing an interest in a business enterprise he has never seen and managed by persons who are strangers to him and whose integrity and competency he is not in a position to evaluate.

Regulation can play an important role in furnishing the necessary underpinning for the development of investor confidence. First, regulation can provide investors with accurate, reliable and current information relating to the business of the company in which they are potential investors including its products, its facilities, its present and potential markets, its capital structure and its securities as well as financial statements prepared and certified by independent accountants.

in accordance with generally accepted accounting principles and auditing standards. Such information assists the investor at the time of initial investment decision in making an informed choice among competing alternatives and on a continuing basis in the valuation of the investment and the determination whether to hold or to sell.

Second, regulation can provide investors with information which enables them to evaluate the integrity of management and which operate as a restraint against management practices inconsistent with operation of the business in the interests of all investors and not only for the benefit of management and insiders. It can provide assurance that the proceeds from the underwriting will be used for the benefit of the company in accordance with the representations in the registration statement and that if the business earns a profit, the public investor expectation for a fair share of that profit will not be defeated. Third, regulation can provide investors with continuing and meaningful assurance of liquidity -- an ability to sell the securities they hold in markets which are reasonably free from fraud, manipulation, and sharp practices so that the prices will reflect the judgments of competing buyers and sellers and not the artificial influence of a few professional traders, insiders or large shareholders.

Regulation also can instill confidence in those who seek financing in the capital markets. It can provide companies seeking capital with assurance that the professional intermediaries serving them have been licensed by the government and meet minimum standards of honesty, competency and financial stability. Regulation can further provide an assurance to a company seeking financing in the capital markets that the price which the company obtains for its securities will reflect a fair evaluation of the company and not merely a price calculated to effect a quick and effortless distribution of the securities by the underwriters.

2. Existing Brazilian Securities Regulation

a. Administration of Securities Regulation

The development of Brazilian capital markets is notable in the extent to which such development has been preceded and accompanied by the development of national securities regulation. Such regulation was enacted not as a political reaction to financial crisis and scandal, as was the case in the United States and other countries, but because of farsighted recognition that adequate security regulation is essential to the development of viable capital markets.

Law 4728 enacted in July of 1965, commonly known as the "Capital Markets Law", gave the Central Bank of Brazil responsibility for the development and implementation of natioanl securities regulation. Under this law the Central Bank was delegated responsibility for 1) supervising the operations of stock exchanges, members of stock exchanges and investment companies; 2) authorizing and regulating the operations of financial institutions; 3) registering public corporations and issues of securities distributed in the capital markets and traded on stock exchanges, and 4) regulating the use of inside information, in securities trading.

These functions are exercised by two divisions of the Central Bank. One division, ISMEC, is primarily responsible for inspecting and monitoring of financial institutions to determine compliance with applicable legislation, checking their accounts and reports for supporting documentation and evaluating internal controls and accounting organization.

ISMEC is organized into three sub-divisions which have responsibility for the supervision of 1) stock brokers, exchanges and distributors of securities; 2) finance companies; 3) investment banks and special assignments. The sub-divisions are supported by a group of 70 experienced inspectors who operate in accordance with reasonably detailed and professionally designed written audit programs for each type of institution.

Although ISMEC appears to have competent personnel and operates under well conceived regulatory programs, it is understaffed. Its actual activities are largely limited to routine review of reports filed with it and the inspection and supervision of those institutions subject to its jurisdiction believed to be in serious difficulty. ISMEC is unable to perform all the auditing functions required of it much less the regulation and supervision reasonably expected of the governmental authority overseeing the operations of broker-dealers, stock exchanges and investment companies. For this reason it does not purport to exercise regulatory functions comparable to that exercised by the SEC over broker dealers, stock exchanges and investment companies.

The other division, GEMEC, concerns itself with the administration of disclosure requirements in the registration of public corporations and the issues of securities for distribution and trading. GEMEC has three major divisions: a financial institution division which reviews the registration statements and reports of financial institutions, a corporation and securities registration division and a study and analysis division with miscellaneous functions. GEMEC administers rules adopted by the Central Bank. It has no independent rule making power. The branch or subdivision of GEMEC with responsibility for administering the registration of corporations and issues of securities has a total of 15 employees including 11 analysts, of whom all but one are economists. The analysts are largely young graduates, since experienced personnel tend to leave the organization for employment at substantially increased salaries with the private financial community. The registration statements received by GEMEC are distributed among the various analysts with no attempt at specialization. The review process consists basically of determining whether all the required information and documents have been submitted and whether the information is internally consistent and appears to be reasonably complete, current and reliable.

In form, this examination process is comparable to that conducted by the SEC with respect to registration statements for public offerings in the United States. An analysis of the workload of GEMEC with respect to corporate and new issue registrations indicates that each analyst must examine between 20 and 25 registration statements per year and therefore an analyst can spend personally on the average two weeks on each registration statement. The workload appears reasonable.

b. Regulation of New Issues

As in the case of SEC regulation, Brazilian securities regulation of new issues of securities is primarily concerned with disclosure of material facts necessary to informed investment decision. Unlike SEC regulation, however, Brazilian national regulation is not supplemented by so-called "Blue-Sky" regulations of various states which, in the United States, often go beyond disclosure and prohibit public offerings of securities where the terms of the offering are deemed inequitable because of excessive dilution, promoter self-dealing, precarious financial condition of the company, or excessive underwriting compensation.

Moreover, prospectuses, as we know them in the United States, are not mandatory in Brazil. New issues can not be approved by the Central Bank, however, unless the minutes of the shareholders' meeting voting upon a new offering is published in the Diario Oficial. Where the distribution in the offing is one of equity, the minutes include declaration of the actual capital of the company, the value of the shares, whether common or preferred, voting or non-voting, and paid in full or on installment. Bond distributions call for a somewhat more complete disclosure pattern, including financial details, amounts of debentures previously issued, par value, interest rate, maturity date, conditions for redemption, time for repayment and, if issued with a mortgage guaranty, certain additional specifics.

Under existing Central Bank regulations a company, prior to a public offering of its securities, must file a registration statement for the securities and, if it has not previously done so, a registration statement to qualify for status as a public company. An analysis of the disclosure requirements for these registration statements indicates an awareness of SEC disclosure practices to which personnel of the Central Bank and GEMEC have been repeatedly exposed through AID technical assistance programs. Under Resolution 88 of the Bank, companies must provide for Bank viewing, inter alia, all financial statements, by-laws and amendments, auditor's certification of the last balance sheet, plan for distribution and placement, together with an undertaking signed by a responsible officer setting forth dividend distribution information and other material which in the judgment of the directors has a bearing on the price of shares. Where convertible debentures are offered, specified relevant information is called for, including the basis for the conversion of the shares, conditions and timing. 1/

Brazilian registration requirements do not, however, call for the mass of detailed factual information found in SEC registration statements. Instead, the Brazilian registration requirements rely heavily on an economic and financial analysis prepared and signed by a qualified economist. The analysis must cover not only the description and history of the company's business, its capital and assets but an analysis of its return on investment, liquidity and turnover ratios, present and future markets and the future plans of the company with emphasis on medium term planning. A registration statement filed with SEC contains no such economic analysis. Instead it confines itself closely to the detailed facts and leaves to the investor the responsibility for making his own analysis and judgments on the basis of those facts. While the SEC believes that analysis of future prospects involving projections and

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1/ Consideration is now being given by the Central Bank to including in the FUMCAP regulatory scheme the requirement that the same information made available to the Central Bank pursuant to Resolution 88, as described in the preceding paragraph, shall also be made available to brokers, by means of prospectuses. This is not to suggest that it is proposed that prospectuses will receive broad distribution, but making them available, on request, will remove difficulties presently attending public viewing of documentation now retained only in the files of the Central Bank.

predictions is too inherently unreliable for use in a prospectus, that position is arguable. Some observers believe that such an analysis should be included in the prospectus, since it is the factor upon which most investors rely upon in making investment judgments.

One cannot criticize present Brazilian disclosure requirements with respect to new issues of securities simply because they are different from the requirements developed by SEC. It is appropriate, however, to analyze those requirements to determine whether they meet the basic needs to investors for the information necessary for long-term investment decision, and for the protections afforded by the restraining influence of disclosure. On the basis of this analysis it is our conclusion that the present registration requirements of the Central Bank are deficient in two significant respects. They are as follows:

(1) In contrast to SEC requirements, the registration statements filed with GEMEC are not required to include disclosure of salaries, bonuses and other remuneration received by the management or information relating to transactions between the company and its management and other insiders or persons and companies affiliated with them.2/

The absence of such disclosure raises a serious question whether existing Brazilian disclosure practices provide an adequate basis for the development of the investor

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2/ It should be noted, however, that some companies do provide such disclosures, e.g., Petrobras, which has provided such information in 1968, 1969 and 1970.

confidence necessary for long-term investments in the capital market. It must be remembered that an investor will entrust his savings to an impersonal and unknown management only if it he has a basis for confidence in the integrity of that management as to a fair allocation of the benefits from the enterprise between the management and the public investors. Disclosure of management remuneration and insider self-dealings provides information material to an evaluation of the integrity of management and to the formation of forming expectations which management should meet. Moreover, disclosure of management renumeration and insider dealings often serves an effective deterrent against unfair management practices.

(2) A second area where present Brazilian disclosure practices are deficient relates to the requirements for financial statements. Under present regulations, registration statements for new issues of securities must contain balance sheets, income statements, and retained earning statements for each of company's last three fiscal years ended prior to filing of the registration. In addition, the registrant is required to fill out forms that provide specific information with respect to retained earnings, assets and liabilities.

However, the information required in the financial reporting section of the registration statement does not conform to that which is considered essential under internationally accepted accounting principles. Inventories are not required to be stated by category and the basis for valuing them need not be disclosed. No specific disclosure or accounting is required for receivables owed by officers, directors, or substantial holders of equity securities. No breakdown of fixed assets my major classes and of sales to parents or subsidiaries is required.

Although financial statements are required to be audited, this auditing requirement is ineffective in absence of the establishment in Brazil of generally accepted accounting principles and auditing standards. Moreover, there are no well defined concepts of professional competence and independence; anyone with a university degree in accounting can sign an audit for the purposes of a GEMEC registration statement.

The Central Bank has authority by legislation to establish accounting and reporting requirements for registrants and auditing standards to be followed by public accountants performing examinations of registrants' financial statements, but it has not as yet exercised this authority.

There are several highly competent and respected accounting firms in Brazil and two professional associations of accountants, one of which has set forth and published in 1966 a booklet setting forth accounting and auditing standards which appear to be fairly comprehensive and reasonably designed to produce fair and reliable financial statements. These guidelines, however, have not been accepted as authoritative by either the accounting profession or the Central Bank.

The reluctance of the Central Bank to act in the area of accounting may be related to the question whether there are an adequate number of accountants presently practicing in Brazil in a position to prepare financial statements in accordance with generally accepted accounting principles and auditing standards. Under Brazil's formal education system a certification of accounting is automatically obtained after graduation from any of the officially recognized schools. There are no uniform standards of qualifications relating to technical competence and work experience. Under these circumstances some members of the accounting profession have expressed the view that the Central Bank would be interfering with the acquired rights of an existing profession if it attempted to establish professional standards which would cause a discrimination in the selection of public accountants by companies desiring to register securities with the Bank.

There can be little doubt, however, that the failure to establish generally accepted accounting principles and auditing standards as well as standards of professional competency and independence has seriously impaired the usefulness of the notable achievements made by Brazil in the development of disclosure requirements for the capital markets. It represents a basic deficiency which should be corrected for the further development of the Brazilian capital markets.

c. <u>Continuing Disclosure Requirements</u>

Until recently the responsibility of the Central Bank and GEMEC for the implementation of disclosure requirements relating to securities was limited to disclosures in registrations of corporations and new issues. The government assumed no responsibility for adopting and implementing continuing disclosure requirements for publicly held companies with outstanding securities actively traded on the stock exchanges. The Rio and certain other exchanges, however, have recognized a responsibility for continuing disclosure; the Rio exchange, for example, has long required that companies file annual financial statements with it, and these statements are published in the Exchange's Bulletin distributed to all members. However the financial statements are not required to be audited, the required contents thereof are not specified and, of course, their reliability has been greatly impaired by the lack of generally accepted accounting principles and auditing standards applicable to the financial reports of publicly held companies.

In July of 1970, the Central Bank inserted in Law No. 5589, which primarily dealt with mechanical problems affecting transfers of stocks, a requirement that companies submit interim earning statements to the stock exchanges on which their securities were traded. The Central Bank has requested that the stock exchanges develop the format and contents of these statements. The Rio Exchange, together with the São Paulo exchange, has worked closely with the Getulio Vargas Foundation and the Brazilian Capital Markets Institute to develop three types of reporting forms; for industrial firms, for commercial firms and for banks. It is contemplated that an earnings statement will be required to be filed for the first six months of a company's fiscal year, and that for the full fiscal year both an earning statement and a balance sheet will be required. The requirements for the statements presently in draft are detailed and will require explanatory footnotes on various of the line items.

Although the exchanges intend to require that the annual financial statements be audited by independent public accountants registered with the Central Bank, the Central Bank has not indicated whether it will maintain a registry of accountants. In any event the absence of generally accepted accounting principles and auditing standards will diminish markedly the efficacy of the requirement for independent auditing.

In addition to the distribution of financial statements to its members, the Rio Exchange also publishes technical analyses of each company traded on the exchange in both provisional and detailed form. These analyses, which contain substantial financial information and analyses useful to investors, are distributed to members and other interested parties. They are available in brokerage houses and at the Exchange for inspection and study by investors and other interested persons.

The effectiveness of disclosure requirements depends, in large measure, not only in the substance and scope of those requirements but also on the thoroughness in which they are administered and enforced. Since exchange continuing-disclosure requirements are relatively new, it is not possible to evaluate the effectiveness of their administration and enforcement. In this connection, however it must be remembered that the remedies available to the exchanges against non-filing or the filing of false reports by a company is limited to suspension or removal of the security from trading on the exchange. Such action, of course, impairs the marketability of the securities and thereby injures the public shareholders of the company.

For this reason, the exchanges in the United States, which exercise similar responsibilities over continuing disclosure and have available the same limited remedies, are reluctant to invoke such remedies. In Brazil, we know of no case where they have been invoked. In so far as we are aware the Central Bank does not assume responsibility for enforcement of continuing disclosure requirements, by resorting to administrative or court action against a recalcitrant company to require that such disclosures be made on a timely basis and be accurate and complete.

d. Protection against Manipulative and Unfair Trading Practices

Under the Brazilian Law, manipulation of securities is a criminal offense. In addition, the Central Bank has authority to suspend or revoke the license of a broker for manipulative activities. In practice, criminal prosecution has been virtually non existent and the authority to suspend or revoke licenses has not been used. The problem in the enforcement of manipulative restraint is complex. Manipulation is a vague concept, which takes on subtle forms and permutations. What may be proper and legitimate supportative trading activity in one context, may be manipulative activity under different facts and circumstances. It is difficult to define by rule as manipulative activity all but the crudest practices. For this reason in the United States, most of the definition of manipulative practices by the SEC has come from administrative and judicial proceedings on a case by case basis, long after the manipulation has occured.

Moreover, enforcement of anti-manipulative restraints requires a large and expertly trained staff to inspect and survey on a continuing basis the trading practices of broker-dealers. SEC enforcement in this area has been hampered by lack of adequate staff and in Brazil, the lack of an adequate staff has made enforcement virtually non-existent. Enforcement of manipulative prohibitions rests in the hands of ISMEC which, as noted above, is understaffed and unable to administer the complex of responsibilities assigned to it.

The exchanges in Brazil, in common with those in the United States, have also recognized a responsibility to guard against unfair and manipulative trading practices in connection with securities listed on the exchanges. Their enforcement and monitoring efforts, however, are largely limited to activities on the floor of the exchange. The Rio exchange maintains a staff of personnel who monitor trading activities with a view towards preventing manipulative practices. It is not uncommon for exchange officials to cancel and reverse trades which have the indicia of manipulative activity. Moreover, the exchange has on relatively rare occasions taken disciplinary action against members who have engaged in such activities. The enforcement capabilities of the exchange, however, are largely limited to activities on the floor and it does not attempt to regulate in any meaningful way activities which emanate off the floor. Indeed, it has no jurisdiction to do so when such activity emanates from persons who are not exchange members.

e. Investor Remedies

Effective administration and enforcement of securities regulation is a huge and complex task. It is unrealistic to expect that this task can be adequately performed solely by government agencies which must necessarily be somewhat removed from the day to day dynamics of the security markets and must depend upon limited budgets subject to conflicting, and perhaps more important, other national priorities. For this reason, in the United States there has been considerable emphasis on private enforcement of the securities laws. One type of such private enforcement emanates from requirements for shareholder voting, which are designed to furnish shareholders, as part owners of the enterprise, with an effective voice in the overall management of the company, as well as a mechanism to voice disapproval of management practices and, in rare cases, to seize control of the enterprise and oust a management with which they are dissatisfied.

Shareholder voting can provide a restraint against management practices which are not in the interest of public investors. But the cost of compliance with the shareholder voting requirements is sometimes criticized as outweighing its benefits.

More important to private enforcement than shareholder voting in the United States has been the right of shareholders to bring lawsuits in the courts, both in a derivative capacity on behalf of the company and in a representative capacity on behalf of a class of shareholders or purchasers of securities, to enforce the federal securities laws. Such actions can result in injunctions against future violations as well as the recovery of damages to compensate investors for losses caused by the violations. While express provisions for such lawsuits are found in various sections of the federal securities law, the courts in the United States have implied rights of civil action even for violations of those provisions where the statute provides no express civil remedies. The Supreme Court of the United States has characterized civil actions by shareholders as an "effective supplement" to government enforcement of the securities laws, and there is little question that they have been a powerful deterrent against violations of the securities laws.

Neither effective shareholder voting nor private rights of action to enforce securities laws are available in Brazil.* Most of the publicly held companies in Brazil issue bearer shares, which are preferred for a variety of reasons by private investors. In the absence of registered shares it is difficult for management to communicate with its shareholders for the purpose of advising them of shareholders meetings and to give them an opportunity vote at these meetings by proxy if, as is usually the case, they do not attend the meeting in person. Moreover, Brazilian corporate law is somewhat lacking in comparison with the corporate law in the United States with respect to provisions for the protection of minority shareholders. In addition, the laws of Brazil do not provide for civil suits brought by shareholders for purchasers of securities on the basis of violation of securities regulations, and there is no indication that the courts will imply such remedies in the absence of express legislative provision. For these reasons, it can be fairly said that private enforcement of the securities laws does not exist in Brazil as an effective supplement to government action.

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* Civil suits are, however, available against certain practices, e.g., mismanagement of the corporation.

3. Recommendations for Regulatory Improvement

In comparing Brazilian securities regulation to the regulation prevailing in the United States, one must recognize that United States securities regulation has developed on the federal level since the early 1930s.

The contents of U.S. securities regulation, including the specific requirements for disclosure, the definition and delineation of manipulative, fraudulent and unfair practices, the accounting principles and auditing standards, the pattern of administration and enforcement, and the existence of effective private remedies for violations, did not spring directly from the basic legislation enacted in the 1930's. Rather it evolved over a period of almost forty years, at times slowly, at other times more dynamically, in response to specific problems arising from the development of the U.S. capital markets.

While United States Securities regulation has been widely hailed as a most effective system of investor protection, those closest to the system are critical of it as being unresponsive to many investor needs and to the changing dynamics of the U.S. securities industry. Such criticism in the past has furnished and will continue to furnish the impetus for further development, change and improvement. It may be correctly said that securities regulation is a never-ending process of striving for an ideal that is ill-defined and never fully attainable.

It is in this context that we approach an evaluation of the Brazilian securities regulation, which unlike U.S. regulation, developed not as a political response to financial crisis and scandal but as a farsighted recognition that such regulation was essential to the development of viable capital markets. In shaping Brazilian securities regulation the Brazilian government has had the benefit of the A.I.D. technical assistance program which has brought its staff in contact with U.S. securities regulation and has enabled it to borrow in its discretion those components of the system which seems most suitable for Brazil in the context of its present economic and capital market development. Accordingly, one must be careful not to attempt to impose on the Brazilian capital market a pattern of regulation which, however well it might operate in the context for which it was shaped, may be illsuited to Brazilian needs.

For this reason, we do not presume competence to suggest thorough going changes in the pattern of Brazilian securities regulation, its judicial enforcement and its corporate law. We have considered only those changes which are deemed essential to proper administration of the capital market loan fund, and to attainment of its objectives. Thus, our recommendations are those which we regard as important prerequisites to the proper administration of the loan fund and the effective development of the capital markets as sources of long term capital financing. Our recommendations encompass three primary areas as follows:

1. The establishment of generally accepted accounting principles and auditing standards for the preparation and certification of financial statements of publicly held companies and of standards of professional competency and independence for certifying accountants.

2. The development of disclosure requirements with respect to management renumeration and transactions between management or other insiders and publicly held companies.

3. The adoption of disclosure and reporting requirements and certain restrictions to insure fair pricing and a bona-fide distribution of issues financed with loan funds and to guard against manipulative activity by underwriters of those issues.

A. Adoption of Generally Accepted Accounting Principles and Auditing Standards

Properly prepared financial statements are essential for the proper evaluation of an investment in securities. They are in fact the bedrock of financial analysis. Financial statements cannot, however, provide assurance of reliability and fair presentation unless they have been prepared by professionally competent and independent accountants who are required to follow, in such preparation, a comprehensive set of generally accepted accounting principles and auditing standards.

Brazil has demonstrated considerable progress in the development of disclosure requirements with respect to the non-financial information necessary for investment decision. It has, however, lagged behind in developing accounting principles and auditing standards for use by independent public accountants in the examination of financial statements. We believe that this deficiency in existing Brazilian securities regulation must be corrected if the FUMCAP loan project is to be properly administered in accordance with its objectives of furthering the development of the Brazilian capital markets as an efficient source and allocator of long term capital to Brazilian private enterprise. Accordingly, we make the following recommendations with respect to financial statements:

(i) The Central Bank should adopt, with the assistance of the Brazilian accounting profession and subject to the approval of A.I.D. or its designee, a basic set of generally accepted accounting principles and auditing standards to which independent public accountants must adhere to in preparing and certifying financial statements of companies whose securities will be offered through FUMCAP. The accounting principles and auditing standards to be adopted by the Central Bank need not be identical to those generally accepted in the United States. Indeed, in some area a significant departure from those principles may well be justified, as, for example, in the area of price level accounting, which is particularly important in Brazil because it has experienced a high rate of inflation.

Attached as Annex VII, Exhibit C to this loan paper is a set of accounting principles and auditing standards. These are proposed only as suggestions and guidelines for the framework in which the Central Bank, with the assistance and advice of the Brazilian accounting profession, may formulate principles and standards best suited to the needs of Brazilian industry and capital markets.

(ii) The Central Bank should define in writing the concept of "independent" public accountant which would include as independent accountants for the purpose of certifying financial statements of a publicly held company, only those persons (1) who are not relatives by blood or marriage of any director or substantial shareholder of the company and (2) who have no direct or indirect financial interest in or relationship with the company, any director or substantial shareholder of the company, any relative of any such person and any other company or enterprise in which a director, substantial shareholder or relative thereof is a director, substantial shareholder or has any material interest. The concept of independence should further be defined to make clear that the accountant must not only be independent in fact but also in mind so that he can approach his responsibility in an objective fashion and in accordance with his professional standards.

(iii) The Central Bank should disqualify any public accountant who cannot demonstrate the professional competence necessary for preparing and certifying financial statements of a company whose securities will be underwritten through FUMCAP. The

Central Bank should excercise this power to insure a high level of professional competence on the part of accountants who seek to certify financial statements as being prepared in accordance with the generally accepted accounting principles and auditing standards adopted by the Central Bank.

In making this recommendation we also have considered the alternative of suggesting that the Central Bank develop and maintain a registry of professionally competent public accountants and that preparation and certification of financial statements for companies whose securities will be underwritten through FUMCAP will be limited to registered accountants. We believe, however, that maintenance of such a registry would constitute an undue administrative burden and subject the Central Bank to unnecessary pressures from accountants who seek the prestige of Central Bank registration but have no practical need for such registration. We believe that the power to exclude persons who cannot demonstrate professional competence, if effectively exercised, will provide adequate protection in this area.

(iv) We recommend that all registration statements for securities of companies being underwritten through FUMCAP include certified financial statements, including balance sheets and income statements, for each of the last three fiscal years prior to filing of the registration statement and that such financial statements be prepared by independent, professionally competent acoountants in accordance with the generally accepted accounting principles and auditing standards adopted by the Central Bank. The Central Bank, however, should have authority to waive this requirement for all but the last fiscal year prior to filing of the registration statement if and to the extent certification of financial statements for three fiscal years would constitute an undue burden on the issuing company.

(v) The Central Bank or FUMCAP should require that every company whose securities have been underwritten through FUMCAP file with the Central Bank and with all exchanges on which their securities are traded, annual financial statements certified by independent professionally competent public accountants in accordance with the generally accepted acoounting principles and auditing standards adopted by the Central Bank Such requirements for financial statements will serve to supplement and buttress the present exchange requirements in this area, and if distributed by the exchanges through their bulletins, will result in wide dissemination among members and availability to public investors.

b. Restraints against Management Remuneration and Insider Transactions with Publicly Held Companies

As previously noted, Brazilian disclosure requirements with respect to registration statements for new issues of securities are fairly comprehensive in non-financial areas. Nevertheless, they do not require disclosure of the renumeration paid by the company to management or that information as to transactions between the company and its management or other insiders be revealed.

The failure to require disclosure of management remuneration and insider transactions represents a basic deficiency in Brazilian security regulation and one that shoulbe corrected if such regulation is to serve effectively the needs of long-term capital investment. As noted previously, it is an essential prerequisite for investor confidence and his willingness to direct savings into long-term securities investments that he have assurances as to the integrity of management, i.e. that management of the company in which he had invested will manage the company in the interest of all shareholder and not just in its own self interest that if the business is profitable, a fair share of those profits will redound to the public investors who have contributed the capital necessary to the success of the business enterprise.

Such disclosures are particularly important in the context of Brazilian business practices. In Brazil it is commonplace for the directors of a company, who are also its active managing officers, to receive, in addition to a basic salary, a percentage of the company's profits as annual compensation for their services. Under the Brazilian law there is a statutory limitation on management bonuses, but only if the corporation does not pay a minimum 6% dividend. There are no limitations on the percentage of profits available to management if the corporation does pay that minimum dividend. Thus, in instances where share ownership of the company is concentrated in the hands of the directors or where shareownership is widely diffused in the hands of public investors, the determination of the percentage of the profits to be allocated to management compensation rests largely in the discretion of the managers.

We believe that these limitations are not adequate. While no governmental authority should presume to determine what portion of the profits should be allocable to management, we believe that public investors are entitled to disclosure of the amount of profits that have been allocated to management and to a commitment as to the percentage of profits that will be allocated in the future. Accordingly, we recommend the following:

1) That each registration statement for companies whose securities are to be underwritten through FUMCAP be required to disclose for management as a group the amount and percentage of the profits allocated to management compensation, whether as salary or as profit sharing bonuses, for each of the last three fiscal years prior to filing of the registration statement.

2) That the registration statement disclose management's intentions as to the amount and percentage of profits that will be allocated in the form of salary and profit sharing bonuses in the future, and that it be understood by management that such representations as to future intentions constitute a contractual commitment to the public investors of the company that such allocations will not exceed the limitations set forth in the registration statement.

3) The annual reports required to be filed with the Central Bank, FUMCAP and with the exchanges on which a company's securities are traded should further disclose for each year the amount of salary and profit sharing bonus allocated to management as a group both in cruzeiros and as a percentage of the company's profits.

The disclosure requirements recommended with respect to management remuneration are somewhat more limited than those required in proxy and registration statements filed by companies registered with the SEC. SEC required disclosures of management compensation includes not only direct salary and other remuneration but also indirect remunerations such as funds set aside for pension and deferred payment plans. Moreover, disclosure of such information is required not only for all officers and directors as a group but also individually for each of the three highest paid officers and directors earning over $30,000 per annum.

We have not suggested that disclosure be required for indirect compensation paid in connection with pension and retirement plans because of the complexity of such computations and because such compensation is not significant in Brazil. We also have not suggested a requirement of disclosure for compensation paid to individual directors out of deference to the local custom and sensitivity concerning such disclosure. We note in this connection that the SEC has on occasion waived its requirements for disclosure of individual executive compensation in connection with public offerings in the United States on behalf of foreign companies, also out of deference to local custom and sensitivity. We believe that such deference is entirely appropriate here and that a significant advance would be made if such disclosures were obtained for the directors of a company as a group.

An equally important deficiency in Brazilian securities regulation is the absence of disclosure requirements or other restraints with respect to transactions between publicly held companies and its management or other insiders. Such restraints against self-dealing are critical to investor protection, which requires that the investor have some assurance that management shall not divert a disproportionate share of the profits from the enterprise to their own benefit.

Ideally self-dealing transactions between a company and its management could be prohibited, except in those instances where an impartial authority can determine that the transactions were fair and reasonable to the publicly held company. Such an approach has been taken in the United States with respect to investment companies registered under the Investment Company Act of 1940. Section 17 of that Act prohibits purchase or sales of securities or other property from or to an investment company by an affiliated person of the investment company, unless the SEC, upon application, can find that the conditions of the transactions are fair and reasonable and do not involve overreaching on the part of any party to the transaction.

Such prohibitions against self-dealing have not been applied in the United States to publicly held companies other than those registered under the Investment Company Act of 1940 and in certain other limited situations. It is considered unrealistic to attempt to do so since conflicts of interests in the management of a publicly held corporation are varied and complex, and it cannot be said that every self-dealing transaction is unfair. Indeed, many times transactions between a company and an insider can represent significant benefits to the publicly held company.

Nevertheless, some restraint against insider transaction must be imposed, particularly in the context of the business structure prevailing in Brazil. It is common in Brazil for large industrial and commercial complexes to be controlled by one person or a family group. The complex often consists of several companies which carry on closely related businesses with other companies in the complex.

For these reasons, we believe it is important to require disclosure of insider dealings with publicly held companies. A requirement of disclosure will operate as a deterrent to overreaching by the management and provide investors with information to form their own judgement as to the integrity of management in their dealings with a publicly held company. Accordingly we recommend that:

1) The Central Bank should require that all registration statements filed by companies whose securities are being underwritten through FUMCAP disclose material transactions between the company and its management or other insiders. For example, the disclosure might cover for the last three fiscal years, prior to filing of the registration statement, all transactions or proposed transactions, including indebtedness, to which the company or any of its subsidiaries was or is to be a party and in which any of the following persons have a direct or indirect material interest: 1) any director of the company or any person proposed to be a director; 2) any security holder of the company who insofar as known to the company owns beneficially directly or indirectly 10% or more of the company's outstanding securities; 3) any relative or spouse of the foregoing persons or any relative of such spouse who has the same home as any of the foregoing persons.

Transactions should be excluded from requirement of disclosure if they are not material or for various reasons may not involve a high potential for overreaches. Some examples of such transactions are: 1) transactions where the rate or charges are determined by competitive bidding or by law or government authorities; 2) transactions which involve bank deposits or other banking services required in connection with the company's business; 3) any transaction where the amount involved does not exceed one hundred fifty thousand cruzeiros; 4) transactions where the interest of the specified person derived solely from ownership of a security and the specified person received no extra or special benefit not shared by all holders of the security; 5) transactions in which the interest of the specified person is solely as a director or a limited partner of a company and that person does not hold a security interest or limited partnership interest amounting to more than 10%; and 6) transactions occurring during a period where the company was not publicly held, if the company does not presently propose to engage in similar transactions in the future.

Disclosures relating to the transactions required to be reported should include a brief description of the transaction, naming the person who had the indirect or direct material interest which required reporting, and stating his relationship to the company and the nature of his interest in the transaction.

The above recommendation follows closely the requirements of the SEC for the disclosure of transactions between management or other insiders of a publicly held company. The only significant difference between this proposal and SEC requirements relates to the exclusion of transactions occurring when the company is privately held, if the company does not propose to engage in similar transactions in the future. We believe that this exclusion is appropriate since transactions between management and a privately helf company furnish little indication as to management's intentions once the company is publicly held and management has assumed fidiciary duties to public shareholders.

4. Disclosures similar to those proposed for registration statements for issues of securities being underwritten through FUMCAP should be contained in annual reports previously proposed to be filed with the Central Bank or FUMCAP and with each exchange on which the company's securities are traded. These disclosures would provide a significant source of continuing information as to management practices and conflicts of interest with public shareholders and further serve as a check upon representations initially made in the registration statement as to future intentions.

5. In addition to the foregoing, disclosure should be required of any securities, or rights to acquire securities, issued or sold to any director of the issuer, any person proposed to become a director, any 10% shareholder of the issuer and any relative or spouse of any such person. Such disclosures should be made in registration statements and annual reports.

c. Underwriting Practices

The third area of critical deficiency in existing Brazilian securities regulation relates to practices in connection with underwritings of securities. As previously noted, it is not uncommon for the offering price of underwritten securities to be deliberately set far below a realistic value for those securities. Underwriters tend to withhold a large portion of the offering from the investing public and then trade in the market with a view toward raising the price of the securities to a point where they can profitably dispose of the securities withheld.

One cannot interfere with the practice of underpricing underwritten securities to the extent that the practice represents a bona-fide business judgement that such pricing is essential to effective public distribution of the securities. But to the extent such underpricing is motivated by opportunities for profit through sales of withheld securities and serves to encourage manipulative activities, it must be curbed. Otherwise the specter is created that FUMCAP funds will be used to finance and subsidize manipulative activities by underwriters. Thus minimum restraints are necessary to preserve the integrity of the administration of the loan fund and are essential to the proper development of the Brazilian capital markets. Accordingly, we recommend the following:

(1) That the Central Bank require that a bona-fide effort be made to distribute securities underwritten through FUMCAP to the investing public and that unless such securities cannot be distributed to the public. Limitations should be placed on the portion of the issue placed with affiliated persons of participating underwriters and dealers, mutual funds affiliated with such underwriters and dealers and all mutual funds. For example the limitations might provide that (a) not more than 10% of any issue of securities be sold in the aggregate to underwriters or brokers participating in the underwriting, any officer, director, partner, 10% shareholder or employee of any underwriter or participating broker, any relative or spouse of any such person, or any company controlled by any of the above persons or companies; (b) not more than 10% of the issue in the aggregate be placed in the account of mutual funds managed by any underwriter or broker dealer participating in the offering or by any officer, director, partner, employee or 10% shareholder of any such underwriter or broker, or any relative or spouse of any such person or any company controlled by any of the above persons or companies, and (c) not more than 50% of any issue of securities be sold to mutual funds, as a group, whether or not such funds are affiliated with the underwriter and/or participating broker.

(2) To implement the above restrictions: (a) all registration statements for securities to be underwritten through FUMCAP should disclose the underwriters' intent with respect to compliance with the above restrictions, (b) each underwriter and participating broker should file promptly after the completion of the underwriting with the Central Bank or FUMCAP a report which states the securities of the issue being underwritten acquired by persons specified in Recommendation No. (1).

(3) Promptly after six months from completion of the underwriting and after one year from such completion, reports should be filed showing the disposition, if any, of the securities sold to such persons and the prices at which such securities were disposed of.

We believe that this system of disclosure and reporting is essential to the development of underwriting practices which encourage fair pricing of the issue and a bona-fide distribution to the public. In making this recommendation we have considered the suggestion that any securities underwritten through FUMCAP which are distributed to affiliated accounts of the underwriter or brokers participating in the distribution be restricted as to resale for a period of one year. We have not made this recommendation in recognition of the fact that persons affiliated with participating underwriters and broker dealers, including publicly held mutual funds managed by such persons, have a legitimate interest in acquiring securities being underwritten and that such a restriction might be unduly harsh and inflexible in the Brazilian context.

We believe that the glare of publicity imposed by the pattern of disclosure and reporting proposed above may well serve as an effective deterrent against undue withholding and provide the information necessary for determination whether more restrictive measures are necessary. Accordingly, we suggest that consideration of a holding period for purchases of underwritten securities by persons affiliated with underwriters and brokers be held in abeyance until the disclosure and reporting system has been put into effect and the results of that system evaluated.

The system of disclosure and reporting should assist in eliminating undue incentives for underpricing initial issues of securities and create better incentives for a bona-fide distribution of those securities to the investing public. Nevertheless, it should be expected that in some instances securities will be traded in the market at prices substantially above the offering price. We question, however, whether proper use of the liquidity fund should permit an underwriter of the offering to support the market at prices above the offering price by buying securities for his own account with the use of liquidity funds. The existence of a trading market in the securities at prices above the recently underwritten offering price furnishes in and of itself concrete evidence that the trading market for those securities is not suffering from a lack of willing buyers and sellers. Justification for support of the trading market for recently underwritten securities after completion of the underwriting rests on the fact that the security is new and unseasoned in the trading market. This lack of seasoning in the trading market may cause the trading price of the security to fall to an unjustifiably low price. Assuming fair pricing, however, there is little basis for arguing that any price above the offering price constitutes an unjustifiably low price.

Accordingly, to preserve the integrity of the loan funds, to avoid the use of funds in market support activities in circumstances which may constitute manipulative activity and to encourage fair pricing in underwritings of securities, we recommend that the Central Bank adopt a rule which would provide that to the extent liquidity funds are outstanding for use by an underwriter or financial agent to finance purchases of stock in support of the market, such underwriter or financial agent should not be permitted directly or indirectly to purchase securities in the market at a price above the offering price except to the extent necessary to fill customer orders.

This proposal is somewhat comparable, but by no means identical, to rules adopted by the SEC to prevent manipulative deceptive practices in connection with trading activity by participants in an underwriting. The SEC rules generally in this area are complex and detailed. Generally speaking, they prohibit any participant or prospective participant in a distribution of securities from bidding for or purchasing the securities being distributed while the distribution is in progress except in certain carefully prescribed situations, including situations involving stabilization transactions. Generally speaking, the stabilization rule permits underwriters of a public offering during a course of the offering to bid for and purchase the securities being distributed at a price not in excess of the public offering price or, if the security being distributed is traded on an exchange, at a price not in excess of a last independent bid or sale price for that security. In no event can the stabilizing price be above the price at which the security is being distributed.

These antimanipulative rules apply only during the course of the distribution and not after the distribution is completed. They do not permit, however, the purchase of securities to cover customer orders if such orders have been solicited. The rule here proposed, on the other hand, would apply beyond the period when the distribution is completed and for as long as liquidity loan funds are outstanding in the hands of the underwriter. However, there are no prohibitions against a underwriter or other participant in the underwriting from soliciting orders from investors to buy at prices above the offering price and from purchasing securities in order to fill such orders.

We believe that the rule as proposed reflects a reasonable balance between the need for market support of newly underwritten securities during the period when it is initially being introduced into the trading market while preventing use of the loan funds to support the market at prices above the offering price under circumstances where the support cannot be rationally justified.

We do not believe that a limitation against the use of liquidity funds for purchasing securities at prices above the offering price should be imposed in the case of price support for bonds which are not convertible into equity securities. The price fluctuation of bonds reflects less speculative elements than equity securities and is closely related to changing interest rates and, in some cases, a judgment as to the likelihood that the issuer will be in a position to honor his debt obligations at maturity. Underwriters using liquidity funds should be in a position to adjust the purchase price to reflect these factors on the basis of their business judgment. Since the factors affecting price fluctuation of bonds are identifiable and such fluctuations are relatively small, there is no need to limit use of bonds funds for liquidity purposes to purchases of the bonds at or below the offering price.

d. Enforcement

Enforcement of the standards set forth in the preceding divisions should be provided for in the agreements between FUMCAP Principal Agents and the underwriters and the agreements between the underwriters and the issuing companies underwritten. The format is simple:

(1) In the agreement between the underwriter and the FUMCAP Principal Agents, it should be provided that violation of stated conditions shall trigger an increase in the interest rate accompanying the Principal Agent/underwriter transaction, with option on the part of the Principal Agent to call the loan.

(2) There should be express provision in the issuing company/underwriter agreement which declares that conditions set forth in said agreement are established for the benefit of shareholders and their successors in interest, and that violation of such conditions is not only actionable by the underwriter pursuant to the terms of the agreement (e.g. paragraph 1 supra), but also subject to specific enforcement and damage actions by the shareholders and successors in interest.

Major conditions set forth in the Principal Agent/underwriter, underwriter/issuing company agreements should be adopted by the Central Bank and the Exchanges as part of their regulations, having the full force and effect of law enforceable to the same extent that other Exchange and Central Bank regulations are.

PROSPECTUS

PART I INFORMATION ON THE ISSUE

a) name and address of firm;

b) date of publication of minutes of General Meeting which authorized the issue and set its conditions, indicating those newspapers of large circulation where publication was made;

c) number and date of registration of issue at the Central Bank of Brazil;

d) conspicuous mention of: "The registration at the CBB means only that there are in the possession of the Bank, for consultation by those interested, the documents and information needed for the evaluation of the risk of the investment by the investor."

e) Characteristics of the issue: total value, number of securities, type (describing exactly the securities which will be floated on the market and also indicating the special rights granted to preferred stock, if available) and nominal value;

f) basic characteristics of the issue;

Breakdown	Offering Price	Underwriting Expenses and Commissions	Net Amount to the Firm (*)
1. By value			
2. Total value			

(*) In the event of underwriting of stocks already available or subscription rights, the expression must be changed to "Net Amount to the Present Shareholders".

g) Conditions and terms for subscription and full payment;

h) Stock Exchange where it is registered; if not yet registered in a Stock Exchange, mention this fact;

i) fiscal incentives if any, to the investor;

j) forecast of placement schedule:

(See next page)

Responsibility	Potential Purchasers					Total
	Public	Mutual Funds	DL 157 Funds	Financial Institutions	Withheld for * the account of the Underwriter	
Institution(s) Leader(s)						
Others						
Total						

(*) Not presently included but proposed for inclusion into FUMCAP Manual.

k) list of financial intermediaries participating in the issue;

l) mention of availability or non-availability of sinking fund;

m) additional explanation deemed necessary.

Remarks: In the case of debentures, the data referred to in item (e) should be complemented with the following:

- mention of numbering and serial number of securities
- remuneration for the securities, and dates of maturity
- date or time and place of payment of interest and amortization. If there is a possibility of call for prepayment, state the times or terms when the holders of debentures may be called by the firm to opt for repayment or conversion into stock;
- time of convertibility into shares, if available;
- basis for conversion, with relation to the number of shares to be issued for each convertible debenture, or between the amount of the principal of the debenture and that of the stocks, specifying the type of stock to be given to the bearer of the convertible debenture;
- guaranty (according to §1 Article 1 of Decree 177-A of 9/15/1893);
- name of the institution or institutions which intend to maintain a permanent market for the convertible debentures.

PART II - INFORMATION ON THE FIRM

Data relative to corporate year ended on ______, _______ and ______

II.1 - Characteristics

a) name of firm
- name and registration in the General Record of Taxpayers
- address
- main office
- legal domicile
- main branches
- other branches

b) summary background on firms activities

c) activities
- principal
- other

d) registrations at the Central Bank of Brazil
- as a legal entity
- as a public held corporation
- issues

e) fiscal year closing on ________, indicating date of publication of the balance sheet in the last three years.

II.2 - Management

a) composition (chart No. 1)
- board of directors
- audit committee
- other committees or council

b) remuneration of board of directors
- fees
- gratifications and participations
- others

c) consolidated by-laws of the firm

II.3 - Corporate Capital

a) composition (chart No. 2)
b) nominal value
c) distribution (chart No. 3)
- directors' holdings
- stockholders with more than 5% of capital
- stocks in the hands of the public
d) evolution (chart No. 4)
e) equity participation in other firms (chart No. 5)
f) profits distribution as set by firm's by-laws.

II.4 - Brief analysis of the market

a) market for product(s)
b) position of the firm vis-a-vis its competitors
c) main competitors

II.5 - Results

a) production and sales (chart No. 6)
b) statement of operational results (chart No. 7)
c) distribution of profits (chart No. 8)
d) effective distribution to shareholders (chart No. 9)
   - dividends
   - stock bonus
e) comparison of assets, liabilities and net worth (chart No. 10)
f) stock net worth value (chart No. 11)
g) liabilities affecting the assets (chart No. 12)
h) loans financed by issuing debentures (chart No. 13)
i) profitability indexes (chart No. 14)
j) liquidity indexes (chart No. 15)
h) average terms for sales (chart No. 16)
l) average term for payment of purchases (chart No. 17)

II.6 - Stocks

a) trading on the market (chart No. 18)
   - Rio de Janeiro Stock Exchange
   - other Brazilian Stock Exchanges
b) average monthly stock quotation in the last 3 years (chart No. 19)
c) stock bonuses and subscription rights (chart No. 20)

Remark: besides fulfilling items I, III and IV as appropriate, if the firm is in process of establishment it should present a brief analysis dealing with the following:

a) Market
   - background
   - product characteristics
   - area of market
   - the firm and its competitors
   - product trading
b) Production Process and Facilities
   - location
   - general and specific aspects
   - description of production process
   - facilities
   - labor force
c) Schedule of sources and uses of resources
d) Costs and profitabilities
e) Conclusions

CHART No. 1

MANAGEMENT (COMPOSITION)

NAMES OF MEMBERS	POSITION	REFERENCE SOURCES

Board of Directors and Audits Committee elected on ____________
Minutes published in Official Gazette of ____________
Mandate expiring on ____________

CHART No. 2

FIRM'S CAPITAL COMPOSITION

Total Capital Cr$ ______
Nominal value per share Cr$ ______

SPECIFICATION	NUMBER	TOTAL PAID UP VALUE
Ordinary Stock		
- Nominative (registered)		
- Bearer		
- Endorsable		
Preferred Voting Stock		
- Nominative (registered)		
- Bearer		
- Endorsable		
Preferred Non-Voting Stock		
- Nominative		
- Bearer		
- Endorsable		
Total		

CHART No. 3

CAPITAL DISTRIBUTION

DIRECTORS, SHAREHOLDERS* (over 5%) and PUBLIC	RELATIONSHIP TO FIRM	No. OF SHARES	VALUE	PERCENTAGE OF CAPITAL

(*) Shareholders holding over 5% of Stock

CHART No. 4

CORPORATE CAPITAL AND ITS EVOLUTION

DATE	INITIAL CAPITAL/AMOUNT OF INCREASE	VALUE CAPITAL AFTER EACH INCREASE	MANNER REALIZING INCREASE	
			Value	Code*

(*) Code: 1. In cash
2. With profits
3. Revaluation of assets
4. With reserves
5. In kind
6. With current account credits

CHART No. 5

STOCK PARTICIPATION IN OTHER FIRMS

NAME OF FIRM	CAPITAL (Cr$1,000)	AMOUNT OF PARTICIPATION	PARTICIPATION FIRM CAPITAL

CHART No. 6

PRODUCTION AND SALES

YEARS	PRODUCTION		SALES	
	UNITS	AMOUNT	UNITS	AMOUNT
19--				
19--				
19--				

CHART No. 7

STATEMENT OF OPERATIONAL RESULTS
(3 last years)

D E T A I L S	19--	19--	19--
A - Amount of Sales			
Services rendered			
- Total			
B - Cost of Sales of Products or Services			
Manufacturing Cost of Products Sold			
- Labor, wages and fringe benefits			
- Materials used (initial inventory + purchases - ending inventory)			
- Depreciation, amortization and write-off			
- Other expenses			
- Manufacturing			
- Maintenance			
Commercial Cost of Sales			
- Commercial and advertising expenses			
T O T A L			
C - Gross Profit (A-B)			
D - Overhead:			
- Administrative expense			
- Directors' fees			
- Tax expense			
- Financial expenses			
- Sunday losses			
T O T A L			
E - Operational Profit (C-D)			
F - Other Income -			
- Financial			
- Participation related			
- Sundry			
G - Net Profit per year (E+F)			

CHART No. 8

DISTRIBUTION OF RESOURCES
(3 last years)

DETAILS	19--	19--	19--
A - NET YEARLY PROFIT			
Plus:			
Previous year balance			
Reversion of Reserves			
B - TOTAL TO BE DISTRIBUTED			
Minus:			
Reserve for bad debts			
Obligatory and tied-up reserves			
Voluntary and untied reserves			
C BALANCE AVAILABLE TO THE MEETING			

CHART No. 9

EFFECTIVE DISTRIBUTION TO SHAREHOLDERS
(3 last years)

YEAR	DATE OF MEETING	AMOUNT DISTRIBUTED	
		DIVIDENDS	BONUS IN CASH

CHART No. 10

COMPARISON OF ASSETS, LIABILITIES AND NET WORTH
(3 last years)

D E T A I L S	19--	19--	19--
A - REAL ASSETS			
AVAILABLE			
SHORT TERM: (up to 180 days)			
- Inventories			
- Accounts Receivable			
- from clients			
- subsidiary associated companies			
- others			
MEDIUM AND LONG TERM (over 180 days)			
- from clients			
- subsidiary or associate companies			
- others			
FIXED ASSETS			
- Technical			
- Financial			
- from subsidiary or associated companies			
- others			
T O T A L			
B - REAL LIABILITIES			
Short term (up to 180 days)			
- from suppliers			
- from subsidiary or associated companies			
- from directors and shareholders			
- from financial institutions			
- others			
Medium and Long Term (over 180 days)			
- from suppliers			
- from subsidiary or associated companies			
- from directors and shareholders			
- from financial institutions			
- others			
T O T A L			
C - NET WORTH (A - B)			

CHART No. 11

NET WORTH PER SHARE (On December 31)

YEAR	NET WORTH (A)	PAID IN CAPITAL (B)	NET WORTH PER SHARE (A/B)

CHART No. 12

ENCUMBRANCES ON ASSETS

D E T A I L S	AMOUNT Cr$	CREDITOR ENTITY
Mortgages		
Guaranties		
Others		

CHART No. 13

LOANS THROUGH DEBENTURES

OUTSTANDING VALUES	MATURITY DATES

- Characteristics of debentures

a) type
b) monetary correction
c) interest amounts

Note: Indicate basis for conversion, in the case of convertible debentures

CHART No. 14

PROFITABILITY INDEXES
(3 last years)

DETAILS	19--	19--	19--
a) $\frac{\text{Gross Profit}}{\text{Sales}}$			
b) $\frac{\text{Operational Profit}}{\text{Sales}}$			
c) $\frac{\text{Net Profit}}{\text{Paid-up Capital}}$			
d) $\frac{\text{Net Profit}}{\text{Net worth}}$			
e) $\frac{\text{Dividends}}{\text{Paid-up Capital}}$			
f) $\frac{\text{Dividends}}{\text{Net worth}}$			

CHART No. 15

LIQUIDITY INDEXES
(3 last years)

YEAR	CURRENT	ACID TEST	GENERAL
19--			
19--			
19--			

SOURCE OF DATA: Chart No. 9

CURRENT: $\frac{\text{Cash + Current assets}}{\text{Current liabilities}}$

ACID TEST: $\frac{\text{Cash + Current assets - inventories}}{\text{Current liabilities}}$

GENERAL: $\frac{\text{Cash + Current assets - Medium and Long Term Assets}}{\text{Current liabilities + medium and long term liability}}$

CHART No. 16

AVERAGE TERM OF SALES

YEAR	TERMS (days) (1)
19--	
19--	
19--	

(1) - Obtained by the following formula:

$$\frac{\text{Average balance of accounts receivable from Customers}}{\text{Total sales}} \times 360$$

CHART No. 17

AVERAGE TERM OF PAYMENT OF PURCHASES

YEAR	TERM (days) (1)
19--	
19--	
19--	

(1) Obtained by the following formula:

$$\frac{\text{Average balance of suppliers accounts payable}}{\text{Total purchases}} \times 360$$

CHART No. 18

MARKET TRADING
(cash operations)

YEAR / MONTH	19--	19--	19--
JANUARY			
FEBRUARY			
.			
.			
.			
DECEMBER			
Monthly average			

CHART No. 19

STOCK QUOTATIONS

Cr$1,00

YEAR / MONTH	19 --	19--	19--
JANUARY			
FEBRUARY			
.			
.			
.			
DECEMBER			
MONTHLY AVERAGE			

CHART No. 20

BONUS and SUBSCRIPTION RIGHTS

DATE OF MEETING	PERCENTAGE OF BONUS	% SUBSCRIPTION

MINIMUM ACCOUNTING PRINCIPLES & AUDITING STANDARDS

We believe that the Central Bank, with the assistance of a board of practitioners, should publish the minimum accounting principles and auditing standards which must be followed by firms and public accountants in obtaining FUMCAP financing. The following lists are illustrative only but serve as an indication of what we might expect to be developed.

AUDITING STANDARDS

Auditing standards differ from auditing procedures in that the standards apply to the quality of performance while the procedures relate to the acts to be performed. We would expect that the minimum standards would be similar to the standards shown in "Statement on Auditing Procedure Nº 33" issued by the A.I.C.P.A. and that two procedural requirements would be added to the standards because of the importance normally attached to these procedures by the profession.

GENERAL STANDARDS

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence of mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

STANDARDS OF FIELD WORK

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Note: Two procedural requirements might be included as a part of this standard; i.e. confirmation of receivables and observation of inventories where they are practicable and reasonable and the assets concerned are material to financial position or results of operations.

STANDARDS OF REPORTING

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all

cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

ACCOUNTING PRINCIPLES

The following listing of principles of financial accounting for corporate business enterprise was taken from Accounting Research Study Nº 7, titled "Inventory of Generally Accepted Accounting Principles for Business Enterprises." This Study, published by the A.I.C.P.A. in 1965, is not an official pronouncement of the Accounting Principles Board or of the Institute, but each principle listed below has authoritative support in A.I.C.P.A. and S.E.C. statements.

Objective A. Account for sales, revenues, income, cost of sales, expenses, gains and losses in such manner as to present fairly the results of operations for the period or periods of time covered.

Principle A-1. Sales, revenues and income should not be anticipated or materially overstated or understated. Accordingly, there must be proper cutoff accounting at the beginning and end of the period or periods.

Principle A-2. Costs of sales and expenses should be appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.

Principle A-3. Appropriate charges should be made for depreciation and depletion of fixed assets and for amortization of other deferred costs.

Principle A-4. Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors.

Principle A-5. Contingency provisions and reserves should not be misused as a means of arbitrarily reducing income or shifting income from one period to another.

Principle A-6. Nonrecurring and extraordinary gains and losses should be recognized in the period they occur, but should be shown separately from the ordinary and usual operations.

Principle A-7. There is a strong presumption that all gains and losses will be included in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.

Principle A-8. Disclose rental charges under material leases and capitalize those which are in effect installment purchases of fixed assets.

Principle A-9. If accounting principles in the determination of periodic results have not been consistently maintained, the effect of the change should be stated.

Objective B. Account for the equity capital invested by stockholders through contribution of assets or retained earnings in a meaningful manner on a cumulative basis and as to changes during the period or periods covered. The account structure and presentation in financial statements of a business entity are designed to meet statutory and corporate charter requirements and to portray significant financial relationships.

Principle B-1. In case there are two or more classes of stock, account for the equity capital invested for each and disclose the rights and preferences to dividends and to principal in liquidation.

Principle B-2. From a financial viewpoint the capital invested by stockholders is the corpus of the enterprise and its identity should be fully maintained. Any impairment of invested capital resulting from operating deficits, losses of any nature, dividend distributions in excess of earnings, and treasury stock purchases is accounted for both currently and cumulatively.

Principle B-3. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. There should be no commingling of retained earnings with invested capital in excess of par or stated values.

Principle B-4. Retained earnings should represent the cumulative balance of periodic earnings less dividend distributions in cash, property or stock, plus or minus gains and losses of such magnitude as not to be properly included in periodic earnings. The entire amount may be presumed to be unrestricted as to dividend distributions unless restrictions are indicated in the financial statements.

Principle B-5. Retained earnings may be decreased by transfers to invested capital accounts when formal corporate action has, in fact, changed the composition of the equity capital. Accumulated deficit accounts may be eliminated against invested capital accounts through formal action approved by stockholders, which establishes a new base line of accountability.

Principle B-6. The amount of any revaluation credits should be separately classified in the stockholder's equity section, and it is not available for any type of charge except on reversal of the revaluation.

Principle B-7. Disclose status of stock options to employees or others and changes therein during the period or periods covered.

Objective C. Account for the assets invested in the enterprise by stockholders (through property contributed or retained earnings) and creditors, in a meaningful manner, so that when considered with the liabilities and equity capital of stockholders there will be a fair presentation of the financial position of the enterprise both at the beginning and end of the period. It should be understood that financial position or balance sheet statements do not purport to show either present values of assets to the enterprise or values which might be realized in liquidation.

Principle C-1. Items classified as current assets should be carried at not more than is reasonably expected to be realized within one year or within the normal operating cycle of the particular business. Cash should be segregated between unrestricted and restricted items, and the inclusion of the latter in current assets must be justified by their nature. Receivables should be reduced by allowance accounts to cover expected collection or other losses. Receivables from officers, employees, or affiliated companies should be shown separately. Inventories should be carried at cost or market, whichever the lower. Cost comprises direct costs plus factory overhead costs, and the basis of determination (e.g., Lifo, Fifo or average) should be stated. Prepaid items should be properly chargeable to future periods.

Principle C-2. Fixed assets should be carried at cost of acquisition or construction in the historical accounts, unless such cost is no longer meaningful. Cost of land should ordinarily be shown separately. Cost of construction includes direct costs and overhead costs incurred, such as engineering, supervision and administration, interest and taxes. Items treated as fixed assets should have at least one year of expected useful life to the enterprise, and normally the life is considerably longer. Practicable yardsticks or criteria should be established in order that consistent distinctions may be made between fixed assets, operating expenses and maintenance. Ordinarily, this should be accomplished by creating a catalogue of property units to be included in fixed assets, any lesser items to be charged to current expense. Items no longer in service should be removed by charge to depreciation reserve or expense in order that fixed assets will represent the cost of properties in service.

Principle C-3. Appropriate provision or allowances should be made in order to charge operations with the investment in depreciable assets over the estimated life thereof. The accumulated allowances, less property retirements, should be shown as a deduction from fixed assets.

Principle C-4. Long-term investments in securities ordinarily should be carried at cost. When market quotations are available, the aggregate quoted amounts should be disclosed. Investments in affiliates should be segregated from other investments.

Principle C-5. The costs of intangible items, such as debt discount and expense, patents, copyrights, research and development (if deferred) and goodwill should be shown separately. Limited-term items should be amortized against earnings over their estimated lives. The policy in regard to amortization of unlimited-term intangibles should be disclosed.

Principle C-6. The nature and extent of hypothecated or pledged assets should be shown.

Objective D. Account for all known liabilities in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by stockholders, will fairly present the financial position of the enterprise at the beginning and end of the period.

Principle D-1. All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed on the face of the summary of liabilities or by footnote.

Principle D-2. Current liabilities should include items payable within one year or at the end of the operating business cycle used in the classification of current assets. Accounts should be shown separately for notes payable to banks, notes payable to others, accounts payable (may include payrolls), Federal income taxes accrued, other accrued taxes, accounts or notes payable to officers, and accounts or notes payable to affiliates .

Principle D-3. Long-term liabilities should be described and due dates and rates of interest shown.

Principle D-4. The nature and extent to which specific liabilities are a preferred lien on assets should be shown.

Principle D-5. Deferred income should be separately classified and described.

Principle D-6. Contingent liabilities of importance should be disclosed.

Objective E. Financial statements should comply with the applicable reporting standards included in generally accepted auditing standards. Reporting to investors should be performed on an entity basis.

Principle E-1. Generally accepted reporting standards applicable to financial statements are set forth in Chapters 7, 8, 9 and 11 of Statements on Auditing Procedure Nº 33, which are incorporated in this Inventory.

Principle E-2. Where there is a parent company and one or more subsidiaries, there is a presumption that consolidated statements are more meaningful than separate statements.

Principle E-3. The accounts of consolidated subsidiaries or divisions operating in foreign countries should be translated into dollars at the appropriate rates of exchange.

Principle E-4. Where two or more previously independent entities merge or otherwise combine in such a manner as to constitute a pooling of interests, the new entity inherits the bases of accountability of the constituent entities.

FINAME - INCOME STATEMENTS FOR 1965 - 1970

(Amounts in Brazilian Cruzeiros Thousands)

REVENUES		1965	1966	1967	1968	1969	1970
1.	Long-term loans	1 155	10 996	14 757	20 413	31 190	37 256
2.	Short-term loans	-	60	4 493	5 937	4 094	3 900
3.	Commitment fees	76	430	1 710	2 970	3 133	3 094
4.	Miscellaneous	3	2	5	2	19	104
	Total Revenues	1 234	11 488	20 965	29 322	38 436	44 354
EXPENSES							
5.	Financial	-	-	3 431	5 640	9 838	11 343
6.	Administrative	175	830	1 450	1 342	1 281	1 306
7.	Other	-	-	82	439	96	2 343
	Total Expenses	175	830	4 963	7 421	11 215	14 992
	Net Income	1 059	10 658	16 002	21 901	27 221	29 362

NOTE: The above figures are those given in the entity's statements converted to the 1970 price level for comparability.

The Annex following this one shows the income statements for 1968 thru 1970 in more detail.

FINAME - INCOME STATEMENTS FOR 1968 - 1970

(In Brazilian Cruzeiros Thousands)

REVENUES	1968	1969	1970
1. Long-term loans			
Local equipment-interest	19 204	27 989	32 513
Imported equipment - interest	1 200	2 873	3 256
Other	9	328	1 487
Subtotal	20 413	31 190	37 256
2. Short-term loans	5 937	4 094	3 900
3. Commitment Fees	2 970	3 133	3 094
4. Miscellaneous	2	19	104
Total Revenues	29 322	38 436	44 354
EXPENSES			
5. Financial - interest	5 640	9.838	11 343
6. Administrative			
Personnel	801	805	861
Other Administrative	541	476	445
Subtotal	1 342	1 281	1 306
7. Other	439	96	2 343
Total Expenses	7 421	11 215	14 992
Net Income	21 901	27 221	29 362

NOTE: The above amounts are the original figures converted to the 1970 average price level.

FINAME - EXTERNAL SOURCES OF FUNDS 1965 - 1970

(Amounts in Brazilian Cruzeiros Thousands)

SOURCES	1965	1966	1967	1968	1969	1970
BNDE:						
Capital Advance	-	46 000	-	-	-	-
Other Advances	-	-	-	86 400	84-600	71-169
CENTRAL BANK:						
AID Program Loan/2 Step	117 660	93 150	24 165	5 760	28 800	15 000
GECRI	-	-	-	9 541	5 390	8 406
Total External Funds	117 660	139 150	24 165	101 701	118 790	94 575
INTERNAL FUNDS GENERATED FROM OPERATIONS ESTIMATED AT:						
Net Income	1 059	10 658	16 002	21 901	27 221	29 362
Principal Repayments	-	18 790	72 260	92 320	136 900	180 590
Total Estimated Internal Funds	1 059	29 448	88 262	114 221	164 121	209 952

NOTE: The above figures are the original amounts adjusted to the 1970 average price level.

FINAME - Financial Position 1968-1969

nounts in Brazilian Cruzeiros Thousands)	1968	1969	1970
CURRENT ASSETS			
Cash	1 679	4 892	1 553
Short-term loans receivable	16 802	22 432	33 472
Other receivables	10 204	14 005	13 609
Other current assets	4	543	452
TOTAL CURRENT ASSETS	28 689	41 872	49 086
LESS			
CURRENT LIABILITIES			
Accounts payable	8 338	13 883	13 528
Central Bank charges payable	1 123	1 169	202
BNDE charges payable	11 590	7 638	-
Short-term loans	12 960	-	-
Other current liabilities	23	68	28
TOTAL CURRENT LIABILITIES	34 034	22 758	13 758
NET WORKING CAPITAL	(5 345)	19 114	35 328
PLUS			
NON CURRENT ASSETS			
Local Equipment Loans	328 843	423 705	474 598
Imported Equipment Loans	43 076	75 036	76 345
Agricultural Loans	8 398	12 157	16 698
Advances on Loans	22 298	4 326	1 033
Fixed Assets (Net)	141	96	69
Total Non Current Assets	402 756	515 320	568 743

	1968	1969	1970
LESS			
LONG TERM LIABILITIES			
Long Term Loans	280 411	389 825	502 906
Other Non current Liabilities	46 269	58 453	-
Total Long Term Liabilities	326 680	448 278	502 906
EQUALS			
NET WORTH			
Capital Advance	28 800	24 000	20 000
Reserves	-	542	452
Retained Earnings	41 931	61 614	80 712
Total Net Worth	70 731	86 156	101 164

OTE:

Original amounts adjusted to 1970 price level.

CAIXA ECONOMICA FEDERAL

INCOME STATEMENT FOR SIX MONTHS ENDED 12/31/70

(Amounts in Cr$ thousands)

FEDERAL LOTTERY:		
Income	88 203	
Less Expenses	(41 269)	46 934
FEDERAL SPORT LOTTERY:		
Income	102 578	
Less Expenses	(56 586)	45 992
Interest Earned	116 263	
Monetary Correction	51 241	
Other Income	105 661	
less		
Interest Expense	(39 883)	
Monetary Correction	(43 105)	
Personnel Expense	(102 315)	
All Other Expenses	(33 420)	54 442
Net Income		147 368

CAIXA ECONOMICA FEDERAL

BALANCE SHEET AS ON DECEMBER 31, 1970

(Amounts in Cr$ thousands)

ASSETS		
Cash		262 753
Loans		
Housing	1 735 922	
Mortgages	480 017	
Personal	556 843	
Consumer Goods	117 910	
All Other	221 789	3 112 481
Advances to Branches		736 201
Marketable Securities		450 534
Other Current Assets		418 290
		4 980 259
Fixed Assets (net)		327 102
Deferred Charges		9 880
		5 317 241
LIABILITIES		
Deposits		
Savings Accounts	1 189 196	
Checking Accounts	885 399	
Time Deposits	73 598	
Governmental Deposits	177 672	
All Other	40 706	2 366 571
Branches - Current Account	476 783	
BNH Refinancing	431 189	
Accounts Payable	119 293	
Federal Lottery - Current Account	118 656	
Deferred Credits	280 127	
Other Liabilities	409 936	1 835 984
Special Funds		
FNDE	1 541	
FNS	3 852	
FEAE	385	
LBA	40 931	
CND	30 699	
MEC	30 699	
All Other	14 128	122 235
Total Liabilities		4 324 790
NET WORTH		
Capital Stock	353 000	
Reserve for Capital Increase	522 718	
Other Reserves	66 387	
Retained Earnings	50 346	992 451
		5 317 241