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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Mr. Broida

Enclosed is a copy of the report on his Latin American trip which Chairman Burns promised to the Committee at the July meeting. Please treat it as a confidential statement.

To the Chairman's regret, the delay in sending the report was unavoidable.

Arthur L. Broida

Arthur L. Broida
Deputy Secretary
Federal Open Market Committee

Enclosure

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REPORT ON LATIN AMERICAN TRIP

The trip covered four countries -- Peru, Argentina, Brazil, and Venezuela -- during the period June 24 to July 7, 1972. It originated with an invitation from Governor Carlos Brignone of the Central Bank of Argentina to visit Argentina. Since I had not been able to attend the meeting of the Governors of the Central Banks of the Western Hemisphere in Tobago earlier in the year, I decided that this would be a good opportunity to renew personal contacts not only with President Brignone, but also the governors and other officials of a few other South American countries. I was accompanied on the trip by Mrs. Burns and by Reed J. Irvine, the Adviser in the Division of International Finance who has responsibility for Latin America.

The bulk of our time was spent in Argentina and Brazil, with briefer stops in Peru and Venezuela. In each country we met with the Governors of the Central Banks, the Ministers of Finance, commercial bankers, both local and American, a variety of businessmen and, of course, the American Ambassadors and members of their staffs. In each of the countries except Peru, I met with the Presidents of the country. This could not be arranged in Peru because of the shortness of my stay.

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In all of the countries visited, we were received warmly, and our discussions were both friendly and frank. I made it clear in each case that I had come to learn about the country and its problems, and I did learn a great deal. In addition, I found that there was a keen interest in the American economy and in problems relating to international monetary reform, and I was asked many questions on these subjects.

Observations on Individual Countries

1. Peru -- My stay in Peru was brief. The short time available was devoted to discussions of international monetary reform, our dispute with Peru over the expropriation of the property of the International Petroleum Company (IPC), the treatment of other private American firms and banks, and the state of the Peruvian economy.

President Barreto of the Central Bank explained his views on the international monetary mechanism at some length. He participated in the Bretton Woods Conference, and he expressed the view that the Bretton Woods system would not have broken down had there been a willingness to apply the kind of discipline on the surplus countries that was called for by the scarce currency

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clause. He was strongly of the view that any reform should emphasize this point. He also felt that gold would have to continue to play a role in the system and that thought would have to be given to changing the formula for allocating SDRs in order to improve the distribution of liquidity. He thought that the Latin American representatives of the Group of Twenty would be a useful counterbalance to the Europeans and Japanese. He said they were continuing to work on proposals for reform that all the Latin American countries could support.

The American bankers and businessmen I talked to were rather gloomy about prospects for American investment in Peru. The IPC case has been a serious irritant in U.S.-Peruvian relations since the assets of the company were expropriated in 1968. No compensation has been paid, and the U.S. has been trying in diverse ways to bring pressure on Peru to agree to compensate Jersey Standard. Although the Peruvians insist that IPC is a unique case and that they will deal fairly with foreign investors, some of their actions cast doubt upon this.

Our bankers told me that they and other foreign banks are subject to serious discrimination. Among other things, they are not permitted to make loans to certain important industries. They are not allowed to have savings accounts or open new branches.

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They cannot sell even small amounts of foreign exchange without obtaining approval of the Central Bank.

Although most of the American bankers and businessmen I spoke to felt that the climate for private enterprise is not favorable in Peru, there have been some promising developments in oil and minerals, and fresh American capital has come in or is waiting to come in to help develop these resources. I was also informed that a substantial amount of Japanese and European money has been or may be loaned in Peru. However, the economy has no doubt suffered from the climate of investor uncertainty.

The country has a dual exchange rate, but I was informed that on the blackmarket the currency sells at more than a 25 per cent discount from the most depreciated official rate.

The economy has been hard hit this year by a freak of nature that has altered the flow of the Humboldt Current, which carries the rich supply of anchovies that are so important to the big Peruvian fishing industry. I was told that the fish had disappeared, and this has been disastrous for the most important export of Peru -- fishmeal.

The Peruvian economy seems to have been reasonably well managed in the face of adversity in the last few years. The president

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of the Central Bank is a professional of long experience, and the Minister of Finance, a general, seems to be a reasonable man. There are obviously diverse elements within the military government, some trying to steer sharply to the left and others trying to adhere to a course more in the center.

2. Argentina -- The economic situation in Argentina is precarious, with inflation proceeding at an annual rate of 60 per cent. The economic ministers know very well what ought to be done, but they are hampered by political factors.

Argentina is planning to hold elections next spring, and President Lanusse is trying to work out an arrangement that will give the Peronists an opportunity to participate in the political process. Peron, despite the damage he did to the Argentine economy in the immediate postwar period, still commands allegiance of a substantial portion of the electorate. The Peronist economic policies are based on greater economic nationalism. The prospect of increased Peronist influence does nothing for business confidence.

As a result, Argentina suffers from both capital flight and from reluctance of new foreign capital to come into the country. American bankers in Argentina reflect the discouragement that this

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engenders, even though a number of their head offices may be participating in a consortium that is planning to lend Argentina $145 million to help the country meet its immediate foreign obligations.

American bankers are handicapped in their operations by discriminatory laws and regulations. The Central Bank prevents foreign banks from providing new services or undertaking any improvements without Central Bank permission. This is interpreted, I was told, in a manner that makes it necessary to get Central Bank permission even to replace a manual typewriter with an electric one. The bankers said that it would be difficult for a foreign bank to get permission to bring in a computer. They are also limited on the expansion of loans to foreign enterprises, and in opening new branches. They must maintain a ratio of capital to deposits that is twice as high as that required of domestic banks.

Central Bank presidents and ministers of economy are changed in Argentina with great frequency, and for reasons that are not always related to their competence in the performance of their duties. Many of the people I spoke to agreed that one of the serious weaknesses in Argentina is the rapid turnover of those who make up the government's economic team. I was told that Argentina had had 25 ministers of economy in 17 years. One of

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the worries of the American bankers who were planning the new loan to the government was that the present economic team might be changed and policies drastically altered at any time. President Brignone was subsequently replaced as head of the Central Bank.

Argentina has some very able economists, a number of whom I met, and they are well aware of the folly of the policies that discourage badly needed investment in the country. There was widespread agreement that inflation and political instability were major reasons why Argentina had not experienced faster economic growth. Other explanations advanced were excessive state intervention in the economy, the lack of a consistent agricultural policy, excessive taxation, and excessive expenditures on social security. I was told that social insurance taxes are equal to 50 per cent of the wage bill. I also noted that, with the present high rate of inflation, interest rates on time and savings deposits and government bonds are actually negative even though they range as high as 22 per cent a year. I understand that many contracts provide for monetary correction to adjust for the inflation, but this practice is not nearly as widespread as in Brazil.

The government has been trying to maintain the real income of the wage earners by permitting wages to rise by nearly one third

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in the first five months of this year. This has seriously endangered the stabilization program, and for a time there was a very serious confrontation between the IMF and Argentina. The Fund moderated its demands and permitted a drawing by Argentina. Nevertheless, one of the influential parties has a platform plank calling for withdrawal from the IMF and other international financial institutions.

3. Brazil -- Brazil is an intriguing place to an economist because of its high rate of economic growth and the great confidence of businessmen in the future, in spite of the high rate of inflation. The explanation of the paradox seems to lie in the fact that the rate of inflation has been reduced greatly from its previous highs (from 90-100 per cent a year to 15-20 per cent). Also, monetary correction has been introduced to approximate the effects of stable money even though the money is far from stable. The exchange rate is being adjusted at very frequent intervals to keep it realistic and thus not interfere with exports. Wages, salaries, pensions, bank deposits, corporate assets, rents, and virtually all things of monetary value, are subject to monetary correction. That is to say, the monetary value is periodically increased to compensate for the rise in the price level.

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It seemed to me that it would be difficult to work such a complicated system without inequities and distortions, but most of the people I asked were unable to indicate any major groups that suffered from the inflation. Finally, I put the question to the Minister of Finance, Delfim Neto. He said that the groups that suffered the most were the public servants and the retirees, since their incomes were not adjusted sufficiently to keep pace with the rise in prices. He thought that some rentiers and the clergy also probably suffered a decline in real income as a result of inflation.

The Minister of Finance thought that it was very important that the rate of inflation be brought down. The goal is to reduce the rate to 15 per cent this year compared to 20 per cent last year, and to aim at perhaps a 12 per cent rate next year. He is a firm believer in the gradualist approach, arguing that a quick deflationary policy had in previous experience produced an adverse political reaction. He did not want to create a recession.

In addition to the ingenuity that has been shown in offsetting the worst effects of inflation, the Brazilian government has accomplished a great deal in the fiscal area. I was told that the budget deficit this year will be only 0.2 per cent of the gross national product. There has been a great improvement in tax collection, brought about in part by the requirement that every resident obtain from the tax

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office each year a card showing that he has reported his income and paid any tax due. Unless one has this card it is impossible to obtain a loan, get a marriage license, or carry out any number of essential transactions. The result has been a tremendous increase in the number of taxpayers.

Moreover, Brazil has developed an ingenious system of tax credits which enable the taxpayer to reduce his tax liability by as much as 51 per cent by making investments of an approved type. This has resulted in a tremendous increase in capital investments in the depressed parts of the country. The Brazilian officials I met are very pleased with the way the tax credit program has functioned.

Another ingenious Brazilian measure is the adoption of a savings fund built up from contributions by employers and used to finance housing. This was introduced as a way of inducing the workers to give up their right to guaranteed employment once they worked for the same employer for ten years. This had become a heavy economic burden, greatly restricting productivity. The employers were happy to cooperate in the savings plan, which was offered to those employees who gave up the right to tenured employment. The overwhelming majority of the workers accepted the alternative. It has benefited both productivity and the financing of low cost housing.

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I spoke to a large number of American bankers in Rio. They reported some restrictions on their activities, but the situation is far better for them in Brazil than in either Argentina or Peru. The main discriminatory restrictions are that unlike Brazilian banks they cannot expand by merging with other banks and they are not permitted to act as collection agents for income tax payments. The foreign banks that have branches in Brazil are required to make half of their loans to Brazilian firms. They said the number of their branches was frozen, but this applied to Brazilian banks as well.

The American banks, both those that have branches there and those that have representative offices, are very active in Brazil. Brazil has external debts totaling about $6.6 billion, and liabilities to American banks amount to about $1 billion.

The present policies of the Brazilian government are conducive to an inflow of banking capital. There is no forward market, but it is known that the price of foreign exchange moves up at the same rate as other prices in Brazil, less an adjustment for price increases abroad. The exchange rate is changed at frequent but variable intervals. Interest rates in Brazil are higher than the inflation rate, and so the lender is assured of a positive real rate of return on his loan. The combination of high domestic interest rates and frequent small devaluations discourages speculation in foreign

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exchange. I was told that previously it was common in Brazil for people to protect themselves against inflation by buying American currency but that this is no longer the case.

One of the topics much discussed in Brazil during my visit was the sharp decline in the Brazilian stock market prices this year. The earlier sharp rise in share prices had brought many small investors into the market, and it was possible for people to borrow from banks against the collateral of shares with a margin requirement of no more than 20 per cent. While the recent slump of the stock market has produced some unhappiness, the depression in the market does not appear to have dulled the optimism about the general business outlook.

One of the great strengths of the Brazilian government lies in its self-confidence, its stability, and its willingness to let the economic team led by Minister of Finance Delfim Neto direct the course of the economy. In contrast with Argentina, where the economic team has been changed repeatedly, Delfim Neto has been in office for five years and seems to be solidly entrenched. He has an excellent understanding of the need to encourage private investment and to permit entrepreneurs to reap satisfactory profits. At the same time, he has shown a willingness to innovate and experiment.

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4. Venezuela -- Venezuela has enjoyed the benefits of high income from its mineral wealth, a reasonable degree of political stability, and a very low rate of inflation.

Venezuela's interest in joining the Andean Pact, which includes Colombia, Ecuador, Peru, Bolivia and Chile, is pulling the country into a more hostile stance toward foreign investment. A law was passed in 1965 requiring foreign insurance companies to sell a majority of their stock to local investors in 5 to 8 years. Last year the natural gas industry was nationalized and a law that was unfavorable to foreign banks was enacted. Foreign banks with branches or affiliates in Venezuela were given the option of retaining control with their operations subject to severely discriminatory regulations or of converting the branch into a local bank with Venezuelans holding at least 80 per cent of the shares. Only First National City Bank opted to retain control of its Venezuelan branch.

The American oil companies are hard-pressed. They are forced to pay more for the oil they pump in Venezuela than for Middle Eastern oil, and pressure is applied to keep them producing and drilling in Venezuela even though it would be more profitable for them to invest elsewhere.

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The officials and directors of the Central Bank of Venezuela showed a keen interest in both the U.S. economy and international monetary reform. They asked more detailed and pointed questions than did the officials in the other countries I visited. In addition to the usual questions about the forum for international monetary reform discussions, the link of SDRs to assistance for developing countries, and the timing of reform discussions, they showed considerable interest in the stability of the Smithsonian agreement, possible violations of it, and the role of gold.

The Minister of Finance showed some concern about the high level of gold and foreign exchange reserves that the country now has. They are concerned about the inflationary impact of the foreign exchange inflow.

Some Concluding Observations

The most important impressions that I carried away are that every country in Latin America is unique, that the continent is in a state of ferment, that there is more sound economic and financial thinking there than I had realized, and that Brazil is setting a particularly constructive example in managing its economic affairs.

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Our Ambassadors felt that my visit supported their efforts to maintain or improve our foreign relations. My schedule was worked out in close coordination with the embassies, and I included the Ambassador or other embassy staff in most of my meetings. This was greatly appreciated, since it helps keep our representatives informed, and it improves their contacts with financial and business leaders in the countries to which they are assigned.

My activities were well covered by the local press and television. The publicity was favorable and helpful in achieving the objective of providing visible evidence of U.S. interest in Latin America.