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# **Brazil: Prospects for the Regime**

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*5 April 1985*

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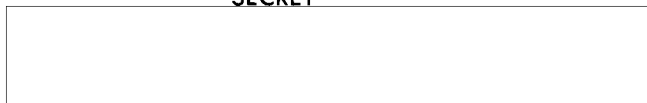
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**BRAZIL: PROSPECTS FOR  
THE REGIME**

Information available as of 5 April 1985 was used in  
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### SCOPE NOTE

The election of Tancredo Neves in January 1985 was a major milestone in Brazil's progress toward full restoration of democratic government. Neves was chosen to become Brazil's first civilian president since 1964. 

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This Memorandum was prepared prior to Neves's illness and is based upon the assumption that he will take office. This key assumption rests on Neves's broad popular support, his personal honesty, and his unique ability to hold together a fragile political coalition. Should Neves die, Acting President Jose Sarney will be installed as president and Chamber of Deputies leader Ulysses Guimaraes as vice president, according to the provisions of the 1967 Constitution. Sarney, however, does not have the broad base of support enjoyed by Neves, and popular pressure for an early direct election for a new president will build quickly. While there is likely to be a period of political uncertainty following Neves's death, there are strong indications that most political and military leaders will give Sarney the support he needs to gain control over the government and to address critical issues, at least in the short term. 

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## KEY JUDGMENTS

President-elect Tancredo Neves and Vice President Jose Sarney inherit pent-up pressures for political change and a still-troubled Brazilian economy burdened with greater than 200-percent inflation and high unemployment, recurring difficulties with the International Monetary Fund (IMF), and a \$100 billion foreign debt. To his advantage, Neves, 75, is a broadly popular, skilled politician, well known for his honesty and ideological moderation as well as his ability to build a consensus among disparate interest groups. We expect the President-elect—once he recovers from surgery and takes over for Acting President Sarney—to exploit his skills and popularity to maintain a temperate, predictable course for Brazil. [REDACTED]

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On the economy, Neves's principal early challenge will be Brazil's unresolved financial negotiations. We believe both Neves and the IMF probably will be sufficiently accommodating, in view of the high stakes involved, to reach agreement in the coming months on a new stabilization program that will allow for continued economic expansion. Neves would refuse IMF prescriptions that he regards as too harsh, however, in order to preserve his political support. An IMF accord probably will pave the way for a rescheduling of foreign bank debt on terms similar to those tentatively negotiated by the outgoing government. Neves, nevertheless, may press for some form of protection against the effects of a substantial rise in international interest rates. [REDACTED]

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Neves is publicly committed to strong economic growth. We believe the continuing momentum of Brazil's incipient recovery will permit him to honor his growth pledge and, at the same time, to tackle what he concedes to be an acute inflation problem in 1985. We expect the civilian government to stress fiscal discipline, financial reform to strengthen the government's control over monetary policy, and an informal "social pact" among labor, business, and government to contain wage and price increases. As a result, we believe that Neves stands a better-than-even chance of slowing the rate of inflation by the end of the year. [REDACTED]

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Still, we believe there is a one-in-three chance that domestic political pressures may force Neves to adopt expansionary economic policies that result in excessive government spending, abandonment by Brasilia of its IMF program, and escalation of inflation to the 300- to 500-percent range. Or, a several percentage point resurgence of foreign interest rates and a sharp drop in Western economic activity may

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impair Brazil's ability to meet its debt obligations. In either event, the effects would diminish Brazil's prospects for a sustained recovery, heighten chances of a confrontation with foreign creditors, and weaken the civilian government's political base. [REDACTED]

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Assessing Neves's prospects for managing the economy is complicated by Brazil's changing political landscape. Neves is committed to the consolidation of democratic government. He intends to overhaul the military-imposed political party system and revise Brazil's Constitution to permit direct presidential elections by 1988 or 1989. In this increasingly open political environment, Neves's consensus-building efforts will be especially vulnerable to the competition for influence among labor, the political left, and the Congress. We expect militant labor leaders in Sao Paulo and leftist politicians to come out strongly against Neves early in his administration, and there are already signs that his electoral coalition is fraying at the edges. [REDACTED]

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We expect the armed forces to monitor the Neves government closely, but we see little likelihood of military intervention in the political process for at least the first year or so of civilian rule:

- Most officers appear to recognize that their prolonged rule tarnished their public image and diminished Brazil's military capabilities, and they seem anxious to return to the barracks.
- Neves has overcome the military leadership's doubts about his ability to protect the armed forces' interests and to keep the economic recovery on track, according to generally reliable sources. He has accomplished this by assuring commanders that he will pursue moderate and pragmatic policies, keep leftists out of key positions, block inquiries into past human rights abuses and corruption, and support current military spending levels and the lucrative arms export industry.

If Neves's economic policies result in rising social unrest or he submits to a leftist clamor for civilian trials of former military rulers—which we do not believe is likely—armed forces leaders probably would openly oppose the President. In our judgment, however, conditions would have to deteriorate gravely before the military would risk popular unrest by forcing Neves from office. [REDACTED]

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We believe Neves will continue the pragmatic, low-profile foreign policy that was favored by the former military government. We expect him to strengthen ties to other Latin American countries, although he may be more critical of Chile than his predecessors; to support the Contadora peace initiative in Central America, while avoiding any direct participation; and to avoid involvement in East-West disputes.

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Relations with Communist countries will probably be unchanged, with Brasilia looking for commercial opportunities but remaining suspicious of Soviet and Cuban political intentions. Neves has publicly stated that he will not renew diplomatic relations with Havana any time soon. He will probably continue to strengthen ties to China, looking for markets for Brazilian goods and expanding scientific and technical cooperation. Relations with the Middle Eastern countries—especially Iraq—probably will remain close as Brazil continues to push arms sales to the region.



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If Neves dies before he is inaugurated or is permanently incapacitated, Vice President Sarney is likely to be formally installed as president, and broad popular and military support for the democratic transition is likely to ensure that he is allowed to remain in office at least over the short term. Sarney lacks wide appeal, however, and he is likely to bow to pressure for an early direct election for a new president, perhaps in 1986. We believe that Sarney will attempt to follow Neves's economic policies over the near term, including the implementation of austerity measures and negotiations with foreign creditors. Over the longer term, prolonged political uncertainty probably would inhibit successful economic stabilization, and Brazil would probably fall out of compliance with IMF lending criteria. While political and economic tensions may tempt the military to intervene, we believe it would act only in the event of prolonged uncertainty and social disorder.



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### DISCUSSION

1. Tancredo Neves, whose administration has ended 21 years of military rule, must contend with a range of sensitive political and economic issues. His major political challenge is to consolidate civilian control by forging an effective government and establishing a mechanism for constitutional, orderly transfer of power to his successor via direct elections.<sup>1</sup> He will also have to deal with the conflicting agendas of newly

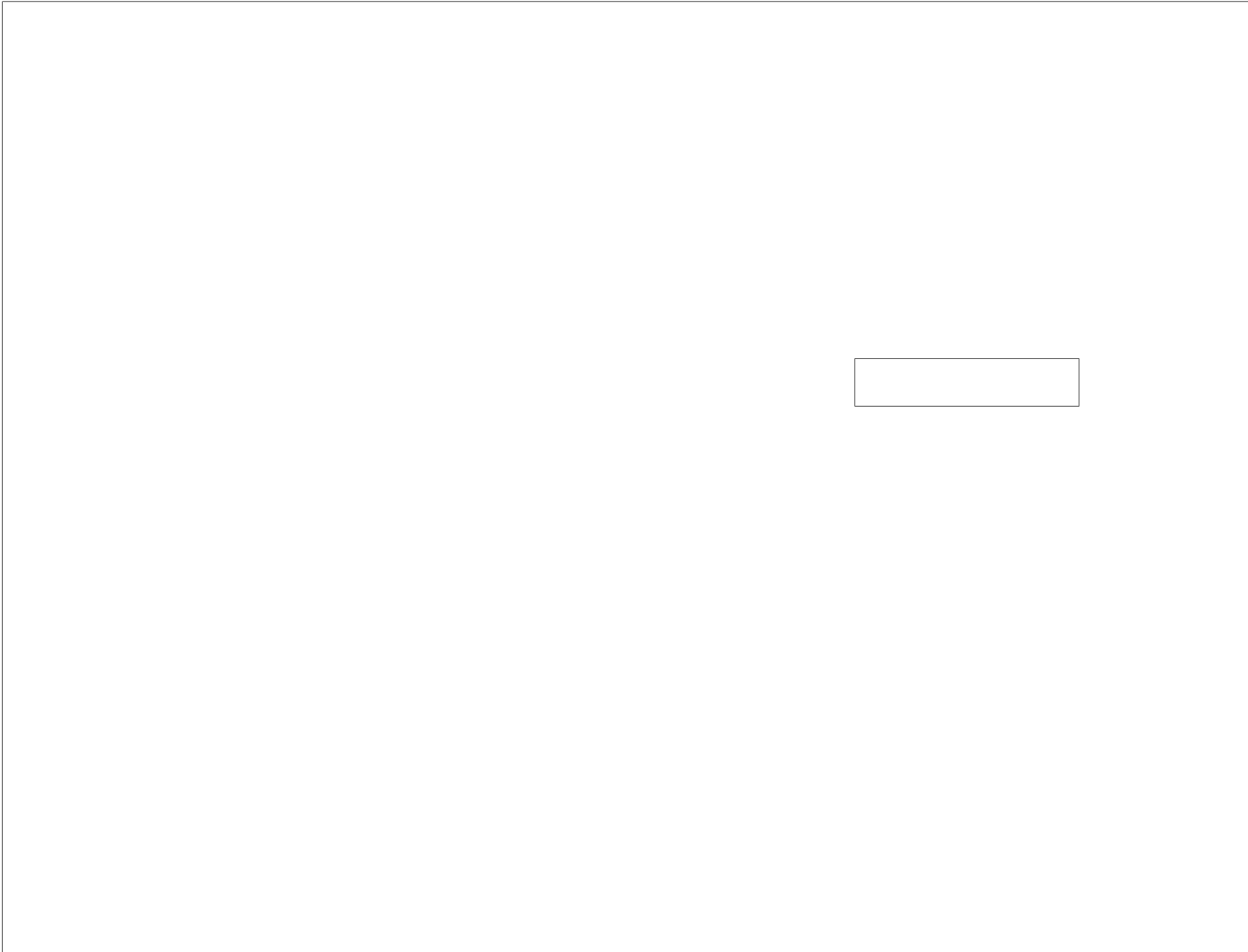
assertive groups—labor, civilian politicians, and small business. In the economic sphere, most economic interest groups and politicians desire an immediate return to rapid economic growth and more equitable distribution of income. Efforts to advance these objectives, however, could result in excessive government spending, lead to confrontation with international lenders, and jeopardize long-term economic growth. While coping with these challenges, Neves will continually have to reassure military officers who, although anxious to return to the barracks, will be monitoring the government closely.

<sup>1</sup> Neves was elected indirectly by an electoral college composed of 686 delegates—the 548 members of the Brazilian Congress plus six electors chosen by the state legislatures in each of the 23 states.



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**What Neves Brings to Office**

2. Neves brings to the presidency extensive experience and broad popular support that should ease the transition from a military to a civilian government. His ties to traditional political groups, however, may eventually alienate those Brazilians expecting a broad-based administration.



work against him because he is not a part of the generation of politicians that matured under the military and now longs for power. He is viewed by many of these people, especially those on the left, as too closely tied to "establishment" politics, despite his role as opposition candidate.



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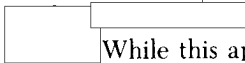
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**Experience and Popular Support**

3. In our view, Neves comes to power with important strengths. A public figure for over 50 years, he has the political acumen necessary to prosper in the shifting currents of Brazilian politics. A recent assessment portrays Neves as conservative, but not doctrinaire, and generally without strong ideological commitments. Moreover, Neves's moderation, personal honesty, and understanding of the Brazilian "rules of the political game"—which prize compromise and consensus building over confrontation—have been keys to his success. He has achieved accommodations with a cross section of the Brazilian political elite, ranging from leftists to his military predecessors, without appearing to identify himself with any group. Other reports portray him as methodical and cautious, making political decisions himself but only after extensive consultations. Neves, for example, made certain he would win the electoral college vote before saying publicly that he would run, according to the Embassy.



6. Neves is also reluctant to delegate authority, according to various sources. Further, although he consults widely,



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While this approach has worked well for him thus far as a politician, some Brazilian observers believe it may cause him problems as an administrator charged with running the country.



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**Meeting the Economic Challenge**

7. Even with his political experience and popular support, Neves faces a formidable challenge on the economic front. He inherits an economy that—despite some recent improvements—remains seriously troubled. Brazil's most notable gains in 1984 were a \$13 billion trade surplus and a 4-percent growth in GDP after three years of recession. Because this recent economic growth has been narrowly based on exports, however, many knowledgeable Brazilians have publicly stated that they believe the government must take action to broaden the recovery and reduce unemployment. Inflation has stubbornly remained above 200 percent for a second straight year, and Brazil is out of compliance with its International Monetary Fund (IMF) stabilization program. In addition, Brazil's \$100 billion foreign debt and higher-than-normal interest rates have produced an annual debt service burden that will absorb some 75 percent of export earnings unless a new debt restructuring arrangement is reached with foreign creditors.



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4. The present political atmosphere should further bolster Neves's position. Opinion surveys have consistently indicated that he enjoys wide popular support. The military broadly accepts Neves and supports the transition. These sources also report that most members of the armed forces believe the military's credibility has suffered from its prolonged tenure in power and its inability to sustain economic growth in the 1980s, as well as from widespread reports of corruption. The officer corps is looking forward to the changeover so that it can focus on repairing its tarnished image and improving military capabilities.



**Neves's Priorities**

8. Given the magnitude and visibility of Brazil's economic challenge, we believe Neves wants to launch his presidency with some major economic policy initiatives in order to distinguish his administration publicly from that of the military. According to various sources, Neves's economic priorities for 1985 are to strengthen growth and employment opportunities, re-

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**Liabilities**

5. While Neves brings experience and popular backing to the presidency, he also brings some shortcomings. His age—he turned 75 in early March—may


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duce inflation, obtain what he considers a fair multi-year rescheduling of foreign debt, and promote a more equitable distribution of income. 

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9. Neves has touted growth as the centerpiece of the new administration's economic program. The task recently has been made easier by last year's export-led recovery, which should pick up speed in 1985, resulting in a GDP growth on the order of 5 percent for the year. Neves has indicated publicly that he hopes to facilitate growth through a combination of eased monetary restraints for private industry, increased subsidies to agriculture, and new government investments in small-scale, labor-intensive public works projects. In addition, according to various sources, he wants to create more industrial jobs, stabilize real wages, and increase social spending to bolster domestic demand as well as promote more even income distribution. 

restructuring of the foreign debt that would include lower interest rates and longer maturities. Neves supported the terms of a tentative multiyear debt rescheduling negotiated by the outgoing military government as the best that Brazil could hope for under the reasonably favorable foreign interest rate conditions and strong demand for Brazilian exports expected throughout 1985. Neves was disappointed that he had to inherit the uncompleted talks because of his concern that the issue could generate substantial discord among his supporters. His advisers are hopeful, however, that the new government will be able to complete the agreement without major changes. 

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10. Reducing inflation has been described publicly by Neves as essential to Brazil's sustained recovery, and it probably will be the most difficult challenge facing him. In our judgment, inflationary pressures are likely to be especially intense during the early months of his administration because of excessive monetary expansion as the military prepared to leave office. To fight inflation in the near term until more fundamental measures can take effect, Neves has proposed an emergency "social pact" among business, labor, and government to limit wage and price increases. He believes such an agreement would change Brazilians' psychological expectations of continued ballooning prices—expectations that are widely thought to be an important component of inflation. 

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13. To accommodate foreign creditors, Neves has underscored his intention to continue IMF-prescribed stabilization measures in 1985, so long as they do not appear to be causing another recession. Difficulties will arise, nonetheless, in reconciling IMF stabilization with the administration's commitment to growth. In February 1985, the IMF suspended its financial support for Brasilia because of the military government's failure to comply with monetary and public-sector deficit targets. Before resuming its support, the Fund wants the Neves government to provide assurances in a new letter of intent that it will take vigorous steps to control accelerating inflation. 

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#### Coping With Interest Group Pressures

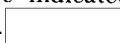
11. For the longer term, Neves believes that the government must curb public-sector deficits to control inflation. To this end, he is reported to favor budget and tax reforms, divestitures of some nonessential state enterprises, and cutbacks in large-scale public projects. According to press reports, Neves's advisers will also seek to reduce production costs in the industrial sector as a way of depressing inflation. In view of Neves's commitment to real wage stability, however, we believe his most likely target will be the reduction of high domestic interest rates. In addition, Neves reportedly thinks he can gradually dismantle Brazil's inflationary indexation system, although not quickly because of potentially disruptive effects on the economy and living standards. 

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14. We believe Neves's economic policy course will be strongly challenged by various interest groups. Several groups—including labor, civilian politicians, and small business—have had little impact on policy-making under the military and see new opportunities for enhancing their positions under a civilian president. Others who have wielded significant influence over the past 20 years will attempt to protect their interests; these include the technocrats directing public-sector economic activity, the amorphous middle class, and influential industrialists. 

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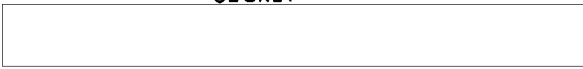
12. On the issue of Brazil's large debt repayment burden, Neves has consistently stated that he wants a

15. Neves, whose constituency spans all these groups, will probably look for ways to accommodate their competing agendas without undermining his economic plans. He is especially concerned that the demands of labor for higher wages, together with business calls for improved profits, may add to inflationary pressures early in his administration. Hoping his proposed "social pact" will mitigate tensions, Neves has met separately with business and labor leaders a number of times, some of whom have indicated receptivity to the idea of an informal pact. 

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**Labor and the New Government**

Organized labor in Brazil—which embraced about 20 percent of the country's 44 million workers as of 1980—hopes to exploit the more open political environment under Neves to bolster its flagging fortunes.

Sharp ideological and personal rivalries, as well as the effects of the recent economic recession, prevented labor from exploiting new opportunities in the late 1970s during the first phases of the military's political liberalization. Moreover, ineffective leadership, declining union membership, and poor showings of prolabor candidates in the 1982 elections have left the unions on the fringes of the political process.

Moderate labor leaders have formulated modest agendas for the new government in an attempt to influence policy and avoid confrontations, at least in the near term. More militant unionists, led by the Workers' Party (PT) under the leadership of Lula da Silva in Sao Paulo state, have pledged to oppose Neves, whom they view as little more than a continuation of military rule. They plan to press for wage hikes and increased autonomy from government controls over internal union affairs. The militants are likely to challenge Neves early in his administration on wage and other issues, but reporting from a variety of sources suggests that the labor movement as a whole will exercise little leverage on the new government.

Neves, for his part, has done little to court the unions. Nonetheless, we believe he recognizes the need for labor peace if he is to deal effectively with triple-digit inflation. We expect him to consult with labor leaders on economic and social welfare issues and to make limited concessions. He probably will stop short of easing government controls on the unions that have helped prevent the militants from gaining control of the labor movement.

16. Despite Neves's efforts at conciliation, we believe that some contentious differences among interest groups will surface, especially on the issues of economic austerity and debt. Brazilian press reporting indicates that most civilian politicians (including many of those in Neves's coalition), organized labor, and the bulk of the middle class are far less willing than technocrats and powerful industrialists—the main beneficiaries of foreign loans—to accept additional sacrifices for the sake of fulfilling foreign debt commitments. Neves's own Brazilian Democratic Movement Party (PMDB) called for a debt moratorium and a break with the IMF during a period of particularly strained relations with foreign creditors in the summer of 1983. If forced to choose on such issues, Neves

**Business and the New Government**

Much of the private business community is looking ahead to the Neves administration with considerable optimism, judging from a variety of sources. Businessmen view Neves as a moderate, consensus-style, and highly popular politician who is likely to strengthen political and social stability in Brazil. Also, a number of Brazilian businessmen anticipate a more open policy-making climate and a much more active role for business in shaping government policy than was permitted during the past 21 years of military rule. Neves, for his part, has encouraged these expectations by suggesting publicly that he will assign some important ministerial posts to people with business and banking backgrounds who have proved their ability to manage major enterprises.

Business for the most part has strongly endorsed several major elements of Neves's economic policy platform, but has reservations about others. In particular, the President-elect's pledges to sustain an economic recovery and to shift greater productive responsibility from the public sector to the private sector have gained widespread business support. Business confidence that the new government will deal effectively with soaring inflation, however, has been slow to materialize. Although private-sector leaders were somewhat reassured by a major economic policy speech by Neves in December underscoring the need for fiscal and monetary discipline, they continue to forecast high inflation rates for this year.

would inevitably antagonize some important interest groups, possibly weakening his political base.

**Influence of Economic Advisers**

17. As part of his effort to devise politically palatable economic policies, Neves intends to revamp the policymaking machinery. Various sources indicate that he plans to abolish the "superministerial" economic policy making function of the government's Planning Secretariat. Unlike the military regime, he intends to consult a wide spectrum of economic advisers ranging from leftists to conservatives. We believe his decisions will be influenced substantially by these people, partly because he lacks expertise in economic affairs and partly because he does not have strong ideological predilections that shape his economic policy views.

18. Although Neves granted government positions to representatives of all his constituent groups in order to hold together the broad coalition that elected him,

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he reserved key policymaking posts for moderate economic advisers. He selected Francisco Dornelles, who was a conservative Finance Ministry official under the military government, as his Finance Minister and economic team leader. Moreover, Joao Sayad and Antonio Lemgruber, Neves's selections to head the Planning Secretariat and the Central Bank, are reported to be advocates of austerity to quell inflation. To placate leftist supporters, we believe Neves will find places for some of Brazil's leading leftwing economists, but in less influential posts. [REDACTED]

### Charting Brazil's Political Course

19. Also among Neves's major challenges will be the consolidation of democratic government and the establishment of mechanisms for the direct election of his successor. Careful management in this area, which includes reform of both the military-imposed political party structure and the Constitution, is critical for ensuring long-term political stability. [REDACTED]

#### Political Party Restructuring

20. The emergence last summer of Neves's electoral coalition, the Democratic Alliance, and the turmoil generated within the military government's Social Democratic Party (PDS) by its controversial candidate, Paulo Maluf, hastened the breakup of the party system created under military rule. While major realignments are under way, the ultimate shape of the party structure remains unclear and will depend far more on fickle personal alliances and regional politics than on ideological considerations. [REDACTED]

21. For the time being, we expect Neves to try to preserve his Democratic Alliance as an umbrella organization to support his policies in the Congress and prepare for the 1986 congressional and gubernatorial elections. His task will be difficult, however, as the different parties and groups within the Alliance begin to pursue their own political interests. His PMDB, for example, which holds about 40 percent of the seats in the Congress, has long been divided into moderate and left-of-center factions. The leftists have complained publicly about Neves's centrist orientation, and Neves has held extensive meetings with them to discourage defections. [REDACTED]

22. The old PDS splintered into two parties under the weight of its unpopular presidential candidate, and we judge further divisions may occur. The pro-Neves dissidents who broke with the PDS to form the Liberal

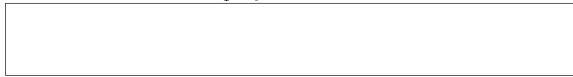
Front in mid-1984 formally converted their group into the Liberal Front Party (PFL) in December, but they remain within the Democratic Alliance. The centrist PFL is more coherent ideologically than the PMDB and has a strong regional base in the northeast. It controls about 25 percent of the seats in the Congress. Neves has met extensively with leaders of the party, promising them a strong voice in his administration in exchange for their support. Key PFL members have said that the party will chart a moderate course and, at least in the near term, back Neves's legislative program. The remnants of the PDS will probably survive as a right-of-center opposition force. We believe there is likely to be considerable infighting in the PDS, however, as various forces battle for control of the party. [REDACTED]

23. The left, also divided, is seeking to rebuild and may present Neves with his earliest and stiffest challenge. Leonel Brizola, the governor of Rio de Janeiro state, is likely to emerge as a key spokesman for leftist opponents of Neves's policies. Brizola now heads the small, divided Democratic Workers Party (PDT), but he plans to try to form a more broadly based Socialist Party. Neves is sensitive to Brizola's ambitions, and a variety of reporting indicates he is trying to undercut the PDT chief, primarily by enticing leaders of smaller parties to spurn Brizola's efforts to form alliances. [REDACTED]


24. Other leftist organizations that could pose problems for the new civilian government include:

- The *Workers Party (PT)*. This party was formed in 1980 with the backing of unions in the industrial city of Sao Paulo. The PT is a militant group that has called numerous strikes. Headed by a charismatic labor leader, Lula da Silva, the PT thus far has had little success in expanding beyond Sao Paulo, where it controls dozens of local unions. The party, badly split during the presidential election, plans a major rebuilding effort in coming months.
- The *Brazilian Communist Party (PCB)*. Although banned, the PCB reportedly controls some members of Congress who formally belong to legal parties. The Communists see new opportunities under a Neves administration and will press for legalization of their party and a voice in the administration in exchange for legislative support. The party's far-left rival, the small *Communist Party of Brazil*, intends to continue agitating against the central government, according to various sources.

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— The *Revolutionary Movement of 8 October (MR-8)*. This proscribed leftist party stepped up political activity in mid-1984 in anticipation of the election. MR-8 leaders reportedly believe they have sufficient influence within the union movement to press Neves for wage hikes and investigations into corruption under the military regime. 

**Assuaging the Military**


28. In addition to serious economic challenges and the need to establish a foundation for lasting civilian government, Neves will have to convince a nervous military establishment and intelligence officials that his course is correct. Although the military is ending its direct control of the government, we expect it to monitor the new civilian administration closely. While broadly supportive of the return to civilian rule and anxious to focus more directly on strictly military matters, the high command retained some doubts about relinquishing power to Neves right up to the time of the election. Armed forces leaders were fearful of possible investigations into human rights abuses and corruption under the military regime. They were also worried that leftists would wield significant influence in Neves's government. In addition, they were uncer-


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**Constitutional Reform**

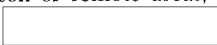
25. Against this backdrop of political restructuring, Neves has stated that he intends to institutionalize civilian government by revising the military-imposed 1967 Constitution. According to various sources, there is broad popular support in Brazil for convening an elected constituent assembly that would establish a system of direct presidential elections. Such elections were advocated during 1984 by groups opposed to the military government—with massive public support—and a constitutional amendment providing for direct elections was almost enacted by the Congress in June. 

26. We believe other critical issues that are likely to be addressed by a constituent assembly include:

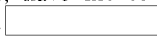
- Opening the political system to accommodate the emergence of new political party groupings.
- Shifting some political and economic power away from Brasilia to the states.
- Increasing congressional prerogatives in policy-making. 

27. Neves supports a constituent assembly but, given the complexity and sensitivity of the issues, has indicated that he will move cautiously. He has decided not to convoke the assembly before 1986, and he does not envisage direct election of his successor before 1988. To hold the assembly sooner, Neves has argued publicly, would require dissolving the Congress at a time when the new administration will be trying to consolidate its position and win passage of key legislation. Moreover, he opposes any efforts to amend the Constitution through congressional action and circumvent the need for a constituent assembly. Neves's advisers have said that he supports proposals for shifting some political and economic power from the central government to the states. He probably calculates that backing this concept will reinforce his political support—especially among Liberal Front Party leaders, who strongly endorse the idea. 

**Brazil: Role of the Armed Forces**

The Brazilian military—at 250,000 men, the largest in South America—is charged with protecting a land-mass that encompasses almost half the South American continent and shares borders with 10 other countries. Without a compelling threat on Brazil's borders, the military leadership has heretofore focused on such internal responsibilities as the maintenance of public order, garrison of remote areas, counterterrorism, and civic action. 

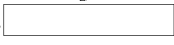
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In addition to their mandate to preserve external and internal security, the armed forces have served—under the Constitution—as the final arbiter of Brazilian politics since the founding of the republic in 1889. The Brazilian military is conservative and hostile to Communists and other leftists. In 1964 the military, responding to what it viewed as a serious threat from the left, broke with its tradition of limited temporary intervention and assumed direct rule for a prolonged period. The last two administrations, however, have moved gradually to restore civilian government. 

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Both in and out of government, the military has aspired to transform Brazil into a world power, according to a variety of sources. Even before the armed forces assumed control in 1964, the priorities associated with the military's great-power ambitions—rapid economic development and national discipline—had clashed repeatedly with the tendency of civilian politicians to seek support among urban workers by promising immediate improvements in living standards. In our view, this inherent conflict remains a potential source of friction between military and civilian leaders as the armed forces relinquish direct control of the government at a time of economic uncertainty. 

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tain about his ability to implement anti-inflationary economic policies while maintaining social order, and concerned that he would reduce military spending. [redacted]

29. Neves has reached accommodations with the armed forces on these issues. He has reassured the armed forces that his government will steer a moderate course and respect their interests. Neves has agreed to block inquiries into past human rights abuses and corruption; name cabinet-level military ministers acceptable to the high command; bar leftists from key posts in his government; and try to delay legalizing outlawed leftwing parties. Moreover, there are indications that he intends to avoid sharp cuts in military spending, and that he will continue government support for the important and lucrative arms export industry. [redacted]

### Neves's Foreign Policy

30. A range of reporting indicates that Neves plans no significant departures from the military government's pragmatic foreign policy, which was driven more by economic than ideological considerations. The selection of the moderate banker, Olavo Setubal, as Foreign Minister underscores, in our view, Neves's intentions to adopt a steady, predictable foreign policy. [redacted]

31. We expect Neves—who has a solid grasp of foreign policy issues—will:

- Maintain Brazil's identification with the Third World but resist pressure to upgrade the country's observer status in the Nonaligned Movement.
- Build ties to democratic American countries. He reportedly anticipates close relations with Presidents Alfonsín of Argentina and Sanguinetti of Uruguay. In a departure from Brazil's traditional posture, however, Neves has been publicly critical of the military regime in Chile, although he has withheld comment on neighboring Paraguay, where Brazil has substantial economic interests. His policy toward Suriname is not clear, but the Brazilian military sees that country as a potential focal point for Cuban activity, and Neves probably will continue the military government's policy of serving as a non-Communist source of political and economic support.
- Support the Contadora peace initiative in Central America. Neves has been critical of superpower involvement in the dispute, but he is unlikely to try to assume a direct role in the

peace process. Neves sent only a tepid response to Nicaraguan President Ortega's message calling for closer bilateral ties. [redacted]

32. On foreign economic policy, Neves may feel compelled to emphasize the political nature of the foreign debt problem and to criticize high interest rates. He is publicly and privately opposed, however, to formation of a cartel of Latin American debtor countries. [redacted]

33. Neves has also been critical of trade barriers in the West while at the same time defending protectionist measures at home. Neves, given the long-term need for foreign exchange to service the foreign debt, is unlikely to lower import restrictions. Neves is also unlikely to make a serious effort to curb problems prompted by Brazil's export drive, including numerous complaints by international competitors of heavy export subsidies and dumping on foreign markets. A variety of reporting indicates that Neves shares his fellow Brazilians' economic nationalism and he is likely to continue protecting a number of nascent domestic industries—such as companies designing and manufacturing minicomputers—against foreign ownership. [redacted]

### Relations With Communist Countries

34. Neves, like most Brazilians, is distrustful of Communism. We expect no dramatic improvement in bilateral relations with the Soviet Union and its allies—including Cuba, which has had no diplomatic or commercial relations with Brasilia since the military assumed power in 1964. Neves has stated publicly that Cuba's aggressive export of revolution poses a threat to hemispheric stability, and that he will not restore relations with Havana any time soon. At the same time, however, Brazil has long pursued trading opportunities in Communist countries, and Neves has given no sign that he intends to reverse this approach. He will probably seek to expand commercial and other relations with the Soviet Bloc when such moves are compatible with Brazilian interests. Even if trade relations with Moscow grow, however, Neves will be on guard against efforts by the Soviets to expand their political influence. [redacted]

35. Both the Soviets and Cubans, for their part, see the return to civilian rule as an opportunity to improve bilateral ties. Moscow sees Brazil as an important regional actor and is anxious to redress the bilateral trade imbalance which favors Brazil. Havana has also tried to achieve a thaw with Brasilia in anticipation of



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Neves's inauguration. Several unofficial Cuban delegations, for example, have visited Brazil to meet with local groups that advocate a restoration of bilateral ties, and delegations of Brazilians to Cuba have received special treatment from the Castro regime.

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36. In contrast to his cautious approach in dealing with Cuba and the Soviet Union, we believe Neves will build on the military government's efforts to strengthen ties with China. During 1984 at least six Brazilian delegations visited China in search of markets for commercial and military goods. The two countries agreed to exchange military attaches, and a nuclear cooperation agreement was also signed. Neves's support for Brazil's foreign policy direction under the military, together with the need to bolster exports, will work in favor of continued expansion of Sino-Brazilian relations.

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**Relations With the Middle East**

37. Relations with the Middle East, which grew dramatically under the military, will probably continue to expand under Neves. The Middle East is the major source of oil imported by Brazil and the major market for Brazilian weapons exports, with Iraq currently the largest customer. The arms relationship with the Arab world is especially important as a source of foreign exchange. Several Arab governments—particularly Saudi Arabia—are financing Brazilian military research projects which, in turn, provide a stimulus to the development of indigenous technological expertise. Neves has shown no inclination to limit arms exports. He is likely to echo the military regime's argument that conventional weapons such as those produced by Brazil are readily available from other sources and that the country must retain its reputation as a reliable supplier. Despite the importance of the Middle East, Neves will probably maintain the military government's evenhanded posture toward Arab-Israeli issues.

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**Outlook for the Next 12 Months**

38. We expect Neves to steer a moderate political and economic course for Brazil for at least the next year, and we judge that he is likely to have the political clout to maintain such a course. Despite the indirect nature of his election, Neves enters office in a position of strength because of his broad popularity, his acceptability to Brazil's military and political elites, and his demonstrated ability to negotiate and compromise with key political actors. Moreover, the public euphoria surrounding the return to civilian rule should help keep opponents in check and provide Neves with

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an initial honeymoon period to consolidate his control over the government.

**Staying the Economic Course**

39. In our judgment, the civilian government is unlikely to make any radical changes in economic policy this year. We believe the new administration will maintain a stabilization program designed to combat Brazil's dangerously high inflation rate and to maintain cooperation with foreign lenders. The continuing momentum of Brazil's incipient recovery probably will permit Neves to honor his growth pledge to his supporters without recourse to major stimulative government policies. Moreover, his recent performance as governor of Minas Gerais state testifies to his willingness to support austere budgetary policies. In addition, we believe Neves will want to maintain restraints this year to pave the way for a stronger recovery in 1986, when he would hope to reap considerable political gain in that year's scheduled congressional and gubernatorial elections.

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40. We believe that Neves and the IMF will try strenuously to reconcile their differences and probably will reach a settlement in the coming months. Various intelligence sources report the new administration's intentions to maintain IMF support by vigorously pursuing an anti-inflation program. Accordingly, Neves's economic team probably will initiate negotiations with the IMF for a new letter of intent soon after the inauguration. Still, insistence by the IMF on measures tough enough to achieve a sharp drop in inflation might backfire and cause him to abrogate relations. Given the widespread antagonism among Brazilians toward the IMF, Neves would not want to be perceived as acquiescing in excessive austerity measures by the Fund.

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41. Whether or not an agreement is reached with the IMF, we believe Neves's moderate economic policy team will seek greater fiscal discipline. The incoming government has affirmed its intention to implement the budget reforms prepared by the military regime to enhance government control over spending. It probably will also take steps to reduce the pay and fringe benefit excesses that pervade the government bureaucracies, cut back nonessential large-scale public works projects, and curtail spending by state corporations.


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42. As a result, in our view, the odds are slightly better than even that the new government will succeed in slowing Brazil's inflation rate by the end of this year, although overall 1985 inflation may top 250 percent because of the effects of monetary expansion on prices in the first half of the year. We judge,

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moreover, that Neves will resist labor demands to raise real wages until he can bring inflation under control. If Neves fully carries out the military regime's planned budgetary and financial reforms, he will be in a better position to limit Brazil's monetary expansion, which should further lower the inflation rate. Such a reduction would be likely to have positive effects on Brazil's investment, economic growth, and foreign payments position. 

43. Brazil's payments position this year should remain strong, in our judgment. Neves's economic team has publicly asserted its intention to maintain the current sizable foreign reserves. Accordingly, we believe the new administration will continue to offer major tax and credit incentives to exporters, especially those in industry. Neves probably will prefer to devalue the cruzeiro only gradually to soften the inflationary impact but, if forced to choose, he is not likely to permit the currency to become significantly overvalued, which would make Brazil's exports less competitive. We expect that continued recovery in the West and some revival of demand in developing countries will combine with favorable government policies to lead to an increase of 5 to 8 percent in export revenues. We expect the export performance will enable this year's trade surplus to remain above \$12 billion, despite substantial increases in nonoil imports. Consequently, we believe Brazil's current account deficit probably will again be small. 

44. An accord with the IMF should pave the way for a rescheduling of foreign bank debt on terms similar to those tentatively negotiated by the outgoing government. Neves may press for some form of protection against a major rise in interest rates. In the event that the IMF program is aborted, the new administration might feel that it is in a strong enough foreign exchange position to press foreign bank creditors for a multiyear debt rescheduling without Fund support. Venezuela has provisionally reached such an agreement with international banks. 

#### Stable Civil-Military Relations

45. The armed forces will remain the most important political group in Brazil, but unless Neves dramatically shifts his conciliatory posture toward the military or strays too far from the moderate course we expect him to steer—changes we regard as highly improbable—we see little likelihood of any military intervention in the political process during the next year. Hardline elements opposed to the turnover of power are being eased out, and we expect the Army high command to use routine promotion and rotation

cycles to replace other potential troublemakers. As the Neves government takes hold, we expect both sides to continue their dialogue to diminish tensions and uncertainties. 

#### Potential Vulnerabilities

46. While we have forecast a moderate, relatively successful first year for Neves, his ability to hold to a centrist course will depend on his own political skills, economic conditions, and the continued willingness of key actors to compromise on contentious issues. Although he has demonstrated his ability to juggle competing demands and build a consensus, we believe there is considerable room for miscalculation that may complicate policymaking, erode his political base, and intensify opposition to his administration sooner than we, or Neves, expect. On the political side, key variables to watch include:

— *Popular expectations and Neves's leadership style.* The transition itself has generated high expectations that could be difficult to fulfill, leading to popular disenchantment if Neves fails to differentiate the policies of his administration from those of the former regime. Further, his reluctance to delegate authority could prevent him from examining policy alternatives and distract him from key issues.

— *Managing Congress.* Legislators, newly freed from the constrictions of military rule, are almost certain to demand a larger role in policymaking, especially on economic issues. There are indications that Neves is already facing difficulties holding together a working majority in the Congress, and he probably will have to make substantial concessions on key legislation. The political party realignment could also result in a splintered system that paralyzes the legislative process—infighting in state legislatures is already intense. Moreover, members of Congress and party chiefs, anticipating the 1986 elections, might be unwilling to identify too closely with the new government.

— *Coping with the left.* Leftists are unlikely to give Neves much breathing room. We believe Brizola will press relentlessly for limiting Neves's term to two years, arguing that he is a transition president without a direct popular mandate. Brizola, as well as other leftists, are also likely to

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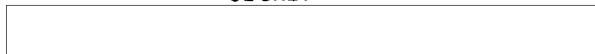
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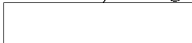
attack the President's economic policy and may demand investigations into past military corruption and human rights abuses. Neves's leftist supporters could be especially susceptible to such appeals. Other leftist groups, including the Communist Party and MR-8, are also likely to intensify their political activity as they seek to exploit the more open environment.

— **Containing labor.** Weak, divided, and lacking a clear agenda, organized labor nonetheless has the ability to carry out disruptive strikes in both urban and rural areas. Several moderate labor leaders have said that they have been disillusioned by Neves's resistance to their calls for more union autonomy. Moreover, there are indications that moderate labor chiefs may be unable to control their rank-and-file members, who appear increasingly influenced by leftists. Leaders of the Workers Party in Sao Paulo intend to oppose a "social pact" with business and the government. Rural labor unrest in the northeast and the interior of Sao Paulo state has also increased in recent months, according to press reports.


— **Military concerns.** The armed forces will watch for policy shifts that threaten their interests. They may, for example, be willing to tolerate some investigations into flagrant military corruption, but they would resist any broad formal inquiries into their activities while in power. They will also be sensitive to any indication of growing leftist influence in the government, shifts in foreign policy—especially any movement toward a rapprochement with Havana—or signs that Neves is unwilling to act firmly against leftist subversive activity or illegal strikes. In our view, there is some possibility of military or rightwing violence, such as bombings, against the government, although the high command should be able to contain such outbreaks. 

47. Whether Neves can limit the impact on his administration of these variables is closely linked, in our view, to his overall economic performance. His success in managing the economy over the next year, in turn, will depend heavily on his ability to maintain foreign banker cooperation and to regain control over Brazil's accelerating rate of inflation. We remain concerned that efforts by Neves to accommodate many or all interest groups and advisers, including those espousing leftwing views, may result in the adoption of inconsistent or misguided policies, such as advocacy of a foreign interest rate capping scheme and expansionary measures to spur rapid, domestically driven growth. 

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48. Should bank rescheduling discussions become protracted because of greater Brazilian demands or inflexible bank positions, the new administration probably would increasingly politicize the issue by appealing to governments of creditor banks to facilitate easier repayment terms. Such a situation would most likely occur under circumstances of resurging foreign interest rates or an unexpected drop in Western economic activity that would cause a major swelling of Brazil's current account deficit. Neves already has indicated that the Foreign Ministry will be given a greater role in foreign debt policy and has selected Olavo Setubal, a highly respected banker, to be its head. 

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49. If Neves does not succeed in holding the line on public spending, his plans to stabilize prices would be undone. Polls indicate that many Brazilians already are skeptical about the new administration's determination to fight inflation and will be alert to its first signs of wavering. A decision by Neves to shift to expansionary fiscal and monetary policies would be likely to lead to a rapid escalation of price increases to the 300- to 500-percent range. A sharp rise in inflation would seriously weaken the civilian government's prospects for sustaining the recovery, disrupt Brazil's relations with the IMF, and damage its political base. 


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