INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/311

BRAZIL

December 2020

2020 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR BRAZIL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2020 Article IV consultation with Brazil, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 25, 2020 consideration of the staff report that concluded the Article IV consultation with Brazil.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 25, 2020, following discussions that ended on October 2, 2020, with the officials of Brazil on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 9, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Statement by the Executive Director** for Brazil.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR20/362

IMF Executive Board Concludes 2020 Article IV Consultation with Brazil

FOR IMMEDIATE RELEASE

Washington, DC – **December 1, 2020:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Brazil.

COVID-19 has upended lives and livelihoods in Brazil, as it has in most countries around the world. Over 5.5 million Brazilians have been infected and more than 160 thousand have died from the disease. Economic activity contracted by 7 percent in the first half of 2020, the unemployment rate rose to 14.4 percent in September, and 11 million workers left the labor force. Households in the lowest income deciles were the most affected by the loss of labor income while women suffered a bigger decline in hours worked than men. Non-financial corporate profitability fell, and leverage surged amid reduced cash flows and high uncertainty. With the sharp contraction in domestic demand, inflation turned negative in April and May but gradually rose to 2.4 percent y-o-y in August, still below the lower band of the headline inflation target.

The government's response to the crisis was swift and sizable. The authorities implemented emergency cash-transfer and employment-retention programs, increased health spending, provided financial support to subnational governments, and extended government-backed credit lines to small businesses. In all, fiscal and quasi-fiscal measures amounted to 18 percent of GDP, raising the primary deficit to about 12 percent of GDP in 2020 from 1 percent in 2019. The Central Bank cut the policy rate by 225 bps in quick succession to 2 percent and announced extensive liquidity and capital relief measures. The policy response averted a deeper economic downturn, stabilized financial markets, and cushioned income loss for the poorest. Retail and industrial activity returned to pre-COVID levels in the third quarter, but the services' sector remains depressed, with a negative impact on employment.

The economy is projected to shrink by 5.8 percent in 2020, followed by a partial recovery to 2.8 percent in 2021. The lingering effects of the health crisis and the expected withdrawal of fiscal support will restrain consumption while investment will be hampered by idle capacity and high uncertainty. Inflation is expected to stay below target until 2023, given significant slack in the economy. The current account deficit is projected to narrow to -0.3 percent of GDP in 2020 from 2.8 percent of GDP in 2019 before gradually increasing over the medium-term as imports and profit distribution recover. With a sharp increase in the primary fiscal deficit, gross public debt is set to rise to 100 percent of GDP and remain high over the medium-term. The record low SELIC has helped reduce government borrowing costs but the local currency yield curve has steepened considerably, highlighting market concerns over fiscal risks. Overall, risks around the baseline are exceptionally large and multifaceted but high international reserves, a resilient banking system, and a low share of public FX debt are important mitigating factors.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They noted that good policies had positioned the Brazilian economy to take off in 2020, but the pandemic had a severe impact on the economy. Directors commended the authorities' strong policy response, which averted a deeper economic downturn, stabilized financial markets, and cushioned the effects on the poor and vulnerable. They stressed that policies should focus on limiting the scarring effects of the pandemic, ensuring medium-term debt sustainability, and pressing ahead with reforms to foster a robust and inclusive recovery.

Directors welcomed the authorities' commitment to preserve the constitutional spending ceiling as a fiscal anchor to support market confidence. At the same time, in the event that economic conditions turn out significantly worse than expected, most Directors emphasized that the authorities should be prepared to provide additional targeted support, and welcomed the authorities' willingness to consider this possibility. A number of Directors also cautioned against an abrupt withdrawal of fiscal support.

Directors stressed that swiftly implementing structural fiscal reforms that lock in medium-term consolidation will be essential to mitigate the risk of undesirable debt dynamics. They recommended reducing mandatory spending and budget rigidities, strengthening the social safety net, reforming the subnational pension schemes and strengthening the subnational fiscal framework, and revamping the tax system.

Directors agreed that monetary policy should remain supportive next year amid the substantial withdrawal of fiscal stimulus, with some Directors noting the scope to loosen monetary policy further, including through forward guidance, if inflation and inflation expectations remain below target. Some Directors cautioned about potential tradeoffs from further interest rate cuts given the unprecedentedly low level of the policy interest rate. In this context, careful monitoring of the implications for financial stability and capital flows of further rate cuts is warranted. Directors noted that approval of formal central bank independence would further strengthen the integrity of the monetary framework. They emphasized that the flexible exchange rate and sizable foreign reserves remain important shock absorbers, and intervention in the FX market should remain limited to addressing excess volatility.

Directors noted that the Brazilian banking system remains resilient but cautioned that continued close surveillance is warranted. They encouraged using the flexibility of the regulatory framework to weather the impact of the pandemic without diluting prudential standards. Continued progress in implementing the 2018 FSAP recommendations will be important.

Directors urged the authorities to press ahead with structural reforms to raise potential growth and improve living standards. They highlighted reforms to make the Brazilian economy more competitive, open to business and trade, and attractive to investment. They welcomed progress with the agenda to lower financial intermediation costs and stressed the need to pass comprehensive tax reform, accelerate the pace of new concessions and privatizations, and finalize trade agreements. Directors also emphasized the importance of labor market reforms, as well as education and re-skilling, to facilitate job reallocation. Directors underscored that preventing legal and institutional setbacks to combating corruption and effectively implementing anti-money laundering is important, as are measures to ensure the

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

integrity of public procurement. A number of Directors also highlighted the importance of policies for a green recovery.

It is expected that the next Article IV consultation with Brazil will be held on the standard 12-month cycle.

Table 1. Brazil: Selected Economic Indicators

I. Social and Demographic Indicators

Area (thousands of sq. km)	8,510	Health	
Agricultural land (percent of land area)	30.2	Physician per 1000 people (2018)	2.2
Population		Hospital beds per 1000 people (2018)	2.2
Total (million) (est., 2019)	210.1	Access to safe water (2018)	83.6
Annual rate of growth (percent, 2018)	0.8	Education	
Density (per sq. km.) (2019)	25.3	Adult illiteracy rate (2019)	6.6
Unemployment rate (2019)	11.9	Net enrollment rates, percent in:	
Population characteristics (2018)		Primary education (2019)	98
Life expectancy at birth (years)	76	Secondary education (2019)	85
Infant mortality (per thousand live births)	12	Poverty rate (in percent, 2018) 1/	25.3
Income distribution (2017)		GDP, local currency (2019)	R$7,257 billion
Ratio between average income of top 10 percent of earners over bottom 40 percent	12.4	GDP, dollars (2019)	US$1,839 billion
		GDP per capita (2019)	US$8,751
Gini coefficient (2018)	53.9		

Main export products: airplanes, metallurgical products, soybeans, automobiles, electronic products, iron ore, coffee, and oil.

II. Economic Indicators

			Proj.						
National accounts and prices	2017	2018	2019	2020	2021	2022	2023	2024	2025
GDP at current prices	5.0	4.6	5.3	-2.6	6.3	6.5	6.3	6.2	6.2
GDP at constant prices	1.3	1.3	1.1	-5.8	2.8	2.3	2.2	2.2	2.2
Consumption	1.4	1.7	1.3	-5.6	2.7	1.5	1.5	1.6	1.4
Investment	2.4	3.1	3.6	-10.8	6.6	5.0	5.6	6.1	6.2
Consumer prices (IPCA, end of period)	2.9	3.7	4.3	2.0	2.9	3.2	3.3	3.3	3.3
Gross domestic investment									
Private sector	12.3	12.7	13.1	12.7	12.9	13.1	13.5	14.0	14.5
Public sector	2.3	2.1	2.0	2.0	2.0	2.1	2.1	2.0	2.0
Gross national savings									
Private sector	20.4	18.6	17.2	29.6	18.7	17.3	17.4	17.7	17.9
Public sector	-6.5	-6.0	-4.9	-15.2	-5.0	-3.9	-4.2	-4.6	-4.7
Public sector finances									
Central government primary balance 2/	-1.9	-1.7	-1.3	-11.3	-2.7	-1.7	-1.2	-0.7	-0.1
Consolidated public sector									
NFPS primary balance	-1.8	-1.7	-1.0	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
NFPS cyclically adjusted primary balance (in percent of potential GDP)	-0.6	-0.7	0.0	-9.8	-1.8	-1.2	-1.0	-0.6	-0.1
NFPS overall balance	-7.9	-7.2	-6.0	-16.3	-6.1	-5.1	-5.4	-5.8	-5.8
Net public sector debt	51.4	53.6	55.7	66.8	71.3	74.4	77.0	79.4	81.3
General Government gross debt, Authorities' definition	73.7	76.5	75.8	96.6	96.7	97.4	97.7	98.3	98.5
NFPS gross debt	83.7	87.1	89.5	101.1	99.3	100.3	100.9	101.8	102.3
Of which: Foreign currency linked	3.6	4.1	4.3	4.7	4.7	4.6	4.5	4.4	4.4
Money and credit			(Annual percentage change)						
Base money 3/	9.6	1.6	3.3	9.9	6.3	6.5	6.3	6.2	6.2
Broad money 4/	4.6	8.1	9.1	12.6	6.3	8.3	8.1	8.0	8.0
Financial sector credit to the private sector									
Bank loans to the private sector	0.0	7.7	5.5	10.0	12.0	9.0	9.0	8.0	8.0
Balance of payments			(Billions of U.S. dollars, unless otherwise specified)						
Trade balance	64.0	53.0	40.5	51.9	53.3	56.7	57.9	57.7	58.9
Exports	218.1	239.5	225.8	210.3	229.1	236.5	240.2	249.6	260.5
Imports	154.1	186.5	185.3	158.3	175.8	179.7	182.3	191.9	201.7
Imports of oil									
Current account	-15.0	-41.5	-50.9	-3.9	-18.1	-29.0	-40.2	-51.8	-61.1
Capital account and financial account	10.3	42.9	53.8	3.9	18.1	29.0	40.2	51.8	61.1
Foreign direct investment (net inflows)	47.5	76.1	50.7	66.2	44.2	51.6	57.8	63.3	69.0
Terms of trade (percentage change)	5.8	-2.2	0.6	4.5	0.9	-1.0	-0.9	-1.3	-1.2
Merchandise exports (in US$, annual percentage change)	18.3	9.8	-5.7	-6.9	9.0	3.2	1.6	3.9	4.4
Merchandise imports (in US$, annual percentage change)	10.3	21.0	-0.6	-14.6	11.0	2.2	1.4	5.2	5.1
Total external debt (in percent of GDP)	32.3	35.3	36.7	48.7	46.6	43.0	41.0	39.0	37.6
Memorandum items:									
Current account (in percent of GDP)	-0.7	-2.2	-2.8	-0.3	-1.3	-1.9	-2.4	-2.9	-3.2
Unemployment rate	12.8	12.3	11.9	13.4	14.1	13.3	12.5	11.6	10.8
Gross official reserves	374	375	357	357	357	357	357	357	357
REER (annual average in percent; appreciation +)	8.5	-13.3	-1.2	…	…	…	…	…	…

Sources: Central Bank of Brazil; Ministry of Finance; IBGE; IPEA; and Fund staff estimates.

1/ Computed by IBGE using the World Bank threshold for upper-middle income countries of U$5.5/day. This number is not comparable to the estimates provided by IPEA in previous years due to methodological differences.

2/ Includes the federal government, the central bank, and the social security system (INSS). Based on the 2017 draft budget, recent announcements by the authorities, and staff projections.

3/ Currency issued, required deposits held at the Central Bank plus other Central Bank liabilities to other depository corporations

4/ Currency outside depository corporations, transferable deposits, other deposits and securities other than shares

INTERNATIONAL MONETARY FUND

BRAZIL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

November 9, 2020

KEY ISSUES

Context. The COVID-19 pandemic has worsened Brazil's longstanding vulnerabilities of low potential growth, high income inequality, and weak fiscal position. While the authorities mounted a rapid and effective response to support the economy and protect the poor and vulnerable, the virus outbreak is yet to be brought under control.

Outlook and Risks. Real GDP is projected to contract by 5.8 percent in 2020 followed by a partial recovery to 2.8 percent in 2021. With weak domestic demand, inflation is likely to end 2020 substantially below target. Debt is projected to jump to 100 percent of GDP, due to a 10.6 percentage point deterioration in the primary deficit in 2020, and continue to rise over the next five years. The high level of debt exposes Brazil to confidence shocks. Securing congressional passage of structural reforms to raise potential growth remains challenging.

Policy Recommendations. After the strong response to the pandemic, policies should focus on ensuring debt sustainability, while limiting the scarring effects of the pandemic to hasten a more robust and inclusive economic recovery over the medium-term.

- *Fiscal policy*. Maintain the expenditure ceiling in the 2021 budget but be prepared to provide additional fiscal support if economic conditions are weaker than the authorities expect. Reallocate resources under the expenditure ceiling to strengthen the social safety net on a permanent basis. Push for the passage of reforms that lock in medium-term consolidation.

- *Monetary and financial sector policy*. Continue to cut the policy rate and use forward guidance to support the economy as long as inflation and inflation expectations remain below target. Closely monitor financial stability risks by regularly conducting stress tests and ensure that regulatory action to mitigate the impact of the pandemic do not dilute prudential standards or accounting requirements.

- *Structural reforms.* Pursue with greater urgency structural reforms to make the economy more competitive, open to business and trade, and attractive to investment. Job creation is needed to end extreme poverty on a lasting basis.

Approved By
Aasim M. Husain (WHD) and Bikas Joshi (SPR)

Team: C.H. Lim (Head), V. Flamini and F. Toscani (all WHD), F. J. Boumediene (MCM), D. Marchettini (SPR), R. Perrelli (FAD) and I. Rossi (LEG), assisted by J. Pereira (Resident Representative) and D. Cunha (Local Economist). Discussions took place virtually during September 21–October 2, 2020. The team met Minister Guedes and Central Bank President Campos Neto and other senior officials, financial sector analysts, think-tanks, academics, and representatives of the private sector. B. Saraiva (OED) participated in most of the meetings. A. M. Husain (WHDIA) and A. Bevilaqua (Executive Director) joined the opening and concluding meetings while A. Werner (WHD Director) joined the concluding meeting with the Minister.

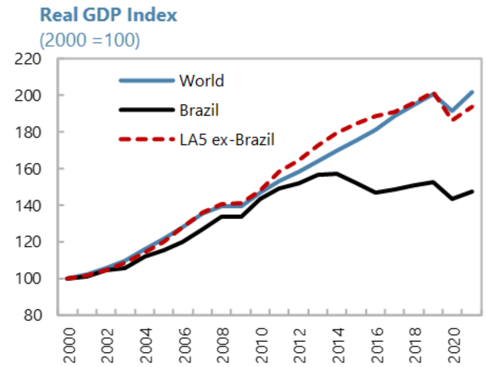
CONTENTS

TABLES

ANNEXES

PRE-COVID: A SLOW RECOVERY BUT PROMISING OUTLOOK

1. Brazil was struggling to kickstart its economy after the severe 2015-16 recession. GDP growth during 2017-19 was disappointingly low, marking the slowest recovery on record for Brazil and among the 10 percent weakest recoveries around the world in the last 50 years. At the end of 2019, GDP per capita was 7 percent below the level in 2014, unemployment was only marginally below the 2017 peak, and gains that had been achieved in reducing poverty and income inequality during the 2000s were partly reversed.

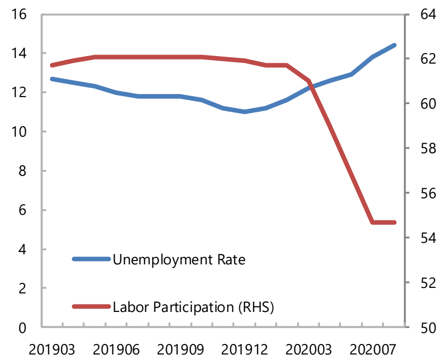


2. But good policies had positioned the economy to take off in 2020. The government embraced an ambitious reform agenda, in line with past Fund recommendations (Annex I), to put fiscal finances on a sustainable footing. A landmark pension reform was passed in October 2019 that stabilized pension spending as a share of GDP, saving the government around 11 percent of GDP over 10 years. Draft legislations were submitted to Congress to control government spending, improve tax efficiency and decentralize fiscal resources. Legislation to give the Central Bank de jure independence was also in the final stages of Congressional approval. These measures, combined with the adoption of the constitutional expenditure ceiling in 2016 and sharp reduction in state bank lending, improved Brazil's fiscal outlook considerably and precipitated a fall in the sovereign risk premium. With core inflation below target, this enabled the Central Bank (BCB) to steadily cut the policy rate to a record low of 4.25 percent by early 2020. The historically low interest rate environment helped trigger a structural transformation of financial markets, ushering in a new class of retail investors and deepening capital markets (Annex II).

THE COVID SHOCK: IMPACT AND POLICY RESPONSE

3. As in many countries around the world, the COVID-19 pandemic has upended the lives and livelihoods of Brazilians. More than 150,000 Brazilians have died and 5 million have been infected, making Brazil one of the hardest hit countries in the world (Figure 1). Insufficient testing hampers a full assessment of the scale of the health crisis but data on excess deaths relative to 2019 suggest that COVID-related mortality may be underestimated by up to 22 percent. Mitigation measures were implemented early on, but quickly lost effectiveness as mobility started picking up. With minimal central coordination, measures were applied with different stringency across regions, contributing to an uneven impact on mobility and economic activity (Annex III). Brazil seems to be past peak pandemic levels, but infection and mortality rates remain elevated. Overall, the government spent close to one percent of GDP to support the health system, mostly in the form of transfers to subnational governments (Annex IV).

Umployment and Labor Participation
(Percent)



Sources: Haver and Fund staff calculations.

4. Many Brazilians lost their jobs or saw their working hours significantly reduced as the pandemic shut down key sectors of the economy. Over 12 million jobs were lost between February and August, of which over 7 million were from the informal sector (Box 1). The unemployment rate rose by about 3 percentage points to 14.4 percent, but this masks the fact that 11 million workers (over 10 percent of the workforce) left the labor force altogether, resulting in a decline in the participation rate from 62 percent in February to 55 percent in August. Households in the lowest income deciles were most affected by the loss in labor income while women suffered a bigger decline in hours worked than men.

5. Non-financial corporate profitability fell, and leverage surged amid reduced cash flows and high uncertainty. Bank loans were the main source of funding, with credit to micro, small and medium-sized enterprises (MSMEs) surging to 20 percent year-on-year in August while credit to large companies grew by 15 percent, reversing a previous trend of negative credit growth. Among listed companies, liquidity coverage continues to be strong and the implied probability of default remains low relative to past crises. Looking at the broader universe of firms, June survey data show MSMEs bearing the brunt of the pandemic, with around 70 percent of MSMEs reporting lost sales relative to 58 percent of large companies.[1]

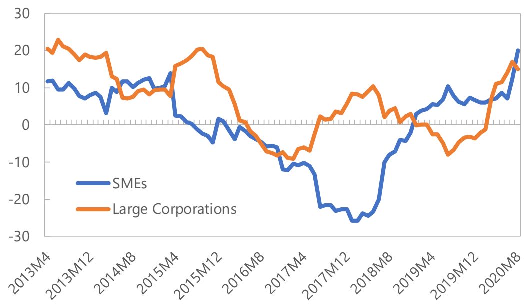
6. Economic activity contracted by 7 percent in H1 2020, the largest contraction in 30 years. Retail sales, services, and industrial production all fell by at least 20 percent from February to April but recovered in May, with the rebound led by retail sales and manufacturing activity. On the demand side, private consumption and investment declined by 13 and 15 percent, respectively in 2020Q2 (Figure 2). Overall, while the Q2 contraction was substantial (-9.7 percent q-o-q), it was better than expected by market consensus.

7. Inflation fell below target. Monthly CPI inflation was negative in April and May, as the fall in domestic demand more than offset the supply shock, but it has turned positive since June, driven by an increase in the price of fuels, durable goods, and processed foods (Figure 3). The exchange rate pass-through to inflation has steadily increased and inflation rose to 2.4 percent y-o-y in August, slightly below the lower band of the headline inflation target. Core inflation measures, however, are still running at low levels and inflation expectations remain anchored, providing the BCB room for continued policy accommodation.

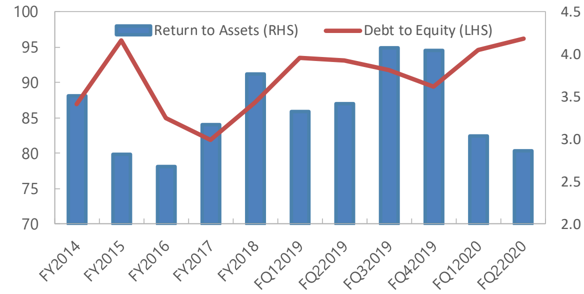
[1] Data on profitability, leverage and liquidity coverage of large companies come from Capital IQ. Data on implied probabilities of default come from Moody's CreditEdge. Survey data on the impact of the pandemic on the corporate sector come from IBGE's new Pulso Empresa.

The Impact of COVID-19 on the Corporate Sector

Loan Growth by Company Size
(Percent, Year-on-Year)

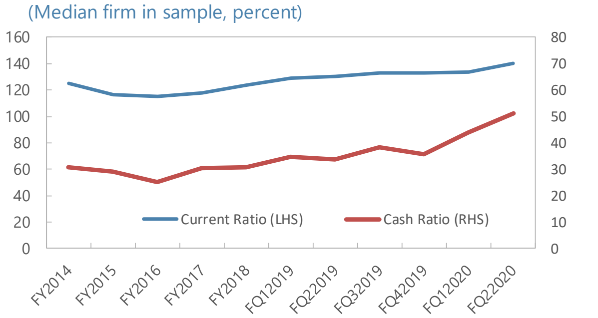


Profitability and Leverage Ratios
(Median firm in sample, percent)



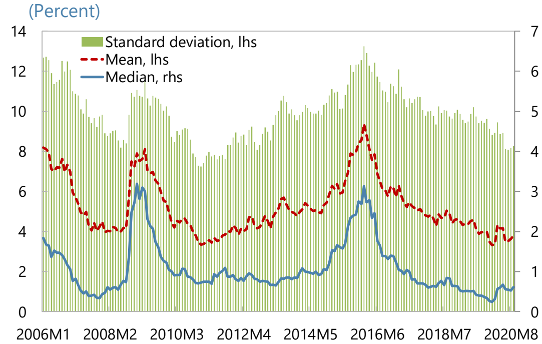
Source: Capital IQ and IMF staff calculations

Liquidity Ratios
(Median firm in sample, percent)



Source: Capital IQ and IMF staff calculations

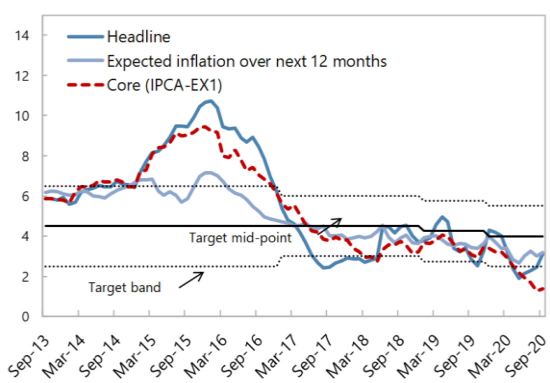
Moody's 1-yr EDFs
(Percent)



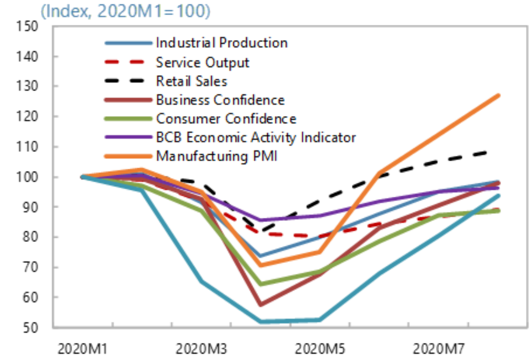
Sources: Moody's CreditEdge Database and Fund staff calculations.

The Impact of COVID-19 on Inflation and Economic Activity

Headline and Core Inflation
(Sesonally adjusted, year-on-year percentage change)



Economic Activity Indicators
(Index, 2020M1=100)



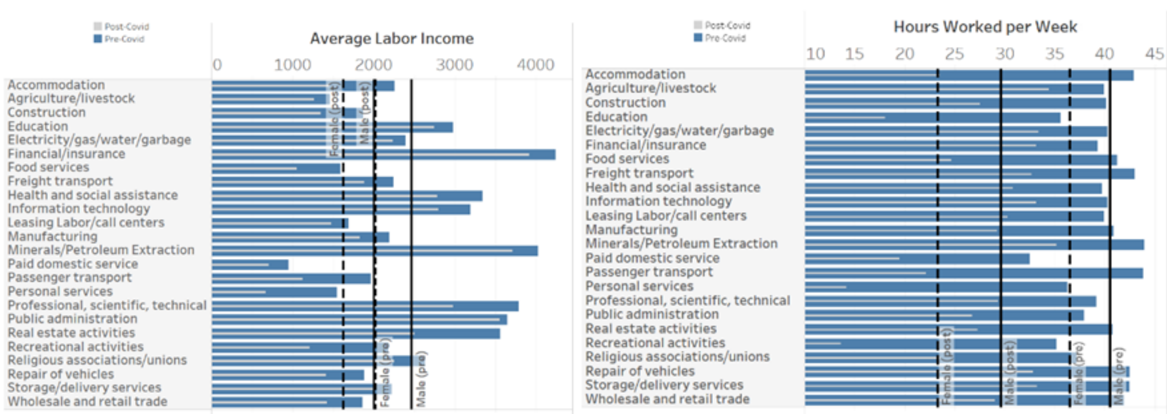
Sources: Haver and Fund staff calculations.

Box 1. The Impact of COVID-19 on the Labor Market

Sectors that are contact intensive with fewer options for teleworking suffered large job losses during February-August of 2020. The fall in employment was more pronounced for informal workers, with 7 million jobs lost compared to 5.5 million in the formal private sector.[1] Employment in the public sector, however, increased by 500,000. The hospitality sector was the hardest hit (loss of 24 percent of its employment share or 1.9 million jobs), followed by paid domestic services (16 percent; 1.6 million jobs), other services (12 percent; 1.2 million jobs), construction (5 percent and 1.2 million jobs), and commerce and trade (3 percent; 2.7 million jobs).

Workers who retained their jobs suffered a sharp reduction in working hours. Data from the Statistic Institute's COVID-19-19 household survey (IBGE's PNAD-COVID) shows that average hours worked per week fell from 39.6 to 27.4 on average (Figure 1). The decline in hours worked was more pronounced for women, who are more likely to be employed in the service sector and non-essential activities, with a decrease of 36.2 percent compared to 27 percent for men. With the support of government job retention programs,[2] income per hour rose from 14.7 to 17.3 R$/h on average for all workers (15.5 to 19.5 R$/h for formal workers). Women's income per hour rose by 28.6 percent compared to 12.1 percent for men as women suffered a more substantial reduction in working hours. The decrease in weekly hours and monthly income was more pronounced for older cohorts of workers (age 54 and higher).[3]

Figure 1: Labor Income and Hours pre- and post-COVID



Source: IBGE, PNAD-COVID.

Labor income fell across the income distribution, but poor households were the most affected. Households in the lowest income decile lost about 1.2 percentage points of their percentile share in total income as their monthly labor income decreased by 30 percent from R$462 to R$313. Labor income in the top decile of the distribution decreased by 17 percent, resulting in an increase in their percentile share by approximately 2.5 percentage points.

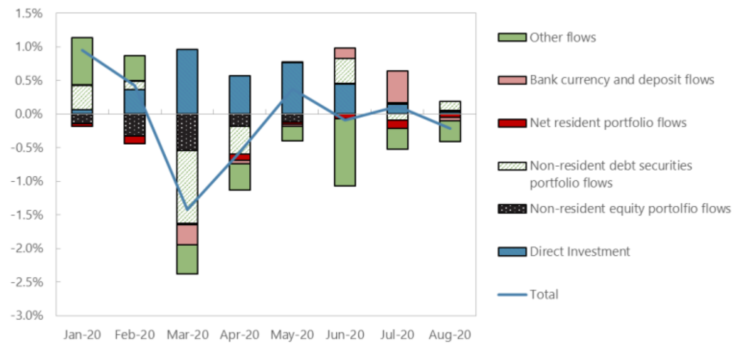
[1] Data from PNAD-Continua. Formal jobs data from the CAGED administrative database show a more positive picture, with about ¼ of the 1.6 million formal jobs lost during March-June recovered as of August.

[2] Two IPEA studies confirm the high income preservation of the job retention schemes (Beneficio Emergencial) for the formal sector: https://www.ipea.gov.br/portal/images/stories/PDFs/conjuntura/200826_cc48_resultados_pnda_julho.pdf and https://www.ipea.gov.br/portal/images/stories/PDFs/nota_tecnica/200603_nt_71_disoc.pdf.

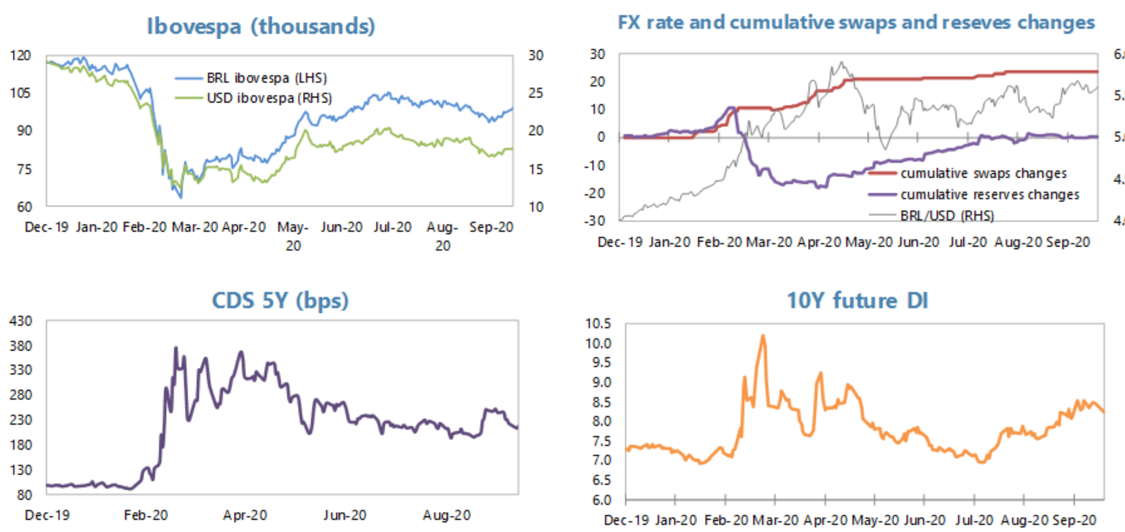
[3] The data on "normally received earnings" from the PNAD-COVID survey are used to proxy pre-COVID income. This is compared with "current income" as reported in the survey.

8. Amid the global spike in risk aversion, Brazil suffered large capital outflows. In the early weeks of the crisis, non-resident investors aggressively sold equities and debt instruments, leading to portfolio outflows of US$32 billion in March and April and a balance of payments deficit of over 2 percent of GDP at the peak. The IBOVESPA stock index dropped 45 percent between February 19 and its low point on March 23, and the domestic yield curve steepened sharply. As the exchange rate came under pressure, the BCB sold US$38 billion in the spot and derivatives market during March and April. Financial flows have since stabilized and international reserves have recovered to end-2019 levels, but the *Real* remains much weaker than at the start of the year and non-resident portfolio outflows have not yet reversed (Figure 4).

Monthly financial account excluding reserve changes
(in percent of GDP)



2020 Financial Market Developments



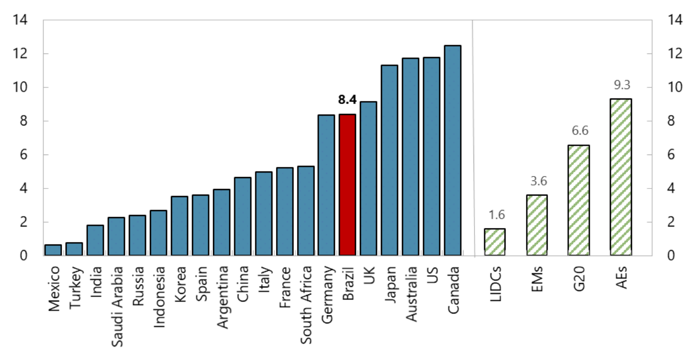
9. The government's response was swift and sizable. In late March, Congress declared a state of public calamity through end-2020, to pave the way for an emergency package of fiscal and quasi-fiscal measures amounting to 18.2 percent of GDP (Annex IV), raising the primary fiscal deficit to 11.6 percent of GDP.[2] Despite already high public debt, Brazil's fiscal support was among the

[2] The state of public calamity was necessary to lift the government's obligation to comply with the primary balance target in 2020 (NFPS deficit of R$118.9 billion or 1.5 percent of GDP) and enabled the government to accommodate exceptional spending needs. In addition, Congress ratified a constitutional amendment to allow the separation of COVID-19 related expenses from the ordinary budget of the Federal Government, creating an extraordinary "war budget" that is exempted from the "golden rule" (which prohibits government borrowing to finance current expenditures). As of mid-October, about 80 percent of the war budget has been disbursed.

largest for G20 countries and twice the EM average. An important element of the government support was in the form of cash transfers (*Auxílio Emergencial* or *Emergency Aid*) to informal workers and poor households. The authorities also increased health spending, provided financial support to subnational governments, extended government-backed credit lines to small businesses, and introduced employment retention schemes. The direct impact of these measures on the primary deficit (excluding automatic stabilizers and other cyclical factors) is estimated at 8.4 percent of GDP.

Brazil NFPS: Deficit-impacting Responses to the Pandemic	**Percent of GDP**
Expenditures	**8.0**
Emergency Aid	4.6
Subnational (non-health) spending	1.8
Health spending	0.8
Employment subsidies	0.7
Others	0.1
Revenues	**0.4**
Tax relief	0.4
Total Impact on Primary Balance	**8.4**
Memo: Auto stab—Revenues	2.8
Memo: Auto stab—Expenditures	-0.5
Memo: Cyclical factors	0.9
2020 Primary Balance	**11.6**

G20 Economies: Deficit-Impacting Responses to the COVID-19 Pandemic, 2020



Source: IMF Fiscal Monitor and staff estimates

10. The BCB eased monetary and financial policy. The BCB cut the policy rate by 225 bps in quick succession to 2 percent, reduced banks' reserve requirements for time deposits, and announced extensive liquidity and capital relief measures (Annex V). To support credit intermediation, the BCB temporarily relieved banks from automatically increasing provisions on renegotiated loans and lowered the capital requirement for credit to SMEs.[3] In addition, the capital conservation buffer (CCoB) was lowered to 1.25 percent for 12 months, while a temporary ban on dividend distributions was imposed to ensure that banks maintain adequate capital buffers. To expand the BCB's crisis-fighting toolkit, Congress passed legislation allowing the BCB to purchase public and private assets for financial stability purposes while a state of public calamity is in force, an option that has not yet been used.

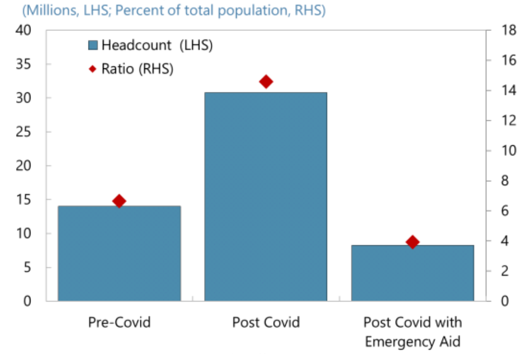
11. The strong policy response averted a deeper economic downturn, stabilized financial markets, and cushioned the effects of the pandemic on the poor and vulnerable.

- *The Emergency Aid (EA) proved crucial in supporting the livelihoods of informal workers and poor households*, lifting the income of an estimated 23 million individuals—10 percent of the total population—above the extreme poverty line (Box 2)[4]. But the extension of the aid to 67.7 million individuals in the first phase meant that the average fiscal costs for nine months will reach

[3] Between March and June, ¼ of both corporate and household loans (R$928 billion) were restructured.

[4] Poverty and inequality structural indicators are usually not measured at high frequency. Nevertheless, there is merit to take a snapshot of the impact of the *Emergency Aid* in May and June to capture its positive (temporary) effects.

around 4.6 percent of GDP. At close to 10 times the annual cost of the well regarded *Bolsa Família* (BF) social assistance program, the EA was large given the available fiscal space.



Sources: PNAD-COVID and Fund staff calculations.

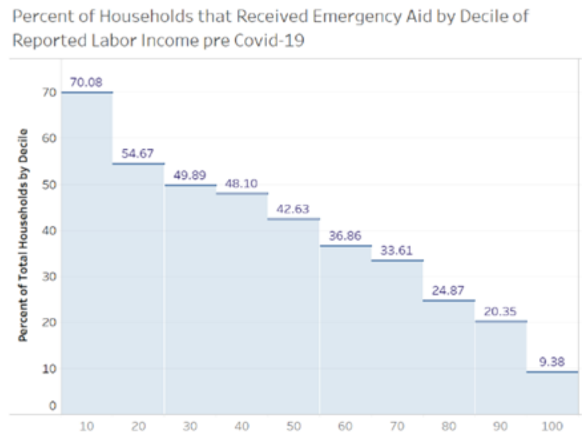
- *The employment retention schemes helped protect formal jobs*. The program subsidizes workers for temporary reductions in hours and is estimated to have saved up to 10 million jobs at a cost of around 0.4 percent of GDP between April and September. With the program extended through end-2020, it will continue to support employment through the first half of 2021 as employers are required to hold the contract for a period of time after the end of the subsidy.

- Liquidity support and capital relief measures preserved the proper functioning of domestic financial markets and supported credit intermediation. As of mid-September, MSMEs have received over R$80bn of targeted loans and credit guarantees. The total support was equivalent to 15 percent of the pre-COVID outstanding credit to MSMEs. The government-backed payroll credit line to SMEs helped save 2½ million jobs between April and October.

Key Crisis Lending Programs	**Disbursements (R$ bn)**	**Type of Government Support**
The National Support Program for Micro and Small Enterprises (Pronampe)	30	Capitalization of Guarantee Fund
Emergency Credit Support Program (PEAC)	51	Capitalization of Guarantee Fund
Working Capital for Business Continuity (CGPE)	3.8	Fiscal incentives for banks who lend under the program
Payroll Credit Line (PESE)	5.3	Direct lending

Note: Disbursements as of September 18, 2020.

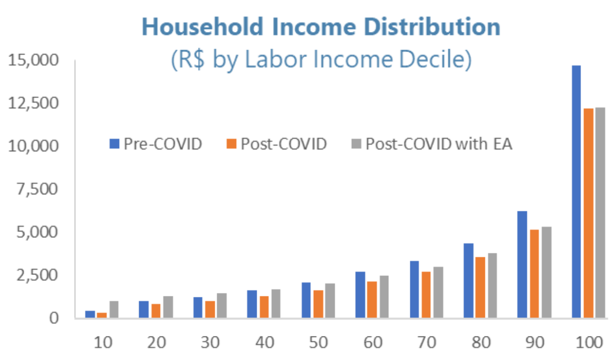
Box 2. The Effect of Emergency Aid on Poverty and Income Inequality

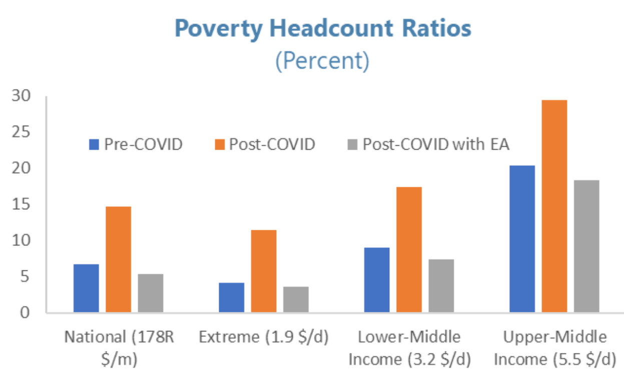


The EA was rolled out in April, with 67.7 million eligible beneficiaries, around one-third of the population.[1] Each beneficiary received monthly cash payments of R$600. Data from PNAD-COVID show that 70 percent of households in the bottom decile received the aid, accounting for 20 percent of total EA disbursements, while the bottom three deciles received 47 percent of the total. The program was extended twice, keeping the program in place through end-2020, with the benefit reduced to R$300 for the last four months of the year.

For the first five months of the program, the transfers increased the average income of the bottom 40 percent of households by 19.8 percent relative to the level of pre-COVID income. The aid corresponds to 150 percent of the pre-COVID labor income in the bottom decile and 40 percent of the pre-COVID median labor income. Households headed by women received twice the amount of transfers.

Consequently, the EA more than compensated the negative impact of the pandemic on poverty and income inequality, at least temporarily. Inequality as measured by the Gini index would have increased from 0.53 pre-COVID to 0.58 post-COVID mainly because Brazil's large informal sector was deeply affected by the pandemic. Likewise, the poverty headcount ratio would have increased sharply from about 6.7 percent to 14.6 percent—corresponding to 16 million individuals.[2] Instead, with the EA the poverty headcount ratio fell to 5.4 percent and the Gini coefficient to 0.5—both lower than their pre-COVID levels. Depending on the poverty line used, EA thus prevented between 14 and 23 million people from falling below the poverty line at the peak of the crisis. Once the aid expires at the end of the year, a substantial improvement in the labor market will be necessary to avoid a potentially sharp increase in poverty and inequality.





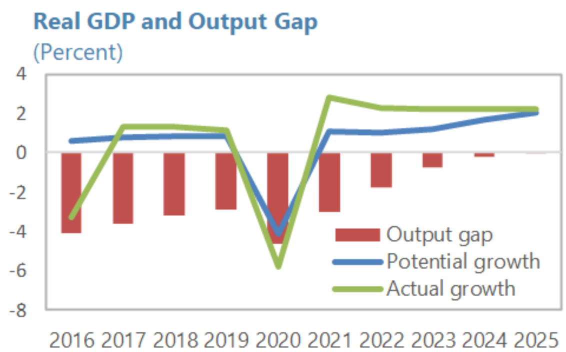
Source: IBGE, PNAD-COVID.

[1] The beneficiaries included 19 million BF beneficiaries, 10.5 million who were already included in the social registry but did not receive BF, and 38 million newly identified informal workers (Caixa App). About 47 percent of the total EA go to the bottom three income deciles compared with more than 70 percent for BF recipients.

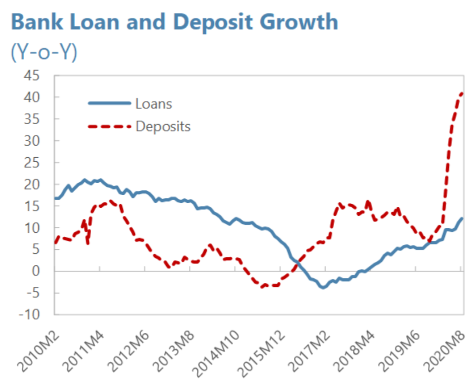
[2] This is an imperfect counterfactual comparison given that in the absence of EA, labor market outcomes might have been different.

OUTLOOK AND RISKS

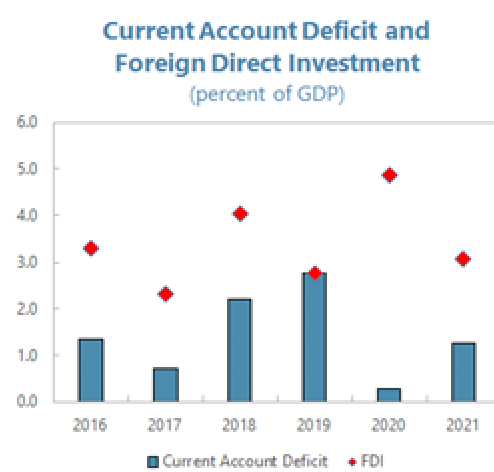
12. The economy is projected to shrink by 5.8 percent in 2020, followed by a partial recovery with 2.8 percent growth in 2021. With the EA cut by half in the last four months of the year, private consumption is expected to recover only modestly in the second half of 2020 and expand slowly through 2021 due to the lingering effects of the health crisis, the withdrawal of fiscal support, and potential labor market scarring (Box 3). The drawdown of household savings accumulated during 2020—household time deposits surged by over 60 percent y-o-y as of August—and employment support will smooth consumption during the first quarter of 2021. As in many countries, investment will be hampered by idle capacity and high uncertainty about growth prospects. Under the baseline, the output gap widens to 4½ percent in 2020 and closes in 2024 while real GDP returns to its end-2019 level in 2023Q2. Given significant slack in the economy, inflation is projected to stay below target until 2023.



Sources: Haver and Fund staff calculations.



13. The current account is projected to narrow to about -0.3 percent of GDP in 2020 from -2.8 percent in 2019 and to gradually return to trend over the projection period. At end-2019, Brazil's external position was moderately weaker than the level implied by medium-term fundamentals and desirable policies (Annex VI). Recent developments, however, suggest a move in the overall external position in 2020 to broadly in line with fundamentals.[5] The trade surplus is expected to rise to 3.8 percent of GDP, supported by the depreciation of the *Real* and lower domestic demand. A significant improvement is also expected in the service

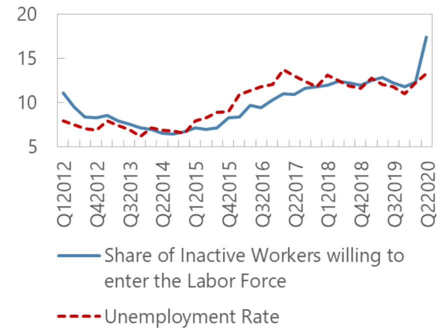


[5] However, this assessment is highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis. A complete analysis—including possible adjustments for transitory factors, such as the sizable capital outflows amid the spike in global risk aversion, and the attendant sizable exchange rate depreciation and import compression—will be provided in the 2021 External Sector Report.

Box 3. Risks of Labor Market Scarring Post-COVID

Brazil's labor market was still recovering from the previous recession. Both the unemployment rate and the share of workers who are outside the labor force but would like to work increased by around 5 percentage points during the 2015-16 crisis. Overall, the last recession caused a substantial increase in labor underutilization which had only partially reversed as of early 2020.

Labor Underutilization:
Unemployment and Workers willing to enter the Labor Force



The COVID shock to the labor market is unprecedented in terms of job losses. April 2020 saw the largest monthly loss of formal jobs on record as well as an unprecedented drop in labor force participation. Nevertheless, job destruction was substantially smaller than in most other Latin American countries, partly due to Brazil's employment protection programs. As laid out in the October 2020 WHD Regional Economic Outlook, maintaining a relationship between firm and worker, even if there is a temporary layoff, reduces the risk of scarring (IMF, 2020). For this reason, the programs could be an important factor in protecting the labor market.

The COVID shock might carry scarring risks beyond more conventional recessions. A large body of evidence shows the long-lasting effects of "conventional" recessions, stemming from hysteresis in business cycle dynamics, structural reallocation, falling investment, and loss of firm-worker matches that imply the destruction of valuable on-the-job experience[1]. The move towards more technology-intensive work, more remote work and automation, spurred by the COVID-19 shock, might additionally complicate the labor market recovery as vulnerable groups are left behind by the structural transformation even if it ultimately improves productivity. In addition, sectors such as tourism might be affected for a long period by changed demand patterns, increasing the risks of long spells of unemployment or underemployment for workers who cannot easily change sectors.

An analysis of past labor market dynamics points to a long-lasting increase in unemployment. A simple bivariate VAR with two lags suggests increases in inactivity resolve relatively quickly while shocks to unemployment tend to be more persistent in Brazil.[2] The fall in labor force participation might thus reverse by early or mid-2021 but unemployment might remain elevated for a long time.

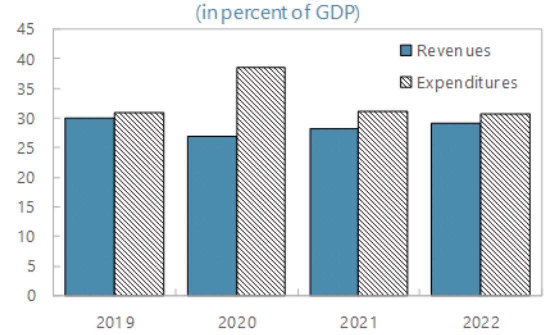
[1] *Western Hemisphere Department, Regional Economic Outlook, October 2020.*

[2] *The unemployment and inactivity series are obtained by splicing together quarterly data from PNAD and PME, with PME data used for 2002-2012. The approach in this analysis is similar to the one used in the 2020 Mexico Article IV Report.*

and income balances, due to the contraction of service imports and reduced distribution of profits, respectively. Portfolio financial flows are expected to contract by about 2.7 percent of GDP, given the large portfolio outflows in the first half of the year, but net FDI have remained strong and will continue to finance the current account deficit. Total external debt and gross financing needs are expected to increase sharply in 2020 mainly due to the GDP contraction in dollar terms, before declining over the medium-term (Annex VII). International reserves are expected to remain stable at US$357 billion (158 percent of the IMF's ARA metric or 184 percent including the US$60 billion swap line with the U.S. Fed). Over the medium-term, the current account deficit is projected to gradually increase as imports and profit distribution recover.

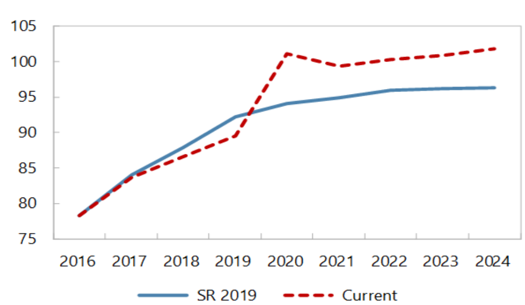
14. The non-financial public sector (NFPS) primary fiscal deficit is projected to rise from 1 percent of GDP in 2019 to 11.6 percent in 2020. Reflecting the impact of the pandemic, total revenues are expected to drop by 3.1 percentage points of GDP and primary expenditures to increase by 7.6 percentage points relative to last year. Over the medium term, the revenues-to-GDP ratio will gradually catch up to pre-crisis levels. With the support of the expenditure ceiling, fiscal consolidation of at least 3 percent of GDP after 2021 will be needed over the medium-term to close the primary deficit and stabilize the public debt ratio at the current level.

Brazil: NFPS Revenues and Expeditures, 2019-2022
(in percent of GDP)

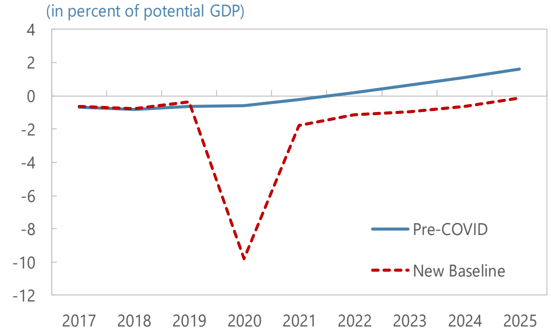


15. With the sharp increase in the primary fiscal deficit, gross public debt is projected to jump to around 100 percent of GDP in 2020 and remain high over the medium-term. Gross financing needs of 28 percent of GDP in 2020 are being met through a combination of domestic issuances and the use of liquid assets (Treasury deposits at the BCB). Financing needs are projected to remain at around 20 percent of GDP, above the DSA-based risk thresholds, through the medium-term (Public Debt Sustainability Analysis). The record low SELIC, combined with the recent shortening in average debt maturities, has allowed the government to reduce its borrowing costs to historically low levels.[6] However, Brazil currently faces a very steep local currency yield curve, highlighting market concerns over fiscal sustainability.

Non-financial Public Sector Debt Projection
(Percent of GDP)



Brazil: Pre-COVID and New Baseline Structural Primary Balance, 2017-2025
(in percent of potential GDP)



[6] Borrowing costs today are 5 percent relative to a high of close to 15 percent in late 2016.

16. Risks around the baseline are exceptionally high and multifaceted. While there are upside risks—the recession could turn out to be less severe or the recovery more robust than projected by staff—the downside risks are significant.

- On the upside, advances in medical treatments, changes in the workplace to reduce trans-mission, or the production of a safe, effective and affordable vaccine may allow activity to return more quickly to pre-pandemic levels. On the downside, if the virus resurges and progress on treatments and vaccines is slower than anticipated, economic activity could be lower than expected, with renewed social distancing. A protracted recession would increase hysteresis effects in the labor market and generate negative feedback loops between the financial sector and the real economy.

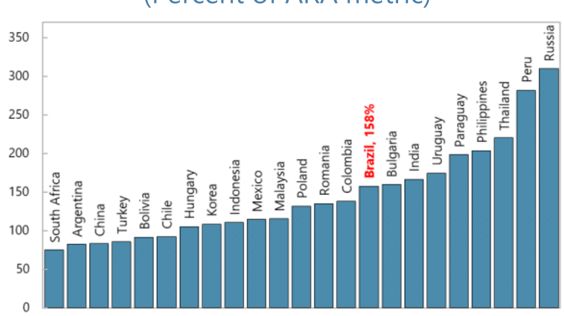
- The risks of political polarization have subsided in the second half of the year but much of the structural reform agenda submitted or about to be presented to Congress in early 2020 has been suspended because of the pandemic, delaying the implementation of key reforms (Annex I). Furthermore, the municipal elections in November have delayed congressional discussions on the 2021 budget and underlying fiscal reforms—including accommodating a new social assistance program to succeed the EA. If no agreement is reached market confidence could be undermined, exacerbating debt sustainability risks. Political risks could also intensify if the economy takes a turn for the worse.

- External shocks, including accelerating de-globalization, volatility in the oil market, and intensified geopolitical tensions pose additional risks (Annex VIII).

- Policy choices next year entail risks. Withdrawing COVID-related policy support prematurely could weaken the recovery while extending support for too long could exacerbate debt sustainability risks. Finding the right balance will be challenging in a highly uncertain environment and policies will have to adapt quickly to changing circumstances.

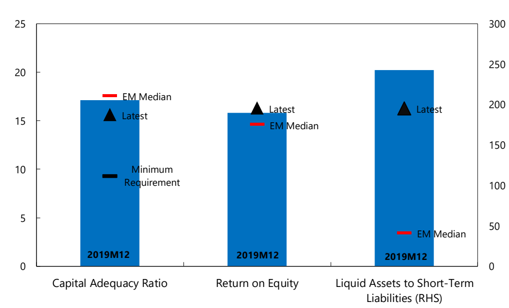
- Nevertheless, high international reserves, a resilient banking system (Box 4), and a low share of public FX debt are important mitigating factors.

Reserves, 2019
(Percent of ARA metric)



Sources: IMF VE database and Fund staff calculations.

Bank Capital and Liquidity Buffers
(Percent)



Authorities' Views

17. The authorities are more optimistic than staff on the economic outlook. They broadly agree with staff's external sector assessment.

- Both the Central Bank and the Ministry of Economy project a contraction of about 5 percent this year followed by a recovery of about 4 percent, in 2021. They point to high frequency indicators on retail sales and manufacturing activity that show robust growth this year at the margin and expect precautionary savings to help sustain private consumption in 2021. In addition, low interest rates, the recent retrenchment of large public banks, and regulatory changes to improve the business climate in Brazil should "crowd-in" the private sector, attract FDI and other PPP infrastructure investment and set the stage for higher growth.

- The authorities agree that the external position in 2019 was moderately weaker than fundamentals and expect a significant improvement in the current account balance in 2020 on the back of a subdued Real, and low profitability.

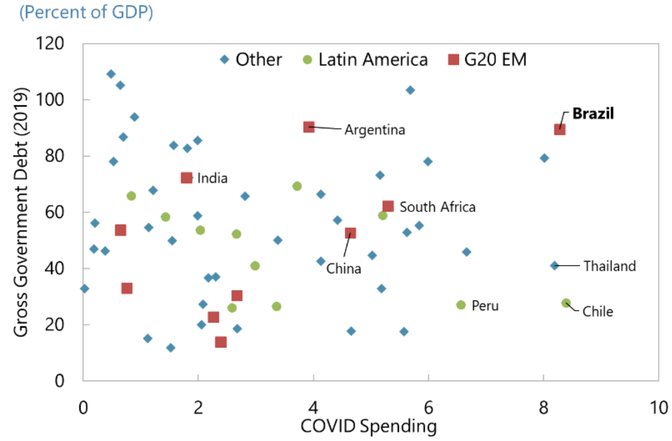
NEAR-TERM POLICY PRIORITIES: SAVING LIVES AND LIVELIHOODS

Preserving the constitutional expenditure ceiling as a fiscal anchor is essential to mitigate the risk of undesirable debt dynamics. The authorities should be prepared to provide additional fiscal support if economic conditions were to turn out worse than they expect. Frontloading structural reforms that lock in medium-term consolidation is essential and could also open up some fiscal space in the near term. Monetary policy should remain accommodative in 2021 if inflation and inflation expectations remain well anchored.

A. Fiscal policy

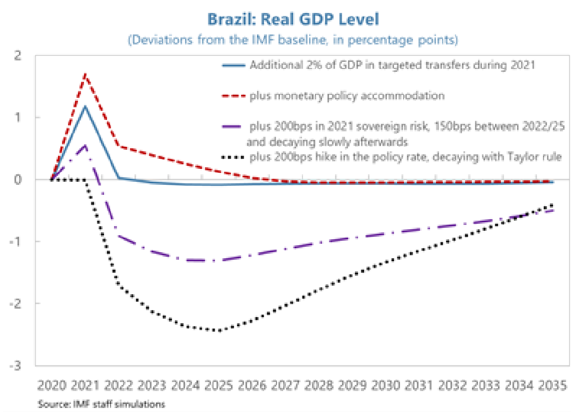
18. The expenditure ceiling implies a sharp fiscal contraction in 2021. In August, the authorities submitted to Congress a budget proposal that does not envisage any pandemic-related extraordinary spending in 2021. Hence, under the baseline, the expiration of the War Budget by end-December 2020 implies a sharp decline of 8.4 of GDP in extraordinary primary expenditures next year. A withdrawal of this magnitude would place Brazil at more than twice the average discretionary fiscal tightening of close to 4 percent of GDP next year across the G-20.

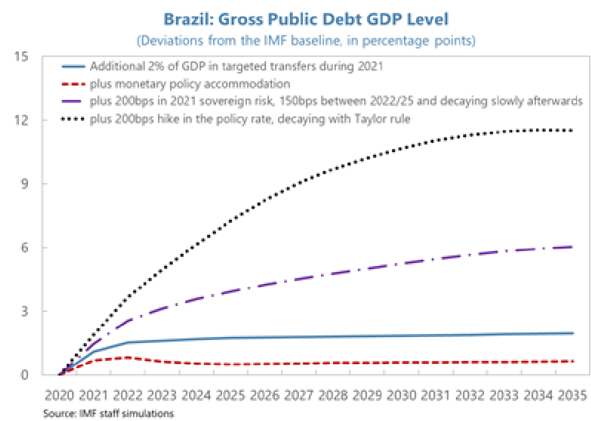
COVID Spending and Gross Debt in Emerging Markets
(Percent of GDP)



Sources: World Economic Outlook and Covid Fiscal Measures Databases

19. Maintaining the expenditure ceiling in 2021 is critical to support market confidence. Markets view the expenditure ceiling as the fiscal anchor to deliver medium-term fiscal consolidation. Without a credible commitment to the expenditure ceiling, the sovereign risk premium could rise, further steepening the yield curve, and in a worst-case scenario set off undesirable debt dynamics. Staff's model simulations suggest that a one-off spending of 2 percent of GDP in 2021 could increase the real GDP level by 1-2 percentage points in the short-term (relative to the baseline) and still preserve debt sustainability if Brazil's fiscal credibility is maintained (Annex IX). However, should backloading fiscal consolidation be perceived as a slippery slope to fiscal profligacy, causing a loss of market confidence and spike in interest rates, real GDP would fall below the baseline and debt-to-GDP could rise by as much as 10 percentage points.





20. However, a more gradual fiscal withdrawal in 2021 would be desirable if economic conditions deteriorate significantly compared to the authorities' current expectations. As the pandemic is still evolving and its scars are unknown, fully unwinding all the extraordinary support in the coming months could risk derailing the incipient recovery. Brazil's output gap is large, and the economy is credit constrained. Importantly, ending cash transfers to vulnerable households and informal workers while the labor market is still weak could lead to higher income and gender inequality. Maintaining some support next year would allow some leeway to fight the lingering effects of the pandemic and reduce Brazil's vulnerability to crisis-related scarring. For example, if economic activity evolves in line with staff's projections, fiscal support of about 2 percent of GDP could allow for some health spending, a better targeted and more affordable version of the Emergency Aid and a streamlined version of the employment protection program.[7] If such additional spending is implemented, securing medium-term fiscal consolidation through structural reforms becomes even more important to maintain market confidence.

21. Structural reforms that lock in medium-term consolidation are vital to preserve fiscal sustainability in a period of high uncertainty. With public debt rising above 100 percent of GDP

[7] This would include temporary cash transfers of R$300 per month to around 40 million vulnerable citizens (equivalent to 1.9 percent of GDP), plus 0.6 percent of GDP of employment subsidies and additional health spending, with 0.5 percent of GDP of the cost financed by the BF budget.

over the medium-term, addressing structural sources of expenditure pressure remains crucial to preserve the constitutional expenditure ceiling. Revenue measures aimed at widening the tax base would also facilitate a faster reduction of debt. Reform priorities fall under four broad pillars: (i) reducing mandatory spending and budget rigidities; (ii) rationalizing and re-focusing existing social protection programs; (iii) reforming the subnational fiscal framework; and (iii) revamping the tax system. Staff estimates that implementing the agenda on structural reforms could save as much as 3.5 percent of GDP for the NFPS while also improving the targeting of social assistance programs.

Brazil: Estimated annual fiscal savings of structural fiscal reforms
(in percent of GDP)

Reducing mandatory spending and budget rigidities	1.0
Reducing tax expenditures	2.0
Reforming subnational fiscal framework 1/	0.5
Total	**3.5**

1/ Savings mainly from subnational pension reforms and outside the Federal budget.

22. Reducing mandatory spending and budget rigidities is essential to free up space for more productive spending. Discretionary spending is less than 7 percent (1.5 percent of GDP) of federal expenditures (Figure 5). Cutting personnel costs and addressing rigidities in central and regional budgets, including through less indexation and earmarking, will enable substantial efficiency gains. Priority actions include:

- Reducing personnel costs. Brazil's wage bill is high relative to its peers.[8] In line with the Emergency Bill submitted in late 2019, a reduction in personnel costs could be achieved via wage, hiring, and promotion freeze, with a hard cap on total remuneration per employee, and allowing wage cuts in proportion to cuts in working hours. These measures would yield savings of up to one percent of GDP per year.

- Overhauling civil service career structures and aligning public compensation with the private sector. Civil servants receive a public wage "markup" of up to 50 percent compared with those who work in the private sector. The authorities' administrative reform proposal goes in the right direction to address these issues but should also include currently employed civil servants to frontload fiscal savings.

- Severing the link between pensions and benefits from minimum wage indexation but allowing adjustments for the cost of living and with careful consideration of the impact on income inequality.

[8] Latest available data (2018) show Brazil's wage bill is 13.7 percent of GDP compared with 10.4 percent in advanced economies, 9 percent in emerging economies, and 8.4 percent in Latin America and the Caribbean. Nearly 75 percent of Brazil's wage bill corresponds to state and municipal governments. Most government workers are in the top two quintiles of the earnings distribution (80 percent of federal workers and 55 percent of subnational workers).

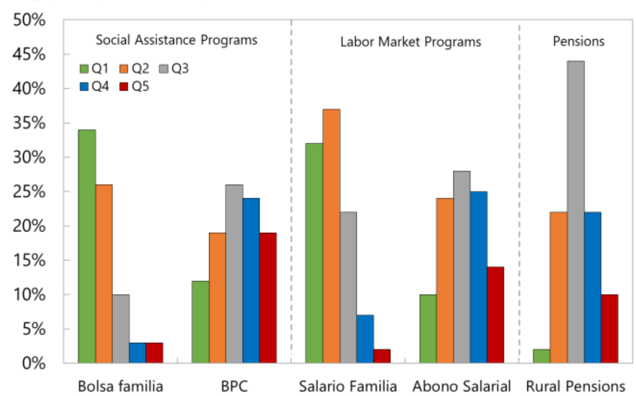
- Removing minimum requirements for state-level spending on education and health, or at the very least creating a joint (instead of the current separate) minimum requirement as proposed in the Federative Pact. This would allow states more flexibility to allocate resources where they are most needed and avoid wasteful spending.[9]

- Releasing unused earmarked resources locked in public funds to relieve financing pressures. This would free up, on a one-off basis, 3 percent of GDP, which could be used for public debt amortization.

23. The social safety net should be strengthened. According to the World Bank, Brazil has many social protection and labor programs, but they are insufficiently coordinated, creating duplication and regressive spending[10] although at 1.5 percent of GDP, Brazil's overall spending on social assistance programs is in line with peer countries. Among the social assistance programs, BF is well targeted and cost effective, but 70 percent of BPC benefits accrue to the richest 60 percent of the population.[11] In addition, labor market programs that provide wage subsidies such as *Abono Salarial* and *Salário Família* have an almost complete overlap of recipients ("double dipping"), mostly of richer households. Staff supports the World Bank recommendation to consolidate all current non-contributory cash benefit programs into one single program. The rationalization could save roughly 0.7 percent of GDP under the expenditure ceiling that could be used to fund an expanded BF or a new social assistance program that is modeled after BF and best practices from OECD countries.

Incidence of Spending on Selected Programs

(By per-capita income quintile)



Sources: World Bank 2017 Public Expenditure Review based on PNAD.

24. Reforming the subnational fiscal framework is key to sustain the provision of core public services. States and municipalities have been struggling with high debt and severe liquidity pressures. Some of the largest states have already defaulted on part of their debt and are running payment arrears (wages and suppliers). The Federal government has provided substantial support through debt service relief over the years and, in the context of the 2020 War Budget, the support helped offset revenue shortfalls and cover extraordinary spending during the pandemic. Expectations of further federal bailouts are entrenched in the system. Reforms are urgently needed.

[9] WP/19/239 and Word Bank (2017) show that there is substantial scope for efficiency savings in health and education spending while maintaining the same outcomes. Potential savings in education are also associated with demographic developments as the share of school age individuals in the population is projected to decline from 35 percent in 2016 to 25 percent in 2030. The World Bank finds that Brazil's public spending on tertiary education and tax deductions on medical bills and private health insurance cater to the rich and are highly regressive.

[10] Labor Market and Social Assistance Program: Integrate to Improve, World Bank, 2017.

[11] The BPC stands for Benefício de Prestação Continuada, a social pension program for the elderly and disabled.

- *Subnational pensions should be reformed in line with the new provisions for federal government employees*. State and local governments were left out of the 2019 federal pension reform. Private sector estimates indicate the reform of subnational pension schemes could save up to 5 percent of GDP over 10 years.

Brazilian States: "Restos a Pagar", 2015-2019
(in percent of GDP)

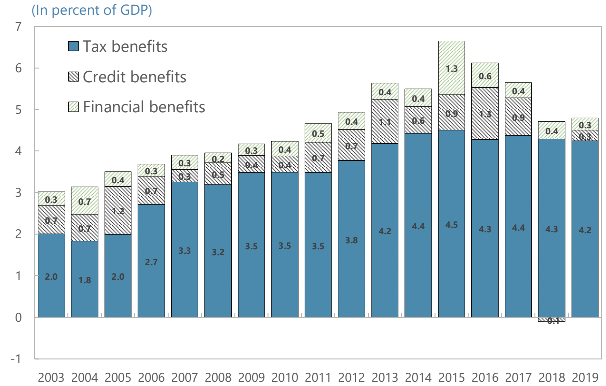
Sources: Brazilian National Treasury; IBGE; IMF staff calculations

- *Adopt a new subnational fiscal framework that imposes credible hard-budget constraints and reduces the expectation of future bailouts by the federal government*. As recommended by IMF technical assistance missions,[12] the framework should include lower safe debt limits to allow better management of adverse shocks and consistency with debt service capacity, along with enhanced fiscal transparency, simplification of the rules' framework to facilitate more effective enforcement, and greater reliance on market discipline. Staff also recommended introducing subnational spending caps on the growth of total primary expenditures at the state level and a balanced budget rule and rainy-day funds for municipalities.

25. Revamping the tax system will help to reduce the misallocation of resources, improve the business climate, and strengthen revenue administration. Priorities should include:

- *Removing distortionary fiscal incentives that, at almost 5 percent of GDP, are high relative to G20 EMs.*[13] Fiscal incentives are inefficient, inequitable, and add to the complexity of the tax regime, leading to tax disputes and revenue loss. The authorities should resume plans to gradually reduce implicit and explicit benefits subject to mandatory periodic reviews. In particular, the small enterprise tax exemptions should be addressed. Staff recommends limiting the eligibility to lower tax rates to truly small businesses, in line with their ability to pay. Fiscal savings from reducing fiscal incentives could amount to at least 2 percent of GDP, which could be used to lower the high payroll and corporate taxes.

Brazil: Fiscal Incentives, 2003-2019
(In percent of GDP)



Source: National Treasury and Fund staff calculations.

[12] *Brazil—Technical Assistance Report—Strengthening the Framework for Subnational Borrowing*, IMF Country Report No. 19/302 (September 2019), and *Brazil—Technical Assistance Report—Strengthening Fiscal Responsibility at the Subnational Level,* IMF Country Report No. 20/227 (September 2020). Washington DC: International Monetary Fund.

[13] Latest available data show the average tax benefits for G20 EMs (excluding Brazil) is 3 percent of GDP compared with 4.2 percent in Brazil.

- *Streamlining the tax system, making it more efficient, growth friendly, and progressive*. Staff welcomes the government's proposal to unify PIS and COFINS into a single federal VAT. The authorities should pursue reforms to harmonize the fragmented federal and subnational tax regimes to lower the cost of tax compliance. They should also review personal income taxes to make them more progressive, including by introducing dividend taxation.

- *Focusing revenue administration reforms to support the implementation of a unified VAT system, enhance the taxpayer compliance framework, and simplify tax arrears collection*. Legal and administrative actions at the federal level as well as coordination between the federal, state and municipal levels to align responsibilities are required to administer a new VAT. The authorities should also modernize their compliance management approach, including by integrating arrears collection as a part of the overall risk management strategy.[14] Tax authorities should be granted powers to enforce the collection of tax arrears without having to require prior court approval.

26. Introducing medium-term fiscal and budget frameworks can improve public financial management and support the implementation of structural reforms. The existing framework is fragmented and excessively focused on intra-year budget implementation, with no clear medium-term anchor. As a result, fiscal policy tends to have a deficit bias, adding pressure on expenditures. Staff recommends developing a fully-fledged medium-term fiscal framework that enhances top-down strategic decision making and guidance for the budget process, the setting of clear fiscal policy objectives and targets (including medium-term debt targets) in a multi-year budget plan, and rolling spending reviews for large and fast growing expenditures. The medium-term budget framework would include macro-fiscal forecasts and ensure strong coordination between planning, budgeting and execution of key policy objectives. In addition, the framework should make existing rules simpler, more flexible, and internally consistent. In this context, introducing an economic escape clause to the expenditure ceiling would allow temporary deviations from the rule to respond to large shocks while preserving the credibility of the fiscal anchor.

Authorities' Views

27. The authorities are fully committed to maintain the expenditure ceiling. They expect a continued reopening of the economy and a strong rebound in activity next year and do not see the need for more stimulus. Importantly, they argued that non-compliance with the ceiling would be negatively perceived by the markets, resulting in an increase in risk premia and a further steepening of the yield curve. This could contaminate the short end of the curve and also de-anchor inflation expectations, forcing the Central Bank to tighten monetary policy, compromising the economic recovery and putting Brazil's debt sustainability at risk. If conditions turn out substantially weaker than they expect, the authorities indicated that they would be prepared to consider providing additional fiscal support.

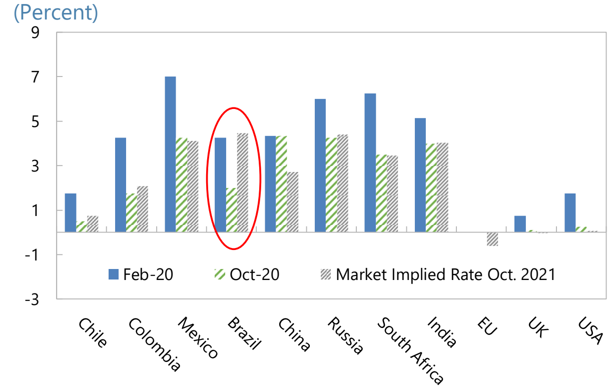
[14] At 304 percent of total tax collection, tax arrears are high. Moreover, about 57.8 percent of the stock of tax arrears was more than 12 months past due. To increase tax collection rates, the authorities are pursuing agreements with taxpayers via administrative and legal channels.

28. The authorities agree that structural reforms are critical to ensure medium-term consolidation. They concur with staff on the need to address widespread budget rigidities, including for the subnational governments. They indicate that the new Federative Pact draft bill will address many of the issues identified by staff. On the revenue side, the authorities underscored their commitment to a comprehensive tax reform. However, unlike staff they support a revenue-neutral tax reform and plan to use the savings from the reduction of tax expenditures to lower the tax rate of the unified VAT. In addition, they see adiminstrative reform as delivering long-term gains and do not intend to apply the reform to current employees.

B. Monetary and Exchange Rate Policies

29. Monetary policy is appropriately supportive. Inflation expectations are well anchored and both core and headline inflation are below target. Following the 225bps cuts, the BCB has taken a cautious stance on further cuts as the current 2 percent policy rate corresponds to a negative ex-ante real rate, which is strongly expansionary even accounting for the substantial uncertainty around the real neutral rate (estimated at around 3 percent). While lending rates remain high, there has been some pass-through to the corporate segment from the recent cuts as a lower share of public bank lending in total lending has strengthened the pass-through of monetary policy. In addition, the corporate debt service burden has declined with lower interest rates since 80 percent of corporate securities debt is linked to the overnight interbank rate. Markets expect the policy rate to rise again in 2021, returning to pre-COVID levels by October 2021.

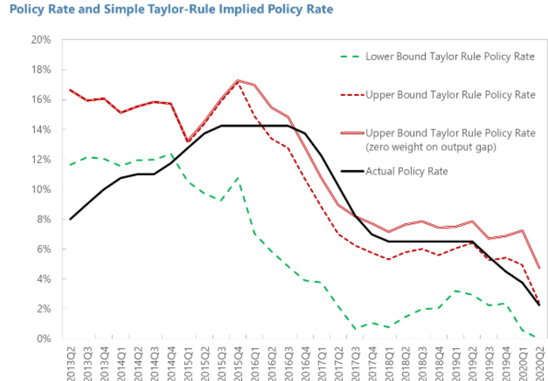
Policy Rate in Brazil and Selected Countries
(Percent)



Sources: Bloomberg and IMF staff calculations.

30. There is room to cut the policy rate further if inflation and inflation-expectations remain below target. With the substantial withdrawal of fiscal stimulus in 2021, inflation dynamics are expected to remain subdued and with little exchange rate pass-through,[15] staff see no constraint to test lower rates while monitoring possible implications for capital flows and financial stability. Simple Taylor rule analysis suggests that the BCB could cut further, especially if the weight on the output gap is non-zero. As a complement, continued use of forward guidance to signal that

Policy Rate and Simple Taylor-Rule Implied Policy Rate



Sources: IMF Staff calculations.
Note: The text chart shows the result from 27 simple Taylor rules with varying assumptions for the neutral rate and the weights for inflation and the output gap. The "Zero weight on the output gap" line expands the set of policy rules to allow for a version with no weight on the output gap. Negative implied policy rate

[15] Staff estimates suggest that the pass-through to inflation should at the most be 2 percent. This estimate however excludes the impact on the service sector.

the policy rate would stay low for longer could have an expansionary effect without risks to financial stability. However, the recent uptick in market-implied inflation expectations for 2021-23, with 2023 expectations now above target, should be tracked carefully. In this context, the authorities' continued commitment to fiscal discipline will be important to keep inflation expectations stable.

31. Structural measures to lower financial intermediation costs are welcome to further improve the pass-through of monetary policy. The recent reductions in banks' reserve requirement ratio (RRR) was an appropriate step to increase liquidity when the crisis hit. While carefully weighing potential financial stability tradeoffs, the authorities could consider making the reduction permanent to reduce banks' liquidity costs, thus helping to narrow borrowing spreads and gradually increase the flow of credit to firms and households. The Central Bank's BC# pillar (see ¶39) on competitiveness which has been advancing in recent months will lower the cost of financial intermediation through improvements in regulation, market access and capital market deepening.

Lending-Funding Spread: Financial System Average
(Percent)

Sources: CEIC database and Fund staff calculations.

32. The reduction in the RRR to 17 percent could be made permanent. After having lowered the RRR from 32 to 25 percent in March, the BCB adopted an additional temporary reduction to 17 percent to provide liquidity to banks due to the COVID shock. They currently plan to increase it to 20 percent in April 2021. If the implementation of a new Emergency Liquidity Assistance (ELA) facility proceeds according to schedule, keeping the RRR at 17 percent would reduce banks' liquidity costs permanently, and contribute to lower borrowing spreads.

33. De jure Central Bank independence would further strengthen the credibility of the monetary framework. With the BCB having been granted the power by Congress to conduct asset purchases for financial stability purposes during states of calamity, the case for formal Central Bank independence has gained greater prominence.[16] Staff urges the authorities to secure approval of the draft bill in Congress as soon as possible.

34. The flexible exchange rate and sizable FX reserves cushion remain important shock absorbers. The authorities have intervened on days of disorderly market conditions but have otherwise allowed the exchange rate to absorb the COVID-19 shock, resulting in a BRL/USD depreciation of 40 percent in the year to October. Stress tests analysis by the authorities suggests that the banking sector is sensitive to large depreciations given banks' open FX positions (3 percent of assets), but that existing capital buffers are sufficient to preserve financial stability; furthermore 95 percent of public debt is denominated in r*eais* and firms with dollar debt are mostly hedged, suggesting economy-wide resilience to FX shocks. While intervention in the FX market should

[16] The BCB already had the power to purchase public assets for monetary policy purposes under normal conditions.

remain limited to addressing excess volatility, vigilance is necessary to detect any emerging financial sector vulnerabilities.

Authorities' Views

35. The authorities view the current monetary stance as appropriate and stressed the importance of the fiscal regime for the monetary policy outlook. The Central Bank noted that the reduction in the policy rate since the onset of the crisis has been substantial. They see potential trade-offs related to further cuts, and they believe a cautious stance is warranted to give the financial system time to adapt to the unprecedented level of the policy rate. The Central Bank also noted their recent introduction of forward guidance as a complementary tool to support the economy but reiterated their public position that forward guidance could only be maintained if the current fiscal regime remained unchanged. At the current juncture the Central Bank is not envisaging the use of asset purchases.

C. Macro-Financial Policies

36. The Brazilian banking system remains resilient but continued close surveillance and bank-by-bank monitoring is warranted. Results from solvency stress tests suggest that the banking system will remain resilient to the COVID-19 shock despite pockets of vulnerabilities (Figure 6 and Box 4). If needed, banks should draw down on their CCoB to absorb the impact of any losses. If the authorities extend the temporary reduction in the CCoB further, it is important that limits to dividend distributions are extended accordingly. Banks should also be encouraged to use their stock of High-Quality Liquid Assets during periods of stress by allowing the Liquidity Coverage Ratio to fall below 100 percent. In a situation in which system-wide liquidity pressure prevails, the BCB should provide additional liquidity by, for example, expanding the collateral base of its lending facilities.

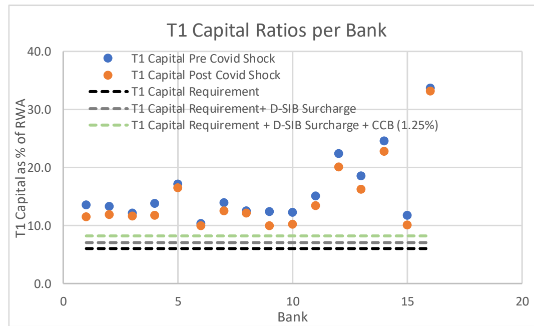
37. The authorities are encouraged to use the existing flexibility of the regulatory framework to weather the short-term impact of COVID-19 without diluting prudential standards or accounting requirements. The recently implemented measure to reduce risk-weights for SME lending, for example, runs counter to this objective. The authorities could consider further extending the temporary relief from automatically increasing provisions on renegotiated loans if the economic recovery stalls and encourage banks to use capital buffers. It is important that supervisory expectations for banks' response to distressed borrowers and the regulatory approach in dealing with the temporary impact of the outbreak be clearly communicated and transparent.

38. Several draft bills recently submitted to Congress address the FSAP recommendation to strengthen the legal protection of supervisors. Overall, the authorities have continued to make progress in implementing financial sector reforms recommended in the 2018 FSAP, but some reforms have stalled (Annex I and X). A bill of law that tackles BCB autonomy was recently approved by the Senate and is currently with the Lower House. A bill for the Bank Resolution Law that includes legal protection of public agents and legal defense of BCB expenses by the General Counsel has been submitted to the Lower House. The BCB has finalized a draft bill for a "Financial Stability

Coordination Law" that is being evaluated by the Office of the President's Chief of Staff (Casa Civil). While a temporary facility for ELA was deployed in April 2020 due to COVID-19, the implementation of a new permanent ELA is ongoing as part of the BC# Agenda and is expected to be completed by November 2021.

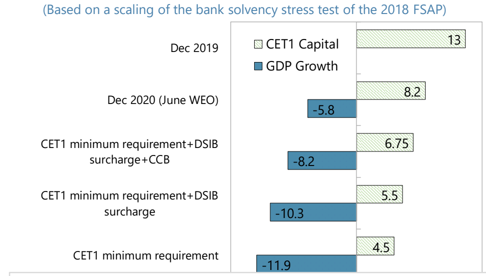
Box 4. Banking Sector Stress Tests

Staff conducted several stress tests, including a recalibration of the 2018 FSAP stress test, to assess the resilience of the Brazilian banking system to the COVID-19 shock. The stress tests do not take into account recent policy measures by the BCB that are likely to improve bank capital, such as suspension of dividend payments, exemption from increasing provisions on restructured loans, and lowering of capital conservation buffer, thus likely overstating the stress results.

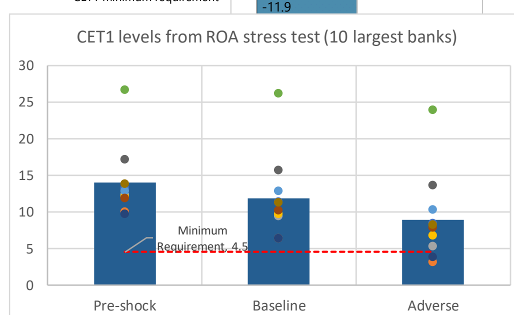


The banking sector is resilient to the expected deterioration in credit portfolio quality. The [5.8] percent fall in GDP is expected to lead to an increase in nonperforming loans (NPLs). Results from various regression models using GDP growth, unemployment and the BRL/USD exchange rate as the main drivers, suggest that NPLs of non-earmarked credit are likely to peak at between 5 and 6 percent. The rise in NPLs would lead to a fall in the average Tier 1 (T1) capital ratio to between 12.4 and 11.9 percent (see chart below), which is well above the regulatory minimum, even when including the D-SIB surcharge and the full CCoB, i.e. 9.5 percent. Furthermore, the relatively narrow distribution across banks implies that none of the 16 largest banks would experience T1 capital shortfalls from the NPL shock.

Bank Capital Ratios and GDP Growth
(Based on a scaling of the bank solvency stress test of the 2018 FSAP)



The scaling of the 2018 FSAP stress test results using staff's latest GDP forecast also suggests that bank capital will remain above the regulatory minimum requirement. The average Common Equity Tier 1 (CET1) capital for banks would fall to 8.2 percent (see chart). And the relatively narrow distribution of banks' capital ratios around the mean suggests that any capital shortfall would be relatively small, when allowing banks to use the CCoB. Furthermore, the FSAP stress test assumes that dividend payouts lower the capital ratio by around two percentage points, while the BCB has temporarily suspended any dividend payments by banks. Nonetheless, the results illustrate that factors other than NPLs (e.g. exchange rate, asset prices) are likely to negatively affect bank solvency.



Modelling Return On Assets (ROA) using a panel model based on LA6 countries suggests only an extreme scenario would lead to capital shortfalls. In addition to the baseline scenario, we consider an extreme scenario with GDP contractions for two years (-7.4% in 2020 and -3.0% in 2021) under the assumption that all banks have the same credit portfolio composition. In this extreme scenario, two banks fall below the 4.5% minimum requirement.

39. Continued progress with the BC# Agenda will contribute to a decrease in credit spreads and improved financial inclusion. High operating costs and loan loss provisioning, as well as bank concentration at the product level are strongly correlated with higher net interest margins in Brazil vis-à-vis its peers.[17] The authorities are making progress with reforms to foster an inclusive and competitive credit market, by allowing credit cooperatives to issue Real Estate Credit Bills (LCI), advancing a rural credit framework, facilitating and expanding microcredit and digitalizing financial instruments. Two initiatives are scheduled to be launched in November 2020: i) a Brazilian Instant Payments System (PIX) that will provide new customers with access to financial services and lower the cost of digital transactions, and ii) phase one of open banking, which will lead to more competitive costs of financial services. A fifth "sustainability" pillar was also introduced to the BC# Agenda focusing on socio-environmental sustainability, the promotion of sustainable finance, proper management of socio-environmental and climate risks within the financial system and the incorporation of sustainable variables in the BCB decision making.

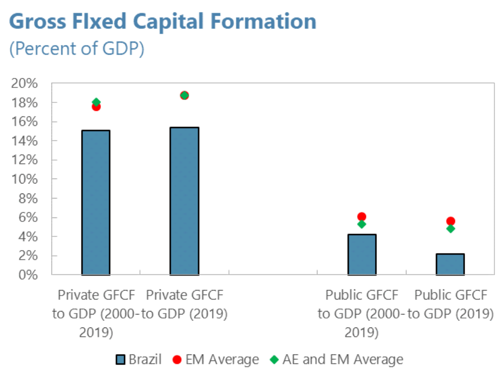
Authorities' Views

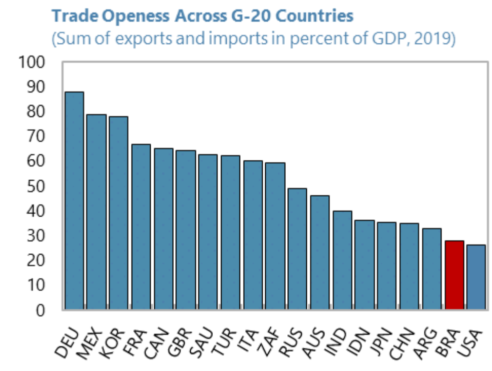
40. The authorities share staff's assessment that the banking system is resilient, but that heightened vigilance is warranted. They assess that banks have provisioned conservatively and do not expect a sharp fall in capital when support measures are withdrawn. The authorities pointed out that they lowered the CCoB due to the stigma attached to using the buffer and ensured that restrictions were in place to prevent financial institutions from seizing the opportunity to use the additional capital to distribute dividends. The authorities extended the reduction of the RRR on time deposits to 17 percent until April 2021, when it becomes 20 percent. Going forward, the decision regarding the appropriate level of the RRR would be made under the scope of the BCB's institutional agenda (BC#) and not related to the circumstances of the pandemic. The authorities also stressed the importance of having a functioning ELA in place to compensate for a lower RRR. The BCB disagrees with the FSAP recommendation to make ELA access contingent on passing a solvency test and believe it is important to retain the discretion to take into account financial stability issues.

D. Pressing Ahead with Productivity Enhancing Structural Reforms

41. Brazil's growth performance has been disappointing. Since the early 1990s, GDP has grown on average by about 2 ½ percent per year, well below other major emerging markets. This relatively weak growth performance is largely explained by a lack of productivity growth compounded by low investment. Total factor productivity in Brazil is close to the levels observed during the 1980s while investment has lagged advanced and emerging economy averages for decades. Brazil is also one of the most closed major economies in the World.

[17] See the 2018 *Financial System Stability Assessment.*





Source: IMF World Economic Outlook (Oct 2020).

42. Improving the competitiveness of the Brazilian economy requires decisive structural reforms. The main priority is to reform the complicated and distortive tax system to improve the business environment. The authorities should also move ahead with (i) closing the large infrastructure gaps, (ii) trade liberalization (iii) fostering greater competition in the financial sector, including by reducing the footprint of state banks in credit markets, and (iv) cutting red tape to reduce the cost of doing business and promote private investment. Pressing ahead with the structural reform agenda is even more urgent now to offset possible scarring effects of the pandemic.

43. Public investment can also play a catalytic role in supporting a post-pandemic recovery in Brazil.[18] Given the limited space for public spending, strategic prioritization and project selection and appraisal are essential. IMF Technical Assistance (PIMA) mission found the most significant areas of weakness in public investment were in the strategic prioritization of spending and project selection and appraisal. Based on those findings, staff urge the authorities to develop a prioritized portfolio of high quality projects and establishing a new, more rigorous process for project selection, appraisal, and approval.[19] The authorities should also improve coordination between federal and subnational governments in investment planning and review funding mechanisms.

44. The authorities are moving ahead with a reform agenda that is aligned with these priorities. While addressing structural challenges has naturally taken a backseat to immediate crisis management priorities, several initiatives continued through the crisis. A newly approved sanitation and sewage bill, as well as the authorities' extensive list of privatization and infrastructure concessions projects will help spur a pipeline of critical projects and investments going forward. The temporary elimination of import tariffs on IT and capital goods (from 14 to 0 percent) is welcome and should be made permanent. Continued efforts to finalize the trade agreement with the EU are

[18] See "Chapter 2: Public Investment for the Recovery," *IMF Fall 2020 Fiscal Monitor* (October 2020). Washington, DC: International Monetary Fund.

[19] The multi-year program (PPA) 2020-23 lists for the first-time priority investment projects for the country, focusing on projects with expected completion dates by 2023. Constitutional Amendment 102/2019 has mandated the government to develop a centralized (federal-state-municipal) database to compare project cost estimates and project execution.

needed, and technical level agreements and protocols aimed at removing tariff and non-tariff barriers with other trading partners should be finalized. The authorities should submit an ambitious market access proposal to join the WTO Government Procurement Agreement (GPA), which would open the government procurement market to foreign competition, and contribute to greater transparency, and good governance.

45. A renewed focus on education and measures to reduce inequality is warranted post-COVID. Increasing enrollment rates for primary and secondary education and improving PISA scores, both of which are well below OECD levels, will be key to improving the human capital of Brazil's labor force. Staff analysis (WP/19/236) suggests that education outcomes could be improved by recalibrating the mix of salaries and personnel more in line with the ratios observed in high performing countries. To limit labor market hysteresis and reduce job mismatch, the move towards more automation, technology intensive and remote work should be accompanied by job re-training and up-skilling programs that facilitate the reactivation of laid-off workers and avoid leaving unskilled workers behind. To improve social mobility and reduce social exclusion, the social safety net should be linked to the labor market through graduation programs that incentivize vulnerable groups to lift themselves out of poverty through access to financial inclusion, training and job search assistance.

Pre-COVID-19 Reform Agenda

	Submitted to Congress?	Needs Constitutional Amendment?
'Plano Mais Brasil' ('More Brazil' Plan)		
•**Emergency adjustment bill** (allows temporary reduction of some mandatory spending – including civil servants' wage/hours cuts of up to 25% - during fiscal stress periods)	Yes	Yes
•**New Federal Pact bill** (revenue decentralization, less subnational spending rigidities, new institutions to strengthen subnational fiscal discipline)	Yes	Yes
•**Public Funds bill** (allow use of earmarked funds of the government to amortize public debt)	Yes	Yes
Tax Reform –revenue neutral		
•Create a uniform VAT (or dual system)	Yes 2/	Yes (except for federal taxes)
•Lower CIT and raise dividend taxes	No	No
•Lower payroll taxes and compensate with new sources of revenue	No	No
Administrative Reform (overhaul of civil service career structures)	Yes 2/	Yes
Pension Reform for Subnational Governments	Yes	Yes
Concessions and Privatizations (including overhaul of regulatory framework for sanitation – approved in July 2020 - and energy sectors)	Yes, for the cited sectors	No
Central Bank Independence	Yes	No
Labor Market Reform ('Green-Yellow Program", encouraging employment of young people)	Yes	No
Financial Sector Reform ('BC#' agenda on competitiveness, inclusiveness, education, and transparency)	Yes, partially	No
•New FX Market Regulation (modernize the system, enabling use of foreign currency bank accounts)	Yes	No

1/ Excludes already approved measures, such as social security reform and the Economic Freedom Act.
2/ Draft legislation submitted by the government in the course of 2020, post-Covid19 outbreak.

Authorities' Views

46. The authorities agree on the importance of structural reforms. They pointed out that despite the crisis, the government accelerated measures to cut red tape, improve regulations and develop infrastructure concessions.

- Simplifying the tax system is one of their highest priorities. The reform has a large positive payoff for private sector investment and is a pre-condition for trade liberalization. In addition, they see administrative reform as an important step not only to improve the long-term fiscal outlook but also to increase productivity by reducing the misallocation of resources between the public and private sector. They see the sanitation and sewage bill as an important step to attract private sector infrastructure investment and plan similar laws to facilitate private sector participation in the gas and electricity sectors.

- Further changes in labor market regulation are currently being considered to reduce labor costs for the private sector and improve the ease of doing business. Policies will focus on including informal workers into the formal market by streamlining rules and assuring judicial security.

- On trade liberalization, the authorities highlighted that the technical details of several agreements (EU, EFTA, Canada, USA, South Korea) have been finalized or are close to be finalized and are confident that they will be ratified during 2020-21. Further steps in trade liberalization will be taken once tax reform is approved.

- The Central Bank is hopeful that the digitalization of payment methods, with the launch of PIX, and the regulation of Open Banking will reduce costs and improve the efficiency of financial intermediation. In addition, the BC# agenda gained a new Sustainability pillar aimed at fostering a sustainable financial system.

ADDITIONAL TOPICS

47. The authorities should continue to prioritize the fight against corruption and money laundering (ML), preventing legal and institutional setbacks. Ensuring the capacity of competent authorities to independently and effectively investigate and prosecute corruption and financial crimes, are fundamental aspects of international standards and effective anticorruption and AML/CFT frameworks. Recent developments underscore the need to remain vigilant to maintain past progress. As is the case in other countries, the pandemic has negatively impacted corruption and ML risks, notably those associated with procurement. The authorities have commenced investigations and have taken prevention and transparency efforts, such as enhancing availability of procurement data at the federal level and reporting mechanisms. Additional useful measures would be to enhance the sharing of beneficial ownership information among relevant competent authorities, and to continue strengthening the frameworks for asset disclosures, lobbying and whistleblower protection.

48. Preparations for the upcoming FATF/GAFILAT AML/CFT assessment are underway. Coordinating and building capacity among competent authorities has been a top priority of the ENCCLA[20] task force and should continue to be prioritized. The Financial Intelligence Unit (FIU) has resumed its work, after multiple institutional relocations and the reversal of a Supreme Court Judge's provisional injunction that limited the FIU's ability to share information with law enforcement without prior judicial authorization. It would be important to finalize and ensure the timely dissemination of the results of the ML/TF National Risk Assessment and the implementation of

[20] National Strategy to Combat Corruption and Money Laundering.

mitigation measures. New AML/CFT customer due diligence regulations on politically exposed persons and beneficial owners have recently been issued, and a sectoral risk-assessment and new technology to enhance risk-based AML/CFT bank supervision have been introduced, allowing for remote supervision to continue despite the pandemic. The legislature has launched a special commission to propose amendments to the AML/CFT law, with a focus on redefining the scope of the ML criminalization. It is recommended that any legislative efforts involve all relevant authorities and stakeholders to ensure FATF compliance.

49. Article VIII issues. The tax on financial transactions (Imposto sobre Operações Financeiras, IOF) on exchange transactions carried out by companies in order to fulfill their payment obligations for purchases of goods and services abroad by their customers gives rise to a multiple currency practice (MCP) subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3. The IOF for these exchange transactions was increased to 6.38 percent in March 2011 and the scope of operations was expanded to other foreign exchange transactions in addition to credit cards in December 2013. These measures need to be gradually relaxed in coordination with the IMF. The authorities expressed their intention to gradually remove the IOF as the fiscal situation allows.

Authorities' Views

50. The authorities generally agree with the observations on AML and anti-corruption, highlighting that higher risks globally are associated with the pandemic. With respect to AML/CFT, they noted the preparations for the upcoming FATF/GAFILAT assessment, and the institutional changes to the FIU which should be beneficial in the longer term to improve the effectiveness of the AML system. They also noted that the decision by a judge of the Supreme Court to curtail some of the powers of the FIU had been overruled by the plenary meeting of the Supreme Court, which helped to alleviate some of the concerns the FATF had expressed. With respect to anti-corruption and procurement, the authorities pointed to measures already taken to address COVID-19 related risks, including preventive and enforcement actions, and stressed the usefulness of the existing transparency portal.

STAFF APPRAISAL

51. The authorities' steadfast commitment to the expenditure ceiling is welcome. With public debt rising to 100 percent of GDP, preserving the constitutional expenditure ceiling as a fiscal anchor is essential to support market confidence and keep the sovereign risk premium contained. Substantial fiscal consolidation is required to close the primary deficit and stabilize public debt over the medium-term.

52. If economic conditions were to turn out worse than the authorities expect, they should be prepared to provide additional fiscal support. While some recent indicators are encouraging and the authorities expect a strong rebound next year, it may take time for employment, incomes, and poverty to return to pre-COVID levels. There is an unusually high degree of uncertainty over how the pandemic will evolve and the expiry of fiscal support at the end of the year will add pressure on the already-wide output gap.

53. Swiftly implementing structural reforms that lock in medium-term consolidation will be essential to mitigate the risk of undesirable debt dynamics. Additional spending could erode market confidence and increase interest rates. Fiscal structural reforms could mitigate such effects and should focus on urgently (i) reducing mandatory spending and budget rigidities to free up fiscal space for discretionary spending, (ii) strengthening the social safety net by rationalizing programs that are inefficient and regressive while preserving efficient targeting; (iii) reforming the subnational pension schemes in line with the new provisions for federal government employees and strengthening the subnational fiscal framework; and (iv) revamping the tax system to improve the business environment, reduce resource misallocation, and tackle income inequality**.**

54. With the substantial withdrawal of fiscal stimulus in 2021, monetary policy carries the burden of supporting the economy. The current 2 percent policy rate corresponds to a negative real rate, which is strongly expansionary. There is room to cut the policy rate further if inflation and inflation expectations remain below target. Possible implications for capital outflows and financial stability risks should be carefully monitored. As a complement, continued use of forward guidance to signal that the policy rate would stay low for longer, conditional on maintaining a sound fiscal regime, could have an expansionary effect without risks to financial stability. The temporary reduction in the RRR could also be made permanent to reduce banks' liquidity costs, thus helping to narrow borrowing spreads and increase the flow of credit to firms and households. Should downside risks materialize after conventional monetary policy has been exhausted, the BCB has the option to purchase assets. The BCB has built its reputation over the years as a credible institution, and the approval of formal Central Bank independence would further strengthen the integrity of the monetary framework.

55. The Brazilian banking system remains resilient but continued close surveillance and bank-by-bank monitoring is warranted. Results from solvency stress tests suggest that the banking system will remain resilient to the COVID-19 shock, and banks have been conservative and forward looking in increasing provisions. The existing flexibility of the regulatory framework should be used to weather the short-term impact of COVID-19 without diluting prudential standards or accounting requirements.

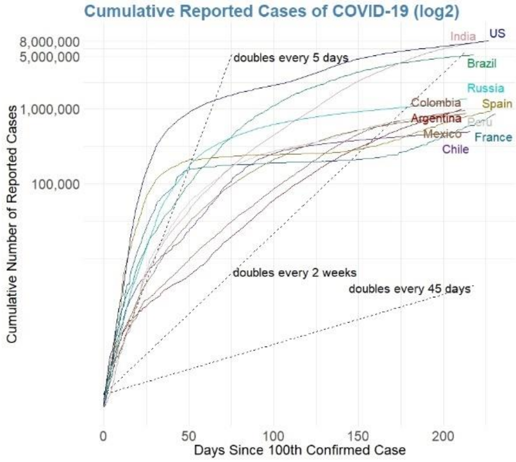
56. The authorities must move ahead with structural reforms to raise potential growth and improve the standard of living for all Brazilians. The pandemic has added to Brazil's growth challenge. To create jobs and lift the poor above the poverty line, structural reforms to make the Brazilian economy more competitive, open to business and trade, and attractive to investment are essential. The BCB is charging ahead with the BC# Agenda to improve market efficiency and reduce the cost of credit, an important part of banking sector reforms needed to raise productivity growth. A renewed push to pass legislation for a comprehensive tax reform, finalize high standard trade agreements with the EU and other trading partners, conclude negotiations to join the WTO GPA, and accelerate the pace of new concessions and privatizations, is still needed to bring productivity gains to the economy. The newly approved sanitation and sewage bill is highly welcomed and should spur a pipeline of critical infrastructure projects and investments going forward.

57. The authorities should continue to prioritize the fight against corruption and money laundering (ML) and prevent legal and institutional setbacks. Coordinating efforts to enhance the AML/CFT framework and preparing for the upcoming FATF/GAFILAT AML/CFT assessment should continue to be prioritized, and legislative efforts should involve all stakeholders to ensure FATF compliance. As in other countries, the COVID-19 pandemic has increased corruption and money laundering risks, notably those associated with procurement fraud and corruption. Hence, continued prevention and transparency efforts to mitigate risks would be useful, including further strengthening the frameworks for asset disclosures, lobbying and whistleblower protection. Ensuring the capacity, resources and independence of relevant institutions is needed to preserve past gains and effectively combat corruption and financial crimes.

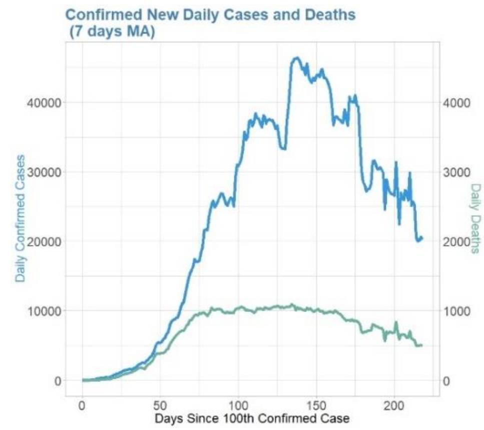
58. It is recommended that the next Article IV consultation takes place on the standard 12-months cycle.

Figure 1. COVID-19 Health Indicators in Brazil

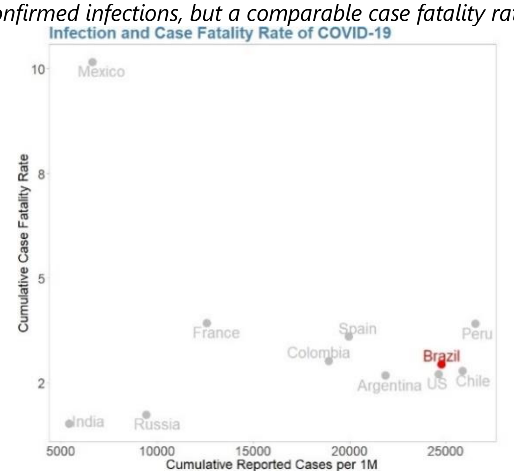
Brazil recorded the second largest number of COVID-19 cases in the world through August 2020, ….



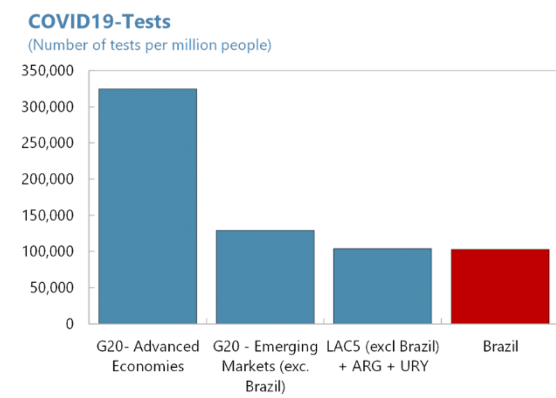
… with the number of new cases now running just below peak levels.



Relative to other countries, Brazil has a high number of confirmed infections, but a comparable case fatality rate,

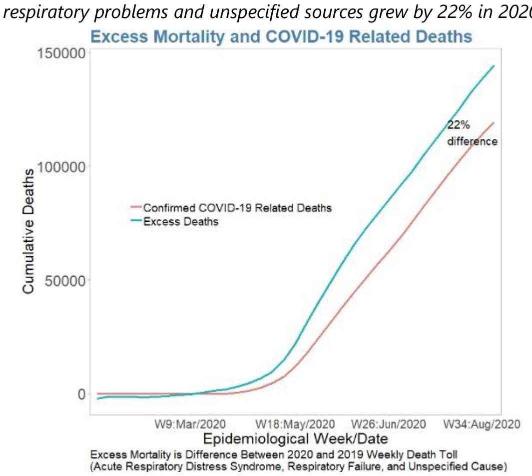


… even though testing is less prevalent.

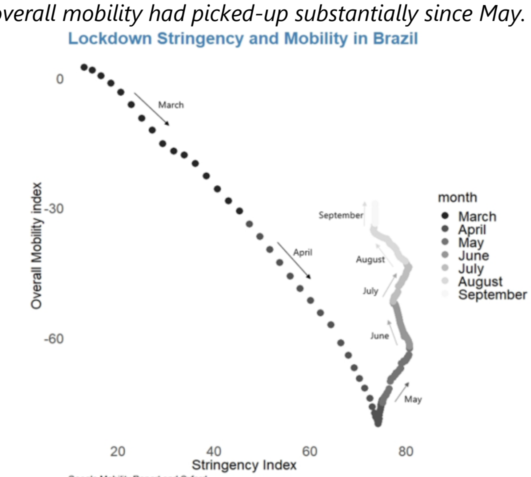


Sources: Worldometers (https://www.worldometers.info) as of October 29, 2020

COVID-related fatalities may be underestimated, as deaths by respiratory problems and unspecified sources grew by 22% in 2020.



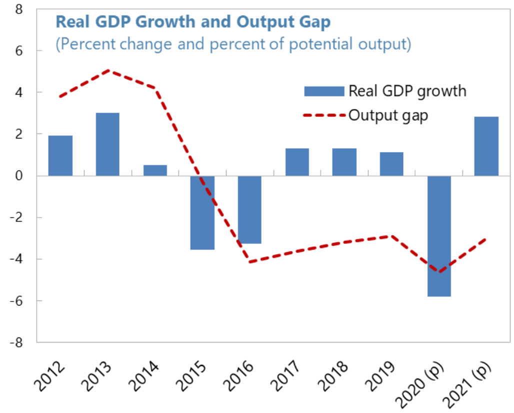
Lockdown measures were most relaxed in August, but overall mobility had picked-up substantially since May.



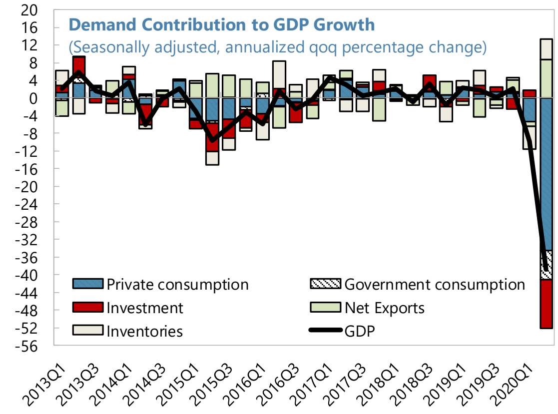
Sources: Brazilian Ministry of Health and Civil Registry, Worlometers, John Hopkins University, Blavatnik School's Oxford COVID-19 Government Response Tracker, and IMF staff estimates.

Figure 2. Real Sector Developments

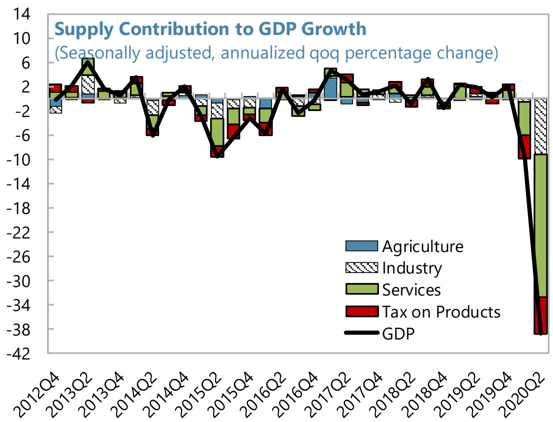
GDP is headed for a sharp contraction in 2020, followed by a gradual recovery in 2021.



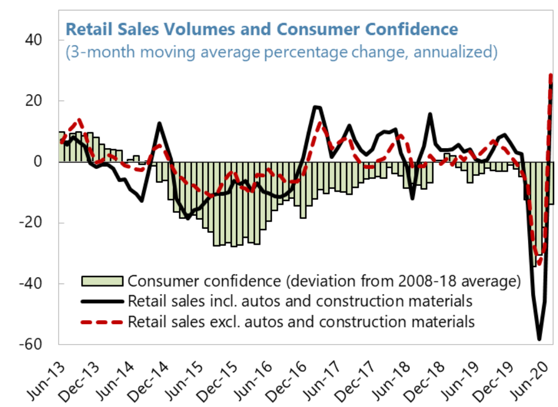
The contraction in 2020H1 was driven by private consumption...



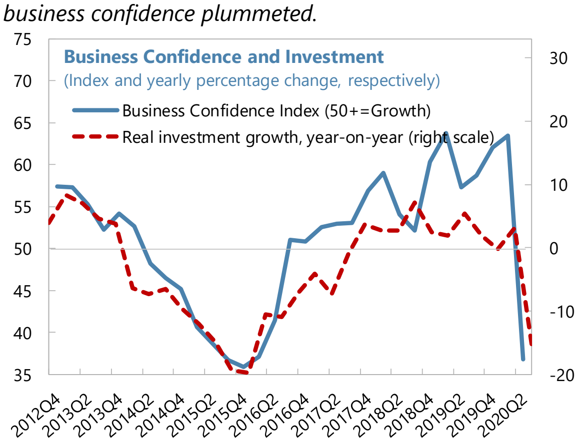
... and services, which were most affected by containment measures and social distancing.



Both headline and core retail sales dipped in April as consumers' confidence waned, but quickly rebounded in May and June.



Investment held up in Q1 but contracted sharply in Q2 as business confidence plummeted.



Industrial production, driven by manufacturing, rebounded strongly in May and June, while services output lagged.

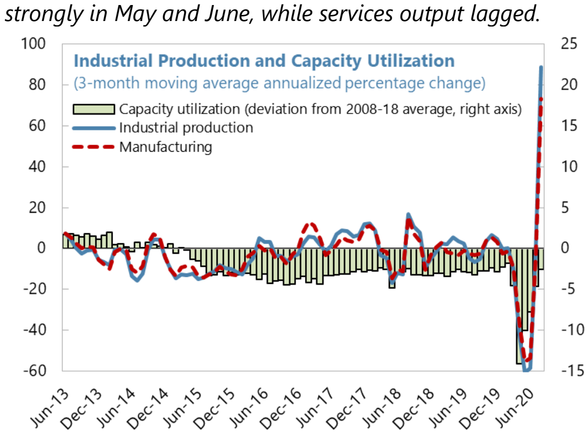
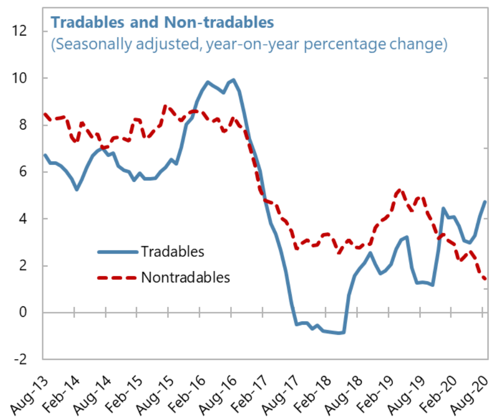
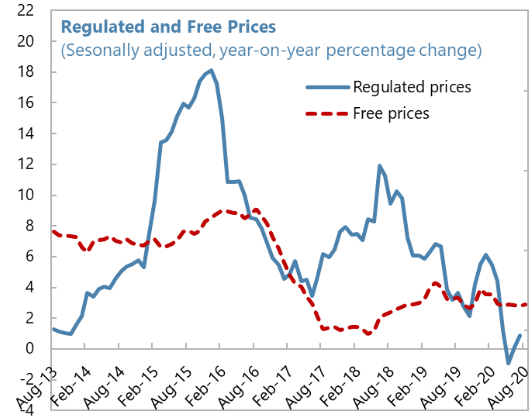


Figure 3. Monetary Sector Developments

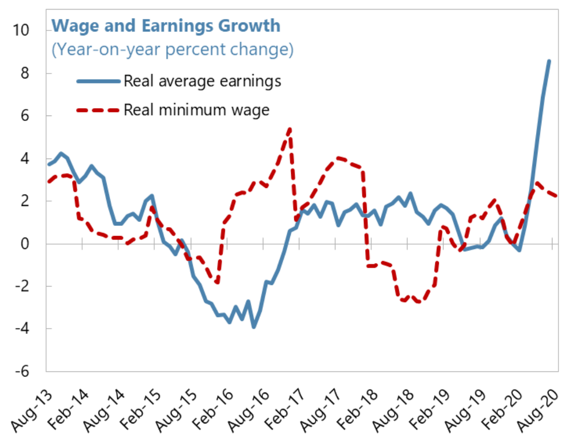
Although both headline and core inflation are comfortably below target, the uptick in tradable inflation since June points to some exchange rate pass-through.



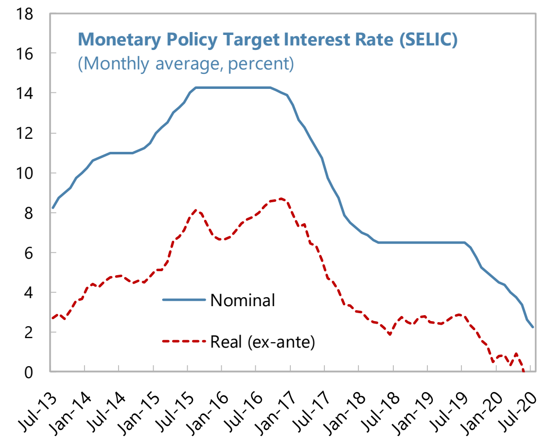
Regulated prices (utilities, public transport, health goods and services, and oil derivatives) also increased recently after the drag from plummeting international oil prices.



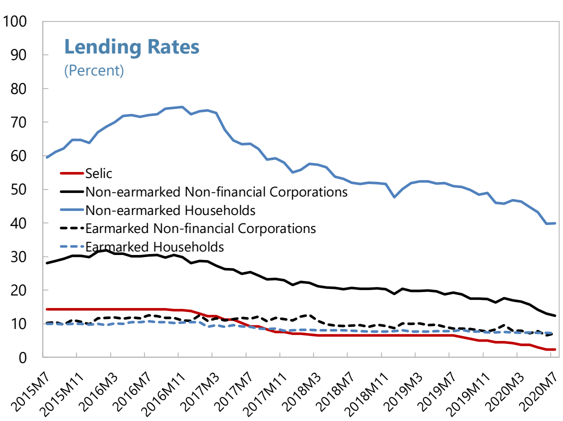
Real average earnings spiked because of diminished working hours and employment support measures.



The SELIC is at historic lows, with negative ex-ante real rate despite low inflation expectations...



..but lending rates remain high despite some passthrough from the most recent cuts.



The central bank increased the stock of FX swaps in March when exchange rate pressures materialized.

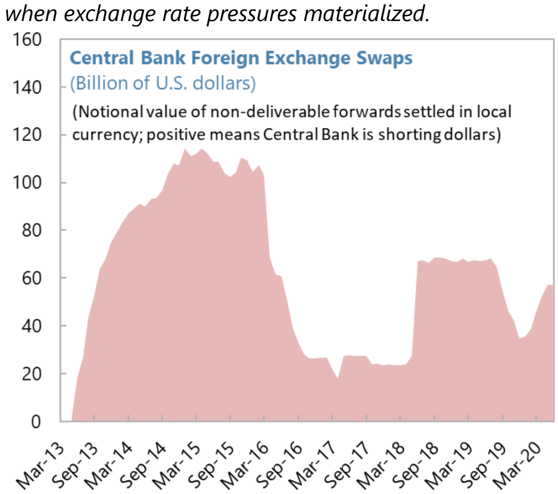
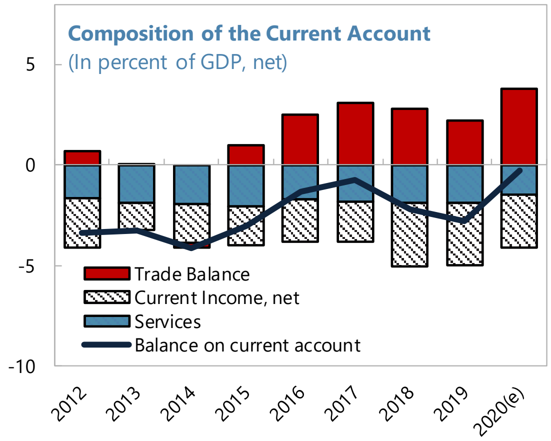
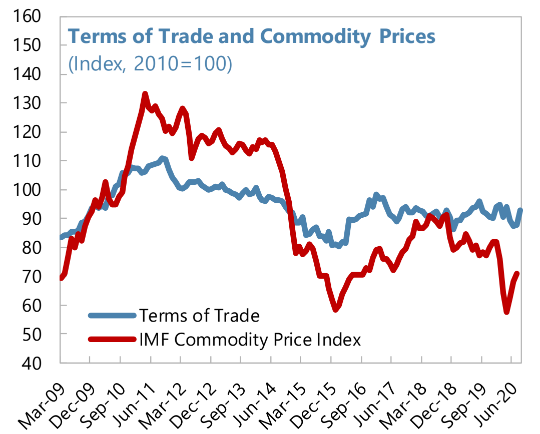


Figure 4. External Sector Developments

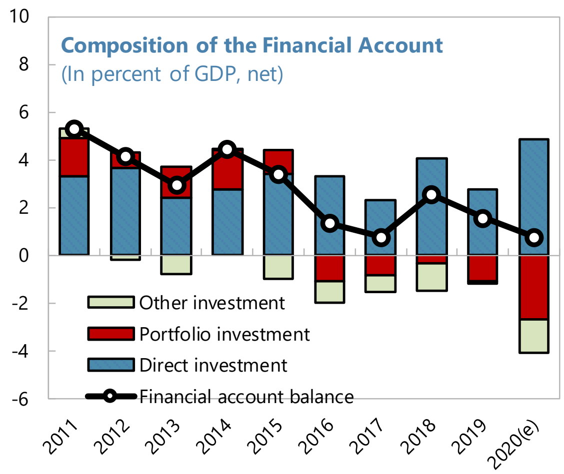
The current account balance is projected to improve in 2020 on the back of higher trade surplus and lower service and income deficits



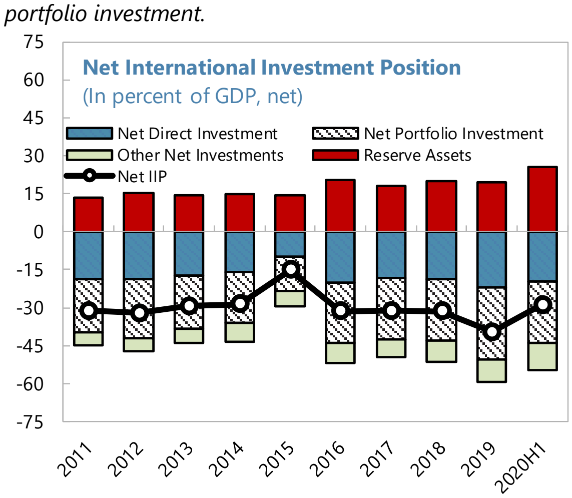
The terms of trade are expected to improve slightly as oil prices collapsed.



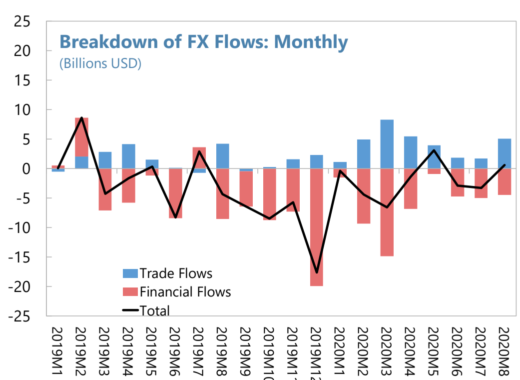
Net FDI are expected to remain strong in 2020, but portfolio debt and equity investment will decline sharply.



In 2020H1, the negative NIIP contracted moderately due to a combination of valuation and volume contraction in portfolio investment.



Financial outflows have been particularly severe in March-April and subsided afterwards.



Central Bank interventions helped to dampen excess exchange rate volatility and reserves accumulation has recovered in recent months.

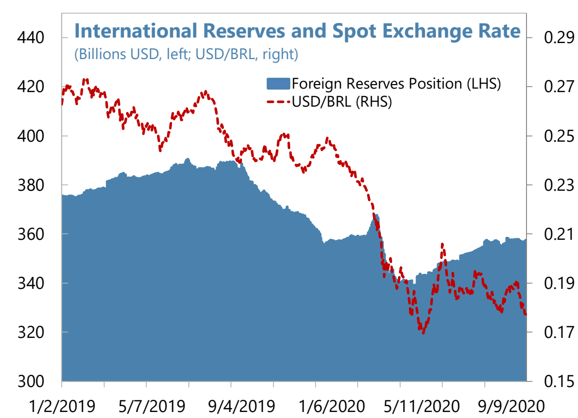
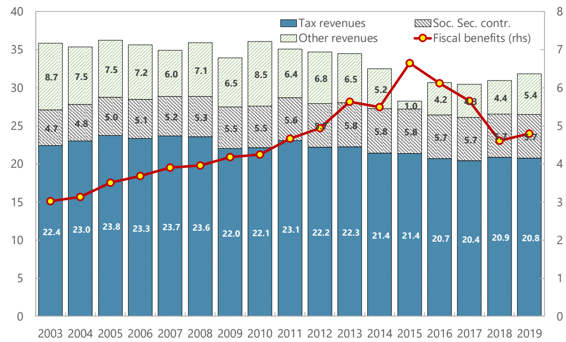


Figure 5. Fiscal Sector Developments

Structurally high tax expenditures have hindered Brazil's revenue performance and constrained fiscal space….

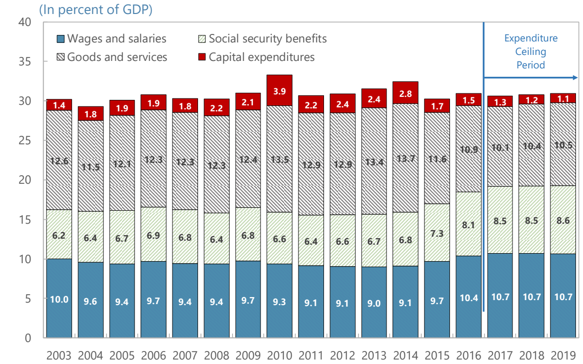
Brazil: Revenue Sources and Fiscal Benefits, 2003-2019
(in percent of GDP)



Source: Minstry of Economy and Fund staff calculations.

…in an environment of ultra-high budget rigidity, rising spending pressures, and binding expenditure ceiling.

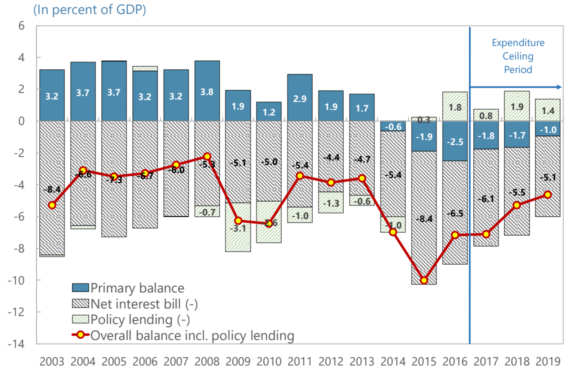
Brazil: Primary Expenditures Composition, 2003-2019
(In percent of GDP)



Source: Minstry of Economy and Fund staff calculations.

Pre-COVID consolidation has been gradual, supported by lower interest payments and policy lending refunds…

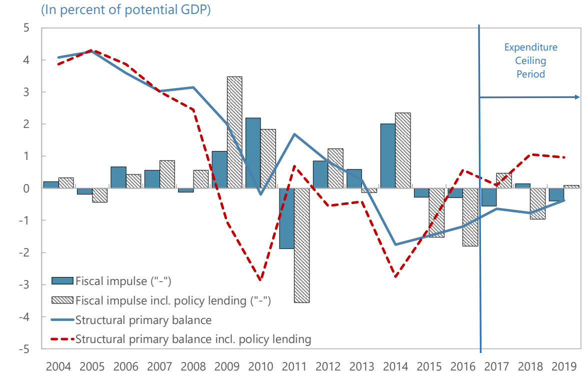
Brazil: NFPS Balance and Policy Lending, 2003-2019
(In percent of GDP)



Source: Minstry of Economy and Fund staff calculations.

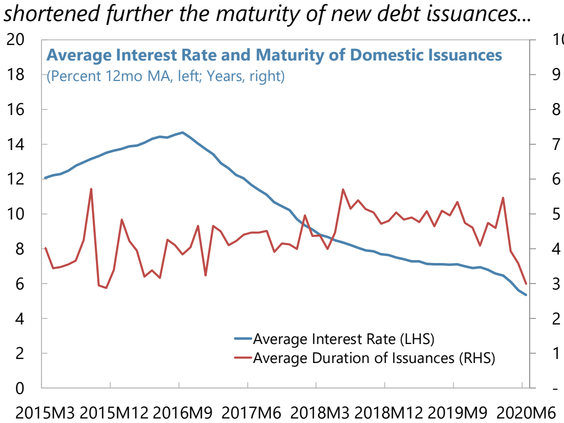
…with milder fiscal impulses (less procyclicality) since the constitutional expenditure rule was enacted in 2017.

Brazil: Structural Position and Fiscal Impulse, 2004-2019
(In percent of potential GDP)



Source: Minstry of Economy and Fund staff calculations.

Despite lower policy interest rate, the authorities have shortened further the maturity of new debt issuances…



…to avoid steeper yields reflecting emerging fiscal risks, very high debt level, and rising gross financing needs.

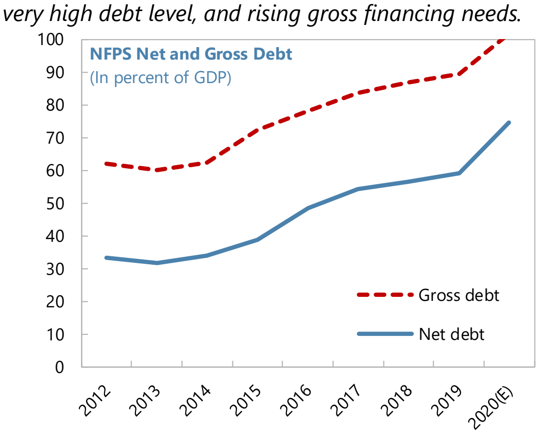
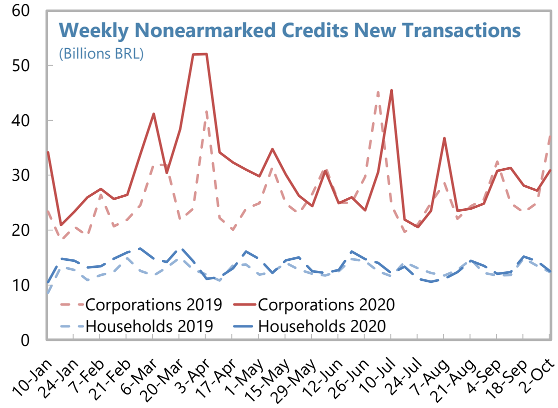
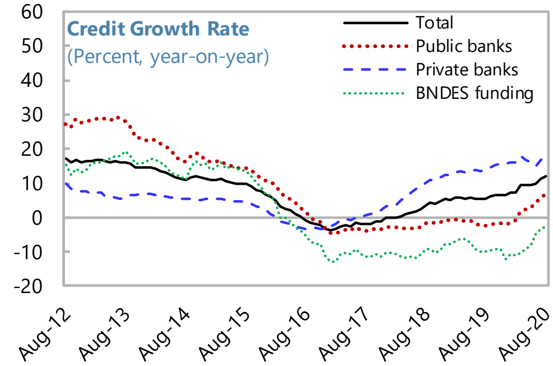


Figure 6. Financial Sector Developments

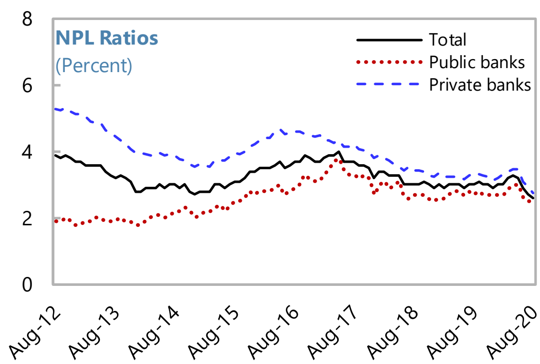
Weekly non-earmarked credit supplied to the private sector has been stronger in 2020 than in 2019, despite COVID-19.



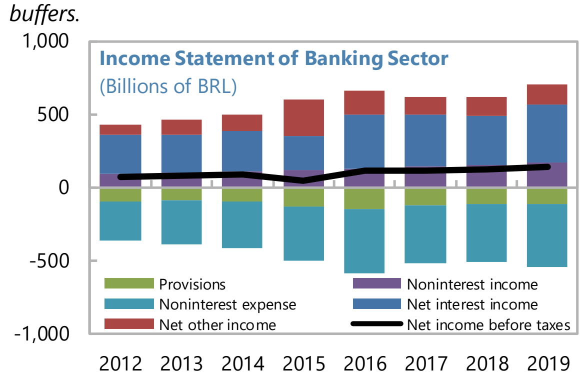
Private bank-lending continues to drive credit growth but public banks started to step in around May/June.



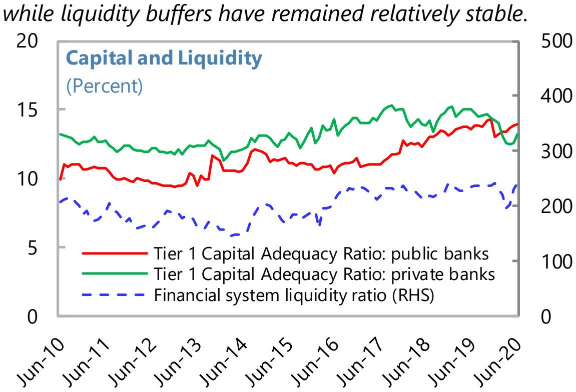
…and non-performing loans have been broadly stable



Long period of high net income has allowed banks to build buffers.



Capital buffers have fallen somewhat since the beginning of the year but remain well above regulatory minimum while liquidity buffers have remained relatively stable.



Sovereign spreads have recovered since the initial scare following the outbreak of the pandemic.

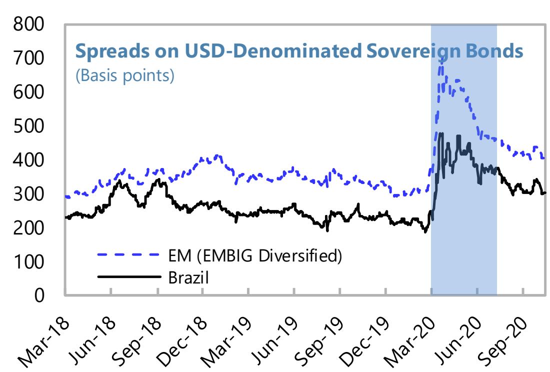


Table 1. Brazil: Selected Economic Indicators

I. Social and Demographic Indicators

Area (thousands of sq. km)	8,510	Health	
Agricultural land (percent of land area)	30.2	Physician per 1000 people (2018)	2.2
		Hospital beds per 1000 people (2018)	2.2
Population		Access to safe water (2018)	83.6
Total (million) (est., 2019)	210.1		
Annual rate of growth (percent, 2018)	0.8	Education	
Density (per sq. km.) (2019)	25.3	Adult illiteracy rate (2019)	6.6
Unemployment rate (2019)	11.9	Net enrollment rates, percent in:	
		Primary education (2019)	98
Population characteristics (2018)		Secondary education (2019)	85
Life expectancy at birth (years)	76		
Infant mortality (per thousand live births)	12	Poverty rate (in percent, 2018) 1/	25.3
Income distribution (2017)			
Ratio between average income of top 10 percent of earners over bottom 40 percent	12.4	GDP, local currency (2019)	R$7,257 billion
		GDP, dollars (2019)	US$1,839 billion
Gini coefficient (2018)	53.9	GDP per capita (2019)	US$8,751

Main export products: airplanes, metallurgical products, soybeans, automobiles, electronic products, iron ore, coffee, and oil.

II. Economic Indicators

			Proj.						
	2017	2018	2019	2020	2021	2022	2023	2024	2025
	(Percentage change)								
National accounts and prices									
GDP at current prices	5.0	4.6	5.3	-2.6	6.3	6.5	6.3	6.2	6.2
GDP at constant prices	1.3	1.3	1.1	-5.8	2.8	2.3	2.2	2.2	2.2
Consumption	1.4	1.7	1.3	-5.6	2.7	1.5	1.5	1.6	1.4
Investment	2.4	3.1	3.6	-10.8	6.6	5.0	5.6	6.1	6.2
Consumer prices (IPCA, end of period)	2.9	3.7	4.3	2.0	2.9	3.2	3.3	3.3	3.3
	(Percent of GDP)								
Gross domestic investment									
Private sector	12.3	12.7	13.1	12.7	12.9	13.1	13.5	14.0	14.5
Public sector	2.3	2.1	2.0	2.0	2.0	2.1	2.1	2.0	2.0
Gross national savings									
Private sector	20.4	18.6	17.2	29.6	18.7	17.3	17.4	17.7	17.9
Public sector	-6.5	-6.0	-4.9	-15.2	-5.0	-3.9	-4.2	-4.6	-4.7
Public sector finances									
Central government primary balance 2/	-1.9	-1.7	-1.3	-11.3	-2.7	-1.7	-1.2	-0.7	-0.1
NFPS primary balance	-1.8	-1.7	-1.0	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
NFPS cyclically adjusted primary balance (in percent of potential GDP)	-0.6	-0.7	0.0	-9.8	-1.8	-1.2	-1.0	-0.6	-0.1
NFPS overall balance	-7.9	-7.2	-6.0	-16.3	-6.1	-5.1	-5.4	-5.8	-5.8
Net public sector debt	51.4	53.6	55.7	66.8	71.3	74.4	77.0	79.4	81.3
General Government gross debt, Authorities' definition	73.7	76.5	75.8	96.6	96.7	97.4	97.7	98.3	98.5
NFPS gross debt	83.7	87.1	89.5	101.1	99.3	100.3	100.9	101.8	102.3
Of which: Foreign currency linked	3.6	4.1	4.3	4.7	4.7	4.6	4.5	4.4	4.4
	(Annual percentage change)								
Money and credit									
Base money 3/	9.6	1.6	3.3	9.9	6.3	6.5	6.3	6.2	6.2
Broad money 4/	4.6	8.1	9.1	12.6	6.3	8.3	8.1	8.0	8.0
Bank loans to the private sector	0.0	7.7	5.5	10.0	12.0	9.0	9.0	8.0	8.0
	(Billions of U.S. dollars, unless otherwise specified)								
Balance of payments									
Trade balance	64.0	53.0	40.5	51.9	53.3	56.7	57.9	57.7	58.9
Exports	218.1	239.5	225.8	210.3	229.1	236.5	240.2	249.6	260.5
Imports	154.1	186.5	185.3	158.3	175.8	179.7	182.3	191.9	201.7
Current account	-15.0	-41.5	-50.9	-3.9	-18.1	-29.0	-40.2	-51.8	-61.1
Capital account and financial account	10.3	42.9	53.8	3.9	18.1	29.0	40.2	51.8	61.1
Foreign direct investment (net inflows)	47.5	76.1	50.7	66.2	44.2	51.6	57.8	63.3	69.0
Terms of trade (percentage change)	5.8	-2.2	0.6	4.5	0.9	-1.0	-0.9	-1.3	-1.2
Merchandise exports (in US$, annual percentage change)	18.3	9.8	-5.7	-6.9	9.0	3.2	1.6	3.9	4.4
Merchandise imports (in US$, annual percentage change)	10.3	21.0	-0.6	-14.6	11.0	2.2	1.4	5.2	5.1
Total external debt (in percent of GDP)	32.3	35.3	36.7	48.7	46.6	43.0	41.0	39.0	37.6
Memorandum items:									
Current account (in percent of GDP)	-0.7	-2.2	-2.8	-0.3	-1.3	-1.9	-2.4	-2.9	-3.2
Unemployment rate	12.8	12.3	11.9	13.4	14.1	13.3	12.5	11.6	10.8
Gross official reserves	374	375	357	357	357	357	357	357	357
REER (annual average in percent; appreciation +)	8.5	-13.3	-1.2	...	...	...	...	...	...

Sources: Central Bank of Brazil; Ministry of Finance; IBGE; IPEA; and Fund staff estimates.

1/ Computed by IBGE using the World Bank threshold for upper-middle income countries of U$5.5/day. This number is not comparable to the estimates provided by IPEA in previous years due to methodological differences.

2/ Includes the federal government, the central bank, and the social security system (INSS). Based on the 2017 draft budget, recent annoucements by the authorities, and staff projections.

3/ Currency issued, required deposits held at the Central Bank plus other Central Bank liabilities to other depository corporations

4/ Currency outside depository corporations, transferable deposits, other deposits and securities other than shares

Table 2. Brazil: Balance of Payments
(in billions of U.S. dollars, unless otherwise indicated)

	2017	2018	2019	2020	2021	2022	2023	2024	2025
					Proj.				
Current Account	**-15.0**	**-41.5**	**-50.9**	**-3.9**	**-18.1**	**-29.0**	**-40.2**	**-51.8**	**-61.1**
Trade balance	64.0	53.0	40.5	51.9	53.3	56.7	57.9	57.7	58.9
Exports (fob)	218.1	239.5	225.8	210.3	229.1	236.5	240.2	249.6	260.5
Imports (fob)	154.1	186.5	185.3	158.3	175.8	179.7	182.3	191.9	201.7
Income, net	-41.0	-58.9	-56.3	-35.6	-44.9	-56.3	-65.4	-72.3	-77.8
Capital and Financial Account	**10.3**	**42.9**	**53.8**	**3.9**	**18.1**	**29.0**	**40.2**	**51.8**	**61.1**
Capital account	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Financial account 1/	9.9	42.4	53.5	3.5	17.7	28.7	39.9	51.4	60.8
Direct investment, net	47.5	76.1	50.7	66.2	44.2	51.6	57.8	63.3	69.0
Assets	21.3	2.0	22.8	-38.2	-6.8	-6.6	-5.7	-4.5	-2.8
Liabilities	68.9	78.2	73.5	28.0	37.4	45.0	52.1	58.8	66.2
Portfolio investment, net	-17.7	-6.9	-20.1	-36.9	-9.0	-5.7	-2.5	0.9	3.4
Financial Derivatives, net	-0.7	-2.8	-1.7	-6.9	-7.1	-7.5	-7.8	-8.1	-8.4
Other investment, net	-14.1	-21.2	-1.5	-18.8	-10.4	-9.7	-7.6	-4.6	-3.2
Change in Reserve Assets, net	-5.1	-2.9	26.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	**4.7**	**-1.3**	**-2.9**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum Items:									
Gross reserves (eop) 1/									
In billions of U.S. dollars	374.0	374.7	356.9	356.9	356.9	356.9	356.9	356.9	356.9
Net international reserves (eop)									
In billions of U.S. dollars	374.0	374.7	356.9	356.9	356.9	356.9	356.9	356.9	356.9
In percent of short-term debt (residual maturity)	257.7	244.7	216.4	213.2	216.9	216.0	214.2	211.2	211.2
Current account (in percent of GDP)	-0.7	-2.2	-2.8	-0.3	-1.3	-1.9	-2.4	-2.9	-3.2
Trade balance (in percent of GDP)	3.1	2.8	2.2	3.8	3.7	3.6	3.5	3.2	3.1
Merchandise exports (in percent of GDP)	10.6	12.7	12.3	15.4	16.0	15.1	14.4	14.0	13.8
Merchandise imports (in percent of GDP)	7.5	9.9	10.1	11.6	12.3	11.5	10.9	10.7	10.7
Export volume (yoy change, in percent)	5.4	3.5	-1.6	-4.9	8.8	4.3	1.7	3.3	3.7
Import volume (yoy change, in percent)	7.0	5.9	3.5	-12.1	13.8	3.6	1.9	4.2	4.2
Export price index (yoy change, in percent)	10.1	5.2	-3.9	-4.0	1.8	0.2	0.6	0.9	0.8
Import price index (yoy change, in percent)	4.1	7.4	-4.5	-8.1	0.9	1.2	1.4	2.2	2.0
Terms of trade (yoy change, in percent)	5.8	-2.2	0.6	4.5	0.9	-1.0	-0.9	-1.3	-1.2
Oil price (Brent blend; US$ per barrel)	52.8	68.3	61.4	41.7	46.7	48.1	49.2	50.2	51.2
Nominal exchange rate (R$/US$, annual average)	3.19	3.65	3.9	5.2	5.2	5.1	5.1	5.1	5.1
REER (annual average in percent; appreciation +)	8.5	-13.3	-1.2	...	...	...	...	...	
GDP in billions of U.S. dollars	2,063	1,885	1,839	1,364	1,432	1,563	1,666	1,787	1,891

Sources: Central Bank of Brazil; and Fund staff estimates and projections.
1/ Historical numbers include valuation changes.

Table 3. Brazil: Main Fiscal Aggregates

(in percent of GDP, unless otherwise indicated)

				Proj.					
	2017	2018	2019	2020	2021	2022	2023	2024	2025
FEDERAL GOVERNMENT 1/									
Net nonfinancial revenue	**17.5**	**17.7**	**18.5**	**15.7**	**17.1**	**17.7**	**17.9**	**18.0**	**18.0**
Revenue administered by SRF	12.7	13.1	13.0	12.6	12.9	13.2	13.3	13.4	13.4
PIT	2.6	2.7	2.8	2.8	2.9	2.9	3.0	3.0	3.0
CIT	3.7	3.7	3.8	3.6	3.8	3.9	3.9	3.9	3.9
Indirect taxes	5.9	6.0	5.5	5.1	5.3	5.4	5.4	5.4	5.4
Trade taxes	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Other	0.0	0.1	0.3	0.5	0.3	0.4	0.4	0.4	0.4
Social security contributions	5.7	5.7	5.7	5.7	5.6	5.6	5.7	5.7	5.7
Other revenue	2.6	2.7	3.8	2.3	2.3	2.4	2.5	2.5	2.5
Transfers to subnational governments (-)	-3.5	-3.7	-4.0	-5.0	-3.7	-3.5	-3.6	-3.6	-3.6
Total primary expenditure 2/	**19.4**	**19.6**	**19.9**	**26.9**	**19.8**	**19.4**	**19.1**	**18.7**	**18.2**
Current expenditures	18.7	18.8	19.1	26.1	19.0	18.6	18.4	18.1	17.9
Personnel	4.3	4.3	4.3	4.6	4.5	4.3	4.2	4.1	4.0
Pension benefits	8.5	8.5	8.6	9.6	9.4	9.4	9.4	9.4	9.4
Other	6.0	6.0	6.1	11.9	5.1	4.9	4.8	4.6	4.5
Capital expenditures	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.7
Unallocated spending cuts	n.a.	n.a.	0.0	0.0	0.0	0.0	0.0	-0.1	-0.4
of which reform of urban civil pensions (RGPS)	n.a.	n.a.	n.a.	-0.5	-0.6	-0.8	-0.8	-0.8	-0.9
Fund surpluses and statistical discrepancy	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance	**-1.9**	**-1.7**	**-1.3**	**-11.3**	**-2.7**	**-1.7**	**-1.2**	**-0.7**	**-0.1**
Borrowing requirement	7.1	6.3	5.6	15.5	5.7	4.7	4.9	5.1	5.1
STATES AND MUNICIPALITIES									
States									
Nonfinancial revenue	**11.3**	**11.3**	**11.3**	**11.0**	**11.2**	**11.3**	**11.4**	**11.4**	**11.4**
Own revenues	8.7	8.7	8.7	8.6	8.6	8.7	8.8	8.8	8.7
Indirect taxes	5.7	5.7	5.7	5.6	5.6	5.7	5.7	5.7	5.7
Other	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Transfers from the federal government	2.6	2.6	2.6	2.4	2.5	2.6	2.6	2.6	2.6
Total primary expenditure	**11.2**	**11.2**	**11.1**	**11.3**	**11.2**	**11.3**	**11.3**	**11.3**	**11.3**
Current expenditures	10.6	10.9	10.8	11.1	10.8	10.9	10.9	10.9	10.9
Personnel	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1
Other	4.5	4.7	4.6	4.9	4.7	4.8	4.8	4.8	4.8
Capital expenditures and other	0.6	0.4	0.3	0.2	0.3	0.4	0.4	0.4	0.4
Primary balance of municipalities	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Primary balance of states and municipalities	**0.1**	**0.1**	**0.2**	**-0.3**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Borrowing requirement	0.7	0.9	0.5	0.7	0.3	0.3	0.4	0.5	0.6
PUBLIC ENTERPRISES 3/									
Federal enterprises									
Nonfinancial revenue	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Expenditures	0.6	0.6	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Personnel	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other current expenditures	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditures	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1
State and municipal enterprises									
Primary balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance of state and municipal enterprises	**0.0**	**0.1**	**0.2**	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Borrowing requirement	0.1	0.0	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
NON FINANCIAL PUBLIC SECTOR (NFPS)									
Primary balance	**-1.8**	**-1.6**	**-1.0**	**-11.6**	**-2.7**	**-1.7**	**-1.2**	**-0.7**	**-0.1**
Primary balance (Authorities' target)	-2.6	-2.4	-2.2	-1.9	-1.6	-0.8	-0.4	0.0	0.0
Overall balance	-7.9	-7.2	-6.0	-16.3	-6.1	-5.1	-5.4	-5.8	-5.8
Structural primary balance 4/	-0.7	-0.8	-0.4	-10.3	-1.8	-1.2	-1.0	-0.6	-0.1
Structural primary balance including policy lending	0.1	1.1	1.0	-11.2	-1.7	-1.0	-0.9	-0.5	0.0
Memorandum items									
Loans to public financial institutions 5/	-0.8	-1.9	-1.4	0.9	-0.1	-0.1	-0.1	-0.1	-0.1
NFPS net interest expenditure	6.1	5.5	5.1	4.7	3.4	3.4	4.2	5.1	5.7
Net public sector debt 6/	51.4	53.6	55.7	66.8	71.3	74.4	77.0	79.4	81.3
Gross NFPS debt	83.7	87.1	89.5	101.1	99.3	100.3	100.9	101.8	102.3
General government debt, Authorities' definition	74.1	77.2	...	...	...	...	...	...	...
Nominal GDP (billions of reais)	6,583	6,889	7,257	7,067	7,510	7,997	8,504	9,033	9,595

Sources: Central Bank of Brazil; Ministry of Finance; Ministry of Planning and the Budget; and Fund staff estimates.

1/ Comprises the central administration and the social security system.

2/ Total primary expenditure is the sum of current (on trend) plus capital (on trend) expenditures, minus unallocated cuts to meet the ceiling.

3/ Excluding Petrobras and Eletrobras.

4/ Structural primary balance adjusts for output gap and one-off measures.

5/ Policy lending to BNDES and others.

6/ Includes assets, which mainly comprise international reserves, financial assets of public enterprises, and assets of the federal labor fund (FAT).

Table 4. Brazil: Depository Corporations and Monetary Aggregates

(End of period, in billions of reais)

	2015	2016	2017	2018	2019
			I. Central Bank		
Net foreign assets	**1,381.5**	**1,179.8**	**1,225.0**	**1,464.9**	**1,421.6**
Net international reserves	1,392.2	1,179.0	1,213.5	1,433.1	1,408.0
Other foreign assets (net)	-10.8	0.9	11.6	31.8	13.6
Net domestic assets	**-787.0**	**-537.3**	**-520.6**	**-749.0**	**-682.0**
Net claims on public sector	242.6	467.8	566.4	493.1	424.9
Net credit to other depository corporations	-882.9	-1,003.5	-1,011.0	-1,080.2	-902.1
Other items (net)	146.8	1.7	76.0	161.9	204.8
Base money	**594.4**	**642.5**	**704.4**	**715.8**	**739.6**
Currency issued	225.5	232.1	250.4	265.0	280.7
Liabilities to other depository corporations	368.4	409.2	453.7	444.1	449.5
Reserve deposits	29.8	38.1	46.4	37.1	35.9
Liabilities to other sectors	0.6	1.2	0.4	6.8	9.4
			II. Depository Corporations 1/		
Net foreign assets	**1,089.3**	**968.2**	**971.2**	**1,171.3**	**1,074.4**
Net international reserves	1,392.2	1,179.0	1,213.5	1,433.1	1,408.0
Other foreign assets (net)	-302.9	-210.8	-242.2	-261.8	-333.6
Net domestic assets	**3,733.8**	**4,452.5**	**4,701.0**	**4,959.3**	**5,615.4**
Net claims on public sector	1,628.1	2,310.1	2,823.5	3,085.9	3,545.1
Credit to other financial corporations	526.0	526.7	336.8	244.4	293.9
Credit to private sector	4,007.0	3,897.6	3,917.3	4,217.8	4,625.1
Of which: loans to private sector	2,909.0	2,824.4	2,824.8	3,043.3	3,209.6
Other items (net)	2,685.4	2,515.7	2,597.6	2,804.3	3,041.2
Capital	855.3	761.9	888.3	1,048.3	1,210.1
Other liabilities excluded from broad money	1,830.2	1,753.8	1,709.3	1,756.0	1,831.1
Broad money (M2) 2/	**4,823.2**	**5,420.6**	**5,672.3**	**6,130.6**	**6,689.8**
Currency in circulation	185.3	192.0	203.9	218.2	228.3
Demand deposits	160.9	169.8	178.1	190.0	216.6
Quasi-money liabilities	4,477.0	5,058.9	5,290.2	5,722.5	6,244.9
			(Percent of GDP)		
Base money	9.9	10.2	10.7	10.4	10.2
Broad money (M2)	80.4	86.5	86.2	89.0	92.2
M3 3/	79.4	84.3	…	…	…
M4 4/	92.6	98.0	…	…	…
Financial sector credit to the private sector	66.8	62.2	59.5	61.2	63.7
Of which: bank loans to private sector	48.5	45.1	42.9	44.2	44.2
Memorandum item:					
GDP (in billions of reais)	5,996	6,269	6,583	6,889	7,257

Sources: Central Bank of Brazil; and Fund staff estimates.

1/ Includes the Central Bank of Brazil, commercial banks, multiple banks, financial (money market) investment funds, Banco do Brasil, Federal Savings Bank, state savings bank, investment banks, National Bank for Economic and Social Development (BNDES), state development banks, finance and investment companies, housing credit companies, and mortgage companies.

2/ M2 includes the liabilities to other financial corporations, state and municipal governments, nonfinancial public enterprises, other nonfinanical corporations, and other resident sectors.

3/ Authorities' definition. M3 comprises M2 plus shares in financial investment funds and the net position of the securities used in their purchase agreements transactions with money holding sectors.

4/ Authorities' definition. M4 comprises M3 plus federal, state, and municipal liquid securities held by the public.

Table 5. Brazil: Medium-Term Macroeconomic Framework
(End of period, in billions of reais)

	2017	2018	2019	Proj. 2020	2021	2022	2023	2024	2025
MACROECONOMIC FRAMEWORK				(Percent of GDP, unless otherwise specified)					
GDP growth at constant prices (percent)	1.3	1.3	1.1	-5.8	2.8	2.3	2.2	2.2	2.2
Consumer prices (IPCA, end of period, percent)	2.9	3.7	4.3	2.0	2.9	3.2	3.3	3.3	3.3
Gross domestic investment	14.6	14.8	15.1	14.7	15.0	15.2	15.6	16.0	16.5
Private sector	12.3	12.7	13.1	12.7	12.9	13.1	13.5	14.0	14.5
Public sector	2.3	2.1	2.0	2.0	2.0	2.1	2.1	2.0	2.0
Gross domestic savings	13.9	12.6	12.3	14.4	13.7	13.4	13.2	13.1	13.2
Private sector	20.4	18.6	17.2	29.6	18.7	17.3	17.4	17.7	17.9
Public sector	-6.5	-6.0	-4.9	-15.2	-5.0	-3.9	-4.2	-4.6	-4.7
External current account balance	-0.7	-2.2	-2.8	-0.3	-1.3	-1.9	-2.4	-2.9	-3.2
Central government primary balance	-1.8	-1.7	-1.0	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
Consolidated non-financial public sector									
Primary balance	-1.8	-1.7	-1.0	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
Overall balance	-9.7	-9.1	-8.7	-7.4	-7.0	-6.1	-5.6	n.a.	n.a.
Public sector net debt 1/	51.4	53.6	55.7	66.8	71.3	74.4	77.0	79.4	81.3
General government gross debt, Authorities' definition	73.7	76.5	75.8	96.6	96.7	97.4	97.7	98.3	98.5
NFPS gross debt 2/	83.7	87.1	89.5	101.1	99.3	100.3	100.9	101.8	102.3
EXTERNAL DEBT 3/ 4/				(Billions of U.S. dollars)					
Total external debt	**667.1**	**665.8**	**679.6**	**667.5**	**669.8**	**675.0**	**684.1**	**698.1**	**712.0**
Medium- and long-term	615.8	598.9	608.7	597.9	599.9	604.6	612.8	625.3	637.7
Nonfinancial public sector	197.7	181.7	192.3	188.9	189.5	191.0	193.6	197.5	197.5
Public sector banks	60.0	38.1	42.9	42.2	42.3	42.6	43.2	44.1	44.1
Private sector	409.4	446.0	444.4	453.3	472.3	496.0	523.9	555.4	555.4
Short-term	51.3	66.8	70.9	69.6	69.8	70.4	71.3	72.8	74.2
Medium- and long-term external debt service	**113.6**	**116.4**	**109.0**	**112.1**	**117.1**	**113.6**	**113.7**	**114.1**	**115.2**
Amortization	93.1	93.8	86.3	90.3	94.9	91.7	91.7	92.0	92.8
Interest	20.5	22.6	22.7	21.8	22.3	21.9	22.0	22.1	22.4
				(Percent of GDP)					
Total external debt	**32.3**	**35.3**	**37.0**	**48.9**	**46.8**	**43.2**	**41.1**	**39.1**	**37.6**
Medium- and long-term	29.9	31.8	33.1	43.8	41.9	38.7	36.8	35.0	33.7
Nonfinancial public sector	9.6	9.6	10.5	13.8	13.2	12.2	11.6	11.1	10.4
Public sector banks	2.9	2.0	2.3	3.1	3.0	2.7	2.6	2.5	2.3
Private sector	19.8	23.7	24.2	33.2	33.0	31.7	31.4	31.1	29.4
Short-term	2.5	3.5	3.9	5.1	4.9	4.5	4.3	4.1	3.9
				(Percent of gross international reserves)					
Medium- and long-term external debt service	**30.4**	**31.1**	**30.5**	**31.4**	**32.8**	**31.8**	**31.8**	**32.0**	**32.3**
Amortization	24.9	25.0	24.2	25.3	26.6	25.7	25.7	25.8	26.0
Interest	5.5	6.0	6.4	6.1	6.2	6.1	6.2	6.2	6.3
Short-term debt	13.7	17.8	19.9	19.5	19.6	19.7	20.0	20.4	20.8
MEMORANDUM ITEMS:									
Gross reserves (eop) 4/									
In billions of U.S. dollars	374.0	374.7	356.9	356.9	356.9	356.9	356.9	356.9	356.9
In percent of external short-term debt (maturity basis)	729.2	560.6	503.6	512.7	510.9	507.0	500.2	490.2	480.7
In months of prospective GNFS imports	17.4	17.7	20.3	17.7	16.9	16.3	15.3	14.4	14.4
In percent of external short-term debt (residual maturity)	257.7	244.7	216.4	212.0	215.8	215.1	213.4	210.6	210.6
Short-term debt in percent of total external debt	7.7	10.0	10.4	10.4	10.4	10.4	10.4	10.4	10.4
Intercompany debt (in billions of U.S. dollars)	227.8	238.6	238.0	250.6	268.9	291.0	316.2	343.4	343.4
In percent of GDP	11.0	12.7	12.9	18.4	18.8	18.6	19.0	19.2	18.2
GDP (billion US$)	2,063	1,885	1,839	1,364	1,432	1,563	1,666	1,787	1,891

Sources: Central Bank of Brazil; and Fund staff estimates and projections.

1/ Includes assets, which mainly comprise international reserves, outstanding liabilities of public financial institutions to the Treasury, financial assets of public enterprises, and assets of the federal labor fund (FAT).

2/ Gross non financial public sector debt consolidates debt of public enterprises with that of general government. Unlike the authorities' definition, gross general government debt comprises treasury bills at the central bank's balance sheet not used under repurchase agreements.

3/ Includes intercompany debt.

4/ Historical numbers include valuation changes.

Table 6. Brazil: External Vulnerability
(in billions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	Proj. 2020
Trade							
Exports of GNFS (12-month percent change, US$)	-5.6	-15.2	-2.8	16.1	8.9	-5.4	-8.7
Imports of GNFS (12-month percent change, US$)	-2.1	-23.7	-16.3	11.3	13.8	-1.1	-19.2
Terms of trade (12-month percent change)	-3.4	-11.0	3.0	5.8	-2.2	0.6	4.5
Current account							
Current account	-101.4	-54.5	-24.2	-15.0	-41.5	-50.9	-3.9
In percent of GDP	-4.1	-3.0	-1.3	-0.7	-2.2	-2.8	-0.3
Capital and financial account	96.8	56.6	16.0	10.3	42.9	53.8	3.9
Capital Account	0.2	0.5	0.3	0.4	0.4	0.4	0.4
Financial Account	96.6	56.2	15.7	9.9	42.4	53.5	3.5
Portfolio investment (net)	41.4	17.8	-20.0	-17.7	-6.9	-20.1	-36.9
Foreign direct investment (net)	67.1	61.6	59.6	47.5	76.1	50.7	66.2
Of which : intercompany loans (net)	38.3	23.7	25.7	4.8	16.5	3.5	9.0
Short-term external liabilities of commercial banks	49.4	42.7	46.8	42.1	45.6	60.0	58.9
External debt							
Total external debt 1/	712.7	664.4	675.8	667.1	665.8	675.8	664.3
In percent of gross reserves	196.0	186.4	185.2	178.4	177.7	189.4	186.1
Amortization of external MLT debt (in percent of GNFS exports)	31.6	51.2	52.2	42.7	39.2	38.2	39.0
External interest payments (in percent of GNFS exports)	7.8	9.8	10.3	9.4	9.4	10.1	10.4
Reserves							
Gross reserves	363.6	356.5	365.0	374.0	374.7	356.9	356.9
In months of prospective GNFS imports	17.9	21.0	19.3	17.4	17.7	20.3	17.7
In percent of broad money (M2)	22.0	28.9	21.9	21.8	23.7	21.5	26.0
In percent of short-term external debt (maturity basis)	234.5	241.8	244.2	257.7	244.7	221.5	...
In percent of IMF metric	155.4	192.2	167.0	160.8	167.8	157.7	...
Exchange rate							
Exchange rate (R$/US$, period average)	2.35	3.33	3.49	3.19	3.65	3.95	5.18
REER (annual average in percent; appreciation +)	-2.1	-17.7	4.9	8.5	-10.4	-1.9	...

Sources: Central Bank of Brazil; Bloomberg; and Fund staff estimates.
1/ Includes intercompany loans.

Table 7. Brazil: Financial Soundness Indicators
(in percent)

	2015	2016	2017	2018	2019	2020M6
			Total banking system			
Capital Adequacy						
Regulatory capital to risk-weighted assets	16.4	17.1	18.2	18.0	17.1	16.3
Regulatory Tier 1 capital to risk-weighted assets	12.7	13.7	14.5	14.6	14.3	13.8
Capital to assets	8.4	9.3	10.0	10.1	10.2	9.4
Gross asset position in financial derivatives to capital	29.6	22.8	19.5	18.4	19.0	41.9
Gross liability position in financial derivatives to capital	35.6	21.8	19.1	19.8	21.6	44.2
Asset Quality						
Nonperforming loans to total gross loans	3.3	3.9	3.6	3.1	3.1	2.8
Provisions to Nonperforming loans	154.4	152.2	163.1	180.3	178.9	205.1
Earnings and Profitability						
Return on assets	1.5	1.1	1.5	1.6	2.0	1.6
Return on equity	15.5	11.3	13.9	14.6	18.0	14.7
Liquidity						
Liquidity assets to short-term liabilities	190.0	236.3	237.5	241.9	242.7	241.9
Liquidity assets to total assets	11.6	14.1	14.6	14.7	14.2	16.1
Net open position in foreign exchange to capital	0.5	0.9	0.7	0.7	0.4	1.0
External funding to total funding	19.5	15.3	14.8	16.9	17.6	20.5
Liquidity Coverage Ratio	190	240	290	240	270	270
Net Stable Funding Ratio	106	107	112	115	113	117
			Public banks			
Capital Adequacy						
Regulatory capital to risk-weighted assets	15.5	16.3	18.5	18.8	18.3	18.2
Regulatory Tier 1 capital to risk-weighted assets	11.0	11.5	12.7	13.1	13.1	14.0
Capital to assets	4.7	4.9	5.7	6.1	6.7	6.7
Gross asset position in financial derivatives to capital	8.2	2.6	1.6	1.7	1.1	4.0
Gross liability position in financial derivatives to capital	3.2	3.0	1.3	1.3	1.2	3.1
Asset Quality						
Nonperforming loans to total gross loans	2.5	3.3	3.1	2.6	2.7	2.4
Provisions to Nonperforming loans	157.8	146.6	158.6	190.9	185.0	198.5
Earnings and Profitability						
Return on assets	1.0	0.6	1.2	1.0	1.7	1.5
Return on equity	14.5	9.0	16.4	12.9	20.6	17.9
Liquidity						
Liquidity assets to short-term liabilities	196.0	282.0	308.7	345.2	438.4	419.8
Liquidity assets to total assets	9.7	13.2	14.8	16.3	19.0	18.2
Net open position in foreign exchange to capital	-1.2	4.4	2.2	4.0	2.1	1.7
External funding to total funding	9.1	6.5	5.7	6.1	5.8	7.4
			Private banks (domestic and foreign)			
Capital Adequacy						
Regulatory capital to risk-weighted assets	17.3	17.6	18.0	17.8	16.3	15.2
Regulatory Tier 1 capital to risk-weighted assets	13.7	14.4	15.0	15.1	14.2	13.3
Capital to assets	11.0	12.3	13.3	12.7	12.2	10.9
Gross asset position in financial derivatives to capital	28.2	28.0	28.2	24.7	26.7	52.9
Gross liability position in financial derivatives to capital	35.3	27.9	27.3	24.5	27.4	50.3
Asset Quality						
Nonperforming loans to total gross loans	4.2	4.9	4.3	3.7	3.6	3.4
Provisions to Nonperforming loans	160.4	153.4	167.3	174.1	177.3	208.6
Earnings and Profitability						
Return on assets	2.2	1.7	1.9	2.0	2.2	1.6
Return on equity	19.0	14.2	14.2	15.7	17.2	13.1
Liquidity						
Liquidity assets to short-term liabilities	212.4	230.4	217.3	212.1	166.4	209.7
Liquidity assets to total assets	11.8	13.7	12.9	12.2	9.3	13.3
Net open position in foreign exchange to capital	0.8	-0.1	0.2	-0.2	-0.2	0.8
External funding to total funding	24.9	20.5	20.6	21.5	21.9	23.2

Sources: Central Bank of Brazil; and Fund staff calculations.

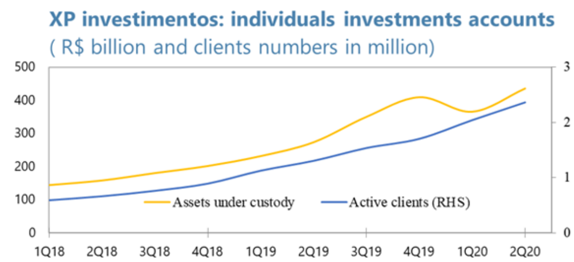
Annex I. Implementation of Past Fund Advice

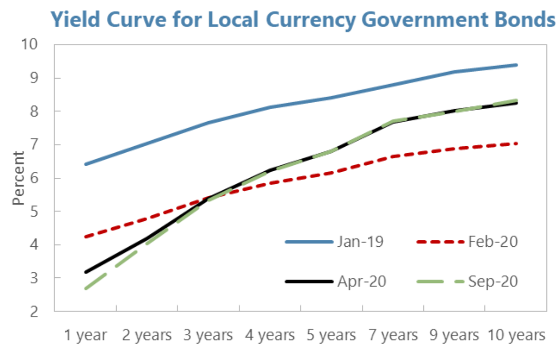
IMF Recommendations	*Rationale*	*Implementation status*
	Fiscal Policy	
Reform the social security system, increasing retirement ages and reducing relatively high benefits, particularly for public sector employees.	Ensure fiscal sustainability and fairness.	A pension reform for private sector workers and federal civil servants was approved in October 2019, which will stabilize pension spending as a share of GDP.
Implement social security reform at the subnational level.	Ensure fiscal sustainability and fairness.	A bill is under discussion in Congress to extend the new pension rules to all state governments. Various states implemented their own pension reforms or are planning to do so.
Reduce the public sector wage bill at all levels of government.	Ensure compliance with the federal spending cap, fiscal sustainability and fairness.	The government submitted draft legislation to allow cuts in civil servants' wages during periods of fiscal stress. An administrative reform proposal, with an overhaul of public sector career structures, was also submitted, but affects new civil servants only.
Review budget rigidities, including mandatory spending, revenue earmarking, and the indexation of key spending items, while protecting social programs such as *Bolsa Familia* .	Facilitate budget management and fiscal consolidation, while creating space for more public investment.	The 'Plano Mais Brasil' proposal includes mechanisms to review some minimum spending requirements, adjust mandatory spending in times of fiscal strain, and reduce earmaking of public funds.
Simplify the tax system.	Promote economic efficiency.	Congress initiated discussions for the creation of a national VAT, while the federal government presented a proposal for a federal VAT. A comprehensive income tax reform is planned for a later date.
Remove distortionary tax exemptions.	Support fiscal sustainability and promote economic efficiency.	No concrete steps have been taken; although the federal VAT reform proposal would eliminate some tax exemptions (revenue-neutral).
Further strenghten revenue administration, in particular efforts to collect arrears.	Support fiscal sustainability and promote economic efficiency.	Reform initiatives have focused on estimating tax gaps, improving taxpayer compliance levels, defining a Business Continuity Plan and an Institution-wide Strategic Plan.
Move toward a medium-term budget framework.	Create fiscal space, protect social programs, and increase investment.	No concrete steps have been taken.
Pursue privatization of SOEs	Promote economic efficiency, support to fiscal consolidation efforts.	SOEs (Petrobras, public banks) sold assets in an ammount equivalent to 0.14 percent of GDP in 2019. No major SOE has been privatized thus far.
	Structural Policies	
Reduce tariffs and nontariff-barriers, and pursue free-trade negotiations outside Mercosur.	Open the economy, increase competition and efficiency.	The government is finalizing agreements/protocols with the EU, Canada, South Korea and the USA, but ratification may need additional political efforts.
Revive investment in infrastructure through new concessions.	Alleviate supply bottlenecks, supporting economic growth. Lower transaction costs.	A newly approved sanitation and sewage bill would help overhaul the sector, opening oportunities for investment in the sector. Thirty-six concesssion contracts have been negotiated in port, airports, and oil and gas sectors. No major agreement has been made in the energy sector.
Improve business environment and reform labor markets.	Attract private investment, improve productivity.	The Economic Freedom Act introduced measures to cut red tape (such as simplified procedures for opening and closing companies), end the requirement to obtain licenses and permits for opening low risk businesses, and streamline some labor rules.
Finalize National Risk Assessment (NRA) in preparation for the next FATF/GAFILAT.	Strengthen AML and anti-corruption frameworks.	The NRA exercise is currently underway; finalization is still pending but scheduled for the coming months.
Enhance the collection of beneficial ownership information, for both foreign and domestic legal entities. Share the information as needed among relevant competent agencies.	Strengthen AML and anti-corruption frameworks.	The tax authority is collecting beneficial ownership information of domestic and foreign legal entities; it would be important to share this information among relevant competent agencies.

IMF Recommendations	*Rationale*	*Implementation status*
Monetary and Financial Sector Policies		
Legislate BCB's independence and legal protection of its staff.	Strengthen the inflation-targetting, micro-prudential, and safety net frameworks.	A bill establishing central bank autonomy with a fixed-term mandate (4 years with one renewal, and staggered with the presidential mandate) for the BCB governor and deputy governors was approved by the Senate in November 2020. The bill is now with the Lower House.
Maintain an accommodative policy stance and prepare to ease further if contractionary effects from fiscal policy materialize.	Support return of inflation to target.	Monetary policy was eased through the second half of 2019 and early 2020, given below-target inflation and inflation expectations. The SELIC was further lowered to cushion the impact of COVID-19 on the economy.
Upgrade regulatory and supervisory framework in line with 2018 FSAP recommendations.	To better deal with related party exposures, large exposures, country and transfer risk and restructured loans.	The National Monetary Council (CMN) has issued resolutions to address large exposure limits, credit operations between related parties and reporting requirements for the restructuring of financial instruments. Several initatives are still at the drafting stage, including IFRS9 implementation.
Bring deposit guarantee fund into the public sector.	Preserve the financial stability function within the government, avoid conflict of interest, better deal with confidential information.	The recommendation to transform the FGC into a fully public-owned institution will not be implemented.
Enhance the central bank's ability to provide emergency liquidity assistance and implement the new resolution regime in line with FSAP recommendations.	Strengthen safety net and bolster banking sector resilience.	Implementation of a new permanent emergency liquidity assistance facility is ongoing, with a November 2021 deadline. The draft bill on resolution was submitted to the National Congress in December 2019.
Give mandate for macro-prudential oversight and crisis management to high level multi-agency committee.	Strengthen transparency and accountability and improve risk management.	The BCB finalized the draft bill "Financial Stability Coordination Law", in agreement with CVM (Securities and Exchange Commission), Previc (pension supervisor) and SUSEP (insurance supervisor). The bill is currently being evaluated by the Office of the President's Chief of Staff (Casa Civil).
Improve loan collateral enforcement, foster bank competition, facilitate client mobility and improve transparency and comparability of financial products.	Improve banking sector intermediation, including by lowering delinquency costs.	The Credit Registry Law was amended in 2019 to adopt the opt-out model instead of the opt-in model. Several BC# measures to foster an inclusive and competitive credit market are underway. The Brazilian Instant Payments System (PIX) and phase one of open banking have been in place since November 2020.
Continue to reduce state intervention in credit markets, including lending by *Caixa* and *Banco do Brasil* .	Improve banking sector intermediation	Public banks were scaling back lending before the COVID-19 shock and plan to continue retrenchment after the crisis.
External Sector Policy		
Limit the use of foreign exchange intervention to adressing disorderly market conditions.	Use exchange rate as a first buffer against shocks.	Interventions have been limited to episodes of excess volatility.
Preserve reserve buffers.	Maintain resilience to external shocks.	Reserve buffers have been preserved at adequate levels.

Annex II. Structural Transformation in Financial Markets

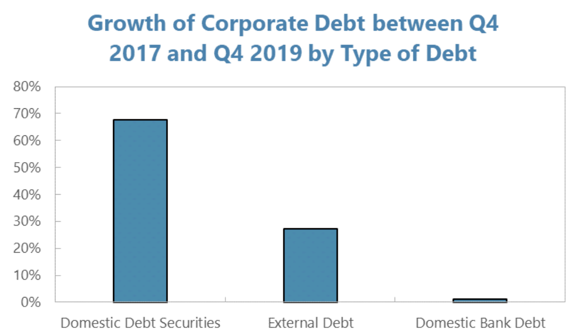
1. **Brazilian financial markets have been going through a structural transformation over the past few years**. Capital markets, including fintechs, have risen in prominence both as a source of financing for firms and an as investment class for retail investors. The transformation was triggered by three important developments: the BCB's BC# Agenda that was launched in 2019 (as a follow-up to the BC+ Agenda) to improve the quality and access of financial services, the reduction of state intervention in credit markets, with Brazil's development bank BNDES significantly retrenching its loan portfolio; and record-low interest rates, with the SELIC reduced by 10 percentage points to 4.25 percent in several easing cycles between 2016 and 2019. These developments collectively spurred greater competition and innovation in capital markets and reduced the cost of borrowing.





2. **Retail investors shifted their assets from low risk assets to high risk equities**. As an example, the number of investment accounts at XP (a major Brazilian fintech) tripled in 2018/19 with large inflows channeled into domestic equities, making Brazilian equities by far the best performers among the LA5 in local currency pre-COVID.

3. **Corporate debt structure shifted toward domestic capital market debt.** Firms replaced external and bank debt with local currency bond debt. The outstanding stock of domestically issued corporate debt rose close to 70 percent between late 2017 and late 2019 while external debt increased by 20 percent (partly driven by exchange rate movements). Domestic bank debt was stable in nominal terms.



4. **Non-resident appetite for Brazilian assets, on the other hand, never fully recovered after the 2015-16 crisis.** Non-resident holdings of government bonds fell sharply during the crisis, from 20 percent in 2014 to 14 percent by end-2016. Following the crisis, non-resident holdings remained broadly unchanged as low interest rates made the Brazilian carry-trade less attractive. On the equity side, non-resident participation has been consistently dropping since end-2017. In

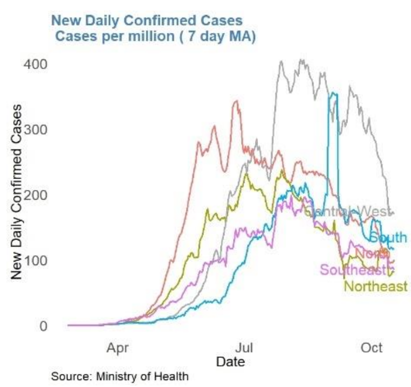
aggregate, financial FX flows to Brazil have been consistently negative since 2013 with 2020 outflows larger than in previous years (for the January-June period).

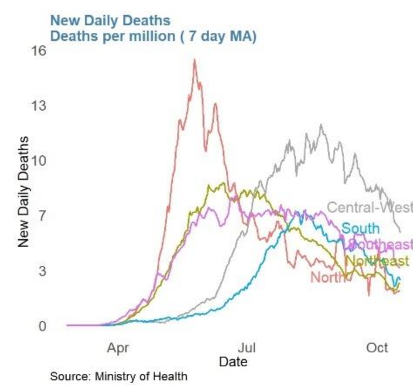
5. The COVID-19 shock has generally reinforced the pre-COVID trends. Non-resident participation in Brazilian capital markets has fallen further (both equity and fixed income) and domestic retail investors continue to move into equities. Driven by this demand, 2020 has seen a record level of initial and follow-on public offerings, totaling R$94 billion as of early October. Large corporates turned to banks, rather than capital markets, however, to satisfy their liquidity needs during the COVID shock.

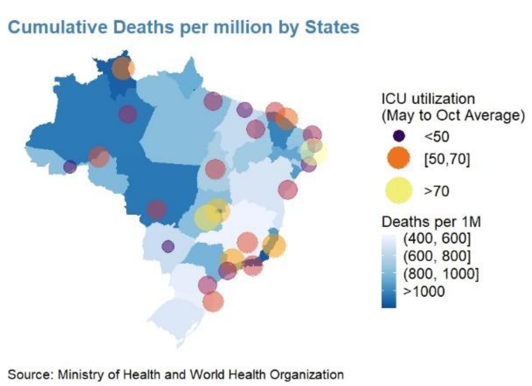
Annex III. The COVID-19 Pandemic and Economic Performance in Brazil: A State-level Analysis

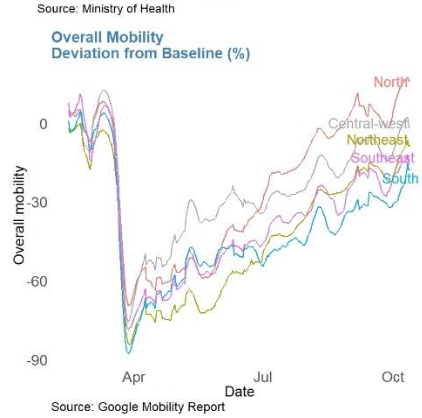
Using cross regional data, this annex presents evidence to show that voluntary social distancing, which is influenced by the severity of the pandemic, affects economic activity in Brazil significantly more than lockdown measures. We also find that retail sales responded more positively to a rise in mobility than services activity. The response is larger in states which benefited more from social assistance programs.

1. The COVID-19 pandemic has affected Brazil's regions unevenly. The Southeast, where the first cases of infection were recorded, had the highest concentration of COVID cases and deaths (35 and 45 percent of the country's total, respectively). A significant escalation in cases was observed around June-July when non-essential businesses reopened in the states' capitals (Sao Paulo and Rio de Janeiro) and the virus spread to the inner cities. However, mortality rates did not rise and remained at the end-May level before starting to decline in September. The northern and central regions, however, were the most affected in per capita terms. Incidence and mortality rates were the highest and health systems came under the most strain (ICU occupancy remained around 90 percent for longer than in other states). The north and northeast suffered its worst outbreak in May, registering the highest death toll in the country. Initial lockdowns in these regions were generally less stringent according to existing indicators (see Figure 1). In the north, where remote communities are harder to reach, mobility fell by less than in all other Brazilian regions. The Center-West (home to Brasilia) successfully contained the spread of the virus until June but has since registered the highest number of new daily cases, after social distancing measures were relaxed.





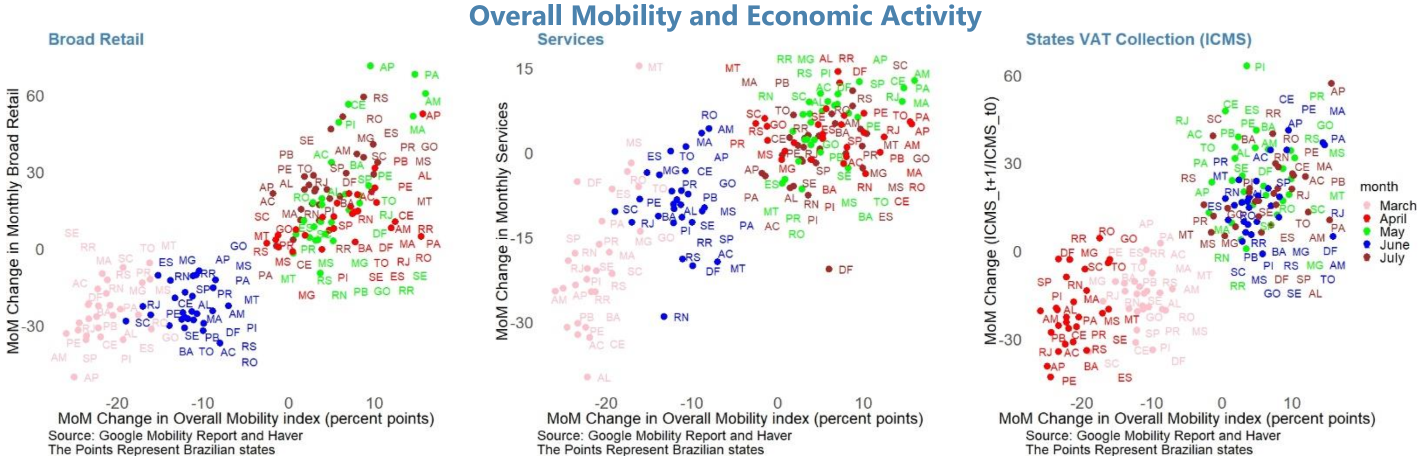




2. Mitigation measures were implemented early on, but steadily lost effectiveness. Most regional governments closed schools and imposed restrictions on non-essential businesses around late March or early April. Social mobility indices dropped by about 50 percent at the time; less than in most other South American countries, but more than in the US and Canada. However, soon after, mobility levels picked up, recovering substantially by June when most social isolation measures were relaxed, and non-essential businesses reopened. Schools, on the other hand, only started reopening in September.[1] Energy consumption, which initially dropped by close to 20%, also recovered quickly and reached 2019 levels by August. Nevertheless, traffic in Brazil's main airports remains substantially (50 percent) below pre-COVID levels.

3. Has economic performance been affected by cross-state differences in social distancing and mobility? IMF research[2] indicates that the adoption of lockdowns and voluntary distancing have contributed to the economic contraction worldwide, particularly in emerging markets. In Brazil, high frequency indicators at the subnational level also point to a similar positive correlation between economic activity and mobility, particularly for (broad) retail sales. Services are mildly correlated with mobility as well. In the remaining section, we use cross-regional data to analyze how lockdown measures have affected mobility, and how mobility in turn affects economic activity.

Overall Mobility and Economic Activity



4. Mobility patterns have mostly been explained by voluntary social distancing, rather than the stringency of lockdown measures. We replicate the IMF (2020) exercise to assess the dynamic response of mobility to the implementation of lockdown measures. A set of panel regressions were estimated using data from 27 Brazilian states from, early-February to end-May[3]:

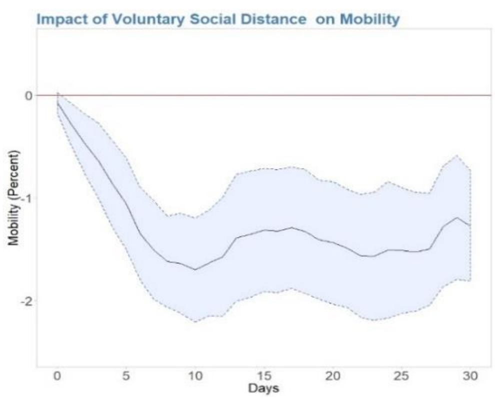
[1] By early October 2020, nearly all 27 federal states allowed the reopening of shopping malls and non-essential businesses. A few states and cities have reopened schools, but many have kept restrictions to cinemas and theatres.

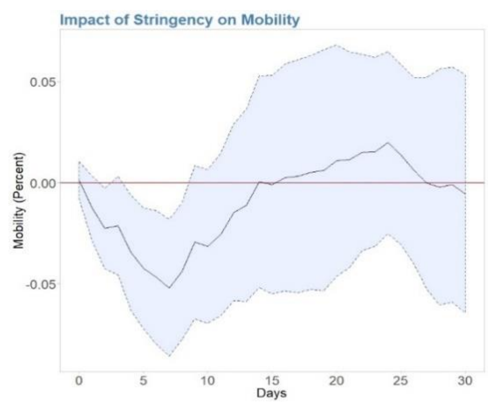
[2] See IMF (2020). The Chapter uses overall mobility as a proxy for economic activity. Here, we study the extent to which mobility has affected different sectors of the economy.

[3] The choice of the time period is determined by the data availability of the lockdown stringency index.

$$mob_{i,t+h} = \alpha_i^h + \tau_t^h + \sum_p^P \beta_{p=0}^h \, ln\Delta cases_{i,t-p} + \sum_{p=0}^P \delta_p^h \, lock_{i,t-p} + \sum_{p=1}^P \rho_p^h \, mob_{i,t-p} + \varepsilon_{i,t+h} \quad (1)$$

where $mob_{i,t+h}$ represents mobility as measured by the Google Mobility Report[4] for state i at time $t+h$, with h being the time horizon; α_i^h and τ_t^h are state and time fixed effects; $ln\Delta cases_{i,t-p}$ is the log daily new COVID-19 cases per million, which is used to indicate the severity of the pandemic and as a proxy for voluntary social distancing[5], with p being the lag length; and $lock_{i,t-p}$ is an index measuring lockdown stringency as calculated in Petherick and others (2020).[6] We find the impact of voluntary social distancing (as measured by $ln\Delta cases_{i,t-p}$) on mobility to be negative, significant and persistent. On the other hand, changes in the stringency of lockdown measures (as measured by $lock_{i,t-p}$) seem to have only a small marginal effect. As in IMF (2020), we interpret this result as suggesting economic activity will remain depressed even if lockdown measures are lifted as long as health risks remain elevated.





5. An increase in overall mobility boosts retail activity and, to a lesser extent, services activity. To proxy economic activity, we used a daily index developed by ITAU bank which maps the consumption of goods and services at the state level. The panel regressions are estimated using data from end-March to end-August[7]:

$$y_{i,t+h}^z = \alpha_i^h + \tau_i^h + \sum_p^P \beta_{p=0}^h \, ln\Delta cases_{i,t-p} + \sum_{p=0}^P \rho_p^h \, mob_{i,t-p} \sum_{p=1}^P \gamma_p^h \, y_{i,t+h}^z + \varepsilon_{i,t+h} \quad (2)$$

---

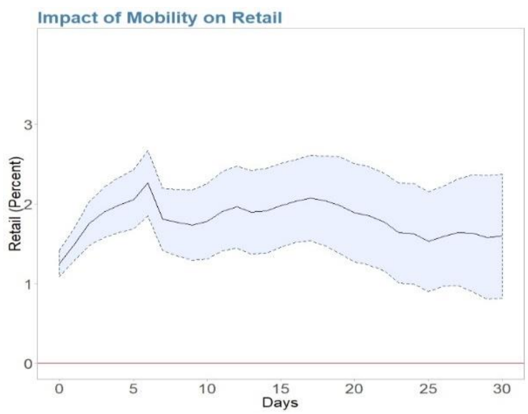
[4] We use the average of mobility indices for groceries and pharmacies, parks, retails and recreation, transit stations, and workplaces.

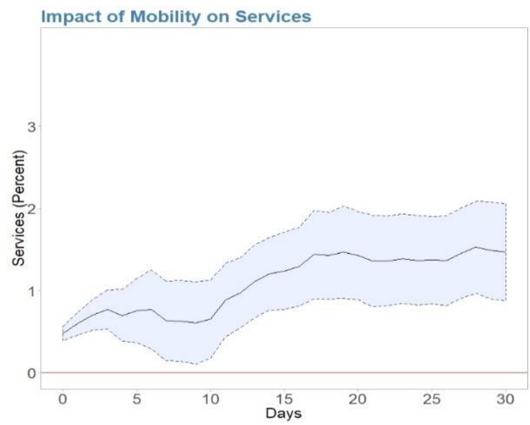
[5] Although insufficient testing may lead to measurement errors concerning the true severity of the pandemic, voluntary social distancing behavior is more closely linked to news and public information about the state of the pandemic. Replacing COVID-19 cases by deaths (which may be subject to less measurement error) in equation (1) leads to very similar results.

[6] We estimate the impulse response functions by local projections according to Jordà (2005). Panel regressions include 7 days of lags. Standard errors are clustered at state level. Petherick et al (2020) extend the Blavatnik School's Oxford COVID-19 Government Response Tracker to Brazilian states. The tracker is survey-based.

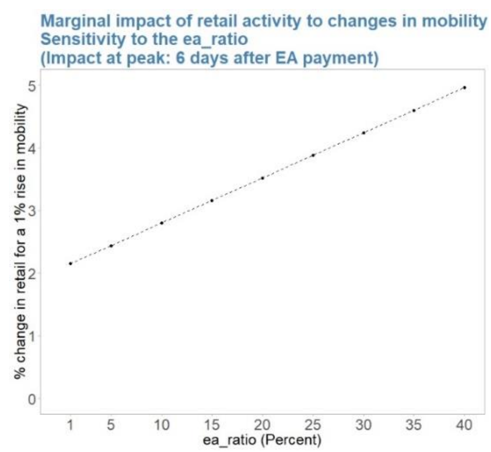
[7] To be able to extend the estimation period through end-August the variable $lock_{i,t-p}$ (lockdown stringency index) was not included as a regressor. A similar exercise controlling for this index but with the sample period restricted to the end-March to end-May period produced similar results regarding the impact of mobility on retail and services activity.

where $z = \{retail, services\}$ and $y^{z}_{i,t+h}$ represents the economic activity proxy for state i at time t+h. We find that a 1 percent increase in average mobility generates an immediate 1¼ percent rise in retail sales, peaking six days later at a 2¼ percent rise. The effect of mobility on services' consumption is much lower than the effect on retail but is significant.





6. The *Auxilio Emergencial* (Emergency Aid or EA) amplified the response of retail activity to mobility. The EA cash transfer program provided funding to poor and informal workers. The support to states in the North and Northeast regions was particularly sizeable, with average monthly transfers representing 37 and 48 percent, respectively, of the December 2019 (formal and informal) labor income. To estimate how the EA influenced the relationship between mobility and economic activity in our framework, we introduce a variable $\text{ea\_ratio}_{\text{i,t}}$ representing the share of the state population which receives the cash transfer where t is a payday of the EA program.[8] $\text{ea\_ratio}_{\text{i,t}}$ is included both as a control variable and in interaction with the mobility index:



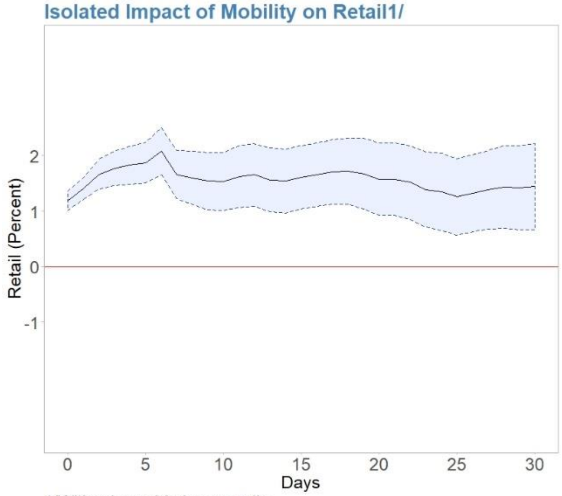
$$y^{z}_{i,t+h} = \omega^{h}\text{ea\_ratio}_{\text{i,t}} + \alpha^{h}_{i} + \tau^{h}_{i} + \sum^{P}_{p} \beta^{h}_{p=0}\, ln\Delta cases_{i,t-p} + \sum^{P}_{p=0} \rho^{h}_{p}\, mob_{i,t-p} + \sum^{P}_{p=0} \mu^{h}_{p}\, mob_{i,t-p} * \text{ea\_ratio}_{\text{i,t}} + \sum^{P}_{p=1} \gamma^{h}_{p}\, y^{z}_{i,t+h} + \varepsilon_{i,t+h} \quad (3)$$

We find that the estimated impact of a 1 percent change in mobility on retail activity rises with the $\text{ea\_ratio}_{\text{i,t}}$. As such, in a state like Piaui, for instance, which has the largest average share of the population (38%) receiving the EA, the rise in mobility is expected to boost retail activity 7 days after an EA payment is 34% larger than in the state of Santa Catarina, which has the lowest average share

[8] We considered the payment schedule for non-BF beneficiaries only, since BF beneficiaries receive these cash transfers through public banks. Their purchases are therefore not captured by our economic activity proxy from ITAU.

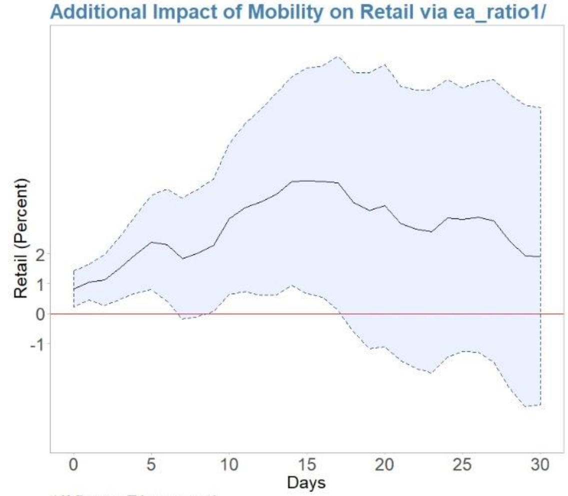
of EA beneficiaries (21%). The direct effect of mobility on retail (independent of EA importance) is still significant, albeit a bit smaller than estimated by equation (2).

Isolated Impact of Mobility on Retail1/



S 1/Without considering ea_ratio.

Additional Impact of Mobility on Retail via ea_ratio1/

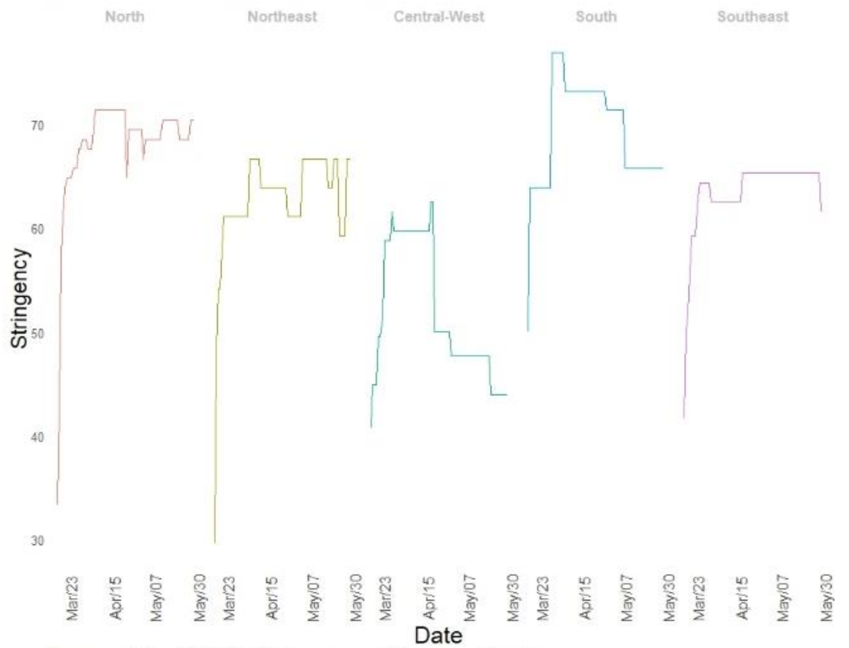


S 1/After an EA payment.

The chart on the left shows ρ_0^h for each h, while on the right hand side we plot μ_o^h. The estimated ω^h is not statistically significant.

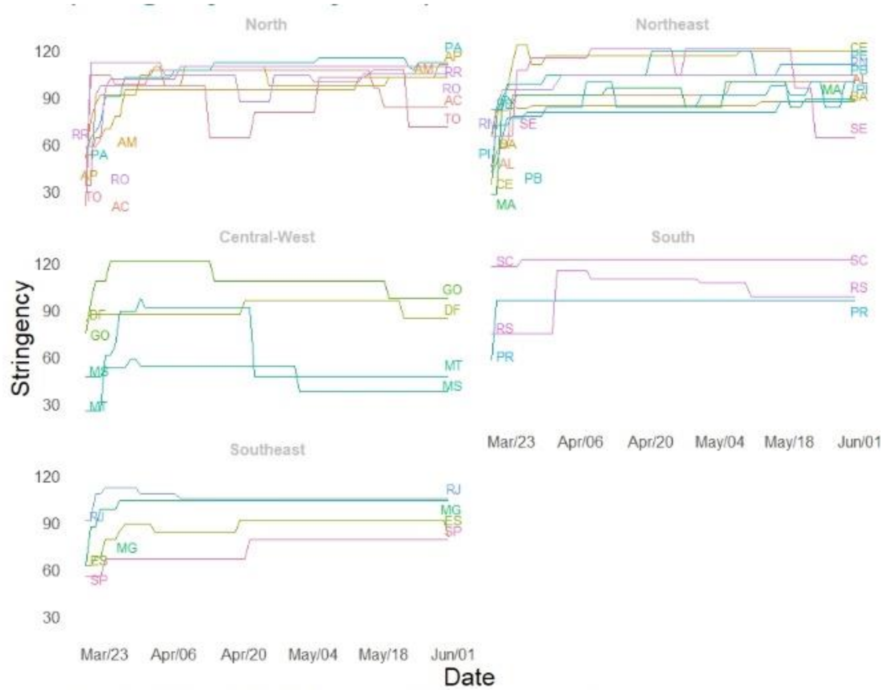
Figure 1. Brazil: COVID-19 Mitigation Measures by Region

Median Stringency Index



Source: Oxford COVID-19 Government Response Tracker

Stringency Index by State



Source: Oxford COVID-19 Government Response Tracker

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Annex IV. Details of The Fiscal and Quasi-Fiscal Policy Response

1. To mitigate the impact of COVID-19 pandemic, the authorities announced fiscal and quasi-fiscal measures adding up to about 18 percent of GDP. The direct impact of these measures on the primary deficit is restricted to 2020 and estimated at 8.4 percent of GDP, the bulk of which is in the form of social transfers. In addition, the authorities provided financial support to firms, while public banks expanded credit lines for businesses and households.

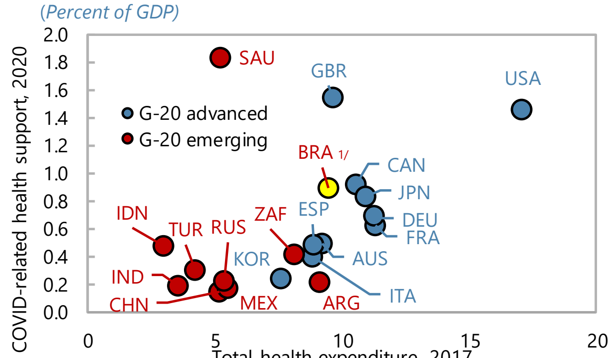
2. Expenditure measures included:

- *Support vulnerable households*. The authorities offered large cash transfers to informal and unemployed workers (EA program, Box 2), originally for a period of 3 months but eventually extended it to the end of 2020. Beneficiaries received R$600 per month (about 60 percent of the minimum wage and over 3 times the medium stipend under *Bolsa Família*) during the first 5 months of the program, while for the remainder of the year (4 months) the government halved the stipend and tightened the eligibility criteria. The government also added 1 million new beneficiaries to the *Bolsa Família* program – with impact beyond 2020 – and provided temporary electricity subsidies to poor families. Together, these measures cost 5.3 percent of GDP. In addition, the government frontloaded pension payments and salary bonuses (for low income earners) within the year.

- *The Emergency Employment and Income Maintenance Program for formal private sector workers,* allows temporary reduction in working hours or suspension of contracts with partial salary compensation by the government to furloughed workers. The program was also initially announced for 3 months but eventually extended through end 2020, and has an estimated cost of 0.7 percent of GD*P*.

- *Increased health spending.* The federal government estimates it will spend 0.7 percent of GDP in 2020 to face the COVID-19 health crisis, half of which is executed at the subnational level as local agencies are at the frontline of the pandemic's response. Funds were used to acquire new hospital equipment and COVID-19 tests, temporarily expand ICU capacity and hire new medical personnel. Earmarked transfers to regional governments and tax breaks (see ¶3 and 4 below) in addition to the 0.7 percent of GDP outlay, put Brazil ahead of most other G20 EMs in terms of budgetary health support, despite an already high level of total pre-COVID health spending.

G-20: Historical health expenditure vs. COVID-related health support
(Percent of GDP)



Source: IMF G-20 Report on SSBIG, 2020; World Bank WDI Database.
1/ Includes Federal Government spending, transfers to subnational governments earmarked to health spending, and tax breaks on medicine and hospital equipment.

3. The government also temporarily lowered the tax burden for employers (mostly through tax deferrals within the fiscal year worth 1.8 percent of GDP), on essential health products (0.1 percent of GDP), and on credit transactions (0.3 percent of GDP).

4. To compensate for revenue losses, support was provided to subnational governments in the form of direct transfers (1.1 percent of GDP) – of which 0.1 percent of GDP was earmarked to local health expenditures related to COVID-19 –, and the suspension of debt service with the federal government (0.5 percent of GDP). The possibility to renegotiate debt with public banks and multilateral organizations was also legislated, with estimated impact of up to 0.4 percent of GDP.

5. Credit and quasi-fiscal support complemented the in-budget measures:

- The Treasury backed over 1 percent of GDP in credit lines to SMEs and micro-businesses to cover payroll costs (requiring employment retention beyond the loan disbursement period), working capital and investment.

- Public banks stepped up credit lines in 4.4 percent of GDP, with emphasis in supporting working capital. Caixa Econômica Federal created new lines for the real estate sector (with 6-month grace periods for companies and households) and purchased payroll-backed and vehicle-loan portfolios from smaller banks. Banco do Brasil expanded credit to households and the agricultural sector and beefed up investments and prepayments of companies' receivables. BNDES granted 6-months moratoria on debt service by companies.

- Contributions by small employers to extrabudgetary savings and training funds were either deferred or temporarily reduced, as another incentive to retain formal jobs (0.5 percent of GDP).

- Last, the authorities authorized new withdrawals from the FGTS (a mandatory savings fund for formal workers), releasing up to 0.5 percent of GDP in cash to households.

Table 1. Brazil: COVID-19 Response – Fiscal and Quasifiscal measures announced by Federal Government

(In billions of R$, unless otherwise indicated)

	With impact on 2020 General Gov. deficit (I)	Frontloading of benefits / Tax deferrals (II)	Financial operations (Federal Government)	Total Impact	Total (% GDP)
Expenditure measures (a)				**485.2**	**6.9**
Advance payment of 13th pension benefit, wage bonuses to low-income workers, and sickness/disability benefits		58.7		58.7	0.8
Covid-19 Emergency Aid to low-income households and informal workers	321.8			321.8	4.6
Gov. compensation for workers with temporarily reduced or suspended contracts	51.6			51.64	0.7
Inclusion of 1 million new beneficiaries in *Bolsa Familia* program	3.1			3.1	0.04
3-month electricity subsidy to poor families	0.9			0.9	0.01
New Min. Health spending to fight Covid19 1/	49.1			49.1	0.7
Revenue measures (b)				**170.5**	**2.4**
Deferral of social contributions paid by employers, as well as small business taxes		128.8		128.8	1.8
Other tax deferrals		14.3		14.3	0.2
Temporarily lower taxes on health products	7.1			7.1	0.1
Temporary elimination of the financial transactions tax	20.3			20.3	0.3
Support to subnational governments (SNGs) (c) 2/				**140.0**	**2.0**
New transfers from federal government to SNGs	79.2			79.2	1.1
of which, transfers earmarked to health spending	*10.0*				
SNG debt renegotiation with central government, public banks, and MDBs	60.9			60.9	0.9
Government-backed credit lines for SMEs and micro-firms (d) 3/			79.9	**79.9**	**1.1**
Quasi-fiscal operations (e)				**378.2**	**5.4**
Credit lines from public banks to SMEs, micro businesses, and individuals				309.8	4.4
Temporary cut of small employers' contibutions to training funds (Sistema S) and deferral of all employers contributions to the FGTS 4/				32.2	0.5
New withdrawals from FGTS authorized 4/				36.2	0.5
Reallocation of public funds to finance crisis-fighting measures (f)			35.5	**35.5**	**0.5**
Memorandum items		**Percent of GDP**			
Fiscal and quasi-fiscal measures, including use of public funds (a+b+c+d+e+f)		18.2			
Fiscal and quasi-fiscal measures (a+b+c+d+e)		17.7			
Fiscal measures affecting the government accounts (a+b+c+d)		12.4			
Direct impact of measures on 2020 primary deficit (column (I))		8.4			
Revenue Measures (taxes)		0.4			
Expenditure measures		6.0			
of which, Covid19-related health spending (federal government and SNGs)		*0.8*			
Supplementary Transfers to SNGs (not earmarked to health spending)		1.8			

Source: Brazilian Authorities and Staff calculations.
1/ Includes spending which supports regional governments but is part of the federal government's budget.
2/ Fiscal space created by these measures is assumed to be fully used by SNGs.
3/ Accounted by the Brazilian National Treasury as part of primary expenditure.
4/ The FGTS is a mandatory savings fund for formal workers, created to insure against unemployment.

Annex V. Details of The Monetary and Financial Policy Response

The BCB has introduced several liquidity and capital relief measures to enable banks to support the real sector with much needed credit, while preserving financial stability. This has so far contributed to increase banking sector liquidity by 4.3 percent of GDP and could potentially reach 16.2 percent of GDP. In addition, banks have benefited from R$1350bn in capital relief. The measures likely contributed to the 13.3 percent increase in non-earmarked credit provisioning from mid-March to Mid-August, compared to the same period last year.

Liquidity Measures

- **A temporary reduction in banks' reserve requirement ratio (RRR) for time deposits from 25 percent to 17 percent.** The measure increased banking sector liquidity by R$70bn and was aimed to address liquidity constraints . Although initially set to expire in December 2020, the BCB has extended the temporary reduction through April 2021, after which the RRR is to adjust to 20 percent.
- **Banks have been granted access to a new lending facility using credit operations as collateral.** This has freed up R$50.5bn of liquidity currently used for lending and has a maximum capacity of R$670bn.
- **Access to a one-year FX repo facility using federal bonds support banks FX liquidity needs.** Banks have currently accessed R$23.2bn of a maximum R$50bn.
- **A new 'Term Deposit with Special Guarantees' (DPGE) allows institutions to take higher deposits guaranteed by the Credit guarantee Fund (FGC).** The FGC's coverage for DPGE was increased from R$20mn to R$40mn per depositor. Higher guaranteed deposits have increased liquidity by R$5.3bn but could potentially reach a maximum of R$200bn.
- **The BCB grants financial institutions loans backed by debentures.** This temporary facility aims to guarantee liquidity and the normal functioning of the private corporate credit market. Up until late august, financial institutions had borrowed R$3bn out of a maximum R$91bn, using debentures as collateral.
- **A 30 percent deduction of savings deposit reserve requirements to be used for micro and small company credit**. This measure will be active for three years and could potentially contribute to a R$55.8bn increase in credit for micro and small companies – R$40bn has been used so far.

Capital Measures

- **Banks have been granted temporary permission to immediately recognize tax credits resulting from losses on FX derivatives positions on earnings.** This is expected to have a direct effect on capital, relieving an estimated R$46bn, which could potentially increase credit provisioning by R$520bn.

- **Temporary suspension from distributing dividends, paying interest on own capital and increasing top managerial compensation.** This also applies for banks with excess CET1 capital (Additional Capital Factor – ACP) and the objective is to prevent the use of funds that may be necessary for sustaining credit provision or covering future losses. This could potentially increase credit by up to R$637bn.

- **The Working Capital Program for Business Preservation aims to provide credit to SMEs.** The loans granted under the program will have a minimum term of three years, with a grace period of six months and could reach R$127bn.

- **A reduction in the minimum capital requirement on SME credit operations.** Specifically, the risk-weight on SME credit risk exposures when calculating risk-weighted assets (RWA) was reduced from 100 percent to 85 percent. This could contribute to a R$35bn increase in SME lending.

Table 1. Brazil: Financial Measures taken since March 2020[1]

(in R$ billion unless otherwise indicated)

	Potential Credit Impact	Implementation 1/	GFC Response
Liquidity support measures 2/			
Reduction in reserve requirements	70	70	-
Changes in LCA regulation	2.2	2.2	82
Loans backed by credit operations	670	50.5	-
FX repos backed by federal government bonds	50	23.2	-
New time deposit with special guarantees	200	18	25
Loans backed by debentures	91	3	10
Lower reserve requirements on saving deposits for banks lending to SMEs	55.8	40	-
Increased flexibility for Agribusiness Credit Bills	2	-	-
Total	***1141***		
As a share of GDP	***16.1%***		
Capital relief measures			
Tax relief on FX overhedging on overseas investments	520	520	-
Reduction of the additional principal capital factor	637	637	-
Working capital program for business preservation	127	3.8	-
Reduction in capital for credit operations with SME	35	35	-
Reduction in capital for small financial institutions	16.5	16.5	-
Reduction in capital for DPGE* exposures	12.7	1.9	-
Total	***1348.2***		
As a share of GDP	***19.1%***		
More flexible credit renegotiations requirements 3/	3200	857.9	-
Other measures			
Swaps lines with the Federal Reserve	US$ 60 billion		US$ 30 billion
Real estate as collateral to more than one loan	R$ 60 billion		

Source: Authorities' estimates.
1/ Information as of September, 2020.
2/ Excludes measures announced prior to the Covid-19 outbreak, which came into effect on March 16: RRR reduction from 31% to 25% (impact of BRL49 billion) and increased eligibility of HQLAs when calculating LCR (impact of BRL86 billion).
3/ Provisioning waver. The ammount refers to outstanding credit potentially affected.
* DPGE - Portuguese acronym for 'Time Deposits with Special Guarantee'; a fixed income security to fund small lenders.

Annex VI. External Sector Assessment

	Brazil: External Sector Assessment 2019
Foreign asset and liability position and trajectory	**Background**. Brazil's NIIP was -40.0 percent of GDP at end-2019, weaker than the 2013-18 average (around -29 percent of GDP). At end-2019 external debt accounts for about 37 percent of GDP and 264 percent of exports. At end 2020H1, the negative NIIP contracted moderately compared to end-2019 due to a combination of valuation effects (assets tend to be in FX while liabilities are concentrated in local currency) and volume contraction in portfolio investments. **Assessment.** Brazil's NIIP has remained negative since the series was first published in 2003. Short-term gross external financing needs are significant, at around 13 percent of projected 2020 GDP, with capital flows and the exchange rate particularly sensitive to global financing conditions.
2019 (% GDP)	NIIP: –40 ; Gross Assets: 50 ; Res. Assets: 19 ; Gross Liab.: 88 ; Debt Liab.: 23
Current account	**Background.** The CA deficit widened from -2.2 percent of GDP in 2018 to -2.8 in 2019 due to a modest pick-up in domestic demand, a slowdown in external demand (exports to key trading partners China and Argentina declined by 2 and 34 percent, respectively), and fairly sizable statistical revisions.\1 In Jan-Jul 2020, the trade balance improved significantly compared to the same period in 2019 (US$26 billion *vs* US$22 billion) on the back of a decline in imports and broadly stable exports, supported by the sharp currency depreciation. The service and income balances have also improved due to lower service imports and distribution of profits and dividends, respectively. Over the year, staff projects an improvement in the CA to about -0.3 percent of GDP. **Assessment.** In 2019, the cyclically adjusted CA deficit was -3.7 percent of GDP, reflecting a still large negative output gap. EBA estimates suggest a CA norm in 2019 of -2.5 percent of GDP. Staff assesses a CA norm between -2 and -3 percent of GDP. Thus, the CA is assessed to have been moderately weaker than the level implied by fundamentals and desirable policies. The medium-term outlook for the CA is difficult to assess given the unfolding COVID-19 crisis and related policy response. Staff expects some improvement in the Cycl. Adj. CA balance in 2020 and a convergence towards the CA norm.
2019 (% GDP)	Actual CA: –2.8 ; Cycl. Adj. CA: –3.7 ; EBA CA Norm: –2.5 ; EBA CA Gap: -1.2 ; Staff Adj.: 0 ; Staff CA Gap: -1.2
Real exchange rate	**Background.** After depreciating by about 8 percent in 2018, the REER (INS) was broadly stable in 2019, depreciating by 1.9 percent relative to 2018. In 2020 the REER has depreciated sharply, falling by an additional 24.9 percent as of end-June relative to end-2019. Depreciation pressures have recently subsided but uncertainty remains high. **Assessment.** Based on the results of the EBA CA balance, REER index and level methodologies, staff assesses the REER gap at end-2019 to be in the range of -4 to 11 percent, with a mid-point of 3.5 percent (overvaluation).\2 The sharp exchange rate correction is likely to lead to a negative gap (undervaluation) in 2020.
Capital and financial accounts: flows and policy measures	**Background.** Net FDI has fully financed CA deficits since 2015 (averaging 3.2 percent of GDP during 2015-19, while CA deficits averaged 2 percent), despite net portfolio outflows of (0.6 percent of GDP on average during 2015-19). In early 2020, however, net portfolio outflows accelerated sharply (1.6 percent of GDP in 2020Q1) before easing starting in late April. FDI inflows have been stronger compared to the same period in 2019, supported by lower acquisition of assets abroad and higher intercompany lending, but portfolio equity investment has declined sharply as foreign investors sold off their shares. Sizable external buffers and a new Swap line with the US Federal Reserve for US$60 billion provide a comfortable cushion against external shocks. **Assessment**. The high degree of uncertainty about the scarring effects of COVID-19 on the global economy make it challenging to assess the medium-term prospects for capital flows. A renewed spike in international risk aversion, potentially linked to a second wave of COVID-19, could trigger a new bout of capital market volatility.

Overall Assessment
Overall Assessment: The external position in 2019 was moderately weaker than the level implied by medium-term fundamentals and desirable policies. On a preliminary basis and adjusting for transitory factors, recent developments suggest a move in the overall external position in 2020 to broadly in line with the level implied by medium-term fundamentals and desirable policies. However, this assessment is highly uncertain given the lack of full-year data for 2020 and the COVID-19 crisis. **Potential Policy Responses:** If imbalances that existed prior to the COVID-19 outbreak persist in the medium term, efforts to raise national savings remain essential to provide room for a sustainable expansion in investment. Fiscal consolidation, anchored by the federal spending cap, will be needed to boost net public savings. Structural reforms to improve efficiency and reduce the cost of doing business would also help strengthen competitiveness. Foreign exchange intervention, including using derivatives, can be appropriate to alleviate disorderly market conditions in the foreign exchange market.

	Brazil: External Sector Assessment 2019 (concluded)	Overall Assessment
FX intervention and reserves level	**Background.** Brazil has a floating exchange rate. Between August and December 2019, the BCB unwound part of its FX swap position while selling dollars in the spot market in nearly equivalent amounts in response to an increasing demand for spot dollars and decreasing demand for FX hedging in Brazil. Consequently, gross reserves fell by about $19 billion in 2019 and ended the year at US$357 billion –about 19 percent of GDP or 158 percent of the IMF's composite reserve adequacy metric. Gross reserves net of FX swaps stood at US$322 billion at end-2019. To dampen excess exchange rate volatility during the COVID-19 shock, the Central Bank sold FX in the spot, repo and FX swap markets in the year through June 10. Nevertheless, reserves remain high at US$348 billion while gross reserves net of FX swaps declined to US$289 billion. **Assessment.** The flexible exchange rate has been an important shock absorber. Reserves are adequate relative to various criteria including the IMF's reserve adequacy metric and serve as insurance against external shocks. The authorities should retain strong external buffers, with intervention limited to addressing disorderly market conditions.	

\1 New questions added to the Brazilian Capital Abroad Survey and to the Foreign Capital in Brazil Survey in 2019 improved the data coverage and accuracy of the services, income, and reinvested earnings components of the balance of payments. The improved data were included in the balance of payments in September/November 2019 and resulted in an upward revision of debits in services, interest and reinvested earnings and the downward revision of credits in reinvested earnings, with consequent increase of the current account deficit for 2018 from US$15bn to US$41.3bn. The change in the assessment for Brazil between 2018 to 2019 is primarily due to these statistical revisions. The new data coverage will apply going forward. Revisions of the 2019 CA, incorporating data sourced from the two surveys, are scheduled for August and November 2020 (with August revisions incorporated in the IMF framework).

\2 Based on CA gap point estimate of -1.2 percent from the EBA CA methodology and Brazil's CA to REER semi-elasticity of -0.11, the REER gap is estimated at 11 percent (overvalued). The two REER methodologies give -10.7 percent (undervalued) and 2.4 percent (overvalued), respectively, with a mid-point of about -4 percent (undervalued). Based on this, staff assesses the REER gap to be in the range [-4, 11], with a mid-point of 3.5 percent (overvalued).

Annex VII. External Sector Debt Sustainability Analysis

External debt is assessed to be sustainable over the medium term, but subject to risks. After a significant increase in 2020, mainly driven by the GDP contraction and exchange rate depreciation, external debt is expected to decline gradually supported by a recovery in equity investments and improved macro-economic conditions. The debt path remains however sensitive to real exchange rate shocks. A significant deterioration in the fiscal position could also deteriorate debt dynamics through higher interest rates and current account deficit.

1. **Total external debt has remained broadly stable at around 36 percent of GDP in the period 2015-2019.** Slight fluctuations around this average value were mainly driven by some variation in GDP growth and exchange rate value. During this period, the share of external debt of the non-financial public sector has declined from one third to one fourth of the total.

2. **The COVID-19 shock is projected to cause a sharp but temporary increase in total external debt and gross financing needs in 2020.** Debt and gross financing needs are projected to increase to 48.7 and 9.8 percent of GDP, respectively, in 2020 compared to 36.7 and 9.1 percent in 2019. This increase is mainly driven by the GDP contraction and currency depreciation. In addition, the reversal of equity investment flows has reduced non-debt financing sources. On a positive note, the currency depreciation has contributed to lower good and service imports, with the current account excluding interest payments expected to reach a zero balance in 2020. Over the medium term, the CA is projected to return to trend, while equity investments and economic growth are expected to recover gradually leading to a steady decline in external debt and gross financing needs. As shown in historical scenarios, if the current account, growth, interest rates, and real exchange rate remain at historical levels over the projection period, the external debt would increase to 60 percent of GDP by 2025.

3. **The external debt path is particularly sensitive to real exchange rate depreciation shocks.** As shown in the shock scenarios, a 30 percent real depreciation would cause external debt to reach 68.6 percent of GDP during the first year and to stabilize at 55 percent of GDP by 2025.

4. **A significant deterioration of the fiscal position could also have a significant impact on external debt dynamics.** This could lead to higher current account deficits, higher interest rates and a slowdown in economic activity, a situation illustrated by the combined shock scenario

.

Table 1. Brazil: External Debt sustainability Framework 2015-2025

(in percent of GDP unless otherwise indicated)

	Actual							Projections						
	2015	2016	2017	2018	2019			2020	2021	2022	2023	2024	2025	Debt-stabilizing non-interest current account 6/
Baseline: External debt	36.9	37.6	32.3	35.3	36.7			**48.7**	**46.6**	**43.0**	**40.9**	**39.0**	**37.6**	**-5.9**
Change in external debt	7.9	0.7	-5.3	3.0	1.4			12.0	-2.1	-3.5	-2.1	-2.0	-1.4	
Identified external debt-creating flows (4+8+9)	9.6	-2.5	-6.7	1.4	1.1			-0.9	-4.0	-3.4	-3.0	-2.7	-2.5	
Current account deficit, excluding interest payments	2.0	0.3	-0.3	1.0	1.5			-1.3	-0.3	0.5	1.1	1.7	2.0	
Deficit in balance of goods and services	1.1	-0.8	-1.3	-0.9	-0.3			-2.3	-2.1	-1.9	-1.2	-0.9	-0.5	
Exports	12.4	12.1	12.2	14.6	14.1			17.4	18.4	17.6	16.9	16.4	16.2	
Imports	13.5	11.3	11.0	13.7	13.9			15.1	16.3	15.7	15.6	15.5	15.7	
Net non-debt creating capital inflows (negative)	-4.0	-3.9	-2.6	-3.9	-2.6			-4.1	-4.0	-4.3	-4.6	-4.7	-4.9	
Automatic debt dynamics 1/	11.6	1.1	-3.9	4.2	2.1			4.5	0.2	0.4	0.4	0.4	0.4	
Contribution from nominal interest rate	1.0	1.1	1.0	1.2	1.2			1.6	1.5	1.4	1.3	1.2	1.2	
Contribution from real GDP growth	1.4	1.2	-0.4	-0.5	-0.4			2.9	-1.3	-1.0	-0.9	-0.8	-0.8	
Contribution from price and exchange rate changes 2/	9.2	-1.1	-4.4	3.5	1.3			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-1.7	3.2	1.4	1.6	0.4			12.9	1.9	-0.1	0.9	0.7	1.1	
External debt-to-exports ratio (in percent)	296.8	310.6	264.1	242.1	259.8			279.8	253.5	244.5	242.5	237.5	231.8	
Gross external financing need (in billions of US dollars) 4/	157.5	121.6	118.6	141.1	167.0			133.3	147.2	159.5	172.3	186.0	198.0	
in percent of GDP	8.8	6.8	5.8	7.5	9.1	10-Year	10-Year	9.8	10.3	10.2	10.3	10.4	10.5	
Scenario with key variables at their historical averages 5/								**48.7**	**50.7**	**52.8**	**55.0**	**57.3**	**59.5**	**-2.7**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	-3.5	-3.3	1.3	1.3	1.1	1.4	3.2	-5.8	2.8	2.3	2.2	2.2	2.2	
GDP deflator in US dollars (change in percent)	-24.0	3.2	13.3	-9.8	-3.6	0.5	13.6	-21.3	2.1	6.7	4.3	4.9	3.6	
Nominal external interest rate (in percent)	2.6	2.9	3.0	3.4	3.4	3.2	0.5	3.2	3.3	3.3	3.3	3.2	3.2	
Growth of exports (US dollar terms, in percent)	-15.2	-2.8	16.1	8.9	-5.4	4.7	14.8	-8.7	10.8	4.6	2.3	4.2	4.6	
Growth of imports (US dollar terms, in percent)	-23.7	-16.3	11.3	13.8	-1.1	5.3	18.5	-19.2	13.6	4.8	6.4	6.4	7.0	
Current account balance, excluding interest payments	-2.0	-0.3	0.3	-1.0	-1.5	-1.8	1.2	1.3	0.3	-0.5	-1.1	-1.7	-2.0	
Net non-debt creating capital inflows	4.0	3.9	2.6	3.9	2.6	3.5	0.6	4.1	4.0	4.3	4.6	4.7	4.9	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

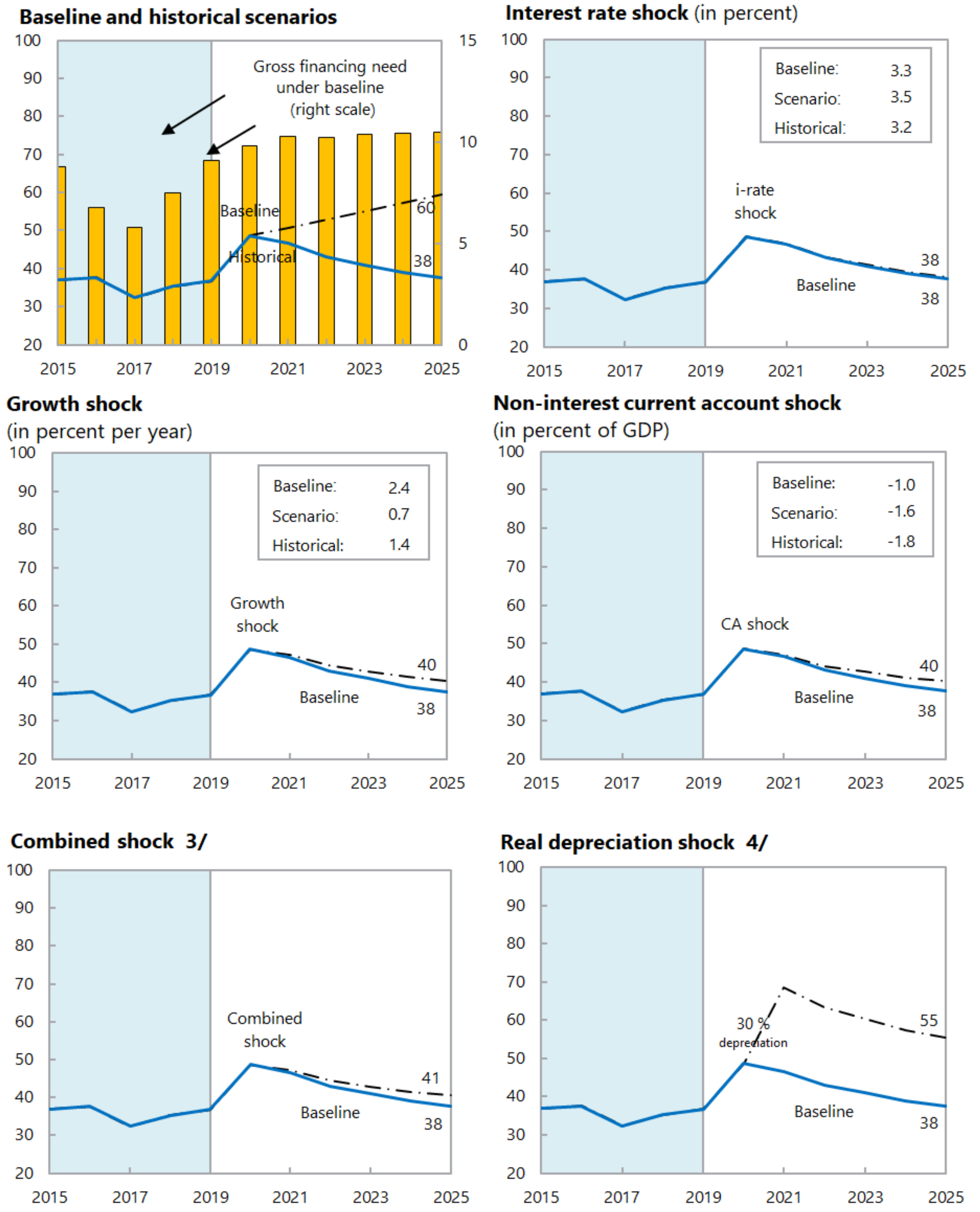
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Brazil: External Debt Sustainability Bound Tests [1/ 2/]

(external debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

Annex VIII. Risk Assessment Matrix[1]

Source of Risks	Relative likelihood	Expected Impact on Economy	Policy responses
		Domestic risks	
Unexpected shift in the COVID-19 pandemic. The disease proves harder to eradicate requiring more containment efforts and impacting economic activity directly and through persistent behavioral changes.	**High**	**High**. Growth dips further, financial markets reassess real economy risks leading to a repricing of risk assets, unmasking of debt-related vulnerabilities, capital outflows, and depreciation pressures.	The central bank should provide additional stimulus and limit FX intervention to disorderly market conditions. The government should reinvigorate its commitment to fiscal sustainability, while stepping up support to the health system in the short run.
Widespread social discontent and political instability. Social tensions erupt as the pandemic and inadequate policy response cause economic hardship (including unemployment, higher incidence of poverty, and shortages and higher prices of essentials) and exacerbate preexisting socioeconomic inequities.	**High**	**High**. Fiscal consolidation is delayed causing a loss of market confidence and an increase in sovereign yields. Public debt and gross financing needs rise sharply undermining debt sustainability.	Social assistance spending and unemployment support would need to be extended and their targeting improved. To restore market confidence, the government should provide clear forward guidance about medium term fiscal consolidation plans and frontload measures necessary to comply with the constitutional spending ceiling in the medium term. Monetary policy should stay accommodative.
Hysteresis and negative feedback loops between the financial sector and the real economy. Amid a highly uncertain health outlook, large output gap and weak labor market, the fiscal withdrawal results in hysteresis, with negative spillovers between households/corporates and the banking sector.	**High**	**High**. Growth dips further, wiping out years of progress in poverty and inequality, possibly resulting in social unrest. Layoffs and companies' closures lead to higher NPLs that in turn lower credit availability, further reducing growth.	The central bank should provide additional stimulus and liquidity support to the financial sector. Social assistance spending and unemployment support would need to be extended, resulting in a smoother fiscal consolidation.
		External risks	
Accelerating de-globalization. Geopolitical competition and fraying consensus about the benefits of globalization lead to further fragmentation.	**High**	**Low**. Reshoring and less trade reduce potential growth. Nonetheless, the effects would be contained given that Brazil is relatively closed and may benefit from trade diversion effects.	Implement structural reforms (financial sector, tax, labor, etc.) and trade liberalization to boost potential growth.
Oversupply and volatility in the oil market. Supply increases following OPEC+ disagreements and lower demand keep energy prices close to historical lows, but uncertainty about possible production cuts and the pace of demand recovery lead to bouts of volatility.	**Medium**	**Low**. Low and volatile oil prices lead to subdued investment spending by Petrobras further compressing, investment and growth.	Given adverse debt dynamics, fiscal policy cannot provide stimulus. Liquidity support targeted to the energy sector could be appropriate, on the back of continued monetary policy accommodation. Structural reforms and trade liberalization would boost growth.
Intensified geopolitical tensions and security risks (e.g., in response to pandemic) cause socio-economic and political disruption, disorderly migration, higher commodity prices (if supply is disrupted), and lower confidence.	**High**	**Medium.** Lower confidence could increase risk aversion against EMs and result in capital outflows and depreciation pressures. However, higher commodity prices would benefit Brazil's terms of trade and partly offset the ER depreciation.	Outflow pressures should be either tolerated or addressed with macro-policy adjustments. The central bank should limit FX intervention to disorderly market conditions.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex IX. Macroeconomic Consequences of Additional Spending in 2021

1. The macroeconomic consequences of extraordinary spending in 2021 are estimated using the IMF's Flexible System of Global Models (FSGM). Staff examines the impact of a one-off spending of 2 percent of GDP in 2021 by simulating alternative scenarios using the FSGM calibrated for Brazil. The FSGM is a general equilibrium model of the global economy combining reduced-form and micro-founded representations of economic factors.[1]

2. Scenario features. Under the staff's baseline scenario, the expenditure ceiling is fully observed through the projection horizon. To assess the macroeconomic impact of the additional spending, we consider four different alternative scenarios: (i) without monetary accommodation, (ii) with monetary accommodation; (iii) with an increase in the sovereign risk premium; and (iv) with an increase in both the sovereign risk premium and policy interest rate. The simulation results are presented as deviations from the baseline scenario.

3. Key macroeconomic assumptions. The conduct of monetary policy is guided by a standard Taylor rule. The sovereign risk premium is exogenous and calibrated to the changes observed in Brazil's 2015-2016 recession when 5-year CDS spread increased on average by 175 basis points over two years. The additional spending in 2021 is targeted at liquidity-constrained households, implying a fiscal multiplier of 0.6 in the baseline and 1.2 in the alternative scenarios with monetary accommodation.

4. Monetary accommodation plays a critical role in the model. The results suggest that a one-off targeted transfer of 2 percent of GDP in 2021 could have a cumulative impact of up to 3 percentage points on the real GDP level during 2021-2025 if full monetary accommodation was provided, substantially reducing the output losses during the pandemic. Meanwhile, the 2025 debt-to-GDP ratio would be 0.5 percentage points above the baseline. In this scenario, firms and households believe the government's full commitment to medium-term fiscal sustainability.

5. Fiscal credibility risks could lead to undesirable outcomes. In a scenario where the one-off targeted transfers threaten the fiscal anchor, staff projects that the sovereign risk premium could increase by 200 bps in 2021 and remain around 150 bps above the baseline over the medium term. This would lead to a cumulative reduction of 4 percentage points in the real GDP level during 2021-2025 and to a rise of similar magnitude in the debt-to-GDP ratio. Under such conditions, a policy rate hike of 200 bps would lead to a reduction in the real GDP level of 8.5 percentage points over the medium term while the debt-to-GDP ratio would be 7 percentage points higher in 2025, and continue to rise beyond the projection horizon.[2]

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[1] Staff's model builds on Andrle, M., et al, 2015, "The Flexible System of Global Models—FSGM," *IMF Working Paper 15/64*. Washington, DC: International Monetary Fund.

[2] The model does not fully internalize the composition of Brazil's debt. For example, the model does not capture that 40 percent of public debt is floating rate and thus reacts quickly to changes in the policy rate.

Annex X. Implementation of Key FSAP Recommendations[1]

Brazil: Key FSAP Recommendations		
Recommendations	**Time**	**Authorities' Actions**
Microprudential and macroprudential institutional arrangements		
Establish a multi-agency high-level committee, with an explicit mandate for macroprudential policy and the power to issue policy recommendations on a comply-or-explain basis.	ST (Short Term)	The BCB has–in agreement with CVM, Previc and SUSEP – finalized a draft bill named the "Financial Stability Coordination Law", which is now being analyzed by the Office of the President's Chief of Staff (Casa Civil).
Strengthen the crisis management institutional arrangements for inter-agency cooperation and exchange of information, including for contingency planning.	MT (Medium Term)	This proposal is directly related to the above-mentioned "Financial Stability Coordination Law". According to the draft bill proposed by BCB, the "Financial Stability National Committee" would have authority over macroprudential policy and crisis management (including contingency plans/crisis management). The BCB's Contingency Plan has already been implemented.
Strengthen legal protection of all supervisors (BCB, SUSEP) through clear rules, including fixed term, condition of dismissal, public disclosure of reasons for dismissal and qualification criteria for appointments. Strengthen the independence of the BCB.	ST	Two bills of law that tackle BCB autonomy are currently under discussion in Congress. One bill has been approved by the Senate, which addresses the Central Bank mandate, including the criteria for the appointment and the dismissal of Governors, and sets four-year tenures (with one renewal) for the Board of Governors. Their tenures do not match the presidential term to avoid a wholesale change whenever a President is elected. This bill has moved to the lower house. The second bill, submitted to the lower house, is broader and proposes legal protection of BCB staff, defines aspects of operational autonomy, addresses the delegation of decisions about other monetary policy and macroprudential tools from CMN to BCB, and enhances policy transparency, such as through the publication of inflation and financial stability reports. This bill has stalled due to COVID and has yet to be evaluated in the specialized committees before a plenary vote. The Bank Resolution bill – submitted to the lower house and currently being discussed by a special congressional committee – also provides for protection of public agents. As it stands, this bill includes both a provision for legal protection of public agents and for legal defense by the General Counsel on BCB expenses. The insurance supervisor (SUSEP) Board has drafted a bill to merge SUSEP with the pension funds supervisor (Previc), addressing, among other issues, the structure of the new authority. This draft bill has not yet been approved by Congress. However, it is worth noticing that the Decree nº 9.727/2019 has established qualification criteria for appointments to strategic positions in the Administration.
Increase resources of CVM and SUSEP.	ST	The CVM budget was reduced to R$ 22 million during 2019 from R$ 30.5 million at the beginning of the year. The total discretionary budget for 2020 was R$ 27.7 million and the expected budget for 2021 was R$ 31.3 million. Notwithstanding the studies underway to merge and restructure SUSEP and PREVIC, budget constraints, throughout the Federal Government currently impose limits to any proposal in this regard.
Systemic risks		
Use Pillar 2 capital requirements to handle bank-specific risk profiles to boost their resilience as needed and to mitigate risks.	ST	Structured and by Reference Add-ons are implemented in our supervisory methodology. The Structured Add-on is in its third year of application to all banks (segments from S1 to S4). The Add-on by Reference is applied to banks allocated to Segment S1 and includes metrics for credit concentration risk and IRRBB since 2020. Technical studies to include banks allocated to S2 Segment in Add-on by Reference process are in place.

[1] The description of authorities' actions in this table was compiled by the Brazilian authorities.

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	**Time**	**Authorities' Actions**
Financial sector oversight		
Upgrade the banking sector's regulatory and supervisory approach to credit risk— including identification and definitions, limits, and reporting requirements—for related party exposures and transactions, large exposures, country and transfer risk and restructured loans.	MT	The following actions have already been completed: (i) The National Monetary Council (CMN) has issued Resolution 4,677/2018 (Basel III reform on Large Exposure Limits), establishing limits and report requirements for single client and large exposures. Rules have been applied for Prudential Segments S1 and S2 since January 2019 and will apply for Segments S3, S4 and S5 from January 2020. The Report on Operational Limits—DLO (Circular Letter 3,926) was adapted to include information on large exposure limits; (ii) The CMN issued Resolution 4.693/2018 addressing credit operations between related parties; (iii) The BCB issued Circular Letters 3,819/2017 and 3,857/2017 on reporting requirements of restructuring of financial instruments, applicable to all financial institutions since May 2018). For the current resolution (Res 4,693 of Oct / 18), accounting items were created to collect information from Related Parties (data from Jan / 19), in which financial institutions will report the greatest exposure to related parties (natural person and legal entity) and other exposures with related parties (natural person and legal entity). A field was also included in the SCR (as of Jan / 19) to inform whether the contracted operation is being carried out with related parties. A number of other initiatives are under analysis or being drafted: (i) Regulation on prudential treatment for transactions with related parties; (ii) Amendment to the regulation establishing specific requirements for country and transfer risks, with specific treatment of indirect risks; (iii) Requirement of producing concentration risks data on a regular basis; (iv) Structured assessment of country, transfer and indirect risk (v) IFRS9 implementation, which will enhance the credit risk framework definitions, including the definition of credit risk exposure.
Strengthen enforcement function of CVM by raising the level of sanctions and ensuring adequate resources for prosecution; strengthen cooperation allowing CVM proper oversight of ANBIMA's SRO activities in the investment fund sector.	ST	An analysis to expand the scope of the agreement with Anbima is ongoing, to include the subject of supervision of (1) mandate (portfolio breaches) and (2) liquidity management. About 555 funds (which represent more than 85% of industry) will be affected. We expect to have a new version of this agreement in the first half of 2021. On regulation, CVM Instruction 607 was issued to regulate the new Law that expanded the CVM's enforcement power. That is, the new regime is totally applicable and in effect.
Implement (BCB, ANS and SUSEP) consistent group-wide supervision of insurance groups and conglomerates with joint rulemaking, implementation, and on-site inspections and granular data sharing.	MT	The granular data sharing depends on legal provisions and on the establishment of partnerships among the supervisors. In the BCB's view, the creation of the "Financial Stability National Committee" would partially bridge this gap.
Crisis management and bank resolution, safety nets		
Revise the draft resolution law in line with the FSAP team's recommendations and promptly enact it.	ST	The draft bill was submitted to the National Congress in December 2019. The Bill of Law 281 of 2019 is pending appreciation by the Lower Chamber.

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	**Time**	**Authorities' Actions**
Revise the ELA framework to provide for a solvency test tied to enhanced supervision, remedial plans, and possibly restructuring measures, and allow for ELA in systemic circumstances upon a MoF indemnity.	ST	While solvency analysis is important for ELA assessment, the BCB does not agree that being solvent on a point-in-time basis should be the main determinant of ELA approval. The systemic impact of a negative response to an ELA request is also relevant, so the BCB prefers to retain the flexibility to decide, with its discretionary power. The recommendation of indemnity of the MoF in case of ELA in systemic circumstance will not be implemented since it may increase moral hazard risk and the current BCB capital structure is public (which means the National Treasury will have to indemnify the BCB anyway, in case of BCB balance sheet loss). The BCB deployed Temporary Liquidity Facilities (ELA for the COVID-19 crisis) in April 2020. Implementation of new permanent liquidity facilities is undergoing, and that project is in the BC# Agenda, with a deadline in November 2021.
Put in place mechanisms to ensure lending from the deposit insurance fund is not used to maintain weak or insolvent banks in operation; and transform FGC into a fully owned public institution.	ST; MT	The FGC has already amended its by-laws to establish communication to the BCB prior to each assistance operation. The process to establish the "Financial Stability National Committee" is ongoing. The BCB has signed a MoU with the FGC to grant access to detailed information on financial institutions that are members of the FGC, in order to facilitate the Fund's assessment and avoid the use of lending to maintain weak or insolvent banks in operation. The recommendation to transform the FGC into a fully public-owned institution will not be implemented.
Financial integrity		
Complete the national AML/CFT risk assessment and introduce a risk-based approach specific to AML/CFT supervision.	ST	The coordination of the activities related to the National AML/CFT Risk Assessment is attributed to the Brazilian Intelligence Unit (Coaf). The decree to establish the Strategic Committee for the National AML/CFT Risk Assessment was issued on March 6, 2020.
Financial intermediation efficiency		
Foster competition through client mobility and financial product cost transparency and comparability.	ST	The National Monetary Council issued Resolution 4,639/2018 to enhance the portability of salaries' accounts. The Credit Registry Law, Lei do Cadastro Positivo, in effect since 2011, was amended by Lei Complementar 166/2019, and regulated by Resolution 4,737/2019, to adopt the opt-out model instead of the opt-in model. Resolution 4,734/2019 and Circular 3,952/2019 set rules for registering and blocking credit and debit card receivables pledged as collateral in credit operations. With these measures, the volume of blocked receivables cannot exceed the outstanding balance of the transaction, which precludes a previous practice of totally blocking the receivables. Moreover, it allows retailers to discount their receivables at any financial or accrediting institution of their choice. The set of credit modalities eligible for portability between institutions now comprises credit granted to individual microentrepreneurs (before restricted to individuals). Resolution 4,762/2019 already allows credit portability for legal entities, but it depends on enacting a specific rule (Circular). Additionally, different credit modalities can be the destination of ported credit, providing a larger menu of options to financial customers. This allows, for instance, the portability of revolving credit operations into personal credit lines, with a fixed number of installments. It might foster the contribution of new entrants and incumbent institutions that do not operate with the original credit modality to a greater competition in the Brazilian credit market.
Reform of public banks		
Change product offering of BNDES under new strategy with focus on catalyzing private sector finance and developing the financial sector.	ST	In December 2019, BNDES launched a new planning and communication tool for strategic agendas and deliveries: the 2020-2022 Triennial Plan. This is based on three main pillars: financial sustainability, focus on social development and divestments of the equity portfolio.

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	**Time**	**Authorities' Actions**
		In terms of financial sustainability, with the Long-Term Rate (TLP) in force and its market convergence from 2023 forward, and a deleveraging policy of continued prepayments of the loans from the National Treasury, the bank has been structured to seek new funding alternatives. This policy also includes developing strategies for syndication of transactions, bringing in more players to fund the projects alongside BNDES, as well as adjusting its loan agreements in order to allow securitization in the future. BNDES started divestments in 2019, in a very cautious manner in order to reduce its risk limit by 90% up to December 2022. In 2020 from January to September, BNDES has divested around R$33.7 billion in equity positions including, Petrobras (R$ 22 billion) and Vale (R$ 8.1 billion). Regarding FAEP, the provisional act has lapsed without approval of Congress. Nevertheless, BNDES is still focused and committed to support the States and Municipalities in their privatization efforts, providing project preparation services in all modalities, including concessions, public-private partnerships (PPP) and privatizations, and sharing knowledge with the public sector. As of September 2020, there were 74 projects being structured by BNDES in its portfolio: 31 federal, 30 state and 13 at municipal level in several sectors such as water and sanitation, ports, highways, street lighting, power distribution among others. A successful auction has occurred in the sanitation sector, with the participation of many private players in the bidding process, and the major part of the portfolio is expected to be auctioned by 2022. Strategic guidelines for this topic include contributions to the financial sustainability of the entities Federation, promoting regulatory security for leverage investments and competitive auctions, and supporting the public sector in structuring long-term partnerships to make feasible private investments in projects of public interest. The bank is also stimulating the opening of the Brazilian infrastructure market, promoting the entry of new national and international players, including operators and financial investors. Regarding the capital markets initiatives, in the second semester of 2019 Fund Manager for the Infrastructure Bonds Special Purpose Vehicle (FDIC Debêntures de Infraestrutura) was selected. However, due to the interest rate curve structure in 2020, the fund is currently not active. (ii) On the other hand, the Sustainable Energy Fund, launched in 2016 and implemented in 2018, with assets under management of R$500 million in infrastructure projects private bonds related to a low-carbon economy, is currently in its investment phase. Since it was launched over 50 primary investment opportunities for the Fund's portfolio have been analyzed, resulting in the subscription of 12 different project debentures. The annualized return (last 12 months) was 19.4% per year and the annualized volatility (last 12 months) was 3.95% per year. The fund's annualized return, from Sep / 2018 to Dec / 2019, was 18.85% per year. (iii) A new and relevant initiative in the Brazilian Capital Markets was launched in May 2020: an RFP process for the selection of FDICs for SMEs as one of the emergency measures to support SMEs during the COVID crisis. The Bank pre-selected 12 FDICs, of which 10 will receive funds up to R$ 5 billion to offer credit for small businesses, helping to diversify the fund sources and improve access to credit.
Focus Caixa on core activities, improve governance, and invite a strategic investor.		**Focus Caixa on core activities:** CAIXA is repositioning its credit operations, prioritizing the granting of loans to the segments linked to microenterprises, to the promotion of housing loans, maintaining its operations in "Minha Casa Minha Vida" and expanding operations to the middle class through resources from savings and increase in the payroll loans portfolio.

Brazil: Key FSAP Recommendations (Concluded)		
Recommendations	**Time**	**Authorities' Actions**
		Improve governance: CAIXA continues to improve its corporate governance practices, seeking to become a reference in the adoption of good management strategies, in line with principles such as transparency, equal treatment, accountability, corporate social responsibility, compliance, strategic risk management and sustainability. In order to face the new context and its strategic objectives, CAIXA is updating its governance model, notably decision-making forums and bodies, as well as their policies and decision-making processes. **Invite a strategic investor:** CAIXA's investment banking group was strengthened with the internal reallocation of multidisciplinary talented professional, aiming to expand the Bank's pre-existing fixed income capital markets' operation and create a complete structure of investment bank products. This structured team will lead to potential strategic and capital market operations of CAIXA and its subsidiaries, with efficiency and transparency. Whenever necessary, the new team will also advise the Government with speed and quality in potential transactions and will bring in revenues to CAIXA's corporate portfolio by providing services to its clients. There are studies in progress, with potential transactions that will add value for CAIXA, its employees, controllers and customers. Some 40 transactions are under analysis, from Equity Capital Markets ("ECM"), Mergers and Acquisitions ("M & A"), Debt Capital Markets ("DCM") to Asset Securitization, which all may exceed R$100 billion.

INTERNATIONAL MONETARY FUND

BRAZIL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 9, 2020

Prepared By

The Western Hemisphere Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of September 21, 2020)

Membership Status: Joined January 14, 1946; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	11,042.00	100.00
Fund holdings of currency (Exchange Rate)	8334.48	75.48
Reserve Tranche Position	2718.18	24.62
Lending to the Fund		
New Arrangement to Borrow	211.98	

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	2,887.08	100.00
Holdings	2939.13	101.80

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved	Amount Drawn
			(SDR Million)	
Stand-by	09/06/2002	03/31/2005	27,375.12	17,199.64
Of which: SRF	09/06/2002	09/05/2003	7,609.69	7,609.69
Stand-by	09/14/2001	09/05/2002	12,144.40	11,385.37
Of which: SRF	09/14/2001	09/05/2002	9,950.87	9,950.87
Stand-by	12/02/1998	09/14/2001	13,024.80	9,470.75
Of which: SRF	12/02/1998	12/01/1999	9,117.36	6,512.40

Projected Payments to the Fund (SDR million; based on existing use of resources and present holdings of SDRs):

		Forthcoming			
	2020	2021	2022	2023	2024
Principal		0.00	0.00	0.00	0.00
Charges/interest		0.05	0.04	0.04	0.04
Total		**0.04**	**0.04**	**0.04**	**0.04**

Safeguards Assessments: A safeguards assessment of the Banco Central do Brasil (BCB) was completed in June 2002 and updated in March 2005.

Exchange Rate Arrangement: Since January 18, 1999, Brazil's de facto and de jure foreign exchange regime has been classified as floating. Brazil accepted the obligations of Article VIII, Sections 2(a), 3, and 4, effective November 30, 1999.

The tax on financial transactions (*Imposto sobre Operações Financeiras*, IOF) of 6.38 percent on exchange transactions carried out through credit card, debit card, and traveler's checks (including cash withdrawals) by companies in order to fulfill their payment obligations for purchases of goods and services abroad by their customers gives rise to a multiple currency practice (MCP) subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3. In January 2008, the IOF for these exchange transactions was raised to 2.38 percent and then further increased to 6.38 percent in March 2011. The scope of operations was expanded to other foreign exchange transactions in addition to credit cards in December 2013.

Last Article IV Consultation

The last Article IV consultation with Brazil was concluded by the Executive Board on July 15, 2019. Brazil is on the 12-month cycle. The Financial Sector Assessment Program (FSAP) took place in 2002 and was updated in 2012 and 2018.

Technical Assistance

The Statistics Department (STA) remotely delivered a mission on Quarterly National Accounts in August 2020 to support the Brazilian Institute of Geography and Statistics (IBGE) in dealing with COVID-19 related challenges in compiling GDP data. The Fiscal Affairs Department (FAD) is supporting the Ministry of Economy in its efforts to strengthen the tax administration system, enhance medium-term fiscal planning, and improve fiscal transparency. Key capacity development services have been delivered by FAD staff to the country authorities in the present consultation cycle. The mission "Strengthening Fiscal Responsibility at the Subnational Level" was carried out in February 2020 to provide technical advice on designing subnational fiscal rules. The mission built on the findings of the April 2019 mission on "Strengthening the Framework for Subnational Borrowing", which provided recommendations to strengthen the institutional framework for subnational public finances with a focus on programs to support states and municipalities under financial distress. A TADAT Performance Assessment mission took place in January 2020. Through an April 2020 mission (remote), FAD continued to support the State of São Paulo in implementing a cost accounting system for the public sector. In recent past, FAD carried out capacity development missions on Cost Accounting (March 2018), "Public Investment Management Assessment" (August 2017), "Supporting Implementation of the Expenditure Rule Through Public Financial Management Reforms" (March 2017), and "Fiscal Transparency Evaluation" (June 2016).

Resident Representative

The IMF maintains a resident representative office in Brasilia. The Resident Representative is Ms. Joana Pereira, who assumed the post in July 2018.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

- World Bank: http://www.worldbank.org/en/country/brazil
- Inter-American Development Bank: https://www.iadb.org/en/countries/brazil
- New Development Bank: https://www.ndb.int/

STATISTICAL ISSUES

(As of September 21, 2020)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National Accounts: Since 2015, the national accounts estimates have been compiled in accordance to the *2008 System of National Accounts* and the availability of annual supply and use tables contributes to the development of consistent national accounts estimates. Systematic implementation of a supply and use tables system would further improve the robustness of quarterly GDP data. The authorities are also working on improving the seasonal adjustment methodology, including to better adjust for working days. The national accounts series and methodological notes are available on the internet (http://www.ibge.gov.br), and the GDP series are available in *International Financial Statistics* (IFS).
Price Statistics: Since July 1999, the price index reference for monetary policy has been the Broad Consumer Price Index (IPCA) compiled by IBGE. The IPCA covers changes in the prices of goods and services purchased by households earning between one and forty times the minimum wage in 11 metropolitan areas and two municipalities. The weight structure of the index was derived from the 2008-09 Consumer Expenditure Survey. Both the Getúlio Vargas Foundation and the IBGE have been compiling producer price indices, IPA and IPP respectively, since 2010.
Government Finance Statistics: The Ministry of Finance and the Brazilian Central Bank (BCB) compile and disseminate government finance statistics using the *Government Finance Statistics Manual (GFSM) 2014* presentation. The reported statistics include the statement of government operations and balance sheet for the general government. In 2015, the National Treasury improved the general government statistics by introducing accrual basis of recording for government expenditures. The new methodology was applied for the series beginning in 2010. Since then, fiscal statistics follow cash basis of recording for revenues and accrual for expenditures. In 2017 non-financial assets were incorporated in the balance sheet for the period 2014 -2016. The gross debt indicator excludes government securities held by the central bank and not used in monetary policy operations.
Monetary and Financial Statistics: The BCB compiles and publishes monetary and financial statistics, with concepts, definitions, and classification that are broadly in line with the *Monetary and Financial Statistics Manual (MFSM) 2000*. In close cooperation with STA, the BCB introduced the standardized report forms based on accounting data in March 2013. However, the institutional coverage of the other financial corporations needs to be expanded to include insurance corporations, open pension funds, capitalization funds, and exchange houses. The BCB regularly reports quarterly FSIs to the IMF for publication. Currently, the BCB reports all core and 18 encouraged FSIs, with data beginning in Q1 2005. Plans are under way to compile the rest of the encouraged FSIs. The BCB also reports data on some key series and indicators of the

Financial Access Survey (FAS), including gender data and the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
External Sector Statistics: Brazil disseminates monthly and quarterly balance of payments and quarterly international investment position data on a sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) basis. Data are sourced from a comprehensive data collection program. The BCB supplements the international transaction reporting system with other available sources such as surveys on transportation and other services, the survey on foreign assets held by Brazilian residents, and the census of foreign capital in Brazil. The BCB disseminates data on International Reserves and Foreign Currency Liquidity monthly. Brazil also participates in the Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS), and reports quarterly external debt data to the World Bank's Quarterly External Debt Statistics (QEDS) database.
II. Data Standards and Quality
In November 2019, Brazil completed the requirements for adherence to the IMF's SDDS Plus—the highest tier of the Data Standards Initiatives. This made Brazil the first country in Latin America to adhere to the SDDS Plus. As allowed under the SDDS Plus, the requirements on the outstanding three data categories—sectoral balance sheets, other financial corporations survey, and debt securities—will need to be completed within the transition period (i.e., within five years from the adherence date). **Implementing G-20 DGI recommendations:** The authorities have already implemented a good number of the recommendations and work is underway to implement the remaining ones. Further progress would focus on monetary and financial statistics, real estate price indexes, and sectoral accounts.

Brazil: Table of Common Indicators Required for Surveillance

(As of October 23, 2020)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	9/23/2020	9/24/2020	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sept. 2020	10/14/2020	M	M	M
Reserve/Base Money	Sept. 2020	10/14/2020	D	M	M
Broad Money	Aug. 2020	10/15/2020	M	M	M
Central Bank Balance Sheet	Sept. 2020	10/14/2020	M	M	M
Consolidated Balance Sheet of the Banking System	Sept. 2020	10/15/2020	M	M	M
Interest Rates[2]	Sept. 2020	10/14/2020	M	M	M
Consumer Price Index	Aug. 2020	9/1/2020	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jul. 2020	9/1/2020	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jul. 2020	9/1/2020	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jul. 2020	9/1/2020	M	M	M
External Current Account Balance	Q2 2020	9/24/2020	Q	Q	M
Exports and Imports of Goods and Services	Aug. 2020	9/24/2020	M	M	M
GDP/GNP	Q2 2020	9/1/2020	Q	Q	Q
Gross External Debt	Jun. 2020	9/24/2020	M	M	M
International Investment Position[6]	Q2 2020	8/31/2020	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

BRAZIL

November 9, 2020

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

Approved By
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Prepared by the Staff of the International Monetary Fund

Debt sustainability risks are high. Gross debt of the non-financial public sector (NFPS) reached 89.5 percent of GDP in 2019, a small increase from 2018. The Covid-19 shock is expected to lead to a jump in debt to around 101 percent of GDP in 2020, driven by a primary deficit of 11.6 percent of GDP and a contraction in nominal GDP. Gross financing needs will reach 28 percent of GDP in 2020, with a substantial fraction financed by liquid assets. Under the baseline scenario, public debt will increase to around 102 percent of GDP in 2025. Given record-low interest rates on Brazilian debt, the interest-growth differential should turn negative in 2021 but this is still not sufficient to offset primary deficits until the end of the forecast horizon. A primary balance of around 0 is needed to stabilize gross debt as a ratio to GDP beyond the projection horizon. This is feasible assuming compliance with the constitutional expenditure ceiling (which would lead to a small primary surplus in 2026). The trajectory of the debt-to-GDP ratio is highly sensitive to shocks to real GDP growth, fiscal deficits and borrowing costs.

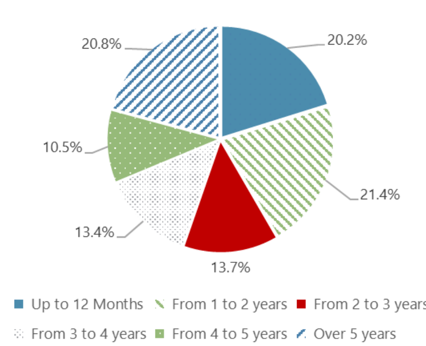
[1] The analysis of public debt sustainability is based on the framework developed for market access countries. See Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries, IMF, May 2013.

BACKGROUND

1. Definitions and coverage. The gross debt statistics of Brazil cover the NFPS, excluding the state-owned enterprises (SOEs) Petrobras and Eletrobras, and consolidate the Sovereign Wealth Fund (until 2019). Following the GFSM 2014 manual, the NFPS debt includes all Treasury securities on the Central Bank's (BCB) balance sheet.[2] As reported by the government, net debt corresponds to the public sector (PS), which includes consolidation with the BCB. Brazil's debt is reported at nominal value.[3]

2. Debt developments. At end–2019, Brazil's NFPS gross debt amounted to 89.5 percent of GDP, 2.8 percentage points higher than a year before. The consolidated public sector net debt amounted to 55.7 percent of GDP at end–2019, reflecting a large stock of assets, equal to 31.1 of GDP, which included international reserves amounting to 19.8 percent of GDP. A primary deficit of 1 percent of GDP and a positive interest–growth differential contributed to the increase in gross debt. Net interest payments of the NFPS and consolidated PS stood at 6.9 and 5.1 percent, respectively, the lowest since 2015 reflecting declining risk premia and a lower SELIC. In 2019, the national development bank (BNDES) repaid R$100 billion (1.4 percent of GDP) in outstanding government securities to the Treasury (in addition to R$130 billion repaid in 2018). These cash payments contributed to reducing financing needs and had a significant impact on gross debt.

Maturity Structure (end-2019)



3. Debt profile. Federal government (FG) domestic tradable securities account for 86 percent of total NFPS gross debt. Around 2/3 of tradable securities are held by the private sector and the rest is held by the BCB.[4] 40.5 percent of FG domestic tradable securities are linked to the SELIC rate (up nearly 4 percentage points in 2019), 32 percent are fixed income securities, and 27 percent are linked to inflation.[5] Average duration of FG securities fell slightly in 2019, from 4.1 to 4 years while average maturity fell from 5.7 to 5.4 years. About 19 percent of FG domestic tradable securities will mature in 2020 of which 25 percent matured in July alone. Foreign currency denominated NFPS debt accounted for only 4.5 percent of GDP at end 2019, broadly stable for over a decade.

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[2] In contrast, the authorities' definition of gross debt includes the stock of Treasury securities used for monetary policy purposes by the BCB (those pledged as security in reverse repo operations) but excludes the rest of the government securities held by the BCB. Thus, per the national definition, gross debt of the general government amounted to 75.8 percent of GDP at end-2019, lower than at end-2018, and widening the gap with the IMF definition, due to the reduction in reverse repos associated in part with the BCB's sale of international reserves during 2019. The definition of net debt is the same between the authorities and the IMF.

[3] The nominal value is calculated as the PDV of future interest and principal payments at the security's contractual interest rate(s), and generally differs from face value.

[4] At end-2019 the BCB used about half of its holdings as security in liquidity-draining operations with the banking system.

[5] A residual 0.5 percent are exchange rate linked securities.

BASELINE AND REALISM OF PROJECTIONS

4. Macroeconomic assumptions. The projections assume a decline in real GDP of 5.8 percent in 2020 followed by growth of 2.8 and 2.3 percent in 2021 and 2022, respectively. Medium-term growth is projected at 2.2 percent. The NFPS primary balance is projected to broadly move to balance in 2025 (0.1 percent of GDP deficit), with a cumulative adjustment of about 2.6 percentage points of GDP during 2021–25 and a large adjustment of 8.9 percentage points in 2021, unwinding the 2020 widening of close to 11 percentage points in the primary balance. Nominal interest rates on new borrowing are substantially lower than in the past due to a record-low policy rate. The effective nominal interest rate is projected at 6.5 percent in 2020, relative to an average of 11.6 percent over 2009-17 and 8.4 percent in 2019 (Box 1).

5. Baseline debt projection. In the baseline scenario, which assumes compliance with the constitutional expenditure ceiling from 2021 onwards (a state of public calamity allowed for exceptional spending in 2020), gross debt jumps to 101.1 percent of GDP in 2020. It declines by around 2 percentage point in 2021 on account of continued use of liquid assets to finance the deficit and then rises again at a diminishing pace to around 102 percent of GDP in 2025.[6] The debt stabilizing primary balance in the baseline scenario is 0 such that debt would stabilize in 2026 under continued abidance with the expenditure ceiling. Net debt of the consolidated public sector is expected to increase faster and longer than gross debt of the NFPS because international reserves are assumed to be broadly constant in nominal terms, thus falling relative to GDP.

6. Baseline gross financing needs projection. Gross financing needs declined from close to 18 percent of GDP in 2015 to below 15 percent in 2019. They are expected to increase substantially in 2020 to 28 percent of GDP, with the authorities making extensive use of their cash buffer to meet the financing needs (Box 2).[7] Partly due to a projected reduction in the average maturity of debt, gross financing needs are projected to decline but remain high by historical standards averaging 20 percent of GDP over 2021-2025 and breaching the high-risk threshold of 15 percent of GDP throughout the projection period (Figure 3). This indicator, however, overstates the financing risks since amortization payments would be about 30 percent lower on average excluding the automatic rollover of BCB held bonds. On the other hand, the interest on existing FG securities reported in the authorities' overall fiscal balance (and used in the DSA) is reported on an accrual basis, in line with the reporting of debt at nominal value. On a cash basis, financing needs are estimated to be on average over 1 percentage point higher per year over 2020-21.

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[6] The current projection does not assume any repayment from BNDES to the Treasury in 2021.

[7] Law 13820/2019 enacted in May 2019: http://www.planalto.gov.br/ccivil_03/_Ato2019-2022/2019/Lei/L13820.htm reformed the institutional framework regulating financial transactions between the Treasury and the BCB. The new law should reduce the amount of Treasury securities issued for BCB recapitalization purposes and is projected to structurally decrease the portfolio of free securities held by the BCB (footnotes 2 and 4). Given the extensive use of the treasury single account for financing in 2020 (which is accompanied by reverse repo operations of the Central Bank to reduce excess liquidity) the free portfolio is forecast to fall significantly in 2020. This will reduce the gap between the authorities' and the IMF's definition of debt all else equal (the gap is forecast to narrow from over 12 percentage points of GDP at end-2019 to below 3 at end-2021). It is possible but not likely at this point, however, that the Treasury will have to issue new securities to the Central Bank to increase the stock of free securities to the required level.

7. Fan chart analysis. Debt sustainability risks are large. Debt only stabilizes at the very end or immediately after the forecast horizon and the path is highly sensitive to the real interest rate, growth and the speed of fiscal adjustment. A negative combination of macroeconomic variables at the 10th percentile would yield debt at 120 percent of GDP in 2025 and on a steep upward trajectory (fan charts in Figure 1). In the most optimistic scenarios, positive shocks could lower public debt to 90 percent of GDP (10th percentile of positive outcomes).

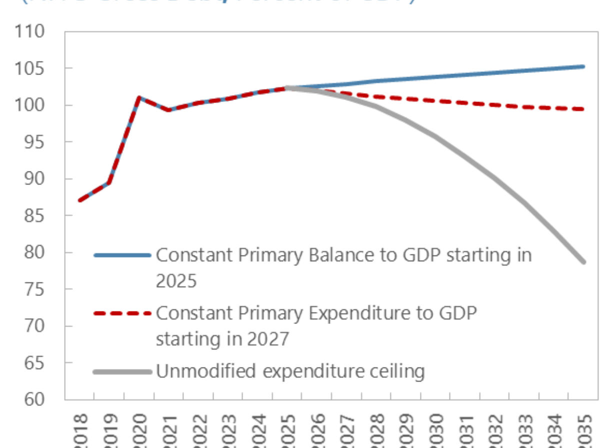
8. Past forecast error. Forecast errors for GDP growth are larger than those in surveillance countries during 2014−16, reflecting the fact that Brazil underwent its largest recession in a century (pre-Covid) during 2015−16 (Figure 2).

9. Realism of projections. Brazil's projected fiscal adjustment in 2021 (reversing the 2020 stimulus) would be in the very tail of the historical distribution. The level of the PB over the forecast horizon, however, is in line with other surveillance countries' experience (Figure 2).

10. Contingent risks from systemic SOEs. The government holds about 50 percent of Petrobras' and Eletrobras' shares, both of which are excluded from the debt definition. Fiscal risks could arise from possible future capitalizations to cover losses. Petrobras's financial position improved substantially in recent years, however, with net debt/EBITDA falling continuously. The current difficult environment led Petrobras to revise its 2020 debt reduction plans with debt expected to remain constant at the 2019 level. Looking forward, and especially if oil prices recover, Petrobras is well positioned to benefit from the growth of pre-salt exploration and further sales of non-core subsidiaries. The government also plans to privatize Eletrobras in the medium term. Overall, the fiscal risks arising from Petrobras and Electrobras are deemed limited at this point.

11. Longer-term debt outlook over 2025-35. Three longer-term fiscal scenarios were assessed to understand how gross NFPS debt might evolve over 2025-35. In all three scenarios nominal GDP growth and the effective interest rate remain at their 2025 levels. In the first fiscal scenario, the primary balance is assumed to remain constant as a share of GDP from 2025 onwards (0.1 percent of GDP deficit). This is essentially a scenario in which the expenditure ceiling is abandoned after 2025 and it results in debt continuing to marginally increase over 2025-35. The second scenario assumes that from 2027 onwards – the year in which by law the parameters of the expenditure ceiling are to be reviewed – primary expenditures remain constant as a share of GDP. In this scenario, debt would fall but still remain around 100 percent of GDP until 2035. In the third scenario, the parameters of the expenditure ceiling remain unchanged and debt drops to 81 percent of GDP by 2035. The reduction in primary expenditures implicit in this scenario is aggressive – they fall from a projected 20.3 percent

Longer-Term Debt Projection:
(NFPS Gross Debt, Percent of GDP)



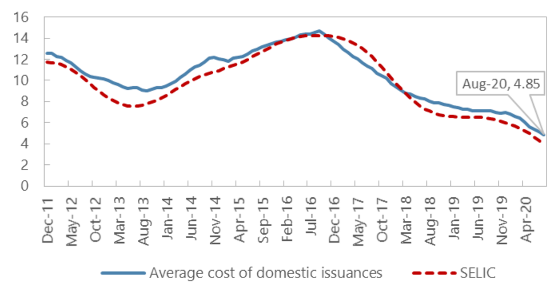
Sources: IMF Staff projections

of GDP in 2021 to 13.8 percent of GDP in 2035. Overall, the longer–term projections highlight that debt sustainability risks are likely to remain elevated in Brazil for many years. To achieve a fiscal path consistent with sustainably declining debt, structural fiscal reforms to cut mandatory spending or increase revenues are necessary; A better debt outlook could also be achieved if potential GDP growth were to increase substantially beyond the current rate of 2.2 percent; or if interest rates were to settle at levels significantly below those assumed in the baseline.

Box 1. The Interest-Growth Differential

The effective interest rate on Brazilian public debt is at record-low levels. Around 40 percent of Brazilian public debt is directly tied to the monetary policy rate. While the yield curve has steepened substantially, the medium- and longer-end of the curve are still at low levels in historical perspective. In addition, the authorities have focused issuances on the shorter-end of the curve, especially in 2020. Overall, the effective interest rate on new issuances has fallen to 4.85 percent by August 2020 (12-month rolling average), around 4 percentage points below the previous low point in 2012.

Monetary Policy Rate and Average Cost of Domestic Public Debt Issuances
(percent, 12 month rolling average)

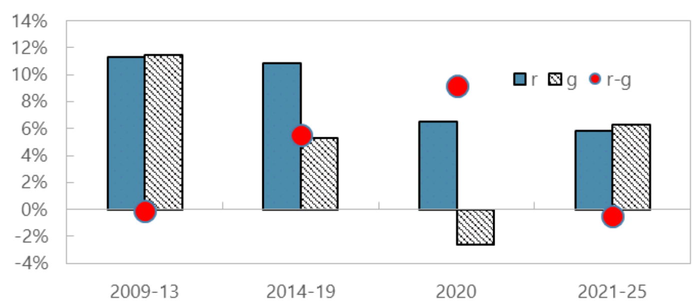


Sources: Brazilian National Treasury, Central Bank of Brazil and IMF Staff Calculations

The low interest rate is expected to lead to a favorable interest-growth differential over 2021-25 after several years of adverse dynamics.

Prior to the 2015-16 crisis, Brazil's interest-growth differential was close to 0 with both high nominal GDP growth and high effective interest rates. Since the crisis, low GDP growth has caused debt dynamics to deteriorate, particularly in 2020 for which nominal GDP growth is forecast to be negative. But given the precipitous fall in interest rates, even the modest expected GDP growth over 2021-25 will take the interest – growth differential back to zero.

Interest rate - growth diferential
(percentage points)



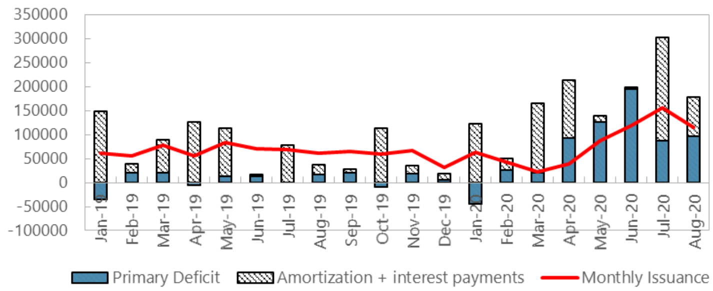
Sources: Brazilian National Treasury, Central Bank of Brazil, IBGE and IMF Staff projections

Box 2. Financing Needs and Source in 2020 and 2021

Debt issuances were below financing needs so far in 2020. Amid high risk aversion, the Federal Treasury rolled over less than 100 percent of debt coming due in March and April. Even though issuances picked up markedly in May -August, they remained below the level required to satisfy financing needs amid the surging primary deficit. Instead the Treasury drew down part of the substantial cash buffer in the treasury single account (TSA) at the Central Bank—a roughly 9 percent of GDP drawdown at end-August. New issuances have focused on short-term, floating rate instruments with a high concentration in bills below 24 months. Non-residents sold local currency debt aggressively in March, outflows continued in April - albeit at a slower pace - and between May-July non-resident flows were close to zero. August saw some minor non-resident buying. Overall, at end-August the stock of non-resident holdings of Brazilian local currency public debt stood 12 percent below the end-February level, now accounting for only 9 percent of total holdings (excluding the BCB). Instead domestic banks and funds stepped in to buy debt–a similar response as in the 2015-16 crisis.

Monthly Debt Issuance vs Monthly Gross Financing Needs

(millions of Reais)

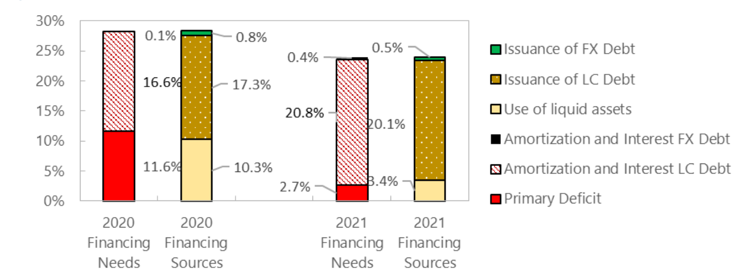


Sources: Btazilian National Treasury and IMF Staff calculations

The use of treasury deposits at the Central Bank will be an important source of financing in 2020 and possibly also in 2021. To replenish the Treasury's cash resources, the authorities transferred part of the BCB's non-realized FX gains on international reserves stemming from the depreciation of the Real in H12020 to the TSA (around 325bn Reais or 4.5 percent of GDP)[1]. For the remainder of 2020, financing needs will be less elevated, reducing the need for further cash drawdowns. But looking ahead to 2021, amortizations will increase, requiring larger issuances than in 2020 and/or continued use of the now partially replenished cash cushion - even with a much-reduced primary deficit. In particular, the first four months of 2021 alone will require rollover in excess of 7 percent of GDP of debt held in the market.

Public Financing Needs and Financing Sources 2020-2021

(percent of GDP)



Sources: IMF Staff projections

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[1] To avoid large flows between the Treasury and the BCB, automatic transfers of non-realized FX gains were discontinued in 2019 but can still be authorized by the Monetary Council on an ad hoc basis (see 2019 Brazil Special Issues Papers). The transactions operate as follows: A depreciation increases net foreign assets of the BCB as well as its current year result (profit), and thus its equity. If the choice is made to credit the TSA, the BCB's liabilities to the government increase and the BCB's current year result falls by the same amount. If and when the Treasury decides to use these resources, the BCB's liabilities to the government fall again and the BCB offsets the resulting increase in liquidity through reverse repos of its holdings of Treasury bonds. In terms of the governments' fiscal accounts, crediting the TSA is neutral. The operation is recorded as an interest revenue and since the overall fiscal balance is presented on a consolidated public sector basis, interest transaction between the Treasury and BCB net out.

SHOCKS AND STRESS TESTS

12. Primary balance shock. The primary balance shock scenario assumes a primary deficit of 7.2 percent of GDP in 2021 and a constant primary deficit of 2.2 percent of GDP per year over 2022-25.[8] The assumption corresponds to the expenditure ceiling being abandoned in 2021, followed by a reversal of the pandemic related stimulus in 2022 but no further consolidation from then on. Overall, in the primary balance shock scenario, the primary balance deteriorates by a cumulative 11 percentage points of GDP over the period 2021–25 compared to the baseline. Debt enters an unsustainable upward path, reaching close to 115 percent of GDP in 2025.

13. Growth shock. Under the growth shock scenario, real output growth is reduced by one standard deviation (3.3 percent) for two consecutive periods starting in 2021. Under this scenario, gross debt continues a steep increase until end 2022, exceeding 110 percent of GDP before increasing at a much reduced rate. Such a shock can be considered a low probability event, perhaps associated with a severe second Covid-19 wave in 2021/22.

14. Real interest rate and real exchange rate shocks. In the real interest rate shock scenario, the real interest rate is increased by 450bps over the period 2021–25. In the real exchange rate shock scenario, the nominal exchange rate depreciates by 47 percent (maximum movement over the past 10 years) in 2021 and appreciates only marginally thereafter. Under the real interest rate shock, gross debt reaches roughly 110 percent of GDP in 2025. Such a scenario could result from a surprise resurgence in inflation, requiring the BCB to abruptly increase the policy rate, linked possibly with an additional increase in the risk premium. The impact of the real exchange rate shock is modest, all else equal, given the low share of FX debt.

15. Combined macro-fiscal shock. The macro-fiscal shock combines the real growth, interest rate, exchange rate and the primary balance shocks as described above. The impact of the macro-fiscal shock on gross debt-to-GDP is extreme. Gross debt reaches exceeds 140 percent by 2025, with gross financing needs increasing to 30 percent of GDP for several years.

[8] The shock assumes only 50 percent of the primary balance adjustment undertaken in the baseline in 2021 and 2022.

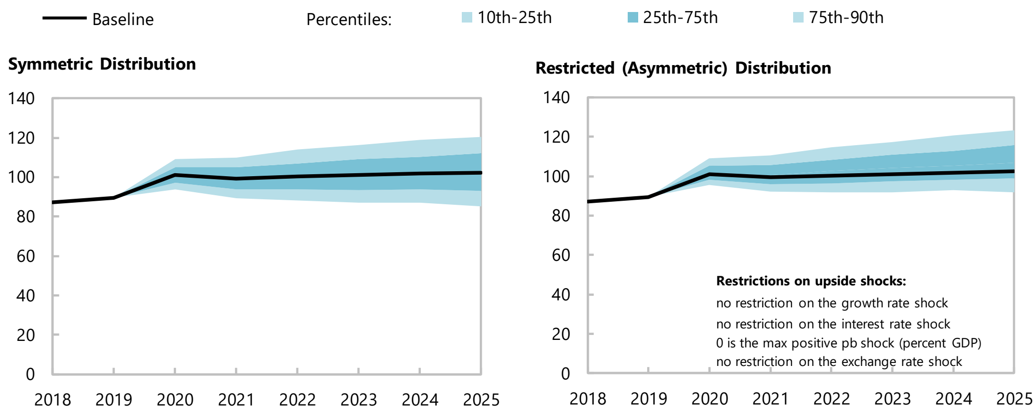
Figure 1. Brazil: Public DSA—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

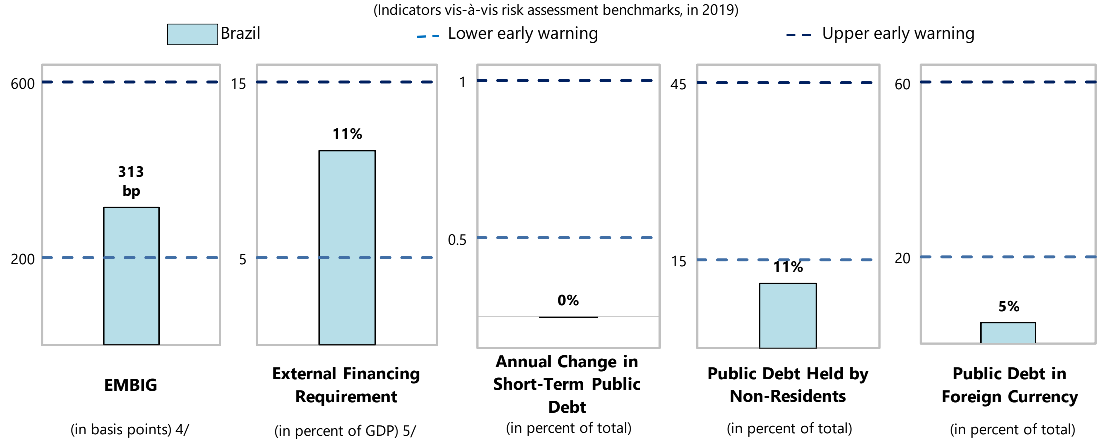
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2019)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

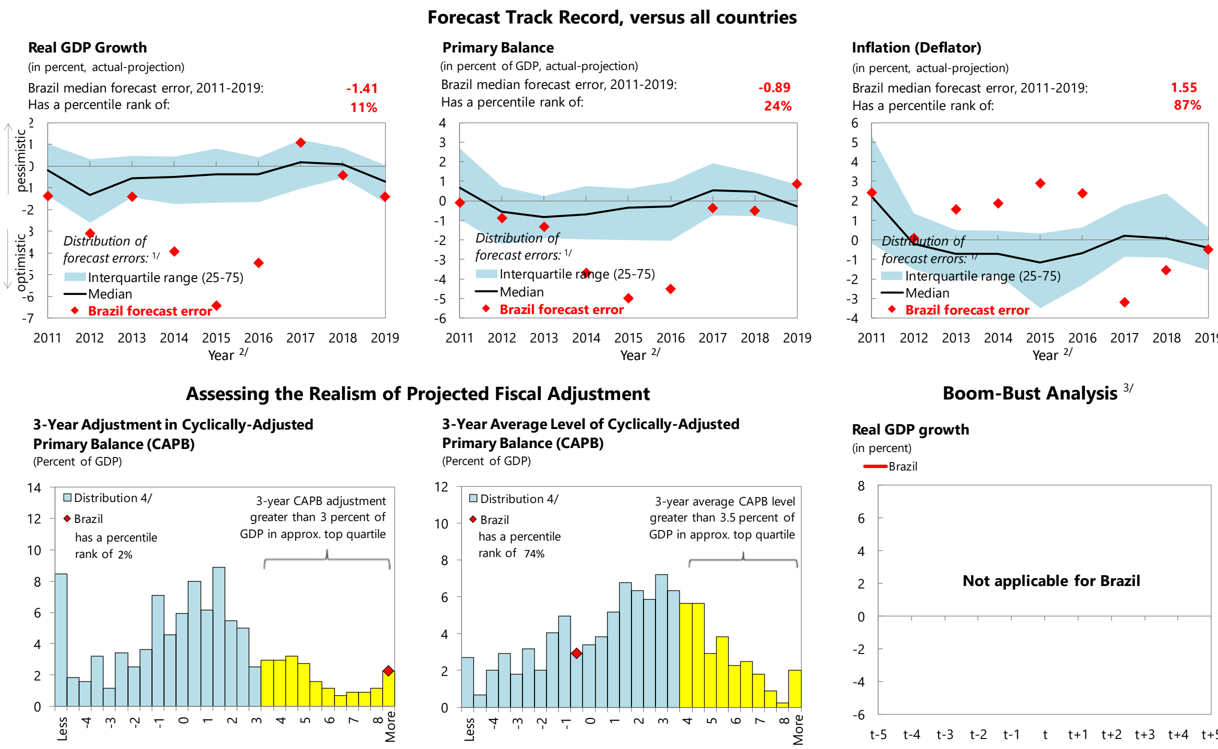
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 28-Jul-20 through 26-Oct-20.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Brazil: Public DSA—Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Brazil, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Brazil: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(Percent of GDP unless otherwise indicated)

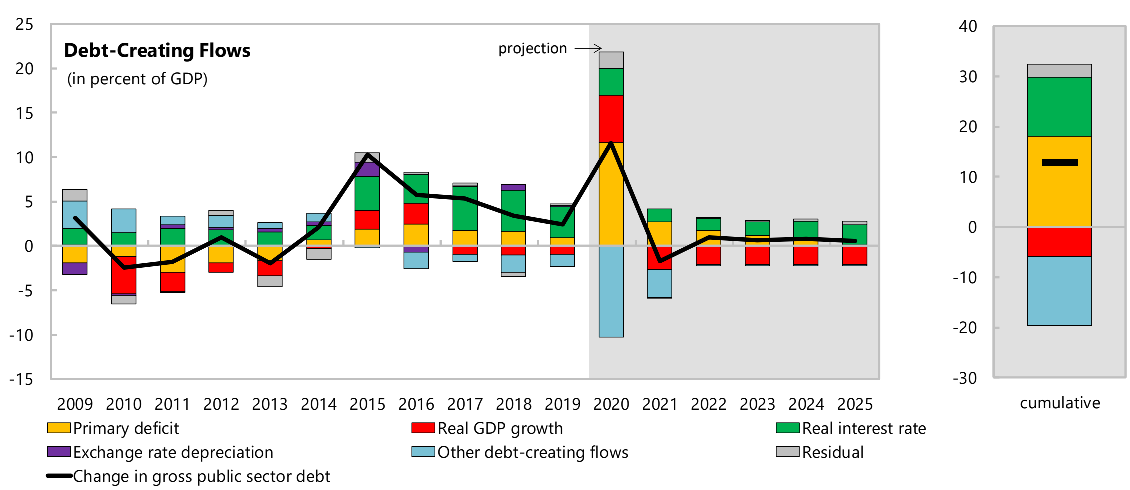
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2009-2017 [2/]	2018	2019	2020	2021	2022	2023	2024	2025
Nominal gross public debt	67.7	87.1	89.5	101.1	99.3	100.3	100.9	101.7	102.3
Public gross financing needs	13.1	15.6	14.3	28.3	23.9	22.5	19.2	18.3	19.3
Net public debt	38.0	53.6	55.7	66.8	71.3	74.4	76.9	79.3	81.3
Real GDP growth (in percent)	1.3	1.3	1.1	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation (GDP deflator, in percent)	7.4	3.3	4.1	3.4	3.3	4.1	4.0	3.9	3.9
Nominal GDP growth (in percent)	8.8	4.6	5.3	-2.6	6.3	6.5	6.3	6.2	6.2
Effective interest rate (in percent) [4/]	11.6	9.1	8.4	6.5	5.0	5.7	5.7	6.2	6.4

As of October 26, 2020		
Sovereign Spreads		
EMBIG (bp) 3/		309
5Y CDS (bp)		214
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB-	BB-
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2009-2017	2018	2019	2020	2021	2022	2023	2024	2025	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.4	3.4	2.4	11.6	-1.8	0.9	0.6	0.8	0.5	12.8	
Identified debt-creating flows	2.4	4.0	2.3	9.8	-1.7	0.9	0.5	0.6	0.2	10.2	
Primary deficit	-0.3	1.7	1.0	11.6	2.7	1.7	1.2	0.7	0.1	18.0	0.0
Primary (noninterest) revenue and grants	31.6	29.1	30.0	26.8	28.3	29.0	29.3	29.4	29.4	172.2	
Primary (noninterest) expenditure	31.3	30.8	30.9	38.5	31.0	30.7	30.5	30.0	29.5	190.2	
Automatic debt dynamics [5/]	1.9	4.2	2.7	8.4	-1.2	-0.7	-0.6	0.0	0.2	6.0	
Interest rate/growth differential [6/]	1.8	3.6	2.5	8.4	-1.2	-0.7	-0.6	0.0	0.2	6.0	
Of which: real interest rate	2.5	4.6	3.5	3.1	1.5	1.4	1.5	2.1	2.3	11.8	
Of which: real GDP growth	-0.7	-1.1	-0.9	5.3	-2.7	-2.1	-2.1	-2.1	-2.1	-5.8	
Exchange rate depreciation [7/]	0.1	0.6	0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.7	-1.9	-1.4	-10.3	-3.1	-0.1	-0.1	-0.1	-0.1	-13.9	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General Government Net Acquisition of Financial Assets	0.7	-1.9	-1.4	-10.3	-3.1	-0.1	-0.1	-0.1	-0.1	-13.9	
Residual [8/]	0.0	-0.6	0.1	1.8	-0.1	0.1	0.1	0.3	0.4	2.6	



Source: IMF staff.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year. Interest payment forecasts on existing debt do not adjust for FX movements.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

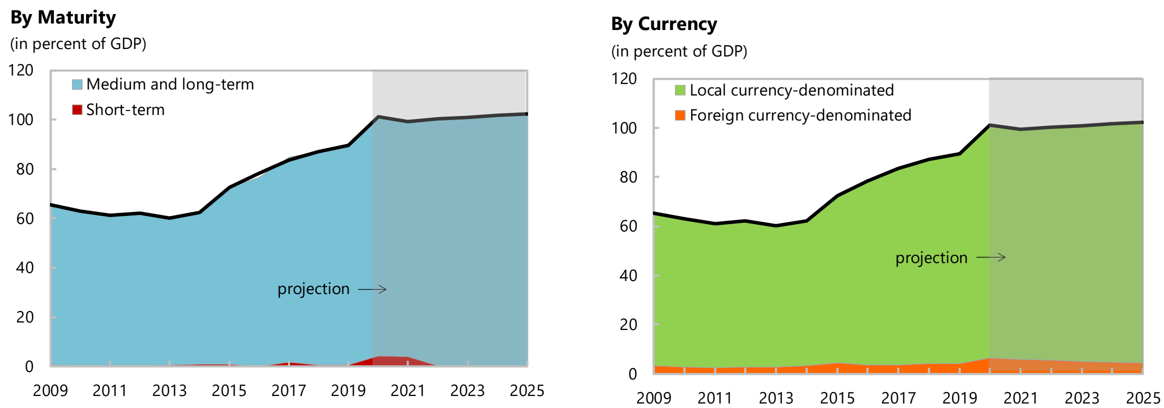
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes exchange rate changes during the projection period.

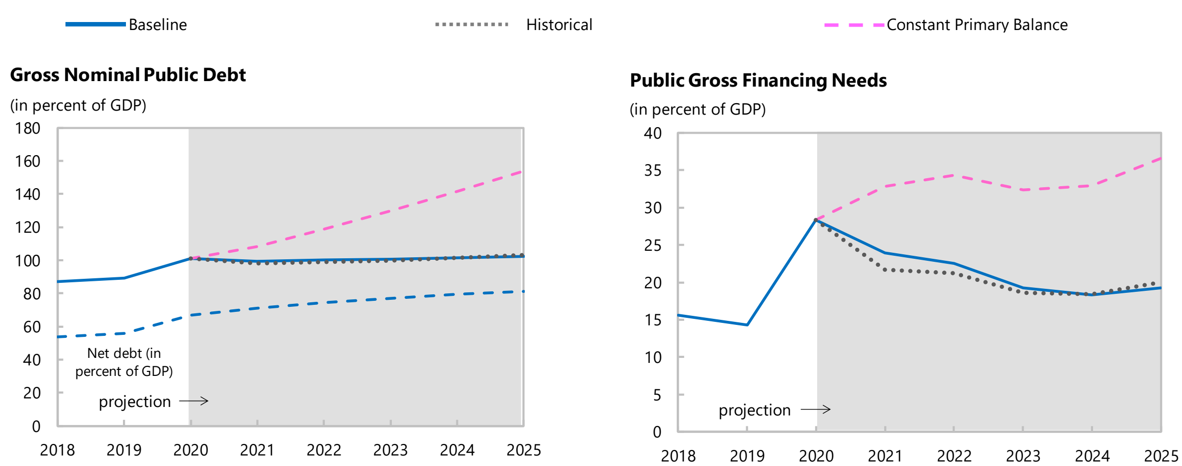
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Brazil: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions

(in percent)

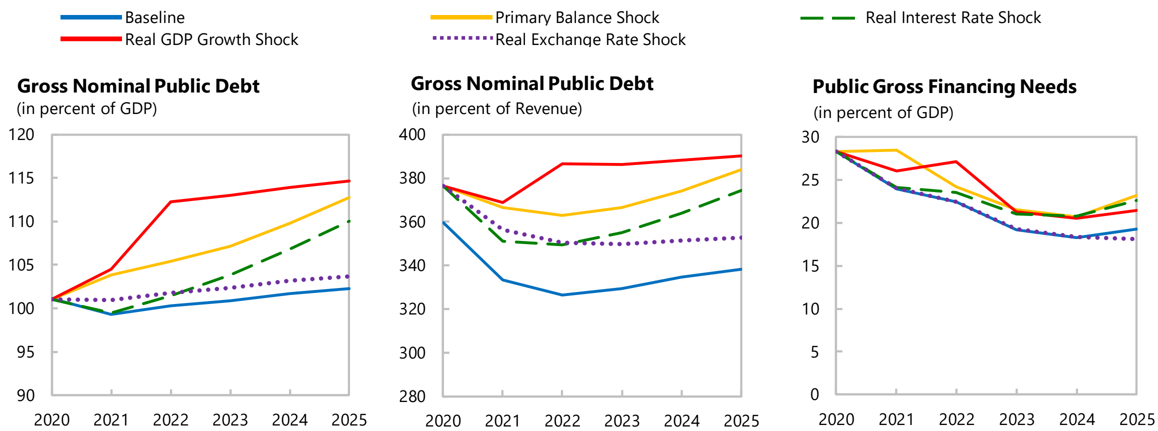
Baseline Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation	3.4	3.3	4.1	4.0	3.9	3.9
Primary Balance	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
Effective interest rate	6.5	5.0	5.7	5.7	6.2	6.4
Constant Primary Balance Scenario						
Real GDP growth	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation	3.4	3.3	4.1	4.0	3.9	3.9
Primary Balance	-11.6	-11.6	-11.6	-11.6	-11.6	-11.6
Effective interest rate	6.5	5.0	5.6	5.6	6.1	6.4

Historical Scenario	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.8	1.4	1.4	1.4	1.4	1.4
Inflation	3.4	3.3	4.1	4.0	3.9	3.9
Primary Balance	-11.6	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	6.5	5.0	6.2	6.3	6.8	7.0

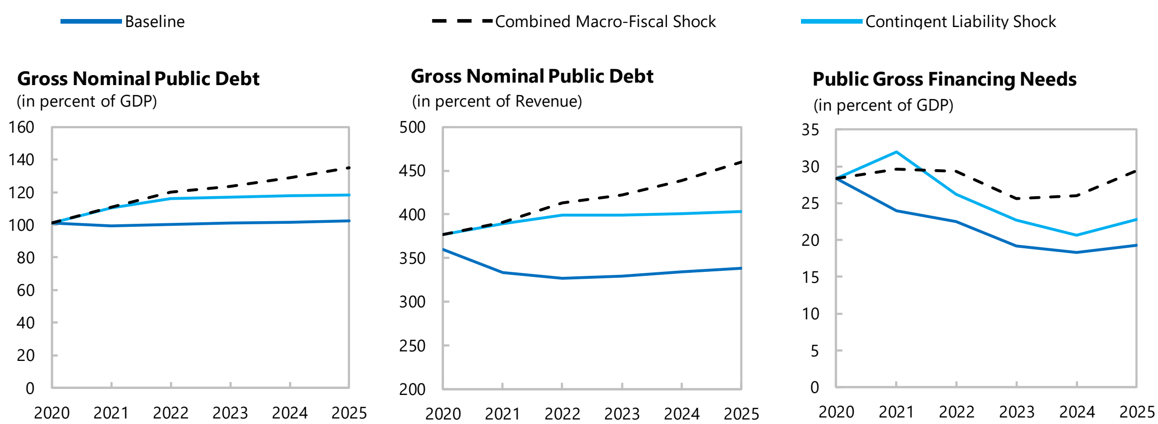
Source: IMF staff.

Figure 5. Brazil: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation	3.4	3.3	4.1	4.0	3.9	3.9
Primary balance	-11.6	-7.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	6.5	5.0	5.9	5.9	6.4	6.7
Real Interest Rate Shock						
Real GDP growth	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation	3.4	3.3	4.1	4.0	3.9	3.9
Primary balance	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
Effective interest rate	6.5	5.1	6.8	7.6	8.4	9.0
Combined Shock						
Real GDP growth	-5.8	-0.4	-1.0	2.2	2.2	2.2
Inflation	3.4	2.5	3.3	4.0	3.9	3.9
Primary balance	-11.6	-7.2	-4.2	-2.2	-2.2	-2.2
Effective interest rate	6.5	5.1	6.8	7.6	8.7	9.4

Real GDP Growth Shock	2020	2021	2022	2023	2024	2025
Real GDP growth	-5.8	-0.4	-1.0	2.2	2.2	2.2
Inflation	3.4	2.5	3.3	4.0	3.9	3.9
Primary balance	-11.6	-4.0	-4.2	-1.2	-0.7	-0.1
Effective interest rate	6.5	5.0	5.8	5.8	6.3	6.5
Real Exchange Rate Shock						
Real GDP growth	-5.8	2.8	2.3	2.2	2.2	2.2
Inflation	3.4	4.8	4.1	4.0	3.9	3.9
Primary balance	-11.6	-2.7	-1.7	-1.2	-0.7	-0.1
Effective interest rate	6.5	5.1	5.7	5.7	6.2	6.4
Contingent Liability Shock						
Real GDP growth	-5.8	-0.4	-1.0	2.2	2.2	2.2
Inflation	3.4	2.5	3.3	4.0	3.9	3.9
Primary balance	-11.6	-9.5	-1.7	-1.2	-0.7	-0.1
Effective interest rate	6.5	5.3	6.0	5.9	6.3	6.4

Source: IMF staff.

Statement by Mr. Bevilaqua on Brazil
November 25, 2020

On behalf of my Brazilian authorities, I would like to thank Ms. Lim and her team for a timely and fruitful Article IV consultation mission. The discussions were candid, and we appreciate staff's flexibility to delve deeper into the country-specific circumstances to form a well-grounded assessment. Overall, after the intense policy dialogue, there is a great deal of convergence between the views of the authorities and staff, with the notable exception of the divergent views regarding the monetary policy recommendation. Other remaining differences, albeit relevant, are mostly of nuance and limited to a couple of specific issues.

The country was starting to reap the benefits of bold reforms when the COVID-19 pandemic struck

Brazil was clearly on track for an economic revival earlier this year. Important steps were taken in 2017-19 to help restore confidence in the sustainability of the fiscal accounts, as well as remove obstacles to the well-functioning of the financial system and transmission of monetary policy. The adoption of a strict expenditure ceiling, the retreat in subsidized public lending, the flexibilization of labor markets and a comprehensive pension reform are among some of the main structural transformations that fundamentally changed the economic landscape. In addition, the push for an ample reform agenda to open the economy further and reduce the presence of the state in many economic sectors bolstered investors' confidence. As a result, policy and market interest rates declined consistently while inflation and inflation expectations remained in check. Capital markets flourished including by filling in the gap left by the retreating subsidized credit for long-term investments on a more robust and sustainable manner. Hence, at the beginning of 2020, the early signals of a strong rebound in investment and growth were visible. The Brazilian economy was converging to a new growth trend.

Effective policy reaction to cope with the unprecedented shock

Brazil was hit hard by the pandemic, but the economic policy reaction was swift and commensurate to the challenge, on par with those of advanced economies. In mid-March, Congress approved a decree recognizing the occurrence of a "state of public calamity" in the country, which triggered the escape clause for the constitutional expenditure ceiling. On those grounds, comprehensive and effective fiscal measures were adopted, among them the Emergency Aid (EA) benefit, which covered 67 million beneficiaries at its peak with a 5-month monthly stipend of R$600 (double in the case of single mothers). In early September, the EA benefit was extended until the end of the year at half the original value. The impact of the EA was substantial, with 15 million people being lifted above the poverty line, while another 10 million people who would have fallen below the poverty line due to the pandemic were kept above it. With an estimated cost for the whole year of R$322 billion (4.5 percent of GDP), the EA amounts to more than 9 years of the successful and highly regarded *Bolsa Família* social assistance program.

The Income and Employment Support Emergency Program was another success. Of the 12 million formal jobs most vulnerable to the pandemic, about 10 million benefited from the program, with workers preserving their jobs and most of their income. In addition to sustaining aggregate demand, the program retained employment links, which are likely to be crucial to avoid scarring and support the post-pandemic recovery. With a direct fiscal cost estimated at R$52 billion (0.7 percent of GDP), this program was highly efficient, managing to absorb a good part of the shock on the formal labor market. In contrast to previous recessions in Brazil, this time job losses in the formal sector were significantly contained.

Additional emergency measures were adopted to address other needs stemming from the pandemic. Complementary measures amounting to R$97 billion (1.3 percent of GDP) were taken to support states and municipalities, and R$113 billion (1.6 percent of GDP) were spent to support the health sector, as well as micro-businesses, small enterprises, and other credit-constrained businesses which were hit hard by the containment measures. Several other measures, with no direct impact on the primary fiscal deficit, were also implemented to support states and municipalities, aggregate demand and credit for an additional 5.3 percent of GDP.

Monetary policy has been highly expansionary while inflation and inflation expectations remain well-anchored. Since March 2020, the policy rate—then at a record low—was slashed by 225 bps to 2 percent. In addition, since August the Monetary Policy Committee (Copom) has been providing forward guidance on the future path of policy interest rates. This guidance states that the policy rate will not be raised as long as inflation expectations and Copom projections for the relevant policy horizon are below target, long-term inflation expectations are firmly anchored, and the fiscal regime is maintained. While portfolio outflows between February and April were sizable, net flows later stabilized, and the exchange rate has continued to work very well as a shock absorber, floating freely and sliding by almost 20 percent since March, with interventions confined to high-volatility episodes.

Early on, the Central Bank of Brazil (BCB) took several regulatory measures to address liquidity needs in the financial system, enhancing resilience and supporting the flow of credit. The Brazilian financial sector was in a sound position when the pandemic hit, with banks well capitalized, well provisioned and showing robust profitability. Liquidity was provided to address bottlenecks and support financial stability—mostly by releasing private resources through a reduction in reserve requirements. Overall, these measures have allowed financial institutions to have the funding necessary to meet liquidity needs, providing market participants with confidence to maintain or expand credit plans. In addition, regulation was adjusted to facilitate the refinancing of corporate and household loans, while monitoring credit quality to prevent possible spillovers. All the measures were taken without moving the focus of the regulatory framework from its goal of ensuring the resilience and soundness of the financial system.

The economy performed better than expected

After plummeting in the second quarter by less than initially projected, the economy rebounded in the third quarter. Output contracted by unprecedented 9.7 percent in 2020Q2 (q-o-q, seasonally adjusted), against market expectations in the beginning of June pointing to a plunge of 14 percent. The forceful policy response was very effective in counteracting the freefall of economic activity and in averting a financial crisis. Brazil's fiscal stimulus, most notably the EA benefit, supported household income, allowing for a quicker recovery than in most peers. In the June WEO update, staff projected a contraction of 9.1 percent in 2020—much worse than what the authorities and market analysts were projecting. Developments since then have vindicated the authorities' more sanguine view, which was predicated on the strength of the policy response and the rollback of lockdown measures. Since then, staff has revised its 2020 growth forecast to -5.8 percent—still more pessimistic than the median market expectation of -4.7 percent and the government projection of -4.5 percent.

While the outlook continues to be characterized by considerable uncertainty, the economic recovery has proceeded with encouraging signals. A sound financial system and lower interest rates have continuously propelled credit even during the crisis. The total credit by the domestic financial system to businesses and households increased by 13 percent in the twelve months to September. From May through September, increased consumer and business confidence have supported the recovery in economic activity and bode well for the near-term outlook. Accordingly, retail sales have followed a V-shaped recovery, growing by 24 percent in 2020Q3 (using the broad concept, including vehicles and construction materials). Industrial production has also rebounded steeply and is already above pre-pandemic levels. The recovery of the services sector—as has been the pattern everywhere—is lagging but already shows early signs that a pickup will take place in 2020Q4 and 2021Q1.

Fiscal, monetary and credit measures will continue to provide support going forward. As services gather steam, the positive traction on the informal job market, which is flexible and reacts swiftly, is expected to be very substantial. Furthermore, the remaining stimulus that will be disbursed in the last six weeks of the year (R$45 billion), plus the R$15 billion that can still be withdrawn from the workers' severance fund (FGTS) and an estimated R$50 billion of EA that has been precautionarily saved will bolster demand in 2021Q1. Programs that support credit to micro-businesses and small enterprises (e.g., Pronampe and PEAC-Maquininhas) are also an effective lifeline for the economic recovery. Positive activity and confidence indicators, gradual job creation, credit expansion and the overall improvement in expectations point to a robust growth recovery—which the authorities believe will be in the range of 3 percent to 4 percent in 2021. This recovery is underpinned by the strong macroeconomic framework and government's firm commitment to an ambitious agenda of structural reforms.

Recalibrating the policy stance and continuing the push for reforms

A determined resumption of fiscal consolidation in 2021 will sustain economic growth prospects and dispel doubts about sustainability. Navigating away from this crisis will be challenging for most, if not all, countries. Limited policy space constrains options and thus requires a delicate balance, to be pursued in every country, between stimulus and sustainability. With public debt approaching 100 percent of GDP, Brazil must protect the integrity of its main fiscal anchor—the constitutional expenditure ceiling—to preserve debt sustainability. Any move that undermines confidence in the existing fiscal framework would push the yield curve higher and steeper, eventually destabilizing the economy, resulting in higher inflation and forcing a reversal of the monetary policy stance.

Further flexibility in budgetary allocation would enhance the efficiency of public spending and have lasting positive consequences for the economy. The authorities have introduced in Congress several proposals for constitutional amendments to reduce revenue earmarking, trim and redistribute mandatory spending, remove the endogenous pressure stemming from the public payroll, and improve the allocation of idle resources currently parked in public funds. The government's goal with these proposals is to regain margin to maneuver within the expenditure ceiling, improving the quality of fiscal policy while retaining the effectiveness of the fiscal anchor.

Monetary policy will continue to be supportive provided that inflation and inflation expectations remain below target and the fiscal anchor is maintained. In October the Copom kept the policy rate unchanged at 2 percent for the second consecutive meeting and clarified its forward guidance, in an environment of higher-than-usual variance in the balance of risks. The Committee made it clear that any change in fiscal policy that undermines the public debt path or compromises the fiscal anchor would lead to a re-evaluation of the forward guidance. Although inflation has remained subdued, recent price pressures led market expectations for 2020 inflation to increase from 2.65 percent to 3.25 percent in the past four weeks, with a smaller (20 bps) increase to 3.22 percent for 2021. While those pressures are mostly localized and temporary, the BCB will continue to closely monitor all relevant indicators.

Overall, the assessment of the Copom members is that the remaining space for additional monetary policy stimulus, if any, would be small. Moreover, given Brazil's history, the well-functioning of some markets or economic sectors could be impaired by the unprecedentedly low levels of the interest rate. Indeed, a majority of the Copom members consider that the current interest rate might be close to the level that could unleash asset price instability. On a brighter note, the BC# agenda is making important progress in all pillars, namely, inclusion, competitiveness, transparency, education, and the recently launched pillar of sustainability. For instance, the agenda to enhance competition in the Brazilian financial system is making meaningful strides with the newly adopted instant payment system, Pix, which became fully operational this week, and the progress in the implementation of the open banking framework.

The authorities would consider fiscal support beyond what is currently envisaged only if there is a second wave of the pandemic that significantly derails the ongoing economic recovery. Outside this tail risk scenario, the instruments to support the recovery will continue to rely on the existing framework—which subjects them to the clear limits imposed by the constitutional expenditure ceiling—furthered by the implementation of the government's reform agenda.

There has been no loss of effectiveness in the AML/CFT supervisory framework due to the pandemic, as new technologies had been in place for effective remote bank supervision. Also, important measures have been taken in preparation for the first AML/CFT National Risk Assessment, which is expected to be concluded by the first quarter of next year. One of the highpoints is a recently adopted Central Bank regulation fostering a risk-based approach by supervised entities (BCB Circular 3,978/2020), which will lead to enhanced controls for situations of greater risk and better procedures for costumer's identification, qualification and classification, including regarding beneficial ownership and politically exposed persons.

Finally, resolute implementation of the reform agenda is an intrinsic part of the overall support to the private sector-led recovery. In addition to the measures to preserve fiscal sustainability and ensure the required flexibility in the allocation of expenditures, the reform agenda includes: (i) a big push in privatizations and concessions; (ii) opening further the Brazilian economy to international trade; (iii) reducing and rationalizing subsidies; (iv) a revenue-neutral tax reform to simplify taxation and improve efficiency; (v) new regulatory frameworks for the sectors of oil and gas, railways, cabotage, energy and sanitation; (vi) a new and modern insolvency legal framework; and (vii) *de jure* central bank independence. The government has submitted the needed draft legislation in Congress, and several of them are making good progress. Notably, the Central Bank Independence bill was approved by the Senate in October. With the conclusion of the municipal election season (second round voting will take place on November 29), the reform agenda is expected to move more expeditiously in the Congress. The authorities very much welcome the staff's views and inputs, including in the form of technical assistance, in support of the reform agenda. The Fund continues to be a partner of preference for the authorities in several of those key areas of reform.