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BRAZIL

July 2019

2019 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 2019 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 July 15, 2019 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 July 15, 2019, following discussions that ended on May 22, 2019, 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 June 25, 2019.
- 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 documents listed below will be separately released.

Selected Issues

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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July 23, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with Brazil

On July 15, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Brazil.

A sluggish recovery is underway, constrained by subdued aggregate demand and lackluster productivity. After contracting by almost 7 percent during the 2015-16 recession, real GDP grew by 1.1 percent per year in 2017 and 2018. Short-term economic indicators show weakness in the first half of 2019. Investment remains subdued, given large spare capacity and uncertainty over prospects for fiscal and structural reforms. Weak global growth and the recession in Argentina are holding back exports and contributed to a widening of the current account deficit to 0.8 percent of GDP last year. The fiscal stance was broadly neutral in 2018, with a slight improvement in the nonfinancial public sector primary balance to -1.7 percent of GDP. The central bank has held the policy rate at the historic low of 6.5 percent since March 2018, providing the economy with some monetary stimulus. Headline inflation is around the 4.25 percent inflation target for 2019, while core inflation is more muted. Improvement in social conditions has stalled in recent years, in part due to elevated unemployment rates.

Growth is projected at 0.8 percent in 2019 and to accelerate in 2020 conditional on the approval of a robust pension reform and favorable financial conditions. The current budget is guided by the federal expenditure ceiling, entailing a minor reduction of the structural primary balance in 2019. Compliance with the ceiling in the following years will depend on approval of the pension reform and other consolidation measures. The current account deficit is foreseen to deteriorate to 1.5 percent of GDP in 2019 mostly on account of one-off operations related to the energy sector and the recession in Argentina. Nonetheless, Brazil's external position remains strong thanks to a large amount of reserves, a flexible exchange rate, and a contained current account deficit fully financed by large FDI inflows. The financial system is well capitalized. Intermediation margins in the banking sector remain high, hindering credit demand and investment.

[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 concurred that the pace of the economic recovery has been sluggish and is subject to downside risks stemming from uncertainty on fiscal consolidation and structural reforms.

Directors underscored that fiscal consolidation and bold reforms are needed to address Brazil's legacies of low growth and high public debt. They concurred that pension reform is imperative to ensure fiscal sustainability and improve equity, and welcomed recent progress in this area. Furthermore, to put public finances on a sustainable path, Directors considered that additional measures are required, including containing the public wage bill, reducing other current expenditure, and addressing budget rigidities. Simplifying the overly complicated and distortive tax system will support growth. Directors also emphasized the need to protect public investment and effective social programs, including Bolsa Familia.

Directors agreed that the current monetary policy stance should remain accommodative in the context of a still large output gap and anchored inflation expectations. They noted that in the future there may be scope to loosen monetary policy further in case fiscal consolidation proves contractionary and inflation expectations remain anchored.

Directors noted that the flexible exchange rate and large reserves remain important to absorb shocks and underscored that intervention in the foreign exchange market should be limited to addressing disorderly conditions. They welcomed the recent bill on the relationship between the Treasury and the Central Bank, which enhances the institutional framework, and underscored the importance of formalizing central bank independence.

Directors agreed that the financial system is broadly resilient but firms and households face an unduly high cost of borrowing. They welcomed progress on strengthening the financial sector and agreed that further steps should be taken to enhance oversight of banks in line with the 2018 FSAP recommendations, particularly the implementation of a new financial resolution regime. Directors also agreed on the importance of improving the efficiency of financial intermediation and welcomed the recent approval of the credit registry law.

Directors encouraged the authorities to step up implementation of structural reforms essential to raise potential growth, including improving the business environment, lowering trade barriers, and boosting productivity. In this respect, they welcomed the recent trade agreement between Mercosur and the EU, which, once ratified, will be key to open up the economy. Reform efforts should also focus on continuing to reduce state intervention in credit markets and improving public infrastructure. Directors underscored that the ongoing efforts to combat

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[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.

corruption and the effective implementation of anti-money laundering remain critically important.

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)	8,512	Health	
Agricultural land (percent of land area)	28.7	Physician per 1000 people (2018)	2.1
		Hospital beds per 1000 people (2018)	2.0
Population		Access to safe water (2015)	98.1
Total (million) (est., 2018)	208.8		
Annual rate of growth (percent, 2015)	0.8	Education	
Density (per sq. km.) (2018)	24.5	Adult illiteracy rate (2016)	7.2
Unemployment rate (Jan 2019)	12.0	Net enrollment rates, percent in:	
		Primary education (2017)	99
Population characteristics (2017)		Secondary education (2015)	84
Life expectancy at birth (years)	76		
Infant mortality (per thousand live births)	13	Poverty rate (in percent, 2017) 1/	25.4
Income distribution (2017)			
Ratio between average income of top 10 percent of earners over bottom 40 percent	12.4	GDP, local currency (2018)	R$6,825 billion
		GDP, dollars (2018)	US$1,868 billion
Gini coefficient (2017)	54.9	GDP per capita (2018)	US$8,995

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
			(Percentage change)					
National accounts and prices								
GDP at current prices	4.6	4.2	5.2	6.9	6.9	6.7	6.7	6.7
GDP at constant prices	1.1	1.1	0.8	2.4	2.4	2.2	2.2	2.2
Consumption	0.8	1.5	0.7	2.1	1.9	1.4	1.6	1.6
Investment	2.0	2.6	4.2	5.8	6.3	6.1	5.8	5.7
Consumer prices (IPCA, end of period)	2.9	3.7	4.1	4.0	4.0	4.0	4.0	4.0
			(Percent of GDP)					
Gross domestic investment	15.0	15.4	15.8	16.2	16.7	17.3	17.8	18.3
Private sector	13.7	14.2	14.7	15.2	15.8	16.4	16.9	17.5
Public sector	1.3	1.2	1.1	1.0	0.9	0.9	0.8	0.7
Gross national savings	14.7	14.6	14.3	14.7	15.1	15.6	15.9	16.3
Private sector	21.1	20.6	20.7	21.0	21.4	21.4	21.5	21.5
Public sector	-6.5	-5.9	-6.4	-6.3	-6.3	-5.9	-5.5	-5.1
Public sector finances								
Central government primary balance 2/	-1.9	-1.7	-1.9	-1.4	-0.8	-0.3	0.3	0.7
NFPS primary balance	-1.8	-1.7	-1.9	-1.3	-0.7	-0.1	0.4	0.9
NFPS cyclically adjusted primary balance	-0.6	-0.6	-0.8	-0.6	-0.3	0.0	0.4	0.9
NFPS overall balance	-7.9	-7.3	-7.6	-7.4	-7.3	-6.8	-6.4	-6.0
Net public sector debt	51.6	54.2	57.8	60.2	61.4	62.8	63.4	64.1
General Government gross debt, Authorities' definition	74.1	77.2	...	...	...	...	...	...
NFPS gross debt	84.1	87.9	92.2	94.1	94.9	95.9	96.1	96.4
Of which: Foreign currency linked	3.7	4.2	4.4	4.5	4.4	4.4	4.2	4.1
			(Annual percentage change)					
Money and credit								
Base money 3/	9.6	1.6	5.2	6.9	6.9	6.7	6.7	6.7
Broad money 4/	4.6	8.1	6.6	8.8	8.9	8.6	8.6	8.6
Bank loans to the private sector	0.0	7.7	7.5	9.0	8.5	8.0	8.0	8.0
			(Billions of U.S. dollars, unless otherwise specified)					
Balance of payments								
Trade balance	64.0	53.6	52.4	50.6	53.6	58.2	60.1	61.2
Exports	217.2	239.0	250.9	255.1	268.6	282.9	296.3	310.5
Imports	153.2	185.4	198.5	204.5	215.0	224.8	236.2	249.2
Current account	-7.2	-14.5	-27.4	-29.6	-32.4	-35.0	-39.5	-43.7
Capital account and financial account	0.8	9.8	27.4	29.6	32.4	35.0	39.5	43.7
Foreign direct investment (net inflows)	50.9	74.3	65.3	60.1	57.8	57.0	57.5	58.0
Terms of trade (percentage change)	0.0	-5.5	1.0	0.0	1.1	0.1	-0.1	0.0
Merchandise exports (in US$, annual percentage change)	17.8	10.0	5.0	6.7	7.0	5.3	4.7	4.8
Merchandise imports (in US$, annual percentage change)	9.9	21.0	7.1	10.3	8.3	4.5	5.1	5.5
Total external debt (in percent of GDP)	32.5	35.6	37.1	35.4	33.5	31.7	29.9	28.3
Memorandum items:								
Current account (in percent of GDP)	-0.4	-0.8	-1.5	-1.6	-1.6	-1.7	-1.8	-1.9
Unemployment rate	12.8	12.3	11.6	10.4	10.0	9.7	9.5	9.4
Gross official reserves	374	375	375	375	375	375	375	375
REER (annual average in percent; appreciation +)	8.5	-10.4	...	...	...	...	...	...

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 plus required and free reserves on demand deposits held at the central bank.

4/ Base money plus demand, time and saving deposits.

INTERNATIONAL MONETARY FUND

BRAZIL

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

June 25, 2019

KEY ISSUES

Recent developments. The economic recovery after the 2015–16 recession has disappointed, with real GDP growing by only 1.1 percent in 2017 and 2018. Inflation is close to target, hovering around 4 percent. Monetary policy is accommodative with policy rates at the historical low of 6.5 percent. Fiscal policy was neutral in 2018 while gross public debt reached 88 percent of GDP. Financial markets have rebounded since the 2018 election.

Outlook. GDP growth is expected to stay subdued at 0.8 percent in 2019 and to accelerate to 2.4 in 2020, assuming a robust pension reform is approved, confidence returns, investment recovers, and monetary policy remains accommodative. Fiscal policy will be mildly supportive in 2019 and subsequently turn moderately contractionary to respect the constitutional ceiling. Gross public debt is projected to peak in 2024 at 96 percent of GDP.

Risks. The main risks stem from fiscal consolidation setbacks. Failure to pass pension reform could adversely affect financial markets, undermining confidence in the reformist agenda. Brazil is also vulnerable to a sudden tightening of global financial conditions and a deeper global economic slowdown. The high level of reserves and solid banks enhance resilience to external shocks.

Policy recommendations. Brazil needs decisive structural reforms to raise potential growth, including tax reforms, privatization, trade liberalization, and measures to enhance the efficiency of financial intermediation. Given the high and increasing level of public debt, fiscal consolidation is essential. The government should preserve a broadly neutral fiscal stance in 2019. From 2020 onwards, fiscal consolidation should be guided by the constitutional ceiling on federal expenditure, which implies a gradual improvement of the primary fiscal balance by about 0.5 percent of GDP per year. To offset the headwinds from fiscal consolidation and given anchored inflation expectations, monetary policy should remain accommodative. The exchange rate should remain flexible to absorb shocks.

Approved By
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Team: A. Spilimbergo (Head), V. Flamini, and D. Sandri (all WHD), M. Soto (FAD), R. Berkhout (LEG), R. Koepke (MCM), and A. Roitman (SPR), assisted by J. Pereira (Resident Representative) and D. Cunha (local Economist). Discussions took place in Rio de Janeiro, São Paulo, and Brasilia during May 6–17, 2019. The team met Minister Guedes and Governor 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, and A. Tombini (Executive Director) joined the concluding meetings.

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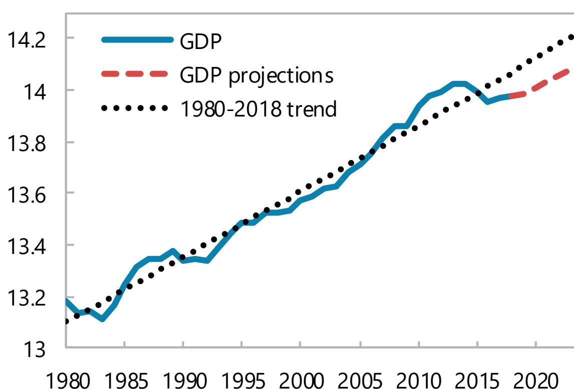
CONTEXT: MODERATE RECOVERY AMID FISCAL RISKS

1. **The recovery remains sluggish.** After dropping by almost 7 percent in 2015–16, real GDP grew by a modest 1.1 percent in 2017 and 2018. The output gap is estimated at - 3.7 percent of potential GDP and real GDP remains well below its historical trend. The investment rate has declined from about 20 percent of GDP in the decade preceding the recession to an historical low of 15.4 percent in 2018, partly driven by the uncertainty surrounding future reforms and the sustainability of public debt.

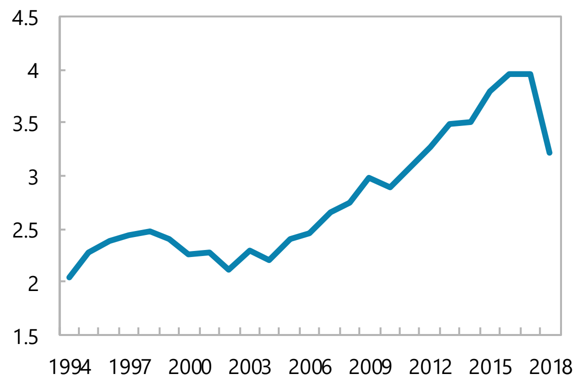
Real GDP
(Millions of 1995 reais, log scale)



Source: World Economic Outlook.

2. **Labor market indicators remain soft and social conditions have deteriorated.** The unemployment rate fell below 12 percent (s.a.) in April 2019 but remains high compared to pre-crisis levels. At 48.2 percent in March 2019 payroll jobs are also marginally increasing as a share of total after receding from their historical high of over 52 percent in 2014. Following the 2017 labor reform, which granted greater autonomy to employers and employees to define working relations, employment litigations decreased by almost 20 percent in 2018. Despite the economic recovery, income inequality and the number of people living in poverty increased in 2017 (latest available).

New Lawsuits Received by Labor Courts
(Million cases)



Sources: Tribunal Superior do Trabalho.

3. **Inflation is around target while monetary policy is accommodative.** Notwithstanding a price spike in June 2018 due to the nationwide strike of truck drivers, headline inflation has declined to about 4 percent, close to the 4.25 mid-point of the inflation target range for 2019. Inflation expectations are anchored around target. The central bank has held the policy rate at the historic low of 6.5 percent since March 2018, providing the economy with moderate monetary stimulus.

4. **Fiscal space is at risk.** In 2018, the NFPS primary balance improved marginally to -1.7 percent of GDP, largely reflecting revenue over-performance, but remains far from the 1.1 percent surplus required to stabilize public debt. Under the baseline scenario, which assumes compliance with the constitutional expenditure ceiling, public debt, which is currently 88 percent of GDP, will peak in 2024 at 96 percent of GDP and start decreasing in 2025. Gross financing needs are above 15 percent of GDP throughout the projection period (see Debt Sustainability Analysis).

5. Loans to households have grown while credit to corporates has stagnated. Public banks have been reducing lending to non-financial corporations for several years, as the funding available to BNDES (*Banco Nacional de Desenvolvimento Econômico e Social*) shrank. Corporate bond issuance has picked up, but still accounts for a small share of overall borrowing. Lending by private banks, including to households, has grown instead at around 8 percent over the past year, leading to a moderate growth of overall bank lending. Central bank estimates suggest a negative credit gap of about 6 percent of GDP. Bank intermediation margins remain high, hindering credit demand and investment in the non-financial corporate sector and holding back household consumption. Financial markets rebounded after the 2018 elections resulting in an easing of financial conditions.

6. The new administration has an ambitious reform agenda, but implementation hinges on a fragmented Congress. Pension reform is the government's key priority. A robust proposal has been submitted to Congress where it requires constitutional amendments (3/5 majority). Besides pension reform, the government's next steps include tax reform, fiscal decentralization, a review of revenue earmarking, an ambitious privatization plan, and the downsizing and refocusing of earmarked credit programs. The authorities consider tax reform—simplification of the tax code and limiting exemptions—as a precondition for successful trade liberalization in Brazil. The government also supports the approval of *de jure* independence for the central bank.

7. Staff's baseline assumes the approval of pension reform and gradual strengthening of the recovery. In line with the government's plan and market expectations, baseline projections assume that the pension reform will be approved this year, restoring confidence in debt sustainability. Positive confidence effects are expected to increase investment and raise GDP growth to 2.4 percent in 2020. The output gap will close by 2023. This is conditional on continuing accommodative monetary policy and favorable financial conditions, and a stable external environment without further weakening of global growth, increase in protectionism, or a sharp tightening of global financial conditions. Inflation is expected to remain close to target while monetary policy provides moderate support.

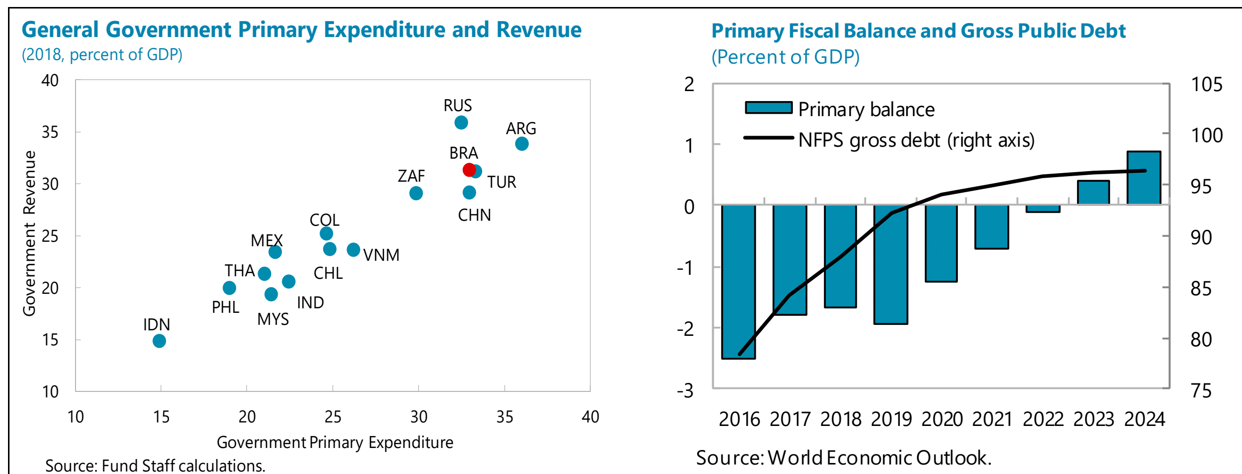
8. Implementation of past Fund advice has been mixed. Monetary and exchange rate policy actions have been in line with past Fund advice. Monetary policy has been supportive in the face of negative shocks, such as the May 2018 truckers' strike and the uncertainty ahead of the presidential elections; FX intervention was limited to episodes of market distress, and reserve buffers have been preserved (Appendix III). The authorities have also made notable progress in implementing financial sector reforms recommended in the 2018 FSAP (Appendix IV). However limited progress has been achieved on other fiscal and structural policies.

POLICY DISCUSSIONS

A. Fiscal Consolidation is Essential to Ensure Debt Sustainability

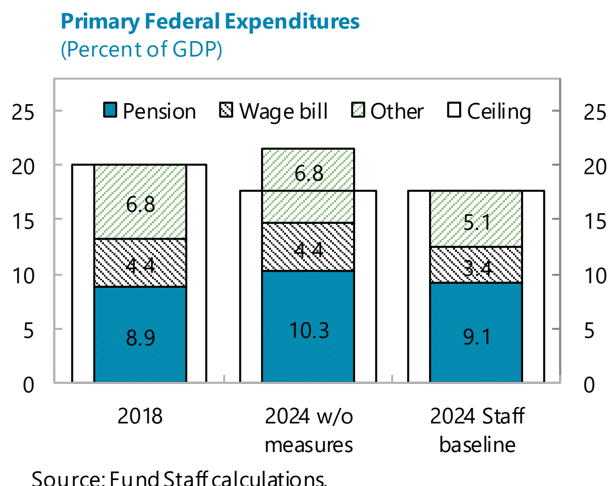
9. The government aims for an expenditure-based gradual fiscal consolidation starting in 2020. Given the high tax burden, the authorities plan an expenditure-based fiscal consolidation

anchored by the constitutional expenditure ceiling, which prevents real increases in primary federal spending. The ceiling is expected to become binding in 2020 and implies a reduction of government expenditures by about 0.5 percent of GDP per year for the next 8 years. Under this baseline, gross public debt is projected to peak at about 96 percent of GDP in 2024.



10. Staff supports the authorities' medium-term fiscal path, but a significant loosening in 2019 would be unwarranted. The structural primary balance is expected to deteriorate by 0.1 percent in 2019. Given the adverse debt dynamics and the need to buttress confidence in fiscal consolidation, the government should avoid any further deterioration of the structural balance in 2019. From 2020 onwards, the expenditure ceiling provides a valuable anchor for fiscal consolidation in line with the authorities' plans, underpinning fiscal policy credibility and market confidence. However, complying with the expenditure ceiling while preserving programs for the poor requires politically challenging reforms.

11. Pension reform is necessary but not sufficient for fiscal sustainability. The government sent an ambitious pension reform proposal to Congress, which is projected to stabilize pension spending over the next decade and make the system more equitable (Box 1). However, the savings from the pension reform would account for only a third of the fiscal adjustment that is needed to comply with the expenditure ceiling by 2024. To comply with the ceiling, the government should reduce other current expenditures, for example by limiting minimum wage increases to cost of living adjustments and delinking pensions and other benefits from the minimum wage, while protecting targeted social assistance programs such as *Bolsa Familia*. Lowering the wage bill would also



make earnings more equitable as public wages are higher than private compensation in comparable professions, and most federal workers are in the top quintile of the income distribution.

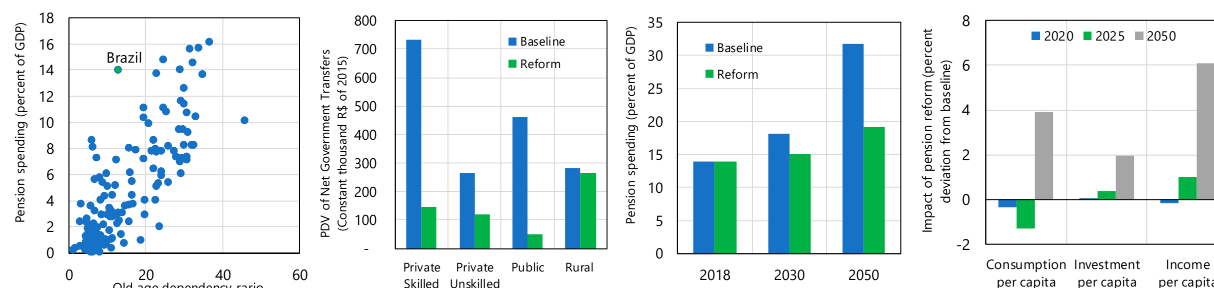
Box 1. Reforming a Fiscally Unsustainable and Inequitable Pension System

At 14 percent of GDP, public pension spending is high relative to other countries. This level of spending is very high considering that Brazil is still a relatively young country. This reflects early access to pensions (the average retirement age is 54 compared to 64 in the OECD economies), generous benefits relative to earnings (70 percent for an average-wage worker compared to 53 in the OECD), and the presence of special regimes for civil servants and the armed forces.

The system is fiscally unsustainable and inequitable. The imbalance between pensions payments and contributions reached 5.5 percent of GDP in 2018. Absent reforms, pension spending is projected to increase to about 30 percent of GDP by 2050, reflecting population aging. In addition to its high fiscal cost, the current system amplifies inequities. The present discounted value of the difference between lifetime pension benefits and contributions is substantially higher for individuals with higher earnings—high skilled workers in the private sector and government workers—than for the low skilled and those in rural areas.

The executive submitted to Congress a draft bill for a new social security system—'*Nova Previdência*'. The bill foresees deep changes to the current framework. It introduces a minimum retirement age (62 for women, and 65 for men; but 60 for rural workers and teachers), raises the minimum contribution time to access pensions (from 15 to 20 years), and lowers replacement rates. The reform also reduces social pensions for those under age 70, limits the generosity of survivor benefits, and equalizes rules for public employees to those in the private sector. In addition, the proposal restricts the annual wage bonus (a publicly financed extra monthly wage to salaried workers in the formal sector) to those earning the minimum wage. Furthermore, the government added a complementary bill with specific rules for containing military pension spending. Overall, the proposed reform is projected to contain the path of pension spending. Total savings are estimated at around R$1.2 trillion over the next ten years (2.5−3.0 percentage points of GDP by 2030), substantially higher than in the original proposal by the previous administration (R$800 billion). Even with these savings, pension reform is expected to just stabilize pension expenditure as a share of GDP.

The pension reform should have a positive impact on the economy in the medium term.[1] On one hand, the reform is projected to reduce per capita consumption as it lowers lifetime pension transfers to households. On the other hand, by increasing private saving and lowering the public debt trajectory, the reform lowers the cost of capital and induces higher investment. The additional savings should also improve the current account and further support output. Furthermore, raising retirement ages, by increasing labor force participation, provides additional boost to potential output. Overall, absent large changes in the risk premium, in the near term the negative effect on consumption dominates and output will be lower than in a no reform scenario. Over time, the effects on investment, net exports, and labor force participation tend to dominate and income per capita would be higher than in the baseline by about 1 percent in 2025 and 6 percent in 2050.

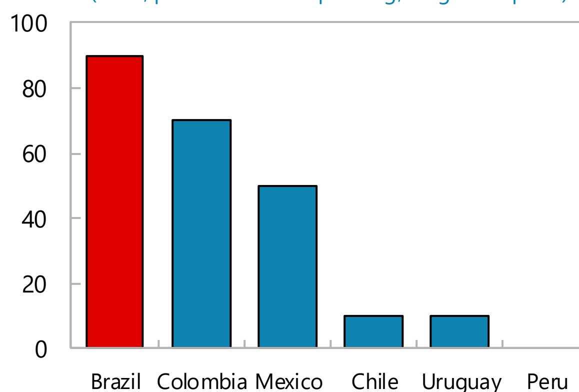


[1] Simulations are obtained using the methodology developed in Carton, Fernandez-Corugedo, Hunt and Voigts, "Demographic Transition and Pension Reforms: Adding Demographics to GIMF". IMF Working Paper, forthcoming.

12. The fiscal framework should be strengthened. To ensure the quality of fiscal adjustment, the authorities should also address budget rigidities, including revenue earmarking, mandatory expenditure (about 90 percent of federal spending cannot be modified without legal changes), and the indexation of key spending items (IMF CR 18/253, Appendix V). The authorities should also move toward a medium-term fiscal framework, supported by simple, flexible, and enforceable rules consistent with debt sustainability. Introducing rolling spending reviews for large and growing budgetary programs would help contain spending.

13. To generate additional fiscal space, revenue administration reforms should continue. Staff supports recent tax administration efforts to promote voluntary compliance through cooperative compliance arrangements, but further reforms are needed. In particular, efforts to collect arrears should intensify by granting the revenue administration powers to enforce debt collections, and payment in installments should be restricted to exceptional cases when the taxpayers' financial situation warrants it.

Mandatory Government Spending in LA6
(2013, percent of total spending, range mid-point)



Source: 2013 OECD Survey on Budge Practices and Procedures.

14. Procurement and investment practices need to be upgraded. The low public capital stock and high infrastructure gap in Brazil call for significant investment going forward (¶39). The recent Public Investment Management Assessment (IMF CR 18/249) identified several weaknesses in the procurement and investment practices. A new procurement law being considered by Congress aims to strengthen some practices, including by improving project appraisal and selection, but more should be done toward removing barriers to foreign participation, enhancing competitive outcomes, and striking a better balance between price and quality in project bidding.

15. Several subnational governments confront severe fiscal challenges. In aggregate, the primary fiscal balances of subnational entities are gradually recovering. However, fiscal risks for some states loom large. Seven states have declared a "state of calamity." Of these, Rio de Janeiro has negotiated a fiscal recovery program with the federal government. To alleviate funding deficiencies in some states, the federal government plans to provide temporary relief while requiring states to commit to fiscal adjustment. While these measures can help states in the short term, without other reforms that affect the structural balances of the states (pension reform, tax reforms, and budget rigidities) and a review of the institutional framework of subnational borrowing, several states are likely to continue to have financial difficulties.

16. Privatization of SOEs can generate moderate fiscal resources. The authorities are aiming to reduce the participation of the public sector in various companies and investment funds. The federal government direct investments amount to R$320 billion—nearly 5 percent of GDP—over half of which are in strategic SOEs (Petrobras and public banks) that are unlikely to be fully sold. Some of the large SOEs plan to divest from subsidiaries and other companies, which would generate revenue to the government.[1] Even though privatization may provide helpful revenues over the near term, amounts are uncertain and cannot obviate the need for fiscal consolidation. Privatization would also have positive effects on productivity by ensuring that companies are managed following market principles.

Government Equity Participations and Investments
(Billions of reais)

SOEs*	263.5
Petrobras	75.3
BNDES	62.8
Banco do Brasil	43.3
Caixa	34.4
Eletrobras	18.4
Other	29.3
Funds	42.5
Other investments	14.3
Total	**320.3**

Source: Federal government's 2018Q3 balance sheet.
*Based on SOEs' book value.

Authorities' Views

17. The authorities are committed to fiscal consolidation guided by the expenditure ceiling. In the context of a slow recovery, the authorities plan to continue containing discretionary expenditure and using any extraordinary revenue (including oil revenue windfalls and privatization proceeds, Box 2) to lower primary deficits and reduce public debt. While pension reform remains the priority, the authorities recognize the need for additional expenditure measures to comply with the expenditure ceiling over the next few years. To this end, they aim to limit the autonomous growth of major mandatory expenditures, such as social security benefits, salary allowance (abono salarial), government payroll and others. A review of tax expenditures and consideration of a revenue-neutral tax reform (aiming at simplifying and harmonizing the tax system) are expected after approval of the pension reform. To improve the collection of tax arrears, the executive is proposing legislation to enhance the administrative and coercive collection powers. This includes denying tax benefits to tax debtors and easing the requirements to collect small debt amounts. The authorities see scope for providing short-term funding relief to subnational governments, but they recognize that addressing structural imbalances would require pension and tax reforms. They also agree on the importance of ensuring consistency across fiscal rules and strengthening the fiscal framework, including by reducing budget rigidities and transitioning toward a medium-term budget framework building on the progress to date, which includes detailed multiyear guidance in budget annexes.

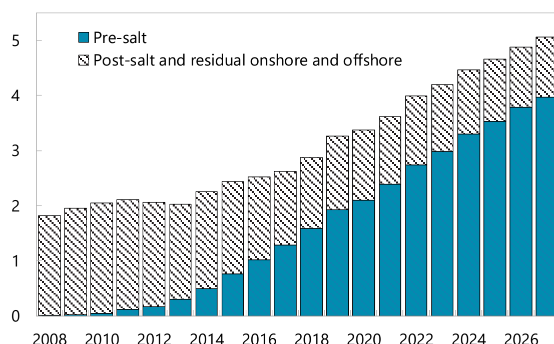
[1] Such sales would have a direct impact through dividends (25 percent of sale value), and taxes on eventual capital gains. There could also be indirect effects, for example if divestment leads SOEs to repay debts with the Treasury.

Box 2. Pre-Salt: A Game-Changer in the Brazilian Oil Sector

From pre-salt oil discovery to the current oil sector framework. In 2006, Petrobras found substantial pre-salt oil reserves. A Transfer of Rights (ToR) deal in 2010 granted Petrobras the right to explore and produce 5 billion barrels of pre-salt oil. Since then, estimated reserves increased by some 6 to 15 billion barrels, leading to a review of the original ToR agreement. Furthermore, since 2016 Petrobras no longer has to participate in all pre-salt exploration contracts, unleashing more investment by other companies.

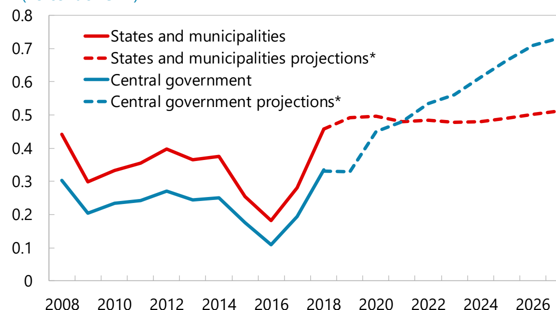
Pre-salt exploration is taking off… Pre-salt production started to increase in 2013. It now accounts for about ½ of total oil output and is expected to reach 78 percent by 2027, with an estimated investment of US$144 billion over the next nine years, of which about 1/3 may come from FDI inflows.

Oil Production
(Million of barrels per day)



Sources: ANP (historical data), EPE (projections), and Fund staff calculations.

Fiscal Impact: Recurrent Revenues
(Percent of GDP)

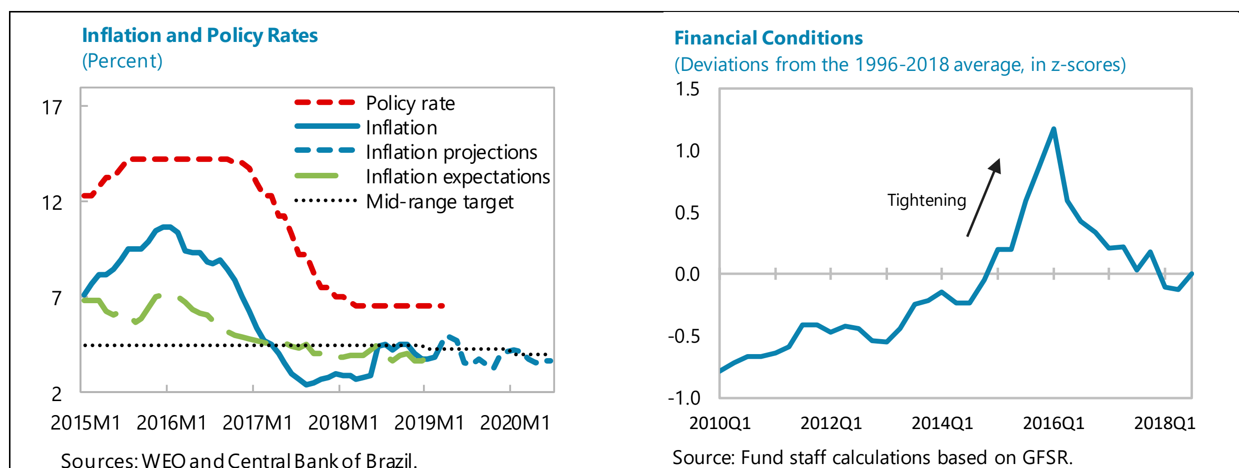


Sources: ANP (historical data), WEO, and Fund staff calculations.
Recurrent revenues: royalties, special participation, oil profit, and R&D fee.
*Under the current framework of revenue sharing with subnational governments.

…with different fiscal implications for local and central governments. Nearly 2/3 of oil and gas royalties currently accrue to states and municipalities on top of ½ of special participation fees in concessions. Under the current framework, these revenues are expected to stay broadly constant over time as a share of GDP. Instead, oil revenues accruing to the central government, which are closely linked to pre-salt profits, would increase in the future. In all, recurrent oil and gas revenue is expected to jump from 0.8 percent of GDP today to 1.2 percent of GDP in 2027. Moreover, the ToR deal will generate (net) one-off revenues of R$73 billion (1 percent of GDP) in 2019/20.

B. Monetary Policy Should Remain Accommodative

18. Monetary policy should continue to provide stimulus. With the policy rate at 6.5 percent and one-year-ahead inflation expectations around 4 percent, the expected real rate is about 2.5 percent. This should provide moderate stimulus given that the neutral rate is estimated by staff to be above 3 percent, although subject to considerable uncertainty. Furthermore, financial conditions—including the domestic price of risk, credit aggregates, and external conditions—have eased since 2016 and are now broadly neutral. The current monetary stance is appropriate given that inflation is close to the mid-point of the inflation target range and the need to support aggregate demand given the negative output gap. As fiscal consolidation comes into effect, monetary policy should stand ready to provide additional stimulus to offset possible contractionary effects, provided inflation expectations remain well anchored.



19. Exchange rate flexibility is important for macroeconomic stability. The exchange rate should continue to be market determined, thus supporting monetary transmission and acting as a buffer against external shocks. Movements in the exchange rate do not pose financial stability concerns for Brazil given that public debt is almost entirely denominated in *reais* and firms with dollar debt are hedged according to analysis by the Central Bank. Foreign exchange rate intervention should continue to be limited to episodes of disorderly market conditions.

20. The new law regulating financial transactions between the Central Bank and the Treasury will strengthen the monetary framework and its transparency. The previous institutional setting, under which gains from foreign reserve valuation and swap operations were transferred to the Treasury whereas losses triggered a Treasury capitalization of the Central Bank through government bonds, swelled the balance sheet of the Central Bank, blurred the relationship between fiscal policy and public debt, and implicitly relaxed the Golden Rule (see Selected Issues Paper). Staff welcome the new bill, which limits such distortions by creating a reserve account where gains are booked to cover for future losses, thus reducing the cash flows between the two institutions.

Authorities' Views

21. According to the authorities, the current monetary stance is appropriately supportive. While noting that headline inflation is close to target and inflation expectations are anchored, the Central Bank emphasizes that addressing fiscal challenges is essential to preserve low and stable inflation and ensure the proper operation of monetary policy. Authorities also stressed that the exchange rate is market determined and FX interventions should be made only in case of disorderly market conditions.

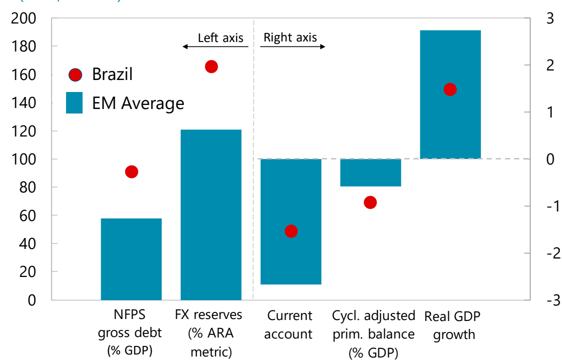
C. Preserve External Buffers

22. Brazil's external position in 2018 was broadly in line with the level implied by medium-term fundamentals and desirable policies. The current account deficit widened to 0.8 percent in 2018 and is projected to deteriorate to 1.5 percent of GDP in 2019, as Petrobras is

expected to repatriate equipment owned by its Dutch subsidiary worth about US$15 billion. As the recovery gains strength, the investment rebound will offset the effects of fiscal consolidation and lead to a widening of the current account deficit to about 2 percent of GDP over the medium term. The current account and exchange rate level are broadly consistent with medium-term fundamentals and desirable policies according to the External Balance Assessment (EBA) and real effective exchange rate (REER) methodologies (Appendix II).

23. External buffers enhance resilience and should be preserved. Compared to other emerging markets, Brazil exhibits a smaller current account deficit, smaller public external debt, and a higher level of foreign reserves (both in percent of ARA metric and in percent of short-term debt and current account deficit, Box 3). Furthermore, external rollover needs for private and public debt are low, at about 6 percent of GDP per year, and Brazil benefits from a large and steady flow of FDI, which more than finances the current account deficit. Public debt is predominantly denominated in local currency and FX debt in the private sector is mostly hedged. Consequently, Brazil's external vulnerability is low. Going forward, preserving external buffers is crucial to maintain resilience to shocks, especially given the difficult fiscal condition.

Vulnerability Indicators, Brazil versus EMs
(2019; Percent)



Source: Fund staff calculations.

24. Capital flow management measures. Brazil maintains two capital flow management measures, namely a tax on financial transactions (IOF) on inflows related to external loans and on in/outflows of other types of assets with varying rates. These measures have been relaxed gradually in recent years in line with the Fund's Institutional View on capital flows.

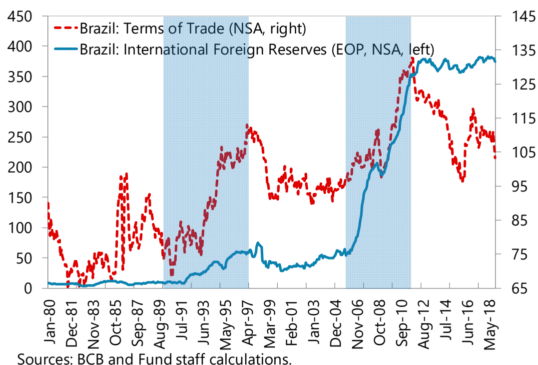
Authorities' Views

25. The authorities agree with staff's external sector assessment. They concur that the REER in 2018 was in line with fundamentals and emphasize Brazil's strong external position, even as they expect a marginal weakening of the current account balance as the cyclical recovery picks up driven by stronger investment. They underscore the importance of preserving existing external buffers, in particular the high level of foreign reserves which has supported the credibility of Central Bank interventions in the FX market during periods of high market volatility.

Box 3. Assessing Reserve Adequacy in Brazil

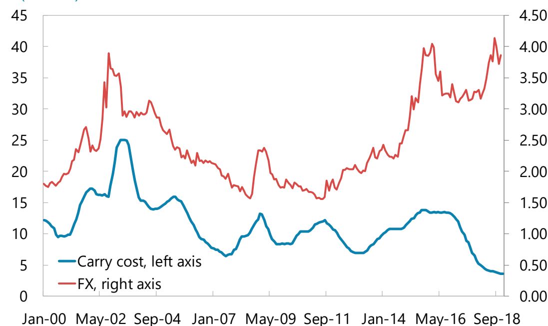
Brazil's international reserves have been stable for the past 8 years. Between 2005 and 2011, Brazil experienced massive capital inflows, on the back of improving terms of trade, with FDI increasing from US$12 to US$86 billion, and portfolio flows surging from US$5 to US$41 billion. Reserves increased from US$50 to US$350 billion. Since 2011, despite a deterioration in terms of trade and exchange rate market pressures, FX reserves remained around US$365 billion (averaging 17 percent of GDP), while their net carry cost declined considerably through the period.

Terms of Trade and International Reserves
(Billions USD, left; 2006=100, right)



Sources: BCB and Fund staff calculations.

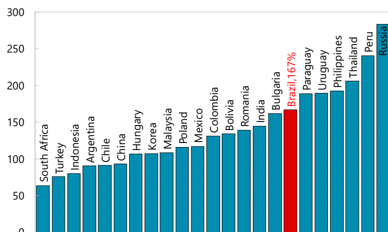
Reserves' Carry Cost* and FX value
(Percent)



Sources: BCB and Fund staff calculations.
* Carry cost = [(1 + SELIC return)/(1+ US Treasury Bill return)-1]

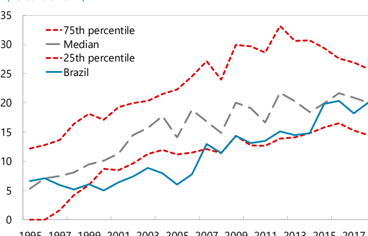
The IMF's reserves adequacy metric[1] (ARA) suggests that Brazil's international reserve level is adequate to cover a broad set of risks. This metric captures relative risks from potential sources of balance of payments pressure and computes the stock of reserves needed to cover: short term debt, other portfolio outflows, M2 (as a proxy of potential capital flight), and exports. As of March 2019, Brazil's reserves level was 165 percent of the ARA metric, slightly above the 100–150 percent appropriateness range, and the EM average (140 percent). Nevertheless, in terms of GDP, Brazil has historically held less reserves than other emerging markets and has only reached the median of 20 percent of GDP after 2015. In terms of M2, Brazil's reserves levels have been lower than the 25th percentile.

Reserves, 2018
(Percent of ARA Metric)



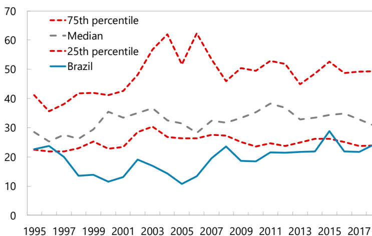
Sources: BCB and Fund staff calculations.

Reserves
(Percent of GDP)



Sources: BCB and Fund staff Calculations.

Reserves
(Percent of M2)



Sources: BCB and Fund staff calculations.

Large buffers enhance resilience. With lingering uncertainty over public debt sustainability, low growth, and potential reversals of capital inflows, holding an adequate level of international reserves is essential for the country to reduce its vulnerability. Brazil can be affected by a tightening of global financial conditions as well as terms of trade shocks and should hold reserves for precautionary purposes.

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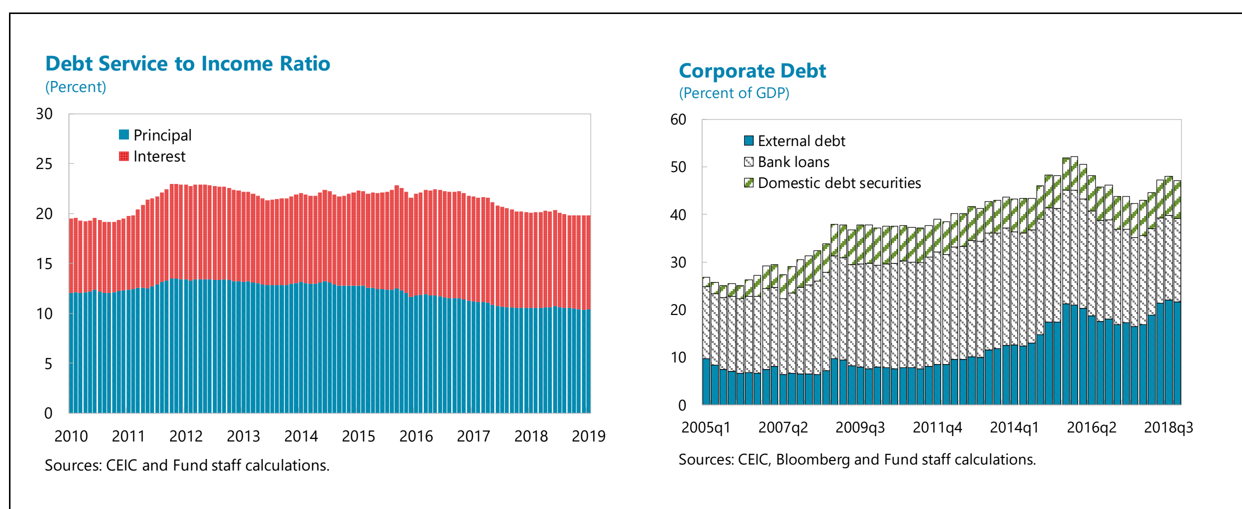
[1] International Monetary Fund, (2013), "Assessing Reserve Adequacy—Further Considerations," IMF Policy Paper, February (Washington: International Monetary Fund). For Brazil the metric is: 30 percent of short-term debt + 15 percent of other portfolio liabilities + 5 percent of M2 + 5 percent of exports.

D. Banks are Resilient, but Interest Margins Remain High

26. Banks are well capitalized, profitable and liquid. Financial soundness indicators show a broad-based improvement since the 2015–16 recession. For example, banks' average ratio of regulatory capital to risk-weighted assets rose to 18 percent at end-2018 from 17.2 percent two years earlier, while non-performing loans fell from 3.9 to 3.1 percent. The 2018 FSAP systemic risk analysis suggests that banks are broadly resilient to further severe macro-financial shocks although they are exposed to concentration, exchange rate, and market risk.

27. Vulnerabilities in the corporate and household sector persist. In the corporate sector, profitability has improved in recent quarters, but leverage remains high. A macro-financial shock could significantly increase debt at risk among corporates, undermining access to additional credit and hindering investment. The manufacturing and energy sectors are particularly exposed to profitability and interest rate shocks. Households also remain vulnerable due to high debt-service to income ratio, driven by high interest rates. Reducing the interest burden on households would support aggregate demand and equality of economic opportunity.



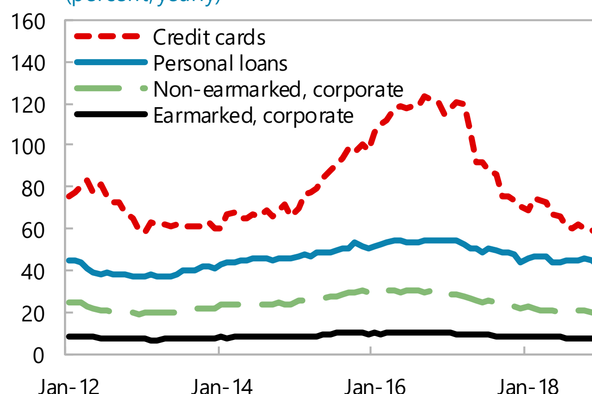
28. The authorities have made notable progress in implementing financial sector reforms recommended in the 2018 FSAP. In financial sector oversight, risk-based supervision has been strengthened and contingency plans for crisis management have been put in place. In credit markets, BNDES lending is being scaled back and refocused towards infrastructure, while the pricing of earmarked subsidized credit is becoming more market-based (TLP reform). The recent approval of a credit registry law (*cadastro positivo*) will facilitate the collection of positive credit information, which should foster customer mobility and reduce credit spreads (Appendix IV).

29. Further action is needed to strengthen the banking sector. The authorities should build on recent efforts to enhance the prudential, crisis management, safety net, and macroprudential frameworks as detailed in the 2018 FSAP. Several legislative efforts are underway to pursue these objectives (Appendix III). To strengthen the underpinnings of the BCB as bank supervisor, the BCB's independence and legal protection of staff should be ingrained in law. The regulatory and

supervisory approach should be upgraded in related party exposures and transactions, country and transfer risk, and restructured loans. A new resolution regime should be introduced promptly to broaden the authorities' toolkit for dealing with systemically important institutions, among other objectives. The process for dealing with weak banks and emergency liquidity assistance (ELA) should be tightened to ensure that such assistance is not provided to insolvent banks. The deposit guarantee fund (FGC) should be brought into the public sector to help prevent conflicts of interest and retain the mandate for financial stability in the public sector, among others. The increasing complexity of the financial system and gaps in systemic risk oversight call for closer coordination among supervisory agencies and the creation of a high-level interagency committee with mandates for financial stability and crisis management.

30. Reforms to improve bank intermediation efficiency should continue. IMF staff analysis suggests that banking sector reforms would generate large productivity gains and enjoy strong public support.[2] Key drivers behind high intermediation margins include high operating costs, large credit losses, bank concentration at the product level, and the high (although declining) share of subsidized lending. The authorities have started to reduce state intervention in credit markets, but further actions are needed to downsize and refocus public banks. Gross disbursements by BNDES have declined by 65 percent from their peak in 2014 and the recent TLP reform has helped link its corporate lending rates to market conditions. However, the loan portfolios of *Caixa* and *Banco do Brasil* have remained broadly unchanged. Proposed laws on corporate bankruptcy and electronic collateral registration would reduce banks' costs from delinquencies. To reduce market power, reforms are needed to facilitate client mobility and financial product cost transparency and comparability. To develop the spot FX market and make it more accessible, the government is planning to make the *real* fully convertible in the medium to long term.

Selected Lending Rates
(percent, yearly)



Source: Central Bank of Brazil and Fund staff calculations.

31. Accession to the OECD's codes of liberalization of capital movements would foster the international integration of financial services. The authorities are pursuing negotiations with the OECD to be compliant with the codes of liberalization by 2020, irrespective of whether Brazil will ultimately become a member of the OECD. Compliance with the codes of liberalization would result in the removal of certain restrictions to international transactions, such as the IOF tax (¶24) and restrictions to the establishment of branches of foreign banks and insurance companies. This would foster competition and the adoption of best practices in the domestic market, helping to improve financial intermediation efficiency. Potential risks from the removal of restrictions on capital transactions include greater exposure to foreign shocks via capital flows reversals, given the likely

[2] Biljanovska and Sandri (2018). "Structural Reform Priorities for Brazil." IMF Working Paper No. 18/224.

increase in foreign participation in Brazil's capital markets. Moreover, a growing presence of foreign banks and insurance companies would likely increase two-way spillovers between the Brazilian and the global financial system.

32. Welcome developments include the rapid growth in lending from cooperative banks and rising competition from fintech firms in recent years. Cooperative banks are fostering competition in credit markets by providing credit to households and SMEs at substantially lower interest rates than the market average (often 20−30 percent lower, depending on the loan type). Fintech firms provide online financial services such as payments, investment management, and lending through technology-enabled platforms, driving down costs in the industry and expanding access to financial services. Total alternative financing in Brazil is estimated to have grown from US$24 million in 2015 to US$216 million in 2017 (latest available).

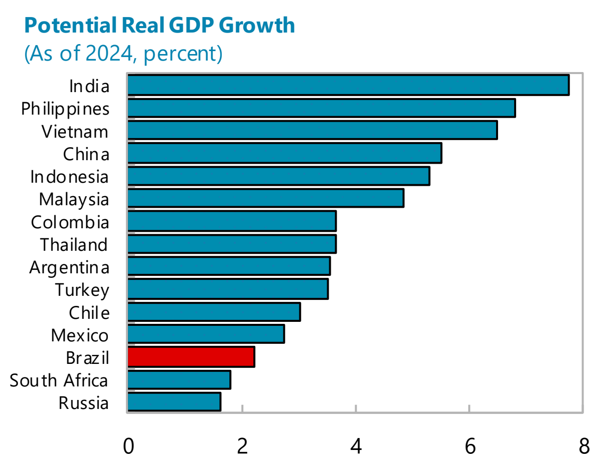
Authorities' Views

33. The Central Bank noted that the proposed legislations on the financial sector will boost resiliency and address several key FSAP recommendations. Legislative efforts are underway to enhance Central Bank independence and legal protection to its staff, strengthen the bank resolution framework, and create a committee responsible for macroprudential policy and crisis management (Appendix IV). There is no plan to transform the *Fundo Garantidor de Créditos* (FGC) into a public institution because it is viewed as working well as a private entity. The authorities agree with the principle that emergency liquidity assistance should only be provided to solvent institutions, but the Central Bank values the discretion afforded under the current framework. Measures to enhance regulation on supervision of large exposures have been implemented in line with FSAP recommendations. The authorities have also taken steps to foster greater financial intermediation efficiency, for example by enhancing account portability and facilitating fintech innovations.

E. Structural Reforms are Vital to Raise Potential Growth

34. Reforms are necessary to raise growth potential. Since 1980, Brazil's average yearly growth has been 2.5 percent, a relatively low level for emerging markets. Large part of this growth was due to labor force growth, which is projected to diminish rapidly in the coming years given the rapid demographic transition. This dismal record is due to stagnant productivity, low investment rates, and recently low growth of the labor force. Currently, Brazil's potential growth of about 2.2 percent is one of the lowest among major emerging markets. This could be even less in the future as the

Potential Real GDP Growth
(As of 2024, percent)



Source: World Economic Outlook.

growth rate of the labor force declines. To lift potential growth towards 3 percent, productivity growth and investment rates should increase well above the levels experienced in the past 20 years (Box 4). This is possible only with the implementation of decisive structural reforms. By stoking growth, structural reforms that boost productivity would also improve debt dynamics in the medium term (DSA, ¶13).

Box 4. Sensitivity of Potential GDP Growth for Brazil

We explore the sensitivity of potential GDP growth using a production function approach. Potential growth is given by the Cobb Douglas production function, $Y_t = A_t K_t^{\alpha} L_t^{1-\alpha}$. We assume that capital evolves according to $K_t = (1-\delta)K_{t-1} + I_t$, where δ is the depreciation rate and I_t is fixed investment. The growth rate of potential GDP, g_t, can then be expressed as

$$1 + g_t = (1 + g_t^A)(1 - \delta + (1 + g_t)\, i_t / k_{t-1})^{\alpha}(1 + g_t^L)^{1-\alpha}$$

where g_t^A and g_t^L are the growth rates of productivity and labor, i_t is the investment to GDP ratio, and k_{t-1} is the capital to GDP ratio.

We calibrate the model using historical data and labor force projections. We set the capital depreciation rate δ and production share α to 4.5 and 46 percent respectively, in line with their historical averages between 2000 and 2018. The capital ratio k_{t-1} is calibrated at its 2018 level of 2.85. Using demographic projections and average employment rates, we estimate that the growth rate of the labor force will decline to about 1 percent during the next decade. Labor growth is expected to decline even further in subsequent years if labor participation does not increase.

The results show that significant structural reforms are needed to lift potential growth markedly above 2 percent. If productivity continues to grow at 0.5 percent and the investment rate remains at about 18 percent in line with the 2000−18 averages, potential GDP growth is projected to be 1.9 percent. To boost potential growth significantly above 2 percent, structural reforms are needed to raise productivity growth to at least 1 percent and support higher investment rates.

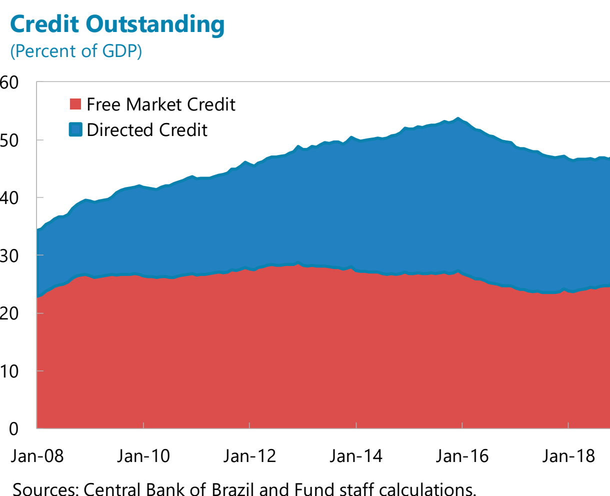
Investment to GDP ratio

Productivity growth	16	17	18	19	20
-0.5	0.6	0.7	0.9	1.0	1.2
0	1.1	1.2	1.4	1.6	1.7
0.5	1.6	1.8	1.9	2.1	2.3
1	2.1	2.3	2.4	2.6	2.8
1.5	2.6	2.8	3.0	3.1	3.3

Source: staff's calculations.

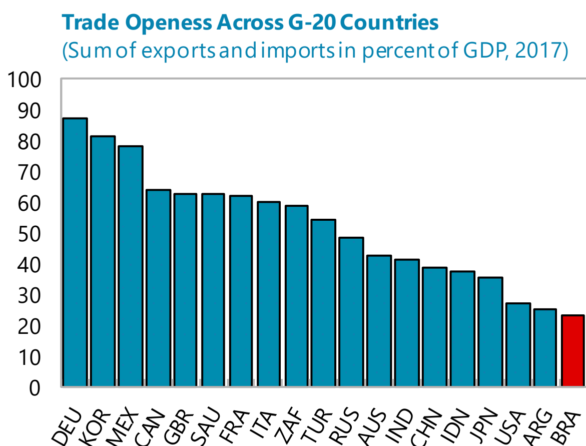
Notes: shaded areas corresponds to 2000-2018 average.

35. The complicated and distortive tax system should be reformed in a revenue-neutral manner. Authorities should eliminate multiple indirect taxes[3] by moving toward a single broad-based VAT (with full refund for VAT on intermediate goods), harmonize the fragmented federal and state tax regimes, and remove distortionary tax exemptions for small enterprises (which encourages inefficient fragmentation of firms to stay small). Given the relatively high tax burden in Brazil, efforts should aim at simplifying the system while raising the same amount of revenues. Fiscal savings from reducing tax exemptions could amount to 2 percent of GDP and be used to either reduce public debt or lower the high level of payroll and corporate taxes. Simplifying the tax system would make compliance less costly and catalyze private investment (¶38).



Sources: Central Bank of Brazil and Fund staff calculations.

36. Trade liberalization is essential to improve competitiveness. In terms of international trade, Brazil is one of the most closed major economies in the world. The last time Brazil undertook efforts to liberalize trade was in the early 1990s. Since then, tariffs have been broadly unchanged and remain higher than in comparable countries. Furthermore, Brazil's non-tariff barriers—especially anti-dumping measures—still impede international trade. Adherence to OECD codes (and eventually an accession) would provide an important opportunity to foster trade integration. The government plans to lower import tariffs on IT and capital goods (from 14 to 4 percent) by August 2019, and efforts to negotiate an EU-Mercosur trade agreement are underway. The BCB's plan to make the *real* fully convertible (¶30) will also lower the cost of cross-border trade and investment.



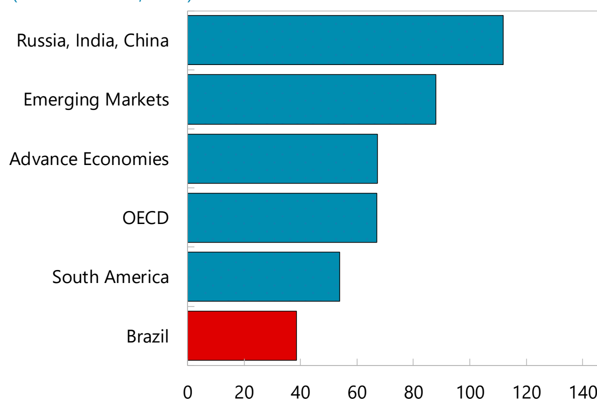
Source: World Economic Outlook (April 2018).

37. Closing the large infrastructure gap would boost productivity. Brazil's public capital stock was 39 percent of GDP in 2015, compared to 88 and 112 percent of GDP in other EMs and BRICs. The quality of infrastructure is also lower than in comparator countries. The infrastructure gap is the outcome of low public investment over the last two decades (less than 2 percent of GDP on average compared to 5.4 and 6.2 percent of GDP in Latin America and other EMs) and the low share

[3] Brazil currently has five major indirect taxes (federal COFINS, PIS/PASEP and IPI; state ICMS; and municipal ISS), which generate a high degree of complexity and partial cascading.

of such investment devoted to infrastructure (22 percent in 2015 versus 45 percent in other EMs). Reducing the infrastructure gap will require significant investment going forward. Given that fiscal space is currently at risk, it will be essential to enhance public investment efficiency and mobilize private capital through concessions. Staff has identified education and health care as potential areas for efficiency savings going forward. The authorities should consider establishing formal spending reviews to contribute to fiscal adjustment while safeguarding service delivery.

General Government Capital Stock
(Percent of GDP, 2015)



Sources: FAD's Investment and Capital Stock Dataset and Fund staff calculations.

38. Reforms to the business environment and labor market will be needed to attract private investment. Attracting private finance and supporting private sector development will require improving the business environment. Current weaknesses in the institutional framework point to the need to simplify the tax system; ease the procedures to start a business; reduce the time and cost to obtain construction permits and register properties; and open up the economy to foreign trade (Ease of Doing Business, 2019). In such context, staff welcome recently introduced provisional measures aimed at reducing red tape and supporting the opening of small businesses, including the removal of licensing requirements for starting low-risk activities, allowing flexible operation hours, and granting price setting flexibility outside regulated sectors.

Authorities' Views

39. The authorities agree on the need for structural reforms. They underscored that reforming the economy and reducing the role of the state is essential but noted the need for strategic prioritization. Pension reform is the most immediate priority. Fiscal decentralization and a comprehensive tax reform would be their next priorities, along with an ambitious privatization program. The executive intends to devolve greater spending to the states following reforms to address the current large-scale earmarking of expenditures in the budgetary process, which will require constitutional amendments. They noted that simplifying Brazil's tax system should give a much-needed fillip to investment and is a necessary pre-condition for trade liberalization. On trade openness, the authorities emphasized that import licenses are granted as long as there is compliance with all the legal and administrative requirements, and efforts are ongoing to simplify and streamline the import licensing processes by eliminating paper copies of documents and reducing average time to obtain licenses. A new licensing system is under development, and a pilot project launched in October 2018 for a restricted number of operations, is expected to be mainstreamed by 2021.

F. Risks and Policy Responses

40. The main risks stem from possible setbacks in fiscal consolidation. The most immediate concerns are that pension reform could stall or its main provisions could be significantly diluted in the legislative process. This could undermine financial markets' confidence in the government's reformist agenda, thereby affecting sovereign yields and the exchange rate. Economic prospects could in turn deteriorate significantly, leading to negative spillovers to neighboring trading partners. Even if a robust pension reform is approved, fiscal risks remain since additional fiscal measures are needed to comply with the constitutional expenditure ceiling. In addition, the privatization efforts may yield lower than expected revenue. Brazil is also vulnerable to external shocks, including a sudden tightening in global financial conditions and a possible global slowdown (Appendix I). However, the limited degree of trade integration, the solidity of the financial system, and sound external position—adequate FX reserves, low current account deficit, and large FDI inflows—act as buffers. Among the upside risks, GDP growth may accelerate faster than projected if the government is able to proceed expeditiously with its ambitious structural reform agenda.

41. Setbacks in the approval of pension reform should prompt alternative fiscal measures. In such an event, the government should adopt alternative fiscal measures (some of which do not require constitutional amendments as in the case of pension reform); over-performing the fiscal targets for 2019 and 2020 would bolster fiscal sustainability and mitigate risks to market confidence. Measures could include: freezing the minimum wage in nominal terms (which limits nominal increases in pensions); addressing budget rigidities to allow for more discretionary reductions in spending; and reducing more the wage bill. The Central Bank should continue to limit FX intervention only to cases of disorderly conditions.

Authorities' Views

42. The authorities maintain that Brazil is resilient to shocks. They stated that the ample reserves, floating exchange rate and credible monetary policy constitute valuable buffers against external shocks. They agreed that a delay in passing a robust pension reform is a risk, but stressed that there is a widespread agreement that a reform is necessary and will occur. They also remarked that the constitutional expenditure ceiling provides a very strong legal reassurance against fiscal slippage.

G. Strengthening Anti-Corruption and Anti-Money Laundering Frameworks

43. The authorities are encouraged to continue and deepen their approach to enforcement of anti-corruption and anti-money laundering measures. The fight against corruption and money laundering (ML) is a long-term policy objective, that requires effective enforcement and a strong preventive framework. The authorities continue to prioritize the fight against corruption and ML, driven by strong and independent law enforcement and judicial authorities. Compared to one year ago, the number of *Lava Jato* cases has again risen, and *Lava Jato* is just one of many ongoing

complex corruption and ML cases. To deter illicit behavior, the authorities have continued their efforts to pursue high profile cases.

44. The new government has introduced legislative amendments that include proposals to improve the effectiveness of the anti-corruption and anti-ML framework. The proposals to prevent the abuse of appeal provisions and statutes of limitations are in line with past staff advice. The amendments also criminalize the use of campaign slush funds. Still missing, however, are provisions to strengthen whistleblower mechanisms, and seizure and confiscation measures.

45. The authorities are in the process of enacting legal provisions to implement United Nations-based targeted financial sanctions requirements. This is the last remaining issue from the previous FATF/GAFILAT assessment (2010).[4] The new legislation should also positively impact the next FATF/GAFILAT assessment, which will be held in less than two years. However, more needs to be done in preparation. The BCB is issuing new risk-based supervisory regulations, in line with international standards. Supervision would be improved by enacting legislation to protect supervisory employees from criminal and civil liability when acting in good faith (in line with FSAP recommendations) and by applying AML/CFT risk matrixes independent of prudential risk classifications.

46. In preparation for the next FATF/GAFILAT assessment, two important issues need to be addressed. The finalization of the National Risk Assessment (NRA) should be a priority. Timely finalization will also allow authorities to take mitigating measures to address risks, in time before the assessment. There is also a need to enhance the collection of beneficial ownership information. The tax authorities have commenced collecting this information from foreign companies that do business in Brazil, which is a commendable step. It is recommended, however, that such information is shared as needed, and the authorities start collecting such information also from domestic legal entities.

Authorities' Views

47. There is an acute awareness of the need to finalize the national risk assessment (NRA), and to increase the transparency of beneficial ownership of companies and trusts. The authorities noted that they have initiated the NRA and finalizing it would allow them to take further mitigating measures to fight money laundering, corruption and other forms of illicit finance. The tax authorities have started collecting beneficial ownership information of foreign companies that operate in Brazil (for tax purposes), and this information should at a minimum be directly accessible to other relevant competent authorities. The authorities consider that the requirement for additional information on beneficial ownership of foreign entities is necessary because the tax authorities would have otherwise less data about foreign entities than Brazilian entities. For domestic companies, only legal ownership information is available in the registers. The level of transparency of the companies' beneficial ownership is however adequate and the availability of information on

[4] This legislative action follows from public statements issued by FATF in 2018 and 2019, urging Brazil to address this deficiency or face membership discussion.

legal and beneficial ownership in the tax administration strengthens the risk analysis and the monitoring of these entities.

STAFF APPRAISAL

48. Historically low growth and high public debt call for bold reforms. Staff supports the government's overarching goals of unleashing growth potential and achieving fiscal consolidation through an ambitious reform agenda. Sequencing of the reforms should give due consideration to Brazil's debt dynamics and business cycle conditions. This calls for a prioritization of the pension reform and other expenditure measures needed to comply with the spending ceiling, followed by tax and other structural reforms, including trade liberalization and the improvement of bank intermediation.

49. Pension reform is the crucial first step. The ambitious pension reform proposal under consideration by Congress would stabilize pension spending over the next decade and make the system more equitable. To deliver the needed fiscal adjustment, the main features of the government proposal—including the planned increase in retirement ages and reduction in the relatively high benefits, particularly for public sector employees—should be preserved.

50. But additional measures are needed to comply with the expenditure ceiling and stabilize debt. To comply with the constitutional expenditure ceiling in outer years, the government should lower the public wage bill (which would also make earnings more equitable relative to private employees) and reduce other current expenditures. While pursuing fiscal consolidation, it is critical to protect effective social programs, including Bolsa Familia, and support public investment. The overly complicated and distortive tax system should be reformed, and efforts to strengthen revenue administration should continue. Windfall revenues from oil—including proceeds from the upcoming Transfer of Right transactions—should be used exclusively to lower debt. The fiscal framework should be enhanced by addressing budget rigidities and moving toward a medium-term budget framework. Deep structural measures, including pension and tax reforms, are also essential to restore the medium-term sustainability of subnational governments.

51. The monetary stance should remain accommodative. The current monetary stance is appropriately supportive given the large output gap and anchored inflation expectations. In the future, to the extent that fiscal consolidation is contractionary, monetary policy could be loosened further provided inflation expectations remain anchored. The recent bill on the relationship between the Treasury and the Central Bank enhances the institutional framework and is welcome. Enshrining central bank independence into law would further improve the inflation-targeting regime.

52. The flexible exchange rate remains important to absorb shocks. Brazil's external position in 2018 was broadly in line with the level implied by medium-term fundamentals and desirable policies. Intervention in the foreign exchange market should continue to be used only to address disruptive market volatility. International reserves provide a buffer against external shocks and should be preserved.

53. Further steps to enhance oversight of the banking sector are warranted. Further enhancing the prudential, crisis management, safety net, and macroprudential frameworks would help shelter the financial sector against risks in the future. The regulatory and supervisory approach to credit risk needs further upgrading with regard to related party exposures and transactions, country and transfer risk, and restructured loans. Strengthening the financial resolution framework, including by bringing the deposit guarantee fund into the public sector, and tightening the process for providing ELA, would enhance crisis management. Efforts to create a multi-agency committee with explicit mandates for macroprudential policy and crisis management should be completed.

54. Structural reforms are necessary to boost productivity. The government has rightly identified reducing the footprint of the state in the economy as a priority, by pursuing privatization, reducing state intervention in credit markets, lowering trade barriers, tackling corruption, and simplifying taxation. While privatization may provide some helpful one-off revenue, its main benefit will come by the improvement in productivity in some key sectors, including infrastructure and energy. Trade liberalization is essential to improve competitiveness, and current plans to lower import barriers are welcome. Prospective OECD accession is an opportunity to foster trade integration, but trade liberalization should be pursued in any case.

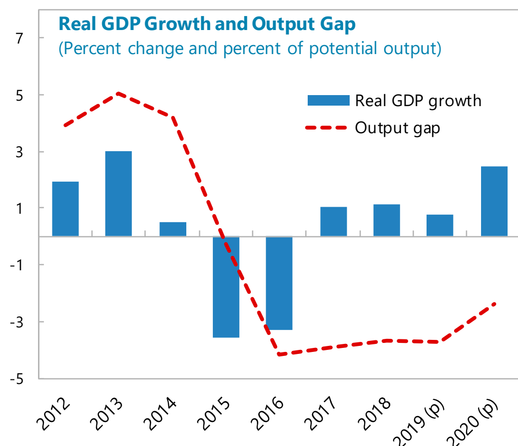
55. Bank intermediation efficiency should be improved. Firms and households face an unduly high cost of borrowing which holds back investment and consumption. A proposed corporate bankruptcy law would reduce delinquency costs for banks, and the recent approval of a credit registry law (*cadastro positivo*) will improve banks' access to positive credit information. Efforts to reduce the role of public banks and directed lending in credit markets should continue. Actions are needed to facilitate client mobility and financial product cost transparency.

56. The effective implementation of anti-money laundering and anti-corruption measures remains critically important. The government continues to pursue significant money laundering and corruption cases and has submitted proposals to improve the legal framework. Authorities are encouraged to continue focusing on preventive measures, effective enforcement, and long-term legislative improvements. In addition, authorities are urged to expedite the completion of the national anti-money laundering risk assessment.

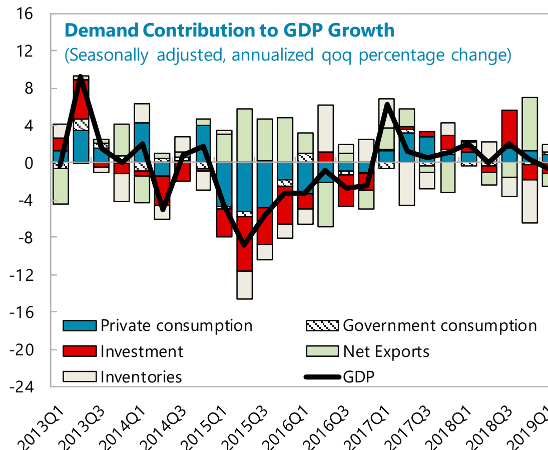
57. It is recommended that the next Article IV consultation takes place on the standard 12-months cycle.

Figure 1. Brazil: Recent Economic Developments

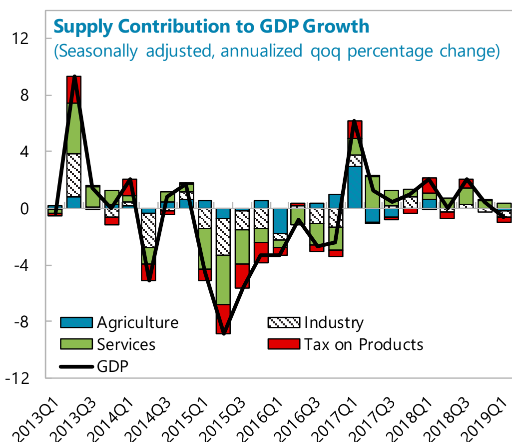
The economic recovery has disappointed in 2017-2018, but is expected to strenghten



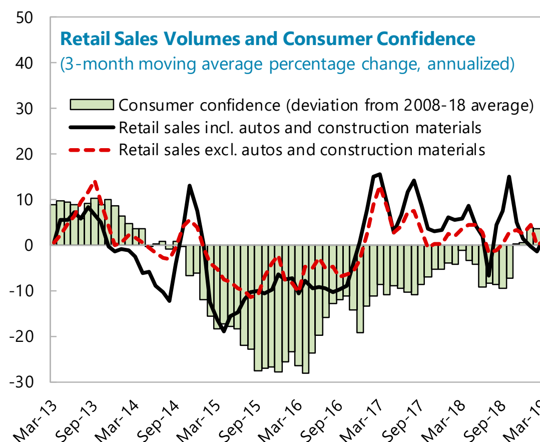
Economic growth has been held back by low investment...



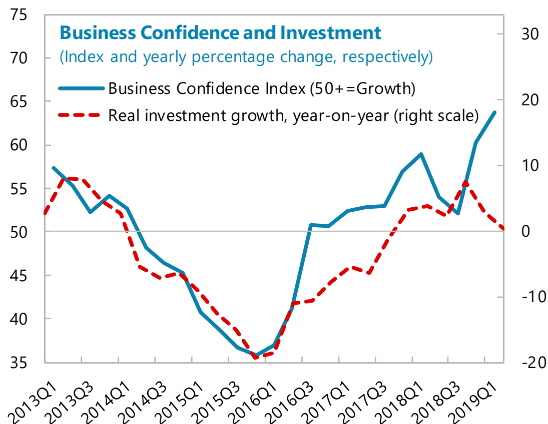
... and weak industrial production



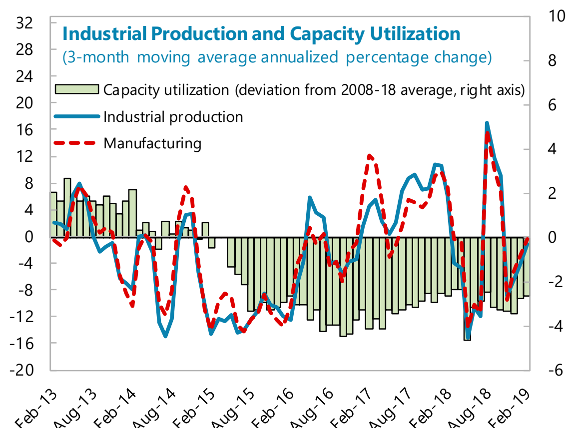
Retail sales are growing moderately and consumers' confidence is strenghtening



Business confidence has improved, but investment growth remains sluggish



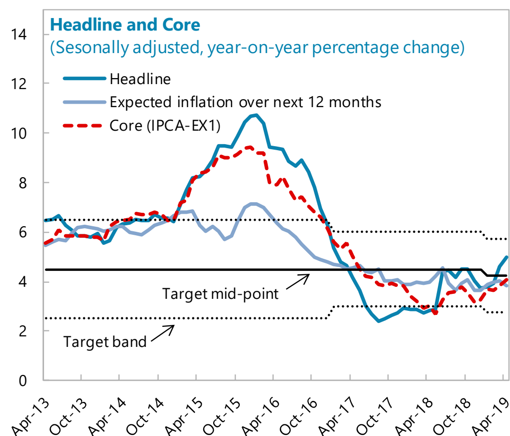
Industrial production remains volatile, while capacity utilization is well below the historical average



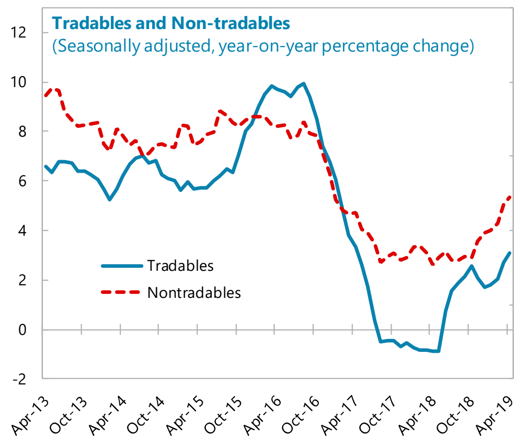
Sources: Haver analytics; IBGE; and Fund staff estimates.

Figure 2. Brazil: Monetary Sector Developments

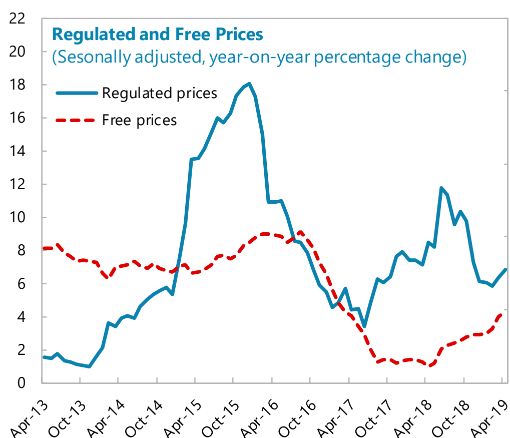
Inflation is hovering around the inflation target and inflation expectations are well anchored



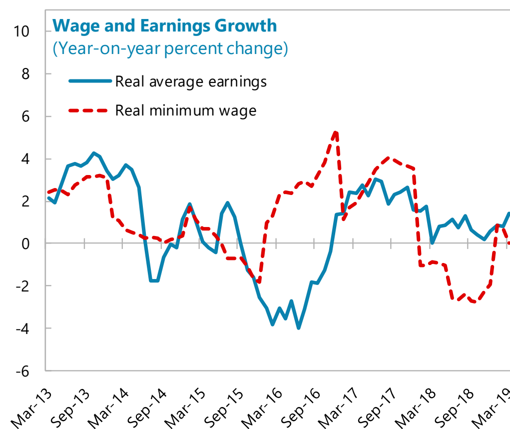
After a sharp drop of food prices in late 2017, inflation in the tradable sector has resumed



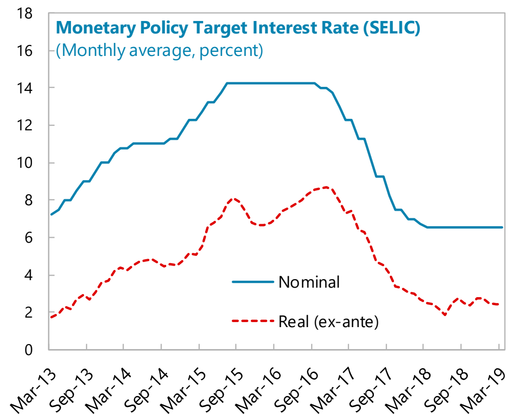
Regulated-price and free-price inflation are converging



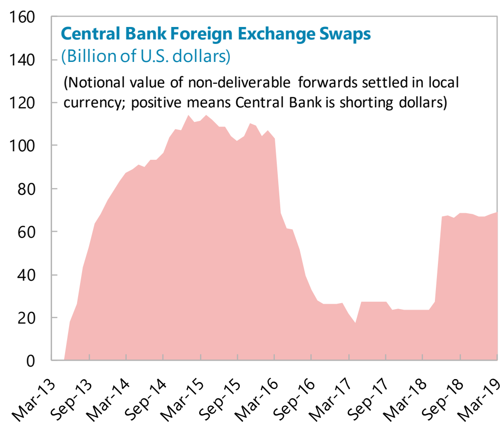
Real wages are growing moderately



The central bank has kept the policy rate at the historic low of 6.5 percent



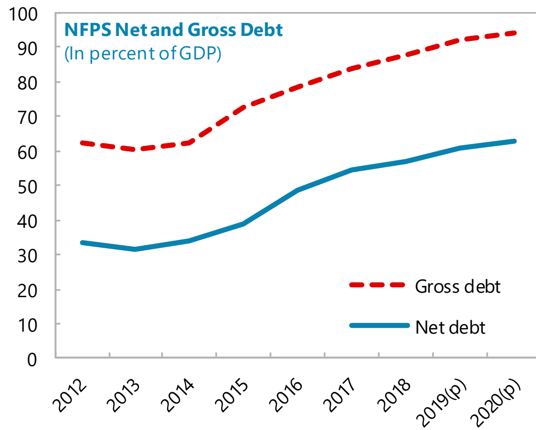
The central bank increased the stock of FX swaps in mid 2018 when exchange rate pressures materialized



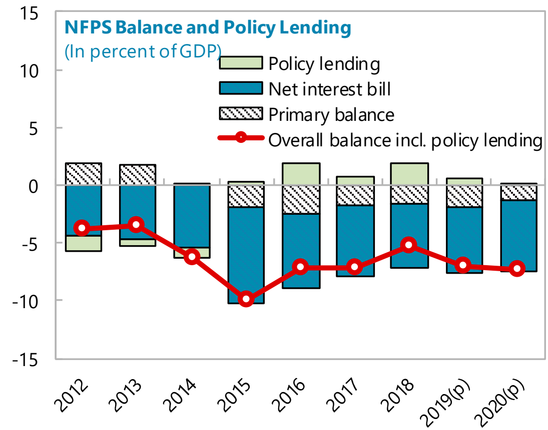
Sources: Haver Analytics, IBGE, BCB, and Fund Staff calculations.

Figure 3. Brazil: Fiscal Policy

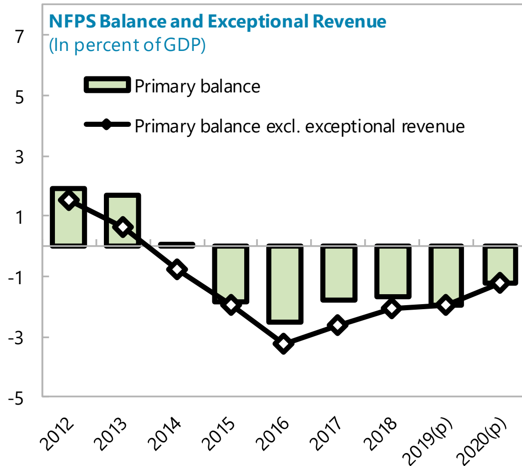
Gross debt has increased to 88 percent of GDP in 2018 and is projected to reach 90 percent of GDP in 2019.



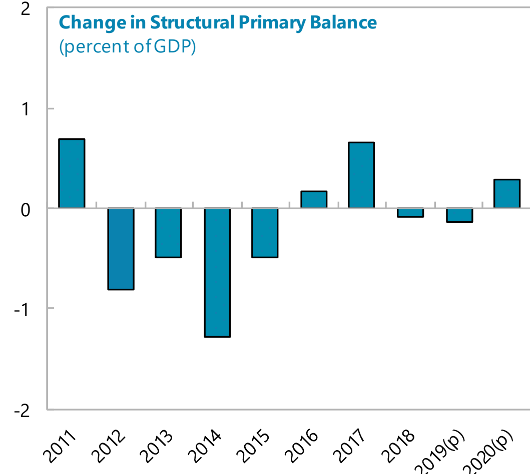
The overall fiscal balance remains negative due to primary deficit and interest bill.



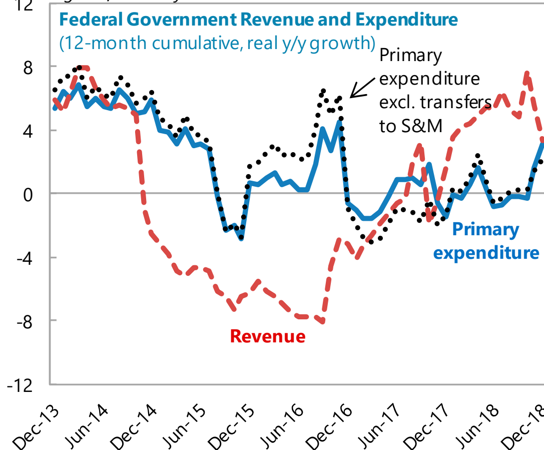
Excluding exceptional revenue, the primary deficit remains around 2 percent of GDP.



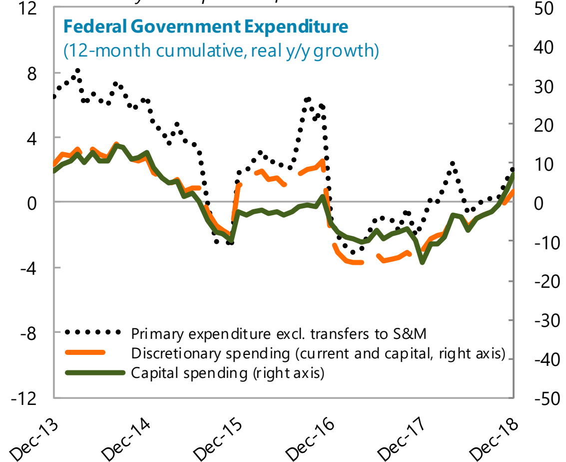
After two years of consolidation, the fiscal stance loosened slightly in 2018 and is projected to loosen further in 2019.



Primary expenditure remains contained and revenue shows signs of recovery.



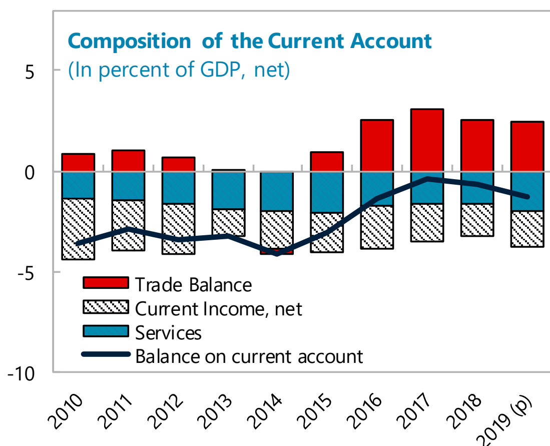
Capital expenditure has been reduced substantially and remains very low in percent of GDP.



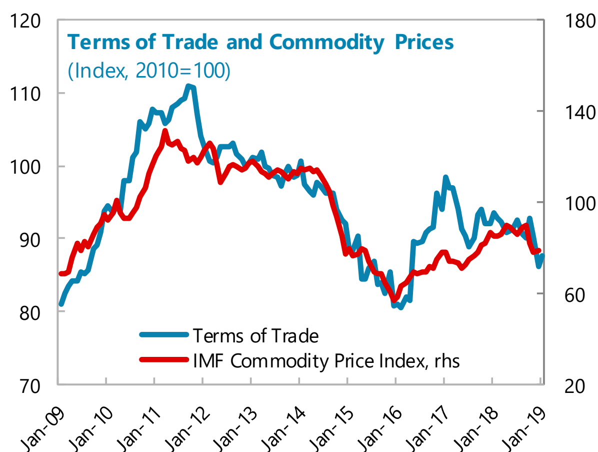
Sources: Central Bank of Brazil, IBGE, Haver Analytics, and Fund staff calculations.

Figure 4. Brazil: External Sector

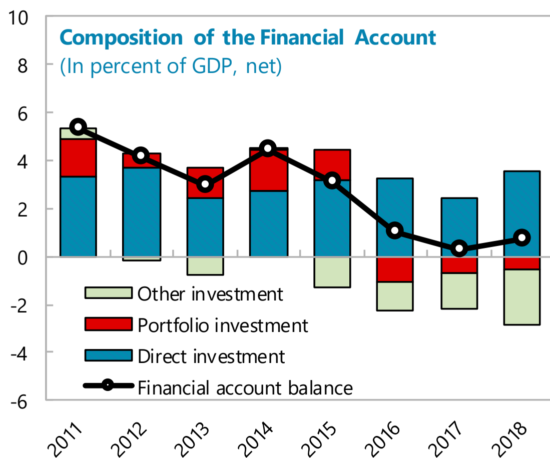
After a deterioration in terms of trade in 2018, the current account is expected to continue deteriorating in 2019…



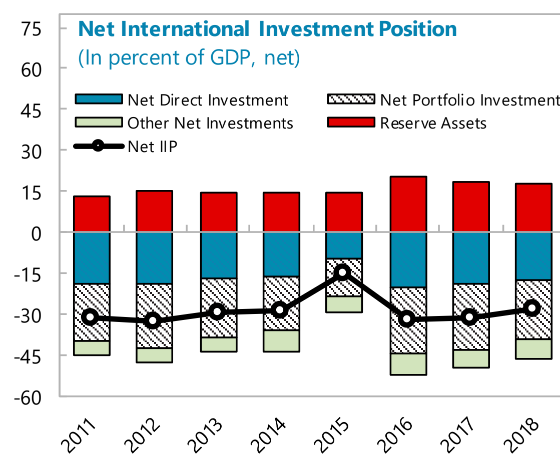
… amidst a modest expected rebound in terms of trade in 2019.



FDI inflows remain fairly large, with a modest increase in 2018.



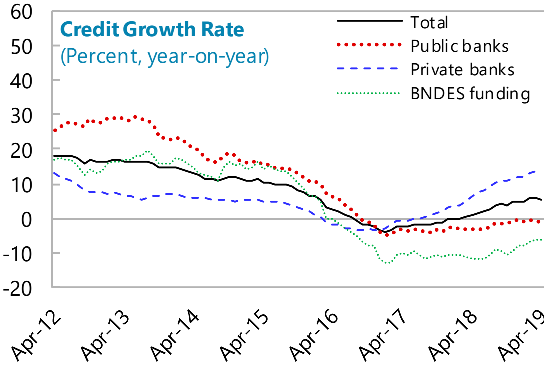
The net international investment position appears to be gradually improving.



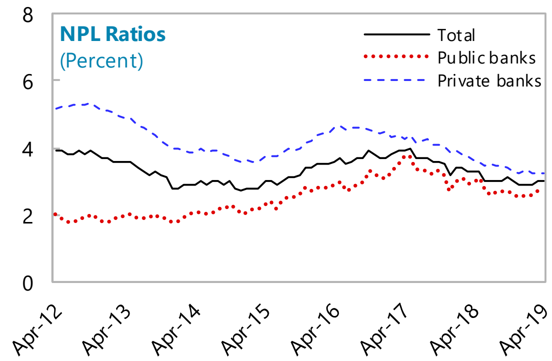
Sources: Central Bank of Brazil; Haver Analytics; and Fund staff calculations.

Figure 5. Brazil: Financial Sector

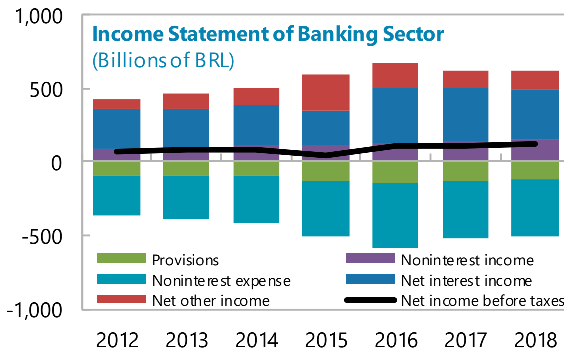
Credit growth has picked up, driven by lending from private banks.



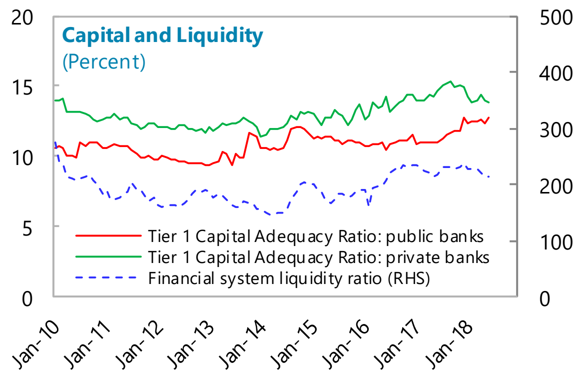
Non-performing loans declined further in 2018.



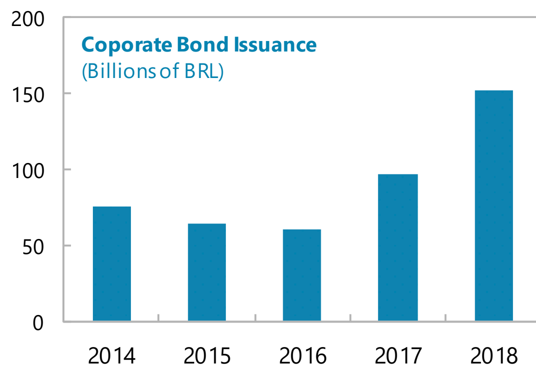
Bank profits before taxes rose in 2018, boosted by non-interest income.



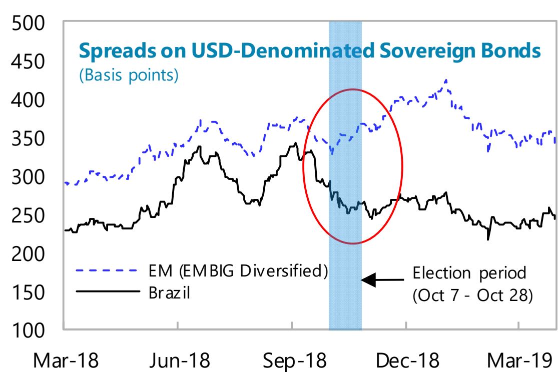
Capital and liquidity ratios remain above the regulatory minima, with private banks having more ample buffers.



Corporate bond issuance picked up in 2017-18.



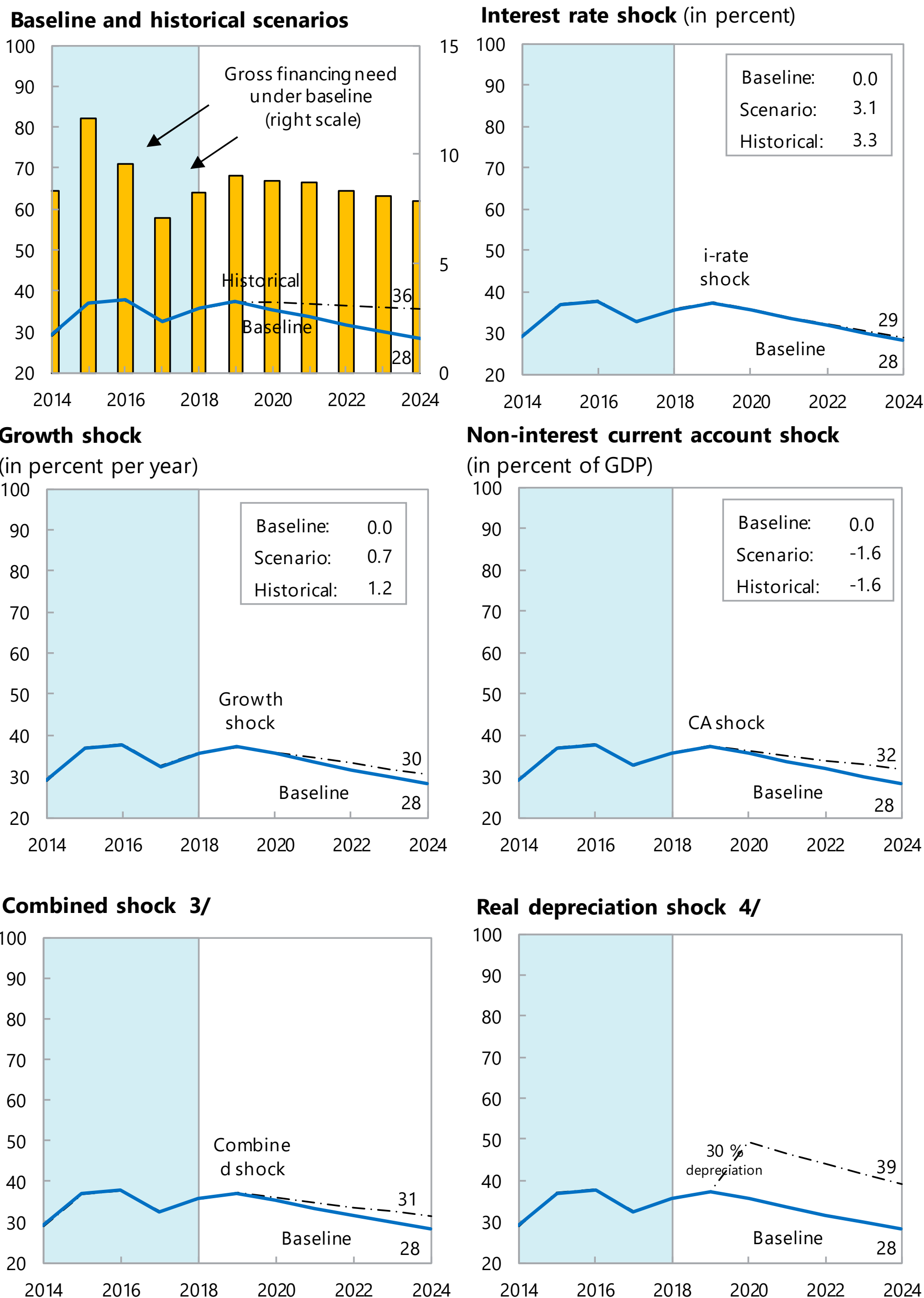
Credit spreads narrowed around the October elections and have remained relatively low since then.



Sources: BCB, Capital IQ, CEIC, Bloomberg and IMF staff calculations.

Figure 6. 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.

Table 1. Brazil: Selected Economic Indicators, 2017–24

I. Social and Demographic Indicators

Area (thousands of sq. km)	8,512	Health	
Agricultural land (percent of land area)	28.7	Physician per 1000 people (2018)	2.1
		Hospital beds per 1000 people (2018)	2.0
Population		Access to safe water (2015)	98.1
Total (million) (est., 2018)	208.8		
Annual rate of growth (percent, 2015)	0.8	Education	
Density (per sq. km.) (2018)	24.5	Adult illiteracy rate (2016)	7.2
Unemployment rate (Jan 2019)	12.0	Net enrollment rates, percent in:	
		Primary education (2017)	99
Population characteristics (2017)		Secondary education (2015)	84
Life expectancy at birth (years)	76		
Infant mortality (per thousand live births)	13	Poverty rate (in percent, 2017) 1/	25.4
Income distribution (2017)			
Ratio between average income of top 10 percent of earners over bottom 40 percent	12.4	GDP, local currency (2018)	R$6,825 billion
		GDP, dollars (2018)	US$1,868 billion
Gini coefficient (2017)	54.9	GDP per capita (2018)	US$8,995

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
			(Percentage change)					
National accounts and prices								
GDP at current prices	4.6	4.2	5.2	6.9	6.9	6.7	6.7	6.7
GDP at constant prices	1.1	1.1	0.8	2.4	2.4	2.2	2.2	2.2
Consumption	0.8	1.5	0.7	2.1	1.9	1.4	1.6	1.6
Investment	2.0	2.6	4.2	5.8	6.3	6.1	5.8	5.7
Consumer prices (IPCA, end of period)	2.9	3.7	4.1	4.0	4.0	4.0	4.0	4.0
			(Percent of GDP)					
Gross domestic investment	15.0	15.4	15.8	16.2	16.7	17.3	17.8	18.3
Private sector	13.7	14.2	14.7	15.2	15.8	16.4	16.9	17.5
Public sector	1.3	1.2	1.1	1.0	0.9	0.9	0.8	0.7
Gross national savings	14.7	14.6	14.3	14.7	15.1	15.6	15.9	16.3
Private sector	21.1	20.6	20.7	21.0	21.4	21.4	21.5	21.5
Public sector	-6.5	-5.9	-6.4	-6.3	-6.3	-5.9	-5.5	-5.1
Public sector finances								
Central government primary balance 2/	-1.9	-1.7	-1.9	-1.4	-0.8	-0.3	0.3	0.7
NFPS primary balance	-1.8	-1.7	-1.9	-1.3	-0.7	-0.1	0.4	0.9
NFPS cyclically adjusted primary balance	-0.6	-0.6	-0.8	-0.6	-0.3	0.0	0.4	0.9
NFPS overall balance	-7.9	-7.3	-7.6	-7.4	-7.3	-6.8	-6.4	-6.0
Net public sector debt	51.6	54.2	57.8	60.2	61.4	62.8	63.4	64.1
General Government gross debt, Authorities' definition	74.1	77.2	…	…	…	…	…	…
NFPS gross debt	84.1	87.9	92.2	94.1	94.9	95.9	96.1	96.4
Of which: Foreign currency linked	3.7	4.2	4.4	4.5	4.4	4.4	4.2	4.1
			(Annual percentage change)					
Money and credit								
Base money 3/	9.6	1.6	5.2	6.9	6.9	6.7	6.7	6.7
Broad money 4/	4.6	8.1	6.6	8.8	8.9	8.6	8.6	8.6
Bank loans to the private sector	0.0	7.7	7.5	9.0	8.5	8.0	8.0	8.0
			(Billions of U.S. dollars, unless otherwise specified)					
Balance of payments								
Trade balance	64.0	53.6	52.4	50.6	53.6	58.2	60.1	61.2
Exports	217.2	239.0	250.9	255.1	268.6	282.9	296.3	310.5
Imports	153.2	185.4	198.5	204.5	215.0	224.8	236.2	249.2
Current account	-7.2	-14.5	-27.4	-29.6	-32.4	-35.0	-39.5	-43.7
Capital account and financial account	0.8	9.8	27.4	29.6	32.4	35.0	39.5	43.7
Foreign direct investment (net inflows)	50.9	74.3	65.3	60.1	57.8	57.0	57.5	58.0
Terms of trade (percentage change)	0.0	-5.5	1.0	0.0	1.1	0.1	-0.1	0.0
Merchandise exports (in US$, annual percentage change)	17.8	10.0	5.0	6.7	7.0	5.3	4.7	4.8
Merchandise imports (in US$, annual percentage change)	9.9	21.0	7.1	10.3	8.3	4.5	5.1	5.5
Total external debt (in percent of GDP)	32.5	35.6	37.1	35.4	33.5	31.7	29.9	28.3
Memorandum items:								
Current account (in percent of GDP)	-0.4	-0.8	-1.5	-1.6	-1.6	-1.7	-1.8	-1.9
Unemployment rate	12.8	12.3	11.6	10.4	10.0	9.7	9.5	9.4
Gross official reserves	374	375	375	375	375	375	375	375
REER (annual average in percent; appreciation +)	8.5	-10.4	…	…	…	…	…	…

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 plus required and free reserves on demand deposits held at the central bank.

4/ Base money plus demand, time and saving deposits.

Table 2. Brazil: Balance of Payments, 2017–24

(Billions of U.S. dollars, unless otherwise indicated)

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
Current Account	**-7.2**	**-14.5**	**-27.4**	**-29.6**	**-32.4**	**-35.0**	**-39.5**	**-43.7**
Trade balance	64.0	53.6	52.4	50.6	53.6	58.2	60.1	61.2
Exports (fob)	217.2	239.0	250.9	255.1	268.6	282.9	296.3	310.5
Imports (fob)	153.2	185.4	198.5	204.5	215.0	224.8	236.2	249.2
Income, net	-37.4	-34.1	-39.1	-35.1	-38.0	-42.4	-45.7	-47.3
Capital and Financial Account	**0.8**	**9.8**	**27.4**	**29.6**	**32.4**	**35.0**	**39.5**	**43.7**
Capital account	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Financial account 1/	0.4	9.3	27.0	29.2	31.9	34.6	39.0	43.3
Direct investment, net	50.9	74.3	65.3	60.1	57.8	57.0	57.5	58.0
Assets	19.4	14.1	15.8	17.5	19.6	21.6	23.9	26.4
Liabilities	70.3	88.3	81.1	77.6	77.4	78.6	81.4	84.3
Portfolio investment, net	-14.0	-11.7	-7.4	-6.6	-5.9	-5.2	-4.4	-3.5
Financial Derivatives, net	-0.7	-2.8	-2.8	-2.9	-3.0	-3.2	-3.3	-3.5
Other investment, net	-30.6	-47.5	-28.2	-21.5	-16.9	-14.0	-10.7	-7.7
Change in Reserve Assets, net	-5.1	-2.9	0.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	**6.4**	**4.8**	**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	374.7	374.7	374.7	374.7	374.7	374.7
Net international reserves (eop)								
In billions of U.S. dollars	374.0	374.7	374.7	374.7	374.7	374.7	374.7	374.7
In percent of short-term debt (residual maturity)	267.7	271.8	272.3	265.9	268.4	270.9	273.5	276.3
Current account (in percent of GDP)	-0.4	-0.8	-1.5	-1.6	-1.6	-1.7	-1.8	-1.9
Trade balance (in percent of GDP)	3.1	2.9	2.9	2.7	2.7	2.8	2.7	2.7
Merchandise exports (in percent of GDP)	10.6	12.8	13.7	13.4	13.4	13.5	13.5	13.5
Merchandise imports (in percent of GDP)	7.5	9.9	10.8	10.7	10.7	10.7	10.8	10.9
Export volume (yoy change, in percent)	11.4	7.0	3.8	1.3	4.6	5.4	4.6	4.3
Import volume (yoy change, in percent)	5.1	6.7	8.4	3.6	5.8	5.0	5.0	4.7
Export price index (yoy change, in percent)	3.8	1.3	1.1	-0.2	0.7	0.1	0.2	0.6
Import price index (yoy change, in percent)	3.7	7.2	0.1	-0.3	-0.4	0.0	0.4	1.1
Terms of trade (yoy change, in percent)	0.0	-5.5	1.0	0.0	1.1	0.1	-0.1	0.0
Oil price (Brent blend; US$ per barrel)	52.8	68.3	65.5	63.9	60.7	58.5	57.6	57.4
Nominal exchange rate (R$/US$, annual average)	3.19	3.65	…	…	…	…	…	…
REER (annual average in percent; appreciation +)	8.5	-10.4	…	…	…	…	…	…
GDP in billions of U.S. dollars	2,053	1,868	1,836	1,908	2,001	2,094	2,191	2,293

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

Table 3. Brazil: Main Fiscal Indicators, 2017–24

(Percent of GDP, unless otherwise indicated)

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
FEDERAL GOVERNMENT 1/								
Net nonfinancial revenue	**17.6**	**17.9**	**17.8**	**18.0**	**18.1**	**18.2**	**18.3**	**18.3**
Revenue administered by SRF	12.8	13.3	13.3	13.5	13.7	13.8	13.8	13.8
PIT	2.6	2.7	2.7	2.8	2.8	2.9	2.9	2.9
CIT	3.7	3.7	3.7	3.8	3.8	3.9	3.9	3.9
Indirect taxes	5.9	6.1	6.1	6.1	6.2	6.2	6.2	6.2
Trade taxes	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Other	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Social security contributions	5.7	5.7	5.7	5.8	5.8	5.9	5.9	5.9
Other revenue	2.6	2.7	2.6	2.5	2.5	2.5	2.5	2.5
Transfers to subnational governments (-)	-3.5	-3.8	-3.8	-3.8	-3.9	-3.9	-3.9	-3.9
Total primary expenditure 2/	**19.5**	**19.7**	**19.8**	**19.4**	**19.0**	**18.5**	**18.0**	**17.6**
Current expenditures	18.8	19.0	19.2	19.2	19.3	19.3	19.3	19.4
Personnel	4.3	4.4	4.4	4.2	4.1	4.0	3.9	3.8
Pension benefits	8.5	8.6	8.9	9.2	9.5	9.8	10.1	10.3
Other	6.0	6.0	5.9	5.7	5.6	5.5	5.3	5.2
Capital expenditures	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Unallocated spending cuts	...	0.0	-0.1	-0.5	-1.0	-1.5	-2.0	-2.5
of which reform of urban civil pensions (RGPS)	...	0.0	0.0	-0.5	-0.6	-0.7	-0.7	-0.8
Fund surpluses and statistical discrepancy	0.0	0.1						
Primary balance	**-1.9**	**-1.7**	**-2.0**	**-1.4**	**-0.8**	**-0.3**	**0.2**	**0.7**
Borrowing requirement	7.1	6.1	6.7	6.5	6.4	6.0	5.6	5.2
STATES AND MUNICIPALITIES								
States								
Nonfinancial revenue	**11.3**	**11.5**	**11.4**	**11.5**	**11.4**	**11.4**	**11.4**	**11.4**
Own revenues	8.7	8.8	8.8	8.8	8.8	8.7	8.7	8.7
Indirect taxes	5.7	5.7	5.7	5.7	5.7	5.6	5.6	5.6
Other	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Transfers from the federal government	2.6	2.7	2.6	2.7	2.7	2.7	2.7	2.7
Total primary expenditure	**11.2**	**11.4**	**11.5**	**11.5**	**11.5**	**11.5**	**11.5**	**11.4**
Current expenditures	10.7	11.0	11.2	11.2	11.3	11.3	11.3	11.4
Personnel	6.2	6.2	6.3	6.2	6.1	6.0	5.9	5.8
Other	4.5	4.8	4.9	5.0	5.2	5.3	5.4	5.5
Capital expenditures and other	0.6	0.4	0.3	0.3	0.2	0.2	0.1	0.1
Primary balance of municipalities	**0.0**	**0.0**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Primary balance of states and municipalities	**0.1**	**0.0**	**0.0**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Borrowing requirement	0.7	0.8	0.9	0.8	0.8	0.8	0.8	0.8
PUBLIC ENTERPRISES 3/								
Federal enterprises								
Nonfinancial revenue	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Expenditures	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Personnel	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other current expenditures	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital expenditures	0.1	0.1	0.1	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
Primary balance of state and municipal enterprises	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Borrowing requirement	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
NON FINANCIAL PUBLIC SECTOR (NFPS)								
Primary balance	**-1.8**	**-1.7**	**-2.0**	**-1.3**	**-0.7**	**-0.1**	**0.4**	**0.8**
Primary balance (Authorities' target)	-2.6	-2.4	-2.2	-1.7	-0.7	0.0	...	...
Overall balance	-7.9	-6.9	-7.6	-7.3	-7.3	-6.9	-6.5	-6.1
Structural primary balance 4/	-0.6	-0.7	-0.8	-0.6	-0.3	0.0	0.4	0.9
Structural primary balance including policy lending	0.1	1.2	-0.3	-0.4	-0.2	0.1	0.5	1.0
Memorandum items								
Loans to public financial institutions 5/	-0.8	-1.9	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1
NFPS net interest expenditure	6.1	5.2	5.6	6.0	6.6	6.8	6.9	7.0
Net public sector debt 6/	51.6	54.2	57.8	60.2	61.4	62.8	63.4	64.1
Gross NFPS debt	84.1	87.9	92.2	94.1	94.9	95.9	96.1	96.4
General government debt, Authorities' definition	74.1	77.2	...	...	...	...	...	...
Nominal GDP (billions of reais)	6,551	6,825	7,182	7,676	8,205	8,755	9,341	9,966

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, 2014–18
(Billions of *reais*, end-of-period)

	2014	2015	2016	2017	2018
			I. Central Bank		
Net foreign assets	**954.9**	**1,381.5**	**1,179.8**	**1,225.0**	**1,464.9**
Net international reserves	965.8	1,392.2	1,179.0	1,213.5	1,433.1
Other foreign assets (net)	-11.0	-10.8	0.9	11.6	31.8
Net domestic assets	**-406.4**	**-787.0**	**-537.3**	**-520.6**	**-749.0**
Net claims on public sector	415.4	242.6	467.8	566.4	493.1
Net credit to other depository corporations	-764.3	-882.9	-1,003.5	-1,011.0	-1,080.2
Other items (net)	57.5	146.8	1.7	76.0	161.9
Base money	**548.5**	**593.9**	**642.5**	**704.4**	**715.8**
Currency issued	220.9	225.5	232.1	250.4	265.0
Liabilities to other depository corporations	325.7	368.4	409.2	453.7	444.1
Reserve deposits	42.7	29.8	38.1	46.4	37.1
Liabilities to other sectors	1.9	0.0	1.2	0.4	6.8
			II. Depository Corporations 1/		
Net foreign assets	**730.7**	**1,089.3**	**968.2**	**971.2**	**1,171.3**
Net international reserves	965.8	1,392.2	1,179.0	1,213.5	1,433.1
Other foreign assets (net)	-235.2	-302.9	-210.8	-242.2	-261.8
Net domestic assets	**3,666.1**	**3,733.8**	**4,452.5**	**4,701.0**	**4,959.4**
Net claims on public sector	1,488.8	1,628.1	2,310.1	2,823.5	3,084.5
Credit to other financial corporations	496.1	526.0	526.7	336.8	244.4
Credit to private sector	3,815.8	4,007.0	3,897.6	3,917.3	4,218.2
Of which: loans to private sector	2,807.8	2,909.0	2,824.4	2,824.8	3,043.4
Other items (net)	2,311.7	2,685.4	2,515.7	2,597.6	2,803.2
Capital	857.9	855.3	761.9	888.3	1,049.0
Other liabilities excluded from broad money	1,453.9	1,830.2	1,753.8	1,709.3	1,754.3
Broad money (M2) 2/	**4,396.7**	**4,823.2**	**5,420.6**	**5,672.3**	**6,130.7**
Currency in circulation	178.3	185.3	192.0	203.9	218.1
Demand deposits	183.9	160.9	169.8	178.1	190.0
Quasi-money liabilities	4,034.6	4,477.0	5,058.9	5,290.2	5,722.6
			(Percent of GDP)		
Base money	9.5	9.9	10.3	10.8	10.5
Broad money (M2)	76.1	80.4	86.5	86.6	89.8
M3 3/	74.7	79.4	84.3	…	…
M4 4/	86.4	92.6	98.1	…	…
Financial sector credit to the private sector	66.0	66.8	62.2	59.8	61.8
Of which: bank loans to private sector	48.6	48.5	45.1	43.1	44.6
Memorandum item:					
GDP (in billions of reais)	5,779	5,995	6,265	6,551	6,825

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, 2017–24

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
MACROECONOMIC FRAMEWORK	(Percent of GDP, unless otherwise specified)							
GDP growth at constant prices (percent)	1.1	1.1	0.8	2.4	2.4	2.2	2.2	2.2
Consumer prices (IPCA, end of period, percent)	2.9	3.7	4.1	4.0	4.0	4.0	4.0	4.0
Gross domestic investment	15.0	15.4	15.8	16.2	16.7	17.3	17.8	18.3
Private sector	13.7	14.2	14.7	15.2	15.8	16.4	16.9	17.5
Public sector	1.3	1.2	1.1	1.0	0.9	0.9	0.8	0.7
Gross domestic savings	14.7	14.6	14.3	14.7	15.1	15.6	15.9	16.3
Private sector	21.1	20.6	20.7	21.0	21.4	21.4	21.5	21.5
Public sector	-6.5	-5.9	-6.4	-6.3	-6.3	-5.9	-5.5	-5.1
External current account balance	-0.4	-0.8	-1.5	-1.6	-1.6	-1.7	-1.8	-1.9
Central government primary balance	-1.8	-1.7	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Consolidated non-financial public sector								
Primary balance	-1.8	-1.7	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Overall balance	-9.7	-9.1	-8.7	-7.4	-7.0	-6.1	-5.6	n.a.
Public sector net debt 1/	51.6	54.2	57.8	60.2	61.4	62.8	63.4	64.1
General government gross debt, Authorities' definition	74.1	77.2	...	...	...	...	...	...
NFPS gross debt 2/	84.1	87.9	92.2	94.1	94.9	95.9	96.1	96.4
EXTERNAL DEBT 3/ 4/	(Billions of U.S. dollars)							
Total external debt	**667.1**	**665.8**	**681.8**	**675.6**	**669.3**	**662.8**	**656.1**	**649.3**
Medium- and long-term	616.0	642.8	635.5	629.7	623.8	617.8	611.6	605.2
Nonfinancial public sector	179.3	176.7	174.7	173.1	171.4	169.8	168.1	166.3
Public sector banks	63.8	62.9	62.2	61.6	61.0	60.4	59.8	59.2
Private sector	420.4	450.1	475.2	496.8	516.8	536.1	555.3	574.7
Short-term	47.5	46.8	46.3	45.9	45.5	45.0	44.6	44.1
Medium- and long-term external debt service	**106.4**	**110.1**	**108.8**	**109.0**	**113.1**	**112.1**	**111.1**	**110.0**
Amortization	88.7	92.1	91.0	91.3	95.0	94.2	93.3	92.4
Interest	17.7	18.0	17.7	17.7	18.1	18.0	17.8	17.6
	(Percent of GDP)							
Total external debt	**32.5**	**35.6**	**37.1**	**35.4**	**33.5**	**31.7**	**29.9**	**28.3**
Medium- and long-term	30.0	34.4	34.6	33.0	31.2	29.5	27.9	26.4
Nonfinancial public sector	8.7	9.5	9.5	9.1	8.6	8.1	7.7	7.3
Public sector banks	3.1	3.4	3.4	3.2	3.1	2.9	2.7	2.6
Private sector	20.5	24.1	25.9	26.0	25.8	25.6	25.3	25.1
Short-term	2.3	2.5	2.5	2.4	2.3	2.2	2.0	1.9
	(Percent of gross international reserves)							
Medium- and long-term external debt service	**28.4**	**29.4**	**29.0**	**29.1**	**30.2**	**29.9**	**29.6**	**29.4**
Amortization	23.7	24.6	24.3	24.4	25.4	25.1	24.9	24.7
Interest	4.7	4.8	4.7	4.7	4.8	4.8	4.7	4.7
Short-term debt	12.7	12.5	12.4	12.2	12.1	12.0	11.9	11.8
MEMORANDUM ITEMS:								
Gross reserves (eop) 4/								
In billions of U.S. dollars	374.0	374.7	374.7	374.7	374.7	374.7	374.7	374.7
In percent of external short-term debt (maturity basis)	786.6	799.9	809.1	816.5	824.2	832.3	840.7	849.5
In months of prospective GNFS imports	17.7	16.4	15.8	15.0	14.3	13.6	12.8	...
Short-term debt in percent of total external debt	7.1	7.0	6.8	6.8	6.8	6.8	6.8	6.8
Intercompany debt (in billions of U.S. dollars)	236.5	268.8	296.0	319.2	340.9	361.9	382.9	404.0
In percent of GDP	11.5	14.4	16.1	16.7	17.0	17.3	17.5	17.6
GDP (billion US$)	2,053	1,868	1,836	1,908	2,001	2,094	2,191	2,293

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 Indicators, 2014–19

(Billions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017	2018	Proj. 2019
Trade						
Exports of GNFS (12-month percent change, US$)	-5.6	-15.2	-2.7	15.6	8.5	5.0
Imports of GNFS (12-month percent change, US$)	-2.1	-23.7	-16.4	9.0	14.4	8.5
Terms of trade (12-month percent change)	-3.4	-11.0	3.0	0.0	-5.5	1.0
Current account						
Current account	-101.4	-54.5	-24.0	-7.2	-14.5	-27.4
In percent of GDP	-4.1	-3.0	-1.3	-0.4	-0.8	-1.5
Capital and financial account	96.8	51.6	10.5	0.8	9.8	27.4
Capital Account	0.2	0.5	0.3	0.4	0.4	0.4
Financial Account	96.6	51.2	10.3	0.4	9.3	27.0
Portfolio investment (net)	41.4	22.2	-19.0	-14.0	-11.7	-7.4
Foreign direct investment (net)	67.1	57.2	58.7	50.9	74.3	65.3
Of which: intercompany loans (net)	38.3	19.3	24.7	6.1	28.0	22.7
Short-term external liabilities of commercial banks	49.4	42.7	40.6	39.7	39.2	38.7
External debt						
Total external debt 1/	712.7	664.4	675.8	667.1	665.8	681.8
In percent of gross reserves	196.0	186.4	185.2	178.4	177.7	182.0
Amortization of external MLT debt (in percent of GNFS exports)	31.6	51.1	52.1	40.8	38.5	36.3
External interest payments (in percent of GNFS exports)	7.8	9.8	10.3	8.1	7.5	7.1
Reserves						
Gross reserves	363.6	356.5	365.0	374.0	374.7	374.7
In months of prospective GNFS imports	17.9	21.1	19.8	17.7	16.4	...
In percent of broad money (M2)	22.0	28.9	21.9	21.8	23.7	22.9
In percent of short-term external debt (maturity basis)	234.7	242.0	265.8	267.7	271.8	...
In percent of IMF metric	155.4	191.6	165.1	161.8	166.0	...
Exchange rate						
Exchange rate (R$/US$, period average)	2.35	3.33	3.49	3.19	3.65	3.91
REER (annual average in percent; appreciation +)	-2.1	-17.7	4.9	8.5	-10.4	...

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

1/ Includes intercompany loans.

Table 7. Brazil: Financial Soundness Indicators, 2014–18

(In percent)

	2014	2015	2016	2017	2018
			Total banking system		
Capital Adequacy					
Regulatory capital to risk-weighted assets	16.7	16.4	17.1	18.2	18.0
Regulatory Tier 1 capital to risk-weighted assets	13.0	12.7	13.7	14.5	14.6
Capital to assets	9.0	8.4	9.3	10.0	10.1
Gross asset position in financial derivatives to capital	11.8	29.6	22.8	19.5	18.4
Gross liability position in financial derivatives to capital	13.9	35.6	21.8	19.1	19.8
Asset Quality					
Nonperforming loans to total gross loans	2.9	3.3	3.9	3.6	3.1
Provisions to Nonperforming loans	155.7	154.4	152.2	163.1	180.3
Earnings and Profitability					
Return on assets	1.3	1.5	1.1	1.5	1.6
Return on equity	13.1	15.5	11.3	13.9	14.6
Liquidity					
Liquidity assets to short-term liabilities	202.2	190.0	236.3	237.5	241.9
Liquidity assets to total assets	12.1	11.6	14.1	14.6	14.7
Net open position in foreign exchange to capital	0.3	0.5	0.9	0.7	0.7
External funding to total funding	15.9	19.5	15.3	14.8	16.9
			Public banks		
Capital Adequacy					
Regulatory capital to risk-weighted assets	16.2	15.5	16.3	18.5	18.8
Regulatory Tier 1 capital to risk-weighted assets	11.8	11.0	11.5	12.7	13.1
Capital to assets	5.1	4.7	4.9	5.7	6.1
Gross asset position in financial derivatives to capital	3.1	8.2	2.6	1.6	1.7
Gross liability position in financial derivatives to capital	2.5	3.2	3.0	1.3	1.3
Asset Quality					
Nonperforming loans to total gross loans	2.0	2.5	3.3	3.1	2.6
Provisions to Nonperforming loans	164.0	157.8	146.6	158.6	190.9
Earnings and Profitability					
Return on assets	1.1	1.0	0.6	1.2	1.0
Return on equity	13.8	14.5	9.0	16.4	12.9
Liquidity					
Liquidity assets to short-term liabilities	209.6	196.0	282.0	308.7	345.2
Liquidity assets to total assets	10.2	9.7	13.2	14.8	16.3
Net open position in foreign exchange to capital	2.2	-1.2	4.4	2.2	4.0
External funding to total funding	6.7	9.1	6.5	5.7	6.1
			Private banks (domestic and foreign)		
Capital Adequacy					
Regulatory capital to risk-weighted assets	17.0	17.3	17.6	18.0	17.8
Regulatory Tier 1 capital to risk-weighted assets	13.1	13.7	14.4	15.0	15.1
Capital to assets	11.5	11.0	12.3	13.3	12.7
Gross asset position in financial derivatives to capital	10.8	28.2	28.0	28.2	24.7
Gross liability position in financial derivatives to capital	12.6	35.3	27.9	27.3	24.5
Asset Quality					
Nonperforming loans to total gross loans	3.8	4.2	4.9	4.3	3.7
Provisions to Nonperforming loans	152.8	160.4	153.4	167.3	174.1
Earnings and Profitability					
Return on assets	1.9	2.2	1.7	1.9	2.0
Return on equity	16.9	19.0	14.2	14.2	15.7
Liquidity					
Liquidity assets to short-term liabilities	200.7	212.4	230.4	217.3	212.1
Liquidity assets to total assets	11.2	11.8	13.7	12.9	12.2
Net open position in foreign exchange to capital	-0.7	0.8	-0.1	0.2	-0.2
External funding to total funding	17.7	24.9	20.5	20.6	21.5

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

Table 8. Brazil: External Debt Sustainability Framework, 2014–24

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	29.0	36.9	37.6	32.5	35.6	**37.1**	**35.4**	**33.5**	**31.7**	**29.9**	**28.3**	**-2.7**
2 Change in external debt	3.9	7.9	0.7	-5.1	3.1	1.5	-1.7	-2.0	-1.8	-1.7	-1.6	
3 Identified external debt-creating flows (4+8+9)	2.2	8.4	-1.4	-6.3	1.0	-0.9	-1.4	-1.2	-1.0	-0.9	-0.8	
4 Current account deficit, excluding interest payments	3.4	2.0	0.3	-0.5	-0.2	0.5	0.6	0.7	0.8	1.0	1.1	
5 Deficit in balance of goods and services	2.2	1.1	-0.8	-1.5	-1.1	-0.3	-0.3	-0.3	-0.4	-0.3	-0.2	
6 Exports	10.8	12.4	12.1	12.3	14.6	15.6	15.6	15.7	15.9	16.0	16.1	
7 Imports	13.0	13.5	11.3	10.8	13.6	15.3	15.3	15.4	15.5	15.7	15.9	
8 Net non-debt creating capital inflows (negative)	-1.6	-2.7	-2.5	-2.5	-2.2	-2.1	-2.0	-2.0	-2.0	-2.0	-2.1	
9 Automatic debt dynamics 1/	0.4	9.1	0.8	-3.3	3.3	0.7	0.1	0.1	0.1	0.1	0.1	
10 Contribution from nominal interest rate	0.7	1.0	1.1	0.9	1.0	1.0	0.9	0.9	0.9	0.8	0.8	
11 Contribution from real GDP growth	-0.1	1.4	1.2	-0.3	-0.4	-0.3	-0.9	-0.8	-0.7	-0.7	-0.6	
12 Contribution from price and exchange rate changes 2/	-0.2	6.6	-1.4	-3.8	2.8	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.7	-0.5	2.1	1.1	2.2	2.4	-0.4	-0.8	-0.8	-0.8	-0.8	
External debt-to-exports ratio (in percent)	269.9	296.8	310.4	265.0	243.8	238.1	227.0	213.6	199.6	187.6	176.4	
Gross external financing need (in billions of US dollars) 4/	204.9	209.4	171.3	144.6	154.2	165.3	167.2	173.3	174.7	177.8	180.7	
In percent of GDP	8.3	11.6	9.5	7.0	8.3	9.0	8.8	8.7	8.3	8.1	7.9	
Scenario with key variables at their historical averages 5/						**37.1**	**37.0**	**36.8**	**36.4**	**36.0**	**35.6**	**-2.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.5	-3.6	-3.3	1.1	1.1	0.8	2.4	2.4	2.2	2.2	2.2	
GDP deflator in US dollars (change in percent)	-1.1	-24.0	3.1	13.1	-10.0	-2.5	1.4	2.4	2.4	2.4	2.4	
Nominal external interest rate (in percent)	2.8	2.6	2.9	2.6	2.7	2.7	2.6	2.7	2.7	2.7	2.7	
Growth of exports (US dollar terms, in percent)	-5.6	-15.2	-2.7	15.6	8.5	4.9	3.9	5.3	6.0	5.3	5.3	
Growth of imports (US dollar terms, in percent)	-2.1	-23.7	-16.4	9.0	14.4	10.8	4.0	5.2	5.6	5.8	5.9	
Current account balance, excluding interest payments	-3.4	-2.0	-0.3	0.5	0.2	-0.5	-0.6	-0.7	-0.8	-1.0	-1.1	
Net non-debt creating capital inflows	1.6	2.7	2.5	2.5	2.2	2.1	2.0	2.0	2.0	2.0	2.1	

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.

Appendix I. Risk Assessment Matrix

Risk Assessment Matrix[1]

Source of Risks	Relative likelihood		Time Horizon	Expected Impact on Economy	Policy responses
			Domestic risks		
Failure to approve robust pension reform. Congress rejects the government proposal or approves a considerably watered-down version.	**Medium**		**ST**	**High**. Financial markets may react abruptly, losing confidence in debt sustainability. Investment does not pick up and economic growth slows down.	The government should reinvigorate its commitment to fiscal consolidation by adopting alternative fiscal measures. The central bank should intervene in the FX market only in case of disorderly conditions.
Economic growth remains anemic. Despite boosting confidence in debt sustainability, fiscal consolidation acts as a strong drag on economic growth undermining public support for the government.	**Medium**		**MT**	**Medium**. Rather than increasing to 2.5 percent in 2020, economic growth stagnates around 1 percent.	Structural reforms are needed to lift potential growth and reassure markets. If inflation remains anchored, the central bank could provide additional stimulus. The exchange rate should be allowed to depreciate.
			External risks		
Rising protectionism and retreat from multilateralism. Additional trade barriers and the threat of new actions reduce growth both directly and through adverse confidence effects (increasing financial market volatility).	**High**		**ST, MT**	**Low**. A global slowdown would hurt economic growth in Brazil. Nonetheless, the effects could be contained given that Brazil is relatively closed and may benefit from trade diversion effects.	Given adverse debt dynamics, fiscal policy cannot provide stimulus. Monetary support could be appropriate, while the exchange rate should remain flexible. Structural reforms and trade liberalization would boost growth.
Sharp tightening of global financial conditions due to market expectations of tighter U.S. monetary policy, triggered by strong wage growth and higher than-expected inflation. This causes higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn.	**Low**		**ST**	**Medium**. The exchange rate could depreciate considerably (raising domestic inflation) while capital outflows materialize.	Monetary policy may have to tighten to offset the secondary effects of the exchange rate depreciation on inflation. FX intervention is appropriate only in case of disorderly conditions. Fiscal policy may also have to tighten to strengthen confidence in debt sustainability.
Weaker-than-expected global growth originating from a slowdown in China. Intensification of trade tensions and/or a housing market downturn prompt a slowdown in China. Financial stresses, including capital outflow and exchange rate pressures, emerge. There are negative spillovers on the global economy through trade volumes, commodity prices, and financial markets. The global growth slowdown could be synchronized as weakening outlooks in the US, Europe, and China feed off each other and impacts earnings, asset prices and credit performance.	**Medium**		**ST, MT**	**Low**. Lower demand from China would reduce economic growth in Brazil and worsen the current account.	The exchange rate should remain flexible The central bank should provide stimulus, while fiscal consolidation stays on track. The government should pursue structural reforms and trade openness to boost growth.

[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.

Appendix II. External Sector Assessment 2018

Brazil: External Sector Assessment 2018

Foreign asset and liability position and trajectory

Background. Brazil's NIIP was -32.1 percent of GDP at end-2018, slightly weaker than the 2011–17 average (around -29 percent of GDP). Over the medium term, the NIIP is projected to strengthen gradually to around -30 percent of GDP, as GDP growth and valuation effects deriving from Brazil's long-dollar position are expected to offset current account deficits (of around 2 percent of GDP). While FDI accounts for about half of all liabilities, the rise in external debt since the global financial crisis (to about 33 percent of GDP and 265 percent of exports) is a source of risk.

Assessment. Brazil's NIIP has remained negative and is currently at the same level as in 2011. Short-term gross external financing needs are moderate, at around 6 percent of GDP, but capital flows and the exchange rate are particularly sensitive to global financing conditions. The CA deficit required to stabilize the NIIP at -35 percent is 1.5 percent of GDP.

2018 IIP (percent GDP)	NIIP	-32.1	Gross Assets	47.9	Res. Assets	20.1	Gross Liab.	80.0	Debt Liab.	22.9

Current account

Background. The current account (CA) deficit widened from 0.5 percent of GDP in 2017 to 0.8 percent in 2018 due in part to a modest pick-up in domestic demand and is expected to gradually widen to about 2 percent of GDP in the medium term as the recovery continues. However, risks stemming from terms of trade fluctuations, unwinding of cross-border integration and trading partner growth remain tilted to the downside.

Assessment. In 2018, the cyclically-adjusted CA was -2.1 percent of GDP, reflecting a still large negative output gap. EBA estimates suggest a CA norm in 2018 of -2.9 percent of GDP. However, taking into consideration the vulnerabilities associated with a sizable negative IIP, financial risks associated with a large and increasing public debt, and the sensitivity to global financial conditions, staff assesses a CA norm between -1.9 and -2.9 percent of GDP. Thus, the CA is assessed to have been broadly in line with the level implied by fundamentals and desirable policies.

CA Assessment 2018	Actual CA	-0.8	Cycl. Adj. CA	-2.1	EBA CA norm	-2.9	EBA CA gap	0.8	Staff Adj.	-0.5	Staff CA gap	0.3

Real exchange rate

Background. After appreciating in 2016–17, the REER depreciated by about 10 percent in 2018, partly reflecting political uncertainty ahead of the presidential elections. As of May 2019, the real has depreciated by 1.4 percent relative to the 2018 average.

Assessment. EBA REER index and level methodologies indicate a 9.5 percent undervaluation and 2.1 percent overvaluation, respectively for 2018. Consistent with the CA gap, staff assess the REER gap to be in the range of -3 to 6 percent.

Capital and financial accounts: flows and policy measures

Background. Brazil continues to attract sizable capital flows. Net FDI has fully financed the CA deficits since 2015 (averaging 3.3 percent of GDP during 2015–18, while CA deficits averaged 1.5 percent), although partially offset by net portfolio outflows (0.8 percent of GDP on average during 2016–18). While interest differentials, broadly adequate external buffers and envisaged reforms to increase trade openness should support portfolio inflows going forward, rigidities in budget, financial sector, and labor and product markets, if not properly addressed, may weaken investors' interest.

Assessment. Weaker than expected global growth, tightening of global financial conditions, and weak implementation of envisaged reforms remain downside risks to capital flows.

FX intervention and reserves level

Background. Brazil has a floating exchange rate. Its gross reserves remained broadly constant in 2018, at US$375 billion at end-2018, some 20 percent of GDP and around 163 percent of the IMF's composite reserve adequacy metric.

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. The authorities should retain strong buffers, with intervention limited to addressing disorderly market conditions.

Overall Assessment

Overall Assessment:

Brazil's external position in 2018 was broadly in line with the level implied by medium-term fundamentals and desirable policies. Following sizable swings in recent years, the REER was broadly in line with fundamentals in 2018. The current account is projected to weaken as the cyclical recovery, especially investment, strengthens.

Potential policy responses:

Efforts to raise national savings are needed to provide room for a sustainable expansion in investment. Fiscal consolidation, including from the federal spending cap and social security reform, should contribute to boosting net public savings. Structural reforms to reduce the cost of doing business would also help strengthen competitiveness. Foreign exchange intervention, including through the use of derivatives, can be appropriate to alleviate disorderly market conditions in the foreign exchange market.

Appendix III. Implementation of Past Advice

Implementation of Past Advice

IMF Recommendations	*Rationale*	*Implementation status*
	Fiscal Policy	
Strengthen primary balance at faster pace than planned, including in 2018, to achieve decline in public debt by 2023.	Faster fiscal consolidation to rebuild buffers.	The primary deficit in 2018 was lower than expected essentially due to revenue overperformance.
Reform social security, include in the regions.	Ensure fiscal sustainability and fairness.	A robust pension reform proposal has been submitted to Congress, affecting state civil servants.
Address revenue and expenditure rigidities.	Facilitate budget management and fiscal consolidation.	Addressing budget rigidities is part of the new government plans, but no concrete proposal has been advanced thus far.
Revise allowances for civil servants and avoid wage increases for civil servants above inflation. Control wage bill in states.	Ensure fiscal sustainability.	The authorities implemented previously approved wage increases. The 2020 Budget Guidance Law proposes no salary increases for civil servants in the executive branch.
Increase spending efficiency.	Create fiscal space, protect social programs, and increase investment.	Federal government investment increased slightly in 2018. The number of ministries was cut from 28 to 21, but efficiency gains are yet unclear.
Severe the automatic link between benefit payments and the minimum wage and/or limit minimum wage increases to cost of living adjustments.	Ensure fiscal sustainability.	A revision of the minimum wage adjustment formula is due in mid 2019. The pension reform proposal aims to delink social pensions from the minimum wage.
Remove distortionary tax exemptions and simplify the tax system	Ensure fiscal sustainability and fairness.	Concrete government proposals for tax reform are not expected before approval of pension reform. A draft bill of Congressional initiative is still an early stage of discussion.
	Structural Policies	
Reduce tariffs and nontariff-barriers, and pursue free-trade negotiations outside Mercosur.	Open the economy, increase competition and efficiency.	The government plans to lower import fees on IT and capital goods (from 14% to 4%) by August 2019. Efforts to negotiate a EU-Mercorsur trade agreement are underway.
Revive investment in infrastructure through new concessions.	Alleviate supply bottlenecks, supporting economic growth, lower transaction costs.	While concessions continue (new airports, ports, and railway auctions completed in February 2019), larger transactions including in the energy sector (with privatization of Eletrobras) remain on hold.
Improve fiscal framework: address budget rigidities, review fiscal rules, introduce a medium term budget framework, and strengthen revenue administration.	Strengthen budgetary planning and execution.	Efforts have focused on increasing the transparency of subnational government accounts and the medium-term implications of current policies, but a review of the fiscal framework remains on hold.
Strengthen governance, anti-money laundering (AML), and anti-corruption measures (e.g. transparency, whistleblower mechanisms, provisional measures and confiscation). Address remaining shortcomings from previous FATF assessment.	Strengthen the governance and AML frameworks.	Progress has been made in relation to the shortcomings related to the previous assessment, and new AML and anti-corruption measures were proposed to Parliament (but have not been adopted). Other measures are pending.

Implementation of Past Advice (Concluded)

Monetary and Financial Sector Policies		
Legislate BCB's independence and legal protection of its staff.	Strengthen the IT, micro-prudential and safety net frameworks.	A draft bill has been submitted to congress but not yet put to a vote.
Maintain an accommodative policy stance to offset contractionary effects from anticipated fiscal tightening.	Support return of inflation to target.	Monetary policy has been supportive in face of negative shocks (May 2018 truckers' strike, electoral uncertainty).
Give mandate for macro-prudential oversight and crisis management to high level multi-agency committee.	Strengthen transparency and accountability and improve risk management.	The draft law that would establish this committee was discussed among relevant agencies (BCB, MoF, CVM) and is currently with the President's Chief of Staff.
Use Pillar 2 capital requirements to handle bank-specific risk profiles.	Boost resilience and mitigate risks.	So far, no banks have been asked to hold additional capital under Pilllar 2, but reviews for structured add-ons are underway and reviews for reference add-ons are expected for next year.
Bring deposit guarantee fund into the public sector.	Preserve financial stability function within the government, avoid conflict of interest, better deal with confidential information.	No progress.
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.	Improvements have been made to the regulations governing large exposures and related party exposures. Further changes are planned (e.g., on country and transfer risks).
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.	No progress on ELA. The new resolution law for the banking sector is awaiting a vote in congress.
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.	Expansion of positive credit registry law recently approved. Draft bankruptcy law and other initiatives pending.
Phase out BNDES subsidized interest rate in line with TLP reform and limit other state intervention in the credit market.	Better capital allocation, level the playing field for private and public banks, reduce parafiscal costs, improve monetary policy transmission, develop capital markets.	The TLP interest rate is being phased in as scheduled. BNDES funding and lending are being scaled back. Additional actions by new administration pending.
External Sector Policy		
Limit use foreign exchange intervention to disorderly market conditions.	Use exchange rate as a first buffer against shocks.	Interventions were limited to episodes of market distress.
Preserve reserve buffers.	Maintain resilience to external shocks.	Reserve buffers were preserved.

Appendix IV. 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 explicit mandate for macroprudential policy and the power to issue policy recommendations on a comply-or-explain basis.	ST (Short Term)	The BCB has finalized a draft bill named "Financial Stability Coordination Law." The successful completion of this action depends on other participants' efforts outside of the BCB. The draft bill is being analyzed by the Office of the President's Chief of Staff (Casa Civil). The BCB, CVM, Previc and SUSEP are in agreement as to the current draft of the bill.
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). BCB's Contingency Plan has already been implemented.
Strengthen legal protection of all supervisors (BCB, SUSEP) by clear rules, including fixed term, condition of dismissal, public disclosure of reasons for dismissal and qualification criteria for appointments. Strengthen the independence to the BCB.	ST	The authorities are taking a number of actions to comply with this recommendation: (1) Draft bill of BCB Autonomy – it will address the current subordination of the BCB to the Ministry of Finance, fixed-term mandates for the Governor and Deputy Governors, as well as introducing rules for early dismissal. It is under National Congress examination. (2) Bank Resolution draft bill which provides for protection of public agents (BCB, SUSEP) in the performance of their duties, against legal actions, except in case of fraud or bad faith. The draft bill is under evaluation by the President's Chief of Staff Office (Casa Civil) for submission to the National Congress. (3) Financial Stability Coordination Law draft bill. (4) Amendment to Article 102, I, "b" of the Constitution to include the BCB Governor and Deputy Governors in the list of authorities whose criminal offenses are originally judged by the Supreme Court (STF). (5) Review the BCB's Board Decisions (Votos BCB-88/2012 and BCB-67/2015), which regulate the legal defense of BCB officials while on duty by the BCB's Legal Department (PGBC). The successful completion of these actions depends on other participants' efforts outside of the BCB. The SUSEP Board is currently drafting a bill to merge the insurance authority (SUSEP) with the pension funds authority (Previc), addressing, among other issues, the structure of the new authority.
Increase resources of CVM and SUSEP.	ST	In April 2019 the Ministry of Finance informed about a substantial decrease on CVM resources (around 30 percent of discretionary expenses as compared to 2018, representing about 8 percent of CVM's overall budget). The reduction is applicable until December 2019. Notwithstanding the studies under way 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	The Structured Add-on was implemented and is in its second cycle of application. Technical guidelines for the application of Add-on by Reference are being discussed. The Add-on by Reference will be applied to banks that mandatorily perform an Internal Capital Adequacy Assessment

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

Brazil: Key FSAP Recommendations (Continued)

Recommendations	Time	Authorities' Actions
		Process (ICAAP). To date, there is no schedule for application to other categories. The metrics for concentration risk and Interest Rate Risk in the Banking Book (IRRBB) have already been defined.
Financial sector oversight		
Upgrade 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). 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
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	In the next few weeks a draft CVM Instruction regulating the strengthened CVM enforcement functions established by Law 13.655/18 will be exposed for public commentaries. The CVM & ANBIMA agreement signed in August 2018, though not having as broad a scope as recommended, is considered a first step since it defined cooperation rules within the investment fund sector. It aims to avoid duplication of work and to reduce observance costs, and covers three issues: ANBIMA assisting the CVM in the licensing of portfolio managers, joint supervision of mark to market valuation performed by 555-fund administrators and joint supervision of fund share distributions performed by securities intermediaries.
Implement (BCB, ANS and SUSEP) consistent group-wide supervision of insurance groups and conglomerates with joint rule-making, 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 FSAP team's recommendations and promptly enact it.	ST	The draft bill is under evaluation by the Office of the President's Chief of Staff (Casa Civil), who will decide on the submission to the National Congress.
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	Discussions on this recommendation are ongoing.

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	**Time**	**Authorities' Actions**
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 a 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/CFR Risk Assessment is attributed the Ministry of Justice (MJSP). The draft Bill to establish the Strategic Committee for the National AML/CFR Risk Assessment is under analysis at the MJSP.
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 first phase of a BCB project to foster financial and technological innovation, called "Lift," was concluded in December, 2018. Among the 18 selected projects, 12 successfully attained the prototype stage. The Credit Registry Law, *Lei do Cadastro Positivo*, in effect since 2011, was amended to adopt the opt-out model instead of the opt-in model.
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 order to foster private sector engagement, one of the priorities defined by BNDES' management is the support to the federal, states and municipalities governments to model the most appropriate solution for project structuring, in several sectors, aiming at privatization, concessions or private public partnerships. In this regard, two recent initiatives should be mentioned: (a) the Provisional Act 882/2019 enacted by the federal government stablishes that BNDES will assume assignments that belong to the Support Fund for Structuring Partnerships (FAEP). According to this Act, the bank will be hired by public administration bodies and entities to provide technical services in the structuring of partnership contracts and privatization measures; (b) Brazilian Federal Government is discussing a significant change in the water and sanitation regulatory framework (Provisional Act 868/2018), with potential to attract private investments to the sector. Since 2016, BNDES has been providing technical support to several states in modelling the most appropriate solution for each case. The Bank is reviewing its internal instruments and policies and re-thinking risk analysis to focus on effectiveness, reducing its participation level in the financing of projects in sectors where the private financiers are willing to be exposed to, while developing other financial instruments, such as guarantees. The Bank has been also engaged in developing initiatives to increase the liquidity of infra bonds and foster the participation of institutional investors in the financing of long term projects, through capital markets initiatives: (i) in the second semester of 2018, BNDES launched a RFP process for the Infrastructure Bonds Special Purpose Vehicle (FDIC Debêntures de Infraestrutura). The fund, managed by a private asset management, will invest in infrastructure bonds and is now being structured. The fund will

Brazil: Key FSAP Recommendations (Concluded)		
Recommendations	**Time**	**Authorities' Actions**
		manage assets of R$500 million, but BNDES will not be a quota holder. Part of its assets will be composed by bonds of sound performing projects currently held by BNDESPar and transferred to this new vehicle in order to attract private investors; (ii) 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 low-carbon economy. It is managed by a private manager and BNDESPar holds 43 percent of its quotas.
Focus Caixa on core activities, improve governance, and invite a strategic investor.	ST	**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. **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 the 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 certainly 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

June 25, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | The Western Hemisphere Department (In consultation with other departments)

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FUND RELATIONS

(As of May 3, 2019)

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)	9,363.16	84.80
Reserve Tranche Position	1,679.00	15.21
Lending to the Fund		
New Arrangement to Borrow	337.28	

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	2,887.08	100.00
Holdings	2,913.56	100.92

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				
	2019	2020	2021	2022	2023
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.05	0.05	0.05	0.05	0.05
Total	**0.05**	**0.05**	**0.05**	**0.05**	**0.05**

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 by credit card, debit card, and traveler's checks (including cash withdrawals) 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 than with credit cards in December 2013.

Last Article IV Consultation

The last Article IV consultation with Brazil was concluded by the Executive Board on July 9, 2018. 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 Fiscal Affairs Department (FAD) is supporting the Ministry of Finance in its efforts to strengthen medium term fiscal planning and improve transparency. An April 2019 mission on "Fiscal Rules and Fiscal Frameworks" provided recommendations to strengthen the institutional framework for subnational public finances with a focus on programs to support states and municipalities under financial distress. FAD also carried out a Public Investment Management Assessment (PIMA), published in November 2018, and a mission on Cost Accounting in March 2018. FAD continues to support the State of São Paulo in implementing a cost accounting system for the public sector.

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

STATISTICAL ISSUES

(As of May 3, 2019)

I. Assessment of Data Adequacy for Surveillance
General: The quality of macroeconomic statistics has improved significantly, and data provision is adequate for surveillance.
National Accounts: Since 2015, the national accounts estimates are compiled in accordance to the *2008 System of National Accounts*. The availability of annual supply and use tables also contribute to the development of consistent national accounts estimates. The national accounts series and methodological notes are available on the internet (http://www.ibge.gov.br), and GDP series are available in *International Financial Statistics* (IFS). Brazil is participating in the G-20 Data Gaps Initiative regarding recommendation 8, which calls for compiling and disseminating sectoral accounts and balance sheets on a quarterly basis.
Price Statistics: Since July 1999, the price index reference for monetary policy has been the Broad Consumer Price Index (IPCA) compiled by the Brazilian Statistical Institute (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 compile 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 19 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

Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since 2001. Uses SDDS flexibility options on the timeliness of the general government operations and depository corporations survey.

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 May 7, 2019)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	5/6/2019	5/7/2019	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/6/2019	5/7/2019	D	D	D
Reserve/Base Money	4/26/2019	5/2/2019	D	M	M
Broad Money	Mar. 2019	5/2/2019	M	M	M
Central Bank Balance Sheet	Mar. 2019	5/2/2019	M	M	M
Consolidated Balance Sheet of the Banking System	Feb.2019	4/12/2019	M	M	M
Interest Rates[2]	5/6/2019	5/7/2019	D	D	D
Consumer Price Index	Apr. 2019	5/2/2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Apr. 2019	6/3/2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Apr. 2019	6/3/2019	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2019	4/29/2019	M	M	M
External Current Account Balance	Q1 2019	4/24/2019	Q	Q	M
Exports and Imports of Goods and Services	Mar. 2019	4/24/2019	M	M	M
GDP/GNP	Q4 2018	2/28/2019	Q	Q	Q
Gross External Debt	Mar. 2019	4/29/2019	M	M	M
International Investment Position[6]	Q4 2018	4/24/2019	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

June 25, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

Approved By
Aasim M. Husain (WHD)
and
Vitaliy Kramarenko (SPR)

Prepared by the Staff of the International Monetary Fund

Debt sustainability risks remain high. Reflecting an additional year of disappointing growth, the gross debt of the non-financial public sector (NFPS) increased by 3.8 percentage points of GDP in 2018, reaching 87.9 percent of GDP. Under the baseline scenario, public debt is projected to peak at 96 percent of GDP in 2024 and financing needs are set to exceed 30 percent of GDP by the end of the forecast horizon. Primary surpluses of about 1 percent of GDP (excluding interest revenue) are needed to stabilize gross debt as a ratio to GDP beyond the projection horizon. The trajectory of the debt-to-GDP ratio is highly sensitive to shocks to real GDP growth, fiscal performance, 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 Electrobras, and consolidate the Sovereign Wealth Fund. Following the GFSM 2014 manual, the NFPS debt includes all Treasury securities on the Central Bank's (BCB) balance sheet.[2] At end-2018, gross debt amounted to 88 percent of GDP. As reported by the government, net debt corresponds to the entire public sector, consolidating the BCB. The consolidated public sector net debt amounted to 54 percent of GDP at end-2018, reflecting a large stock of assets, equal to 36 of GDP, which included international reserves amounting to 21 percent of GDP. Brazil's debt is reported at nominal value.[3]

2. **Debt developments.** At the end-2018, Brazil's NFPS gross debt amounted to 88 percent of GDP, 3.8 percentage points higher than a year before. Public sector net debt amounted to 54 percent of GDP. A primary deficit of 1.7 percent of GDP and net interest payments of 5.6 percent of GDP contributed to the increase in gross debt. Net interest payments were lower than in 2016 and 2017 (6.5 and 6.1 percent of GDP respectively), reflecting declining premia (compared to 2016) and a lower SELIC that reached its historical low in April 2018. Average maturity of federal government (FG) securities edged up slightly to 4.8 from 4.3 years in 2017, driven by an increased issuance of SELIC-linked bonds (see below), which have a longer maturity than the average federal government debt. In 2018, the national development bank (BNDES) repaid R$130 billion (close to 2 percent of GDP) in outstanding government securities to the Treasury, and additional repayments of at least R$40 billion (about 0.6 percent of GDP) are expected in 2019. These cash payments are earmarked to debt repayments and will contribute to reducing financing needs over time.

3. **Debt profile.** FG domestic tradable securities account for 92 percent of total NFPS gross debt, of which close to 2/3 is held by the public and the rest is held by the BCB.[4] Nearly 37 percent of FG domestic tradable securities are linked to the SELIC rate, 34 percent are fixed income securities, and 29 percent are linked to inflation. The increase in the share of SELIC-linked securities during 2018 (from 33 percent of total FG domestic tradeable securities in 2017) was the result of debt management operations aimed at reducing interest and rollover risks amid the increased market risk aversion that followed the truckers' strike in mid-May, and to accommodate demand preferences. About 17 percent of FG domestic tradable securities will mature in 2019. Foreign currency denominated NFPS debt accounted for only 4.4 percent of GDP at end 2018. Gross financing needs have been consistently above 15 percent of GDP per year and are projected to rise to over 30 percent of GDP by 2024. However, a large fraction of the NFPS debt (about 30 percent of total) is held by BCB and automatically rolled over.

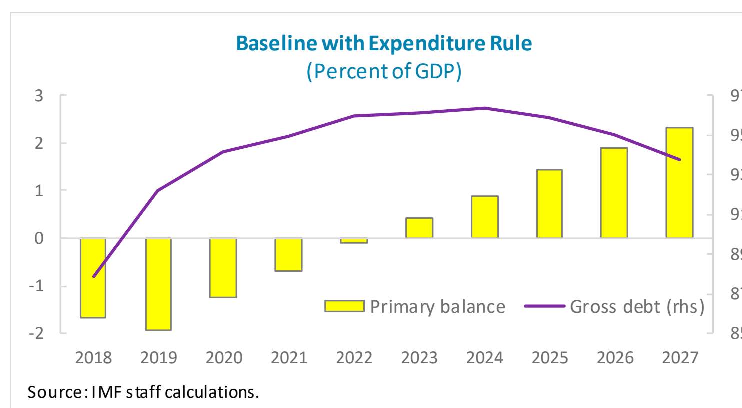
[2] In contrast, the authorities' definition of gross debt includes the stock of Treasury securities used for monetary policy purposes by the BCB (those pledged as security in reverse repo operations) but excludes the rest of the government securities held by the BCB. Thus, per the national definition, gross debt of the general government amounted to 77.2 percent of GDP at end-2018.

[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] The BCB uses about 2/3 of its holdings as security in liquidity-draining operations with the banking system.

BASELINE AND REALISM OF PROJECTIONS

4. Macroeconomic assumptions. The projections assume real GDP growth of 0.8 percent in 2019, 2.4 percent in 2020 and 2021, and a return to potential growth of 2.2 percent starting in 2022 onwards. The primary balance is projected to move into positive territory in 2023 (0.4 percent of GDP), with a cumulative adjustment of about 3 percentage points of GDP during 2019–24. Nominal interest rates on new borrowing are between 6.5 and 10 percent over the projection horizon, bringing the effective interest rate to about 9 percent on average.[5] In the baseline scenario, which assumes compliance with the constitutional expenditure ceiling, gross debt remains on an upward trajectory peaking at 96 percent of GDP in 2024[6] If the expenditure ceiling remains in place until 2027, and the primary balance follows the same consolidation path, debt is projected to start falling in 2025. The timing of the debt peak is sensitive to assumptions about the real interest rate and growth over the projection horizon. The debt stabilizing primary balance (excluding interest revenue) in the baseline scenario is 1 percent of GDP (Box 1).[7]



5. Debt profile risks. The stock of debt and the gross financing needs are high and volatile, mainly because of the repayment schedule of existing zero-coupon bonds. Gross financing needs breach the high-risk threshold of 15 percent of GDP through the projection period (Figure 1). This indicator, however, overstates the financing needs for two reasons. First, the actual rollover risk is lower because of the BCB's automatic debt roll over policy. Gross financing needs would be about 30 percent lower on average excluding rollover of BCB held bonds. Second, the interest on existing FG securities reported in the authorities' overall fiscal balance (and used in the DSA) includes accrued interest, in line with the reporting of debt at nominal value. This concept overstates the government's need for borrowing from markets in the early projection years relative to cash interest. Nevertheless, debt sustainability risks are large: if reforms are not implemented, public debt could reach 120 percent of GDP in 2024 (90th percentile of forecast

[5] Interest rates on new borrowing are derived by applying the expectations hypothesis of the term structure of interest rates to the Brazilian yield curve as of March 2019.

[6] 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 significantly reduces the amount of Treasury securities issued for BCB recapitalization purposes and is projected to decrease the portfolio of free securities held by the BCB (footnotes 2 and 4). Considering the new framework, current debt projections are flatter than previous estimates under comparable macro assumptions.

[7] The debt stabilizing primary balance shown on the right-most column of the table on "Contributions to changes in public debt" in the Baseline Scenario (2 percent of GDP) corresponds to a concept of the primary balance that includes interest revenue. The definition of the primary balance as a non-interest concept is customary in Brazil and corresponds to 1 percent of GDP quoted in the main text.

distribution) based on the historical variance and covariance of macro variables (fan charts in Figure 1). On the other hand, positive shocks could lower public debt to 80 percent of GDP (10th percentile).

6. 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 during 2015–16 (Figure 2).

7. Realism of projections. Brazil's projected fiscal adjustment (an improvement of about one percentage point in the cyclically-adjusted primary balance-to-GDP over 3 years) is based on the constitutional expenditure rule. The extent of the adjustment is in line with other surveillance countries' experience (Figure 2).

8. Contingent risks from systemic SOEs. The government holds about 50 percent of Petrobras' and Electrobras' shares, both of which are excluded from the debt definition. Fiscal risks could arise from possible future capitalizations to cover losses. However, Petrobras's financial position improved substantially in 2018 compared to 2017, and its net debt declined by 1/3 compared to 2015. Looking forward, under the current legal framework Petrobras is well positioned to benefit from the growth of pre-salt exploration and the planned sale of non-core subsidiaries, which are projected to place its financial position on a stable footing. While a legal probe against Electrobras could cost the government about R$8 billion (0.1 percent of GDP in 2019) the government plans to privatize the company in the medium term. Hence, the fiscal risks arising from Petrobras and Electrobras are deemed limited.

Box 1. Large Fiscal Effort to Stabilize the Debt Ratio

A primary surplus of about 1 percent of GDP is needed to stabilize the gross debt-to-GDP at 96 percent in 2024. The table below reports the debt-stabilizing primary balance (DSPB) required to stabilize the gross debt-to-GDP at 96 percent for various combinations of real growth and real interest rates.[1] Under the baseline scenario of 2.2 percent growth and 9 percent nominal effective interest rate, the DSPB is about 1 percent of GDP. A lower primary surplus can stabilize the debt only with higher real growth or lower real interest rates (or both), as shown in the shaded area in the table.

Debt stabilizing Primary Balance in 2024
(At 96.4 percent of GDP)

Real Growth Rate \ Real Effective Interest rate	3.5	4	4.4	5	5.5
1	1.4	1.9	2.2	2.8	3.3
2	0.4	0.9	1.3	1.8	2.3
2.2	0.2	0.7	1.1	1.6	2.1
3	-0.5	-0.1	0.3	0.9	1.3
4	-1.5	-1.0	-0.6	-0.1	0.4
4.5	-1.9	-1.5	-1.1	-0.5	-0.1

Source: IMF staff calculations.

An adverse shock that lowers growth or increases real interest rates will require even higher DSPB. In an event that real growth falls (below 2 percent) and real interest rates increase (above 5 percent), the primary surplus required to stabilize the debt-to-GDP level becomes large, above 2 percent of GDP.

[1] The debt stabilizing primary balance is calculated using the formula: $pb_t = d_{t-1}\frac{r-g}{1+g} - int\ rev_t$, where pb_t is the primary balance, d_{t-1} is gross debt in percent of GDP, r is the effective real interest rate, g is real GDP growth, and $int\ rev_t$ is revenue from interest.

SHOCKS AND STRESS TESTS

9. Primary balance shock. In the primary balance shock scenario, consolidation efforts are deferred, and the expenditure cap is abandoned starting in 2020. The primary balance deteriorates cumulatively by 8 percentage points of GDP over the period 2020–24 compared to the baseline. Under this scenario, gross debt-to-GDP increases to 104 percent (8 percentage points above the baseline) in 2024, while gross financing needs reach 36 percent of GDP.

10. 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 2020. Over the period 2020–21, real GDP contracts by a cumulative 1.7 percent. Under this scenario, gross debt-to-GDP reaches 103 percent, with gross financing needs standing at 34 percent of GDP.

11. Real interest rate and real exchange rate shocks. In the real interest rate shock scenario, the real interest rate is increased by 400bps over the period 2020–24. In the real exchange rate shock scenario, the real exchange rate depreciates by 26 percent (maximum movement over the past 10 years) in 2020, and it remains at this level until the end of the projection period. Under the real interest rate shock, gross debt and financing needs increase to 103 and 35 percent of GDP respectively in 2024, while the impact of the real exchange rate shock is modest, pushing debt-to-GDP up by less than 1 percentage point above the baseline in 2024.

12. 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 large. The gross debt-to-GDP ratio reaches almost 120 percent by 2024, 22 percentage points above the baseline, with gross financing needs increasing to 43 percent of GDP.

13. Stronger growth. In this scenario, the output gap closes faster as growth is on average one percentage point higher in each projection year compared to the baseline. Stronger primary surpluses in this scenario are a consequence of higher revenues, and lower shares of expenditures to GDP under the constitutional spending ceiling (which applies to nominal expenditure). Gross debt-to-GDP declines by 13 percentage points of GDP by 2024. The underlying assumption in this scenario is that the authorities comply with the expenditure ceiling using high-quality measures and implement growth-enhancing structural reforms.

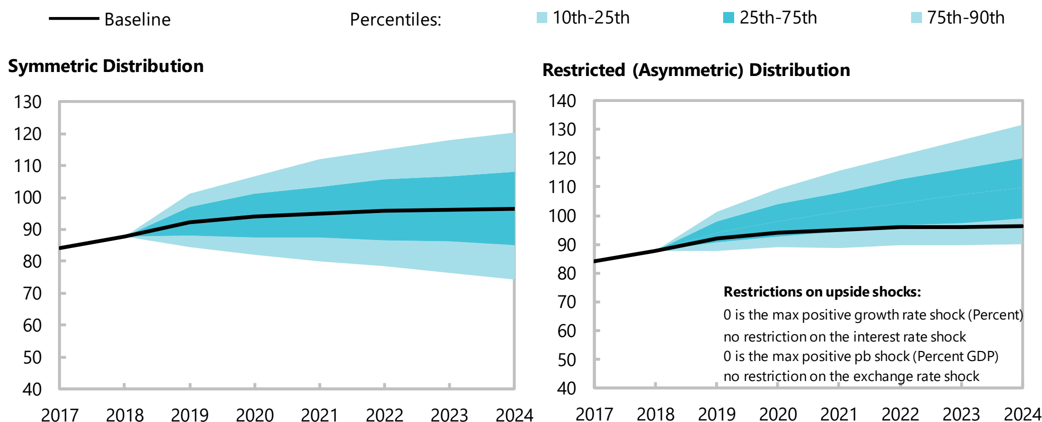
Figure 1. Brazil: Public DSA—Risk Assessment

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

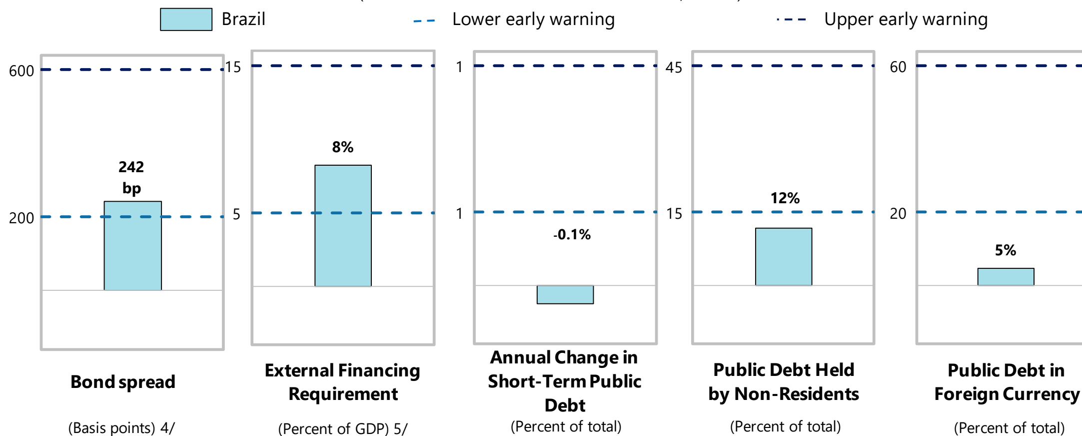
Evolution of Predictive Densities of Gross Nominal Public Debt

(Percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



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.

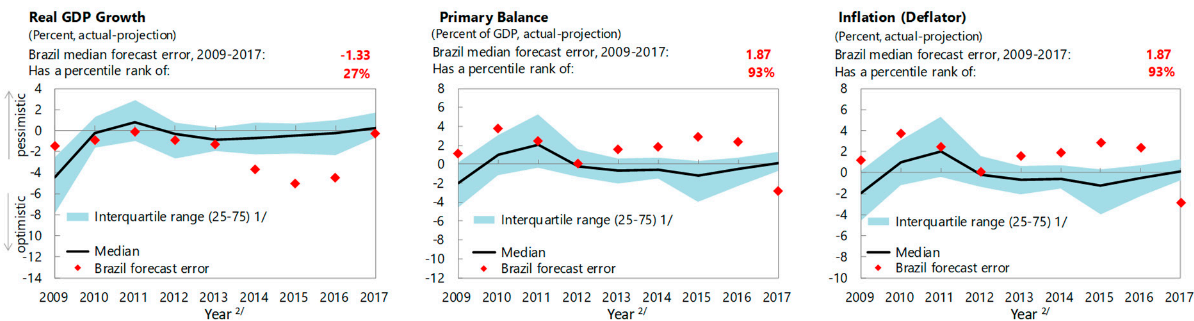
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

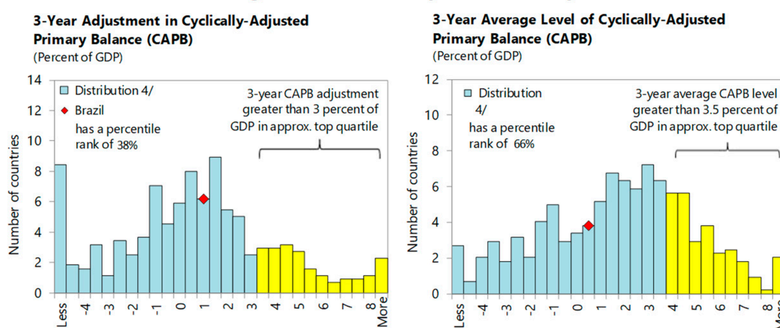
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 21-Dec-18 through 21-Mar-19.

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 surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Brazil.
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)

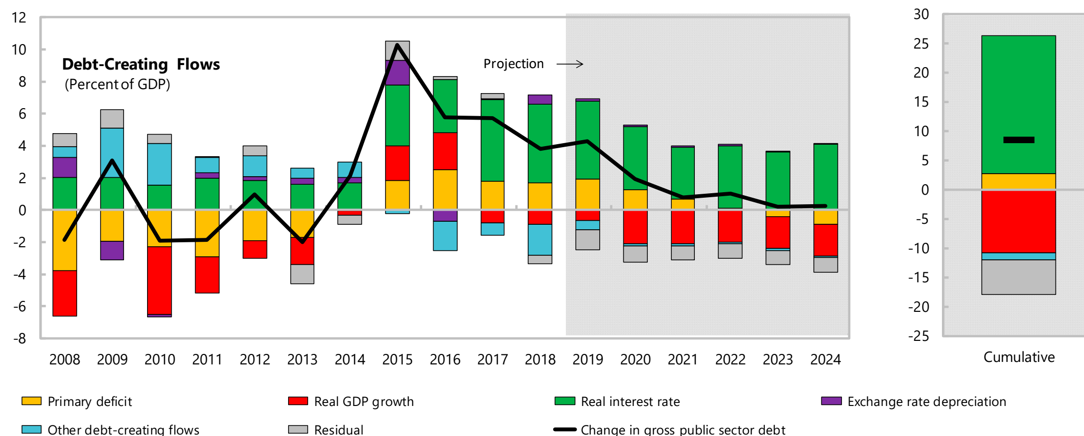
Debt, Economic and Market Indicators 1/

	Actual					Projections					
	2008-13 2/	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	66.1	72.6	78.3	84.1	87.9	92.2	94.1	94.9	95.9	96.1	96.4
Public gross financing needs	16.4	18.9	20.6	19.4	15.5	17.2	20.9	24.1	27.2	29.5	31.6
Real GDP growth (in percent)	0.4	-3.6	-3.3	1.1	1.1	0.8	2.4	2.4	2.2	2.2	2.2
Inflation (GDP deflator, in percent)	7.9	7.6	8.0	3.5	3.0	4.4	4.3	4.4	4.4	4.4	4.4
Nominal GDP growth (in percent)	8.3	3.7	4.5	4.6	4.2	5.2	6.9	6.9	6.7	6.7	6.7
Effective interest rate (in percent) 4/	11.9	13.7	12.6	10.3	9.1	10.3	9.0	8.2	8.9	8.5	9.0
Effective real interest rate (in percent)	3.7	5.6	4.2	6.6	5.9	5.6	4.5	3.6	4.3	3.9	4.4

As of March 21, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		239
5Y CDS (bp)		163
Ratings	Foreign	Local
Moody's	Ba2	Ba2
S&Ps	BB-	BB-
Fitch	B	B

Contribution to Changes in Public Debt

	Actual					Projections							
	2008-13	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Cumulative	Debt-Stabilizing Balance 10/
Identified debt-creating flows	2.5	9.1	5.6	5.4	4.4	5.6	3.0	1.7	1.9	1.1	1.1	14.3	2.0
Primary deficit	-0.4	1.9	2.5	1.8	1.7	1.9	1.3	0.7	0.1	-0.4	-0.9	2.7	
Primary (noninterest) revenue and grants	31.5	28.6	28.6	29.2	29.5	29.4	29.6	29.7	29.8	29.8	29.8	178.0	Without interest
Primary (noninterest) expenditure	31.1	30.4	31.1	30.9	31.2	31.4	30.8	30.4	29.9	29.4	28.9	180.7	1.1
Automatic debt dynamics 5/	2.6	7.5	4.9	4.4	4.6	4.2	1.8	1.1	1.9	1.6	2.1	12.8	
Interest rate/growth differential 6/	2.2	5.9	5.6	4.3	4.0	4.2	1.8	1.1	1.9	1.6	2.1	12.8	
Of which: real interest rate	2.4	3.8	3.3	5.1	4.9	4.9	4.0	3.2	3.9	3.6	4.1	23.6	
Of which: real GDP growth	-0.1	2.1	2.3	-0.8	-0.9	-0.7	-2.1	-2.1	-2.0	-2.0	-2.0	-10.9	
Exchange rate depreciation 7/	0.3	1.5	-0.7	0.1	0.6	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.3	-0.3	-1.8	-0.8	-1.9	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-1.2	
Privatization	0.0	0.0	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	0.0	0.0	
Other flows	0.3	-0.3	-1.8	-0.8	-1.9	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-1.2	
Residual, including asset changes 8/	0.0	1.2	0.2	0.4	-0.5	-1.3	-1.0	-0.9	-0.9	-0.9	-0.9	-5.8	
o/w "Interest revenue" 9/	1.3	0.2	-2.2	-1.6	-1.8	-1.4	-1.1	-1.0	-0.9	-0.9	-0.9	-6.2	



Source: IMF staff.

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

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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 asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

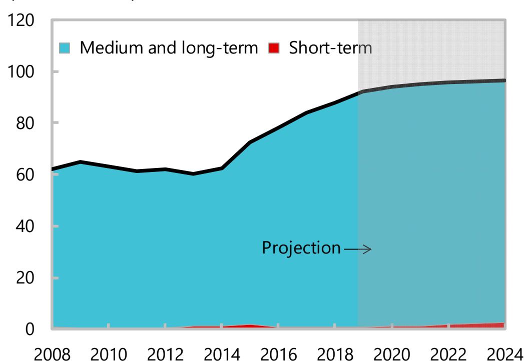
9/ "Interest revenue" is a reconciliation series calculated as a difference between the gross interest of the NFPS and the net interest of the PS. This concept is used to maintain consistency between the fiscal accounts, in which the net interest used to compute the overall balance includes also the net interst bill of the BCB, and gross interest of the NFPS in the DSA.

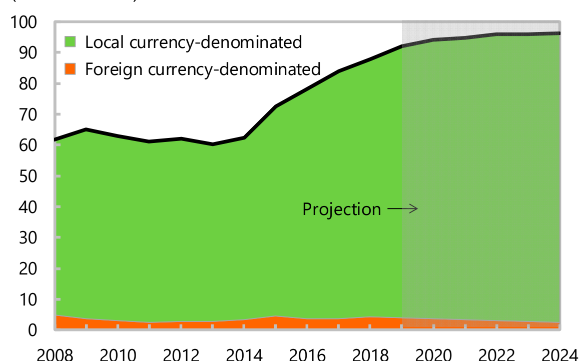
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Up to 2024, the primary balance is a non-interest balance, with interest income showing in the residual. From 2025 onwards interest income counts toward the required primary balance.

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

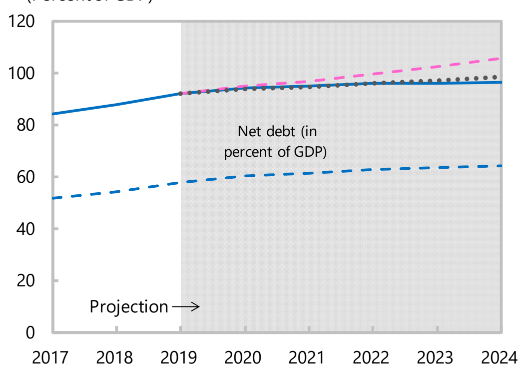
Composition of Public Debt

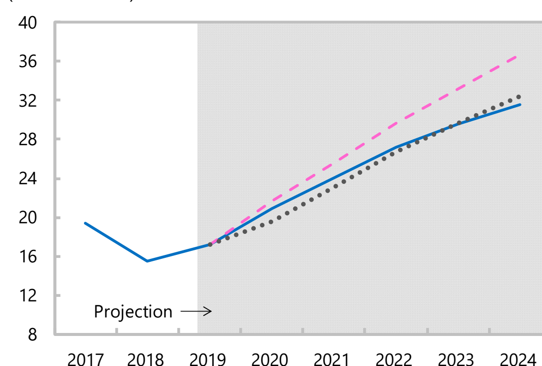




Alternative Scenarios

Baseline | Historical | Constant Primary Balance





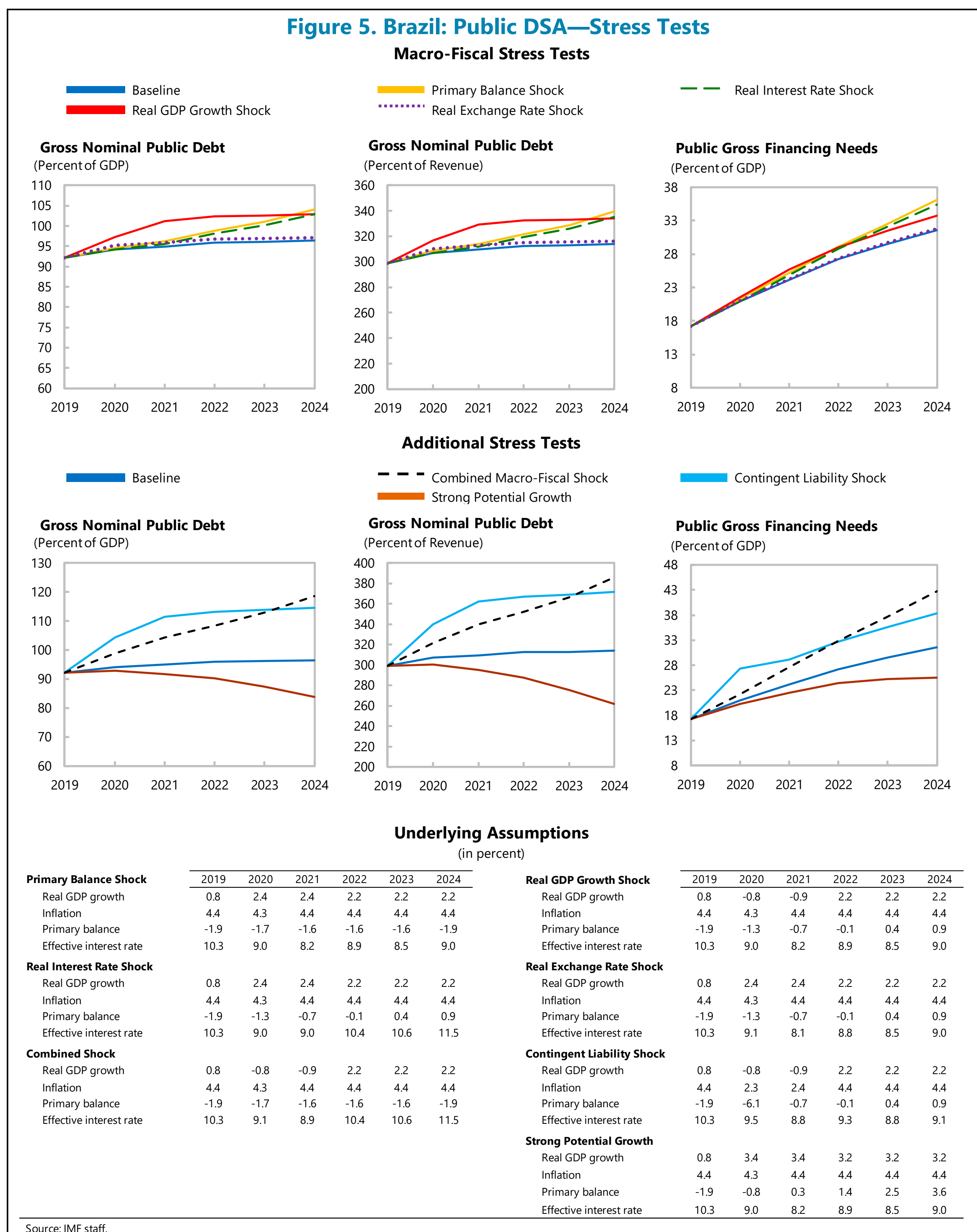
Underlying Assumptions

(Percent)

Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.8	2.4	2.4	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary Balance	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Effective interest rate	10.3	9.0	8.2	8.9	8.5	9.0
Constant Primary Balance Scenario						
Real GDP growth	0.8	2.4	2.4	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary Balance	-1.9	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	10.3	9.0	8.2	8.9	8.5	9.0

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.8	1.2	1.2	1.2	1.2	1.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary Balance	-1.9	0.3	0.3	0.3	0.3	0.3
Effective interest rate	10.3	9.0	8.1	8.8	8.3	8.9

Source: IMF staff.



Underlying Assumptions
(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	0.8	2.4	2.4	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-1.7	-1.6	-1.6	-1.6	-1.9
Effective interest rate	10.3	9.0	8.2	8.9	8.5	9.0
Real Interest Rate Shock						
Real GDP growth	0.8	2.4	2.4	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Effective interest rate	10.3	9.0	9.0	10.4	10.6	11.5
Combined Shock						
Real GDP growth	0.8	-0.8	-0.9	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-1.7	-1.6	-1.6	-1.6	-1.9
Effective interest rate	10.3	9.1	8.9	10.4	10.6	11.5

	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	0.8	-0.8	-0.9	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Effective interest rate	10.3	9.0	8.2	8.9	8.5	9.0
Real Exchange Rate Shock						
Real GDP growth	0.8	2.4	2.4	2.2	2.2	2.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-1.3	-0.7	-0.1	0.4	0.9
Effective interest rate	10.3	9.1	8.1	8.8	8.5	9.0
Contingent Liability Shock						
Real GDP growth	0.8	-0.8	-0.9	2.2	2.2	2.2
Inflation	4.4	2.3	2.4	4.4	4.4	4.4
Primary balance	-1.9	-6.1	-0.7	-0.1	0.4	0.9
Effective interest rate	10.3	9.5	8.8	9.3	8.8	9.1
Strong Potential Growth						
Real GDP growth	0.8	3.4	3.4	3.2	3.2	3.2
Inflation	4.4	4.3	4.4	4.4	4.4	4.4
Primary balance	-1.9	-0.8	0.3	1.4	2.5	3.6
Effective interest rate	10.3	9.0	8.2	8.9	8.5	9.0

Source: IMF staff.

Statement by Alexandre Tombini, Executive Director for Brazil
July 15, 2019

The Brazilian authorities welcome the candid dialogue with IMF staff under this year's Article IV consultation. The new administration took office in January and has worked diligently to put forward reforms that address the main bottlenecks that have been hampering economic growth in Brazil. The most urgent focus has been on the social security reform, which is the main structural adjustment required to reestablish fiscal sustainability. The reform agenda, however, is comprehensive, including expenditure prioritization, removing budget rigidities, privatizations, trade liberalization, and a series of measures to improve business climate. As in any other consolidated democracy, building broad social consensus is key to advance such a bold structural agenda. Many of the reform initiatives need congress approval, some with qualified majority in both houses, which means that legislative timing needs to be respected. The social security reform is well in the process of being approved, which will create momentum for the passing of the remaining reforms. The government is fully committed to the reform agenda and has been spending its political capital to advance it.

Reforms to restore sustainability and unleash potential growth

Brazil is on the verge of approving a major social security reform that will be instrumental to reestablishing fiscal sustainability. The social security system in Brazil is distortionary, inequitable and is the reason for the shortfall in the public sector primary balance. Revamping social security is a politically complex enterprise in any country. In Brazil this reform has been a top priority in the past several years. The new administration assigned the highest importance to the social security reform and submitted a comprehensive and ambitious constitutional amendment bill to Congress. The proposal is estimated to yield savings of above R$1 trillion over a period of ten years and stabilize social security spending relative to GDP, even as population ages. The Lower House already took the most decisive step of a first-round approval of the amendment, which retains the bulk of the savings and is now expected to be sent to the Senate for consideration shortly after the legislative recess in August.

The new social security framework will address critical equity and sustainability issues and help restore the investment capacity of the public sector. In 2018, the social security deficit amounted to 5.5 percent of GDP and, in 2019, 73 percent of the federal primary spending budget is committed to social security and social assistance, which rose from less than R$600 billion in 2014 to about R$1 trillion in 2019. Such an increase crowded out public investment, which fell from R$77 billion to R$36 billion in the same period. The savings entailed by the reform will revert this explosive trajectory. Moreover, the proposal will align the systems for civil servants and private sector workers, correcting distortions and privileges. Among the main changes entailed by the proposal, we highlight (i) the establishment of minimum retirement ages of 65 years (men) and 62 years (women); (ii) the increase in required contribution periods; (iii) the change in the calculation of benefits; (iv) the establishment of progressive contributions for both

private sector workers and civil servants; and (v) changes in the rules for survivors' pensions. Such changes will align Brazilian social security to international sustainable practices.

Additional measures are being taken to ensure fiscal sustainability. Notwithstanding the expected remarkable impact of the pension reform, correcting the fiscal imbalance will require other reforms that are already in the pipeline. The new administration remains committed to promote the fiscal adjustment based on expenditure restraint. Furthermore, the constitutional spending ceiling requires additional cuts to create room for needed investment. In addition to containing real increases in the wage bill, the administration is attempting to reduce tax expenditures, subsidies, mandatory expenditures and the scope of earmarked revenues. Any extraordinary federal revenues, including oil windfalls and privatization proceeds, will be used to reduce public debt and deficits. While advancing this agenda, the government envisions an important decentralization toward states and municipalities.

The bold reform agenda also includes trade liberalization, privatization and measures to improve the business environment. Brazil remains excessively closed to trade, with tariff and non-tariff barriers that hamper productivity growth and the competitiveness of key sectors. The fact that, after being stalled for 20 years, the Mercosur-EU trade agreement was finally unlocked is a clear signal of this administration commitment to trade liberalization. Meanwhile, the privatization program is proceeding and encompasses divestment shares owned by the development bank (BNDES), private recapitalization of Eletrobras, divestment of Petrobras subsidiaries, as well as airport, road and other infrastructure concessions. It is expected that privatization will reduce both public debt and deficit, while improving the provision of infrastructure services, and enhancing competition and productivity growth. To foster the ease of doing business in Brazil, the government issued a provisional measure to trim the bureaucracy to start a business, reduce barriers to entry, enhance legal certainty, reduce and simplify regulations, and incentivize innovation. On top of that, Brazil has announced its adhesion to the Madrid Protocol on trademarks and patents, while launching a program to reduce the backlog in patent requests and the timeframe for patent concession.

A broad reform program is being undertaken in the financial sector. Having increased in depth and inclusion in the past two decades, the financial sector in Brazil is robust and lucrative. The 2018 FSAP has also confirmed the assessment that regulation and supervision are generally sound and effective. That notwithstanding, a host of measures have been taken or are being considered to address issues in the areas of financial sector oversight, crisis management, and intermediation efficiency, among others. On the whole, the banking reform agenda aims at modernizing savings instruments, enhancing their reach and reducing the cost of credit from the supply side. In parallel, a law that regulates and reduces the financial flows between the Central Bank (BCB) and the Treasury has been approved, and a bill establishing the formal operational autonomy of the BCB has been submitted to Congress. Overall, a more inclusive and efficient financial sector, as well as an independent central bank are important underpinnings for a lower neutral interest rate and lower lending rates.

Brazil has made remarkable progress in the institutional consolidation of anti-corruption tools and practices. The quest to fight corruption and build trustworthy and fully accountable

governance institutions is a top priority for the Brazilian society. The national risk assessment (NRA) will be finalized soon, strengthening money laundering controls. The tax authorities are also improving the collection of beneficial ownership information of foreign companies that operate in Brazil, equalizing the level of information in relation to Brazilian entities. Furthermore, Brazil is a very active key partner of the OECD and has presented its application to full membership. The completion of the accession process will represent the consolidation and the international recognition of Brazil's institution building efforts.

Recovery is still lagging but will be supported by appropriate policies and reforms

Given the lack of fiscal space, growth recovery will continue to be supported by an accommodative monetary policy stance, met by confidence enhancing and cost reducing reforms. The policy interest rate is at historic lows and, with inflation expectations well-anchored around the target, ex-ante real interest rate is appropriately expansionary. The BCB agenda aiming at enhancing financial intermediation efficiency will play a critical role in diminishing the still high lending margins. Non-earmarked credit, especially to households, has resumed growth at a reasonable pace and, together with increasing total labor income, have sustained consumption growth, even as quarterly GDP posted a negative result in the first quarter this year. With output falling in the quarter, the BCB revised down its growth projection for 2019 to 0.8 percent. This outlook hinges, nonetheless, on a scenario of continuing reforms and speeding up activity throughout the year. While addressing fiscal challenges remain essential, monetary policy will continue to be calibrated according to current and prospective inflation conditions, as well as inflation expectations.

Contrasting to the encouraging reform scenario, the economic recovery has not picked up steam yet. After the 2015-16 recession, growth in 2017 and 2018 was subpar and the outlook for this year remains unsatisfying. Last year, a combination of negative shocks – namely, the truck drivers' strike, the crisis in Argentina, and the political uncertainty around the elections – contributed to the weak growth result. Even with the initial rebound in confidence at the end of the election cycle late last year, investment remained subdued and job creation is still slow. The sluggish demand and persistent uncertainty coupled with substantial spare capacity are holding up a more vigorous investment response and have affected confidence negatively. The approval of the pension reform will be a game changer, as, other than fiscal, macroeconomic fundamentals are well balanced.

Pension reform will remove an important source of uncertainty and provide a confidence boost with immediate positive effects in activity. Staff is overestimating the direct short-term impact of the reform on demand, as the increase in savings will accrue over time. Yet, the indirect confidence effect is expected to be powerful. First, it will eliminate a major fiscal risk. Second, and just as important, it will confirm the expectation that the remaining of the reform agenda will follow up steadily. Such a reversal in the risk scenario coupled with a push in infrastructure concessions and outright privatizations could revive investment, which would add to the resilient consumption to sustain a more robust recovery.

External and financial resilience

The external sector remains well adjusted and the floating exchange rate continues to play a crucial role as shock absorber. Throughout this year, the current account deficit has hovered around 0.8 percent of GDP and is expected to widen somewhat as domestic demand, especially investment, picks up in the second semester. Meanwhile, foreign direct investment has been in a rising path and the 12-month accumulated ratio of FDI to GDP is currently above 5 percent. International reserves have remained at a comfortable level (around US$380 billion), and we welcome the staff's analysis showing the crucial role played by such a robust external buffer to enhance resilience to shocks. Even considering that external vulnerabilities in Brazil are low, we agree that international reserves are critical to stand off remaining risks. Foreign exchange interventions will continue to be used only to address disruptive market conditions.

The banking sector remains robust and non-earmarked private credit is on the rise. While deleveraging of subsidized credit continues to take place, outstanding non-earmarked credit to households and business is projected to increase by 13 and 10 percent respectively. The contrast between the growth rates of non-earmarked and earmarked credit (11.6 vs. 0.4 percent) is consistent with the goal of reducing the dependence on public banks to the provision of credit. Accordingly, the change introduced in the calculation of the BNDES interest rate aligning it to market rates, made commercial banks more competitive in that segment. Furthermore, with the low interest rate environment and improved investors' appetite, capital markets have been replacing the traditional banking sources. The 12-month volume raised in the domestic capital market was nearly four times larger than the credit provided by BNDES, reverting the previous predominance of subsidized credit by the development bank. A joint initiative taken by the BCB, the securities commission (CVM) and the insurance supervisor (Susep) will enhance the capital market's ecosystem of facilities in several segments (e.g., private equity, housing, derivatives, hedge, and insurance). The ongoing reform agenda is expected to give further traction to this transformation in credit provision and support the recovery.

Final remarks

Ongoing reforms and macroeconomic policies are set to ensure sustainability, support the recovery and unleash higher potential growth. Brazil is transitioning away from an unsustainable fiscal path and towards a more open and competitive economic framework, which will remove obstacles to productivity growth. First and foremost, the pension reform is a necessary step to restore fiscal sustainability. Furthermore, it will be complemented by other measures that will open space in the budget to public investment without compromising sustainability and maintaining the spending ceiling. Apart from the fiscal imbalances – which are being addressed –, other macroeconomic aspects are sound, with inflation and inflation expectations well-anchored around the target, the exchange rate broadly in line with fundamentals and desirable policies, a balanced current account and strong reserve position, and a robust financial system.