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BRAZIL

May 2015

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with Brazil, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 16, 2015, following discussions that ended on December 15, 2014, 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 March 4, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its March 16, 2015 consideration of the staff report that concluded the Article IV consultation with Brazil.
- A **Statement by the Executive Director** for Brazil.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

BRAZIL

March 4, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

KEY ISSUES

Context. Brazil is in a tough spot. Led by weak investment and plummeting confidence, growth, after slowing markedly since mid-2013, came to a virtual halt in 2014. This largely reflects the impact of diminished competitiveness, the erosion of policy credibility, owing to a persistent deterioration of fiscal outcomes and above-target inflation, and a worsening of external conditions for the country. Ensuring strong and sustained growth is essential for consolidating impressive gains in social inclusion, and requires *inter alia* a rebalancing from consumption toward investment-led growth. The space for policies to boost demand is limited, and their focus should, in turn, be on alleviating supply-side constraints and boosting productive capacity. A new economic policy team is faced with the challenge of restoring policy credibility and bolstering confidence in economic decision-making, notably in the context of a weakening domestic and external environment.

Outlook and Risks. Economic activity is expected to contract in the near-term. Macroeconomic policies are assumed to improve gradually, in line with policy announcements, with attendant implications for credibility. Economic growth is projected to rise over the medium term, but its potential will depend critically on the pursuit of much-needed structural reforms. Risks to the outlook are significantly to the downside, and include adverse ramifications from the ongoing corruption probe concerning Petrobras, the possibility that fiscal policy goals may not be fully met, and energy and water rationing. External downside risks emanate from a tightening of global financial conditions, geo-political tensions, and contagion from adverse developments in other emerging economies. These risks could conflate if they were to combine with domestic policy shortfalls, and would threaten macro and financial stability.

Policy recommendations. Notwithstanding waning growth, slack and policy space are limited. The focus of policies should be to bolster credibility and address supply-side constraints, with a view to enhancing the economy's productive capacity. Fiscal consolidation should proceed without delay along the announced lines, while monetary policy should remain tight to bring inflation to target. At the same time, emphasis should be placed on strengthening fiscal and monetary policy frameworks and alleviating structural bottlenecks, to boost investment, productivity and competitiveness. The exchange rate should remain the main external shock absorber, with intervention limited to episodes of excessive volatility. Lending by public banks should play a complementary role, with a focus on missing markets. Targeted prudential measures to strengthen the financial system, especially a tightening of lending standards to preserve asset quality in public banks, are advisable to help deal with vulnerabilities in the financial system that may emerge in an environment marked by low growth, tighter financial conditions, and possibly rising unemployment.

Approved By
Krishna Srinivasan and Tamim Bayoumi

A team comprising A. Cuevas (head), M. Garcia-Escribano, I. Karpowicz, F. Lipinsky, T. Matheson (all WHD), H. Kang (MCM), J. Pereira (FAD), and C. Saborowski (SPR), and F. Bornhorst (Resident Representative) visited São Paulo, Rio de Janeiro and Brasilia during December 2−15 to meet with private sector participants, think-tanks, academics and senior officials from both the incoming and outgoing teams. P. Nogueira Batista and I. Oliveira Lima (all OED) participated in the meetings. A. Werner (Director, WHD) and K. Srinivasan (Deputy Director, WHD) joined the concluding meetings.

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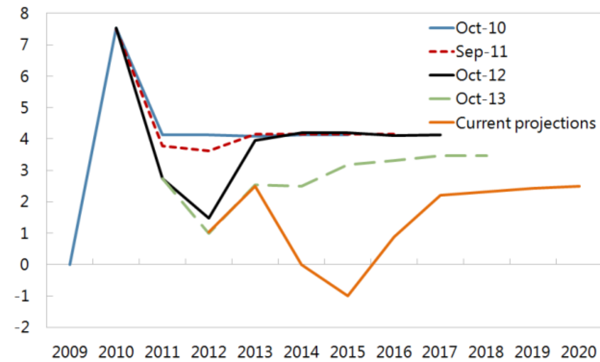
CONTEXT: DISAPPOINTING GROWTH

Brazil: Revisions in Growth Forecasts

(In annual percentage change, per vintage)



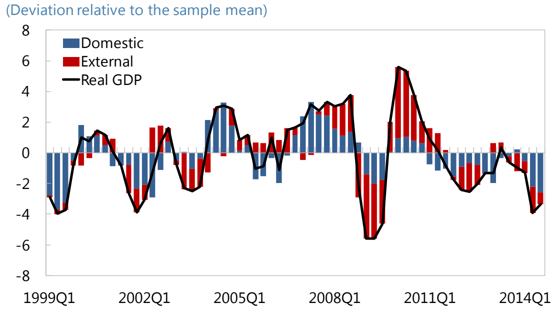
Sources: WEO and Fund staff estimates.

1. **Brazil's growth has persistently decelerated in recent years**. The impulse from decade-old reforms, expanding labor income, and favorable external conditions, which enabled a consumption and credit-led growth, has lost steam. A major expansion in the operations of the national development bank, BNDES, in the last few years has failed to boost investment, which has been sluggish since 2011 because the economy has lost competitiveness, the business environment has worsened and commodity prices have fallen from record highs. Moreover, structural sources of pressure on fiscal spending have necessitated a high tax burden. At the same time, unwarranted microeconomic interventions have contributed to reduced dynamism and increased financial stress in key sectors. For instance, in the energy sector, instead of promoting measures to increase efficiency, the government introduced a policy to subsidize electricity prices in 2012, increasing demand despite early signs of drought and driving electricity companies to borrow to cover increased generation costs in the expectation of future government compensation. Likewise, a high regulatory burden slowed implementation of the infrastructure investment program, especially in its initial phases.

2. **The economy stalled in 2014.** Activity contracted in the third quarter of 2013 and in the first two quarters of 2014. A confluence of external and, more importantly, domestic factors helps explain the recent moderation in activity.

Brazil: Historical Decomposition of Real GDP Growth

(Deviation relative to the sample mean)



Source: Staff estimates. Historical decomposition from a SVAR model with four lags that includes a set of external variables (US GDP, US CPI, US 10-year bond yield, Brazil EMBI Spread, Terms of Trade) and a set of domestic variables (CPI, policy rate, exchange rate, and GDP). All variables are specified in y-o-y percentage changes and orthogonally identified in the order listed above.

- Weak investment in recent quarters reflects tighter financial conditions, and, more importantly, policy drift and uncertainty, including in the run up to the presidential elections. Business confidence has dropped to historical lows.

- Consumption has also moderated notwithstanding strong wage increases, as job creation has halted and financial conditions have tightened, affecting household income and consumer confidence, which is now below levels seen during the global financial crisis.

- At the margin, additional headwinds in 2014 came from the ongoing drought and the World Cup—which caused a reduction in working days and provided a space for public demonstrations which impacted confidence.

3. **Poverty, inequality, and unemployment have been on a declining trend for more than a decade, thanks in part to effective social policies, but further progress will depend crucially on strong and sustained economic growth**. Over the last 12–15 years, millions of families have been lifted from poverty owing to social policy interventions and buoyant real increases in the minimum wage (Box 1). Income inequality has also declined, and access to education and health has broadened. Over that period, relatively strong growth helped unemployment fall to historically low levels, although most recent declines are largely explained by declining labor force participation rather than job creation (Box 2). Further improvements in living standards hinge on securing strong, balanced, and durable growth, to ensure continuing employment growth and sustained funding for essential social programs.

Box 1. *Bolsa Família* and *Brasil sem Miséria*: The End of Extreme Poverty in Brazil[1]

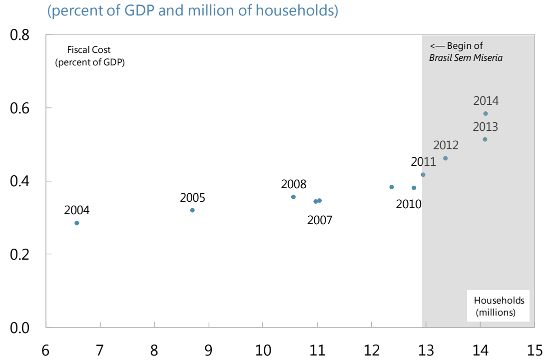
***Bolsa Família* (BF), the conditional cash transfer program created in 2003, is the flagship of Brazil's social programs.** Eligibility is determined by household income per capita. Conditionality includes mandatory enrollment and minimum school attendance for children and adolescents, vaccination and good nutrition for young children, and pre- and postnatal care for women, among others. Building on the success of BF, the government launched *Brasil sem Miséria* in 2011 to *overcome* extreme poverty. This program goes beyond income transfers and promotes educational qualification, integration in the labor market, and improved access to public services.

A wide reach at a low fiscal cost. BF has expanded from initially 3.6 to 14.0 million families (end-2014), reaching nearly 50 million people or ¼ of the population. Despite its wide reach, its fiscal cost is less than 0.6 percent of GDP per year; the average monthly transfer per family was R$169 (US$65) at end-2014.

Poverty mapping and coordination within the government were strengthened concomitantly. The government has actively worked to identify eligible households. At the same time, a unified registry of beneficiaries was created for monitoring recipient families.

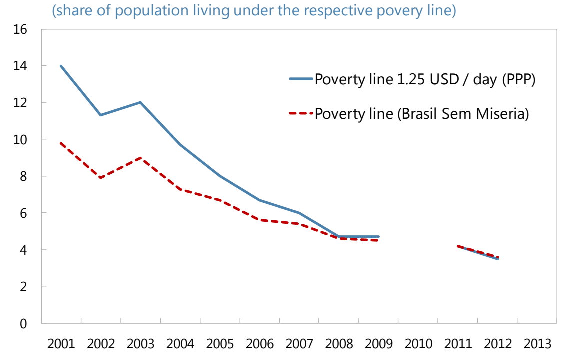
Social outcomes have improved significantly. An estimated 22 million people were lifted from extreme income poverty alone since the 2011 expansion of the program, and extreme poverty has reached historically low levels. The impact of BF on the well-being of beneficiaries goes well beyond income support. Participants have higher school attendance rates, higher school progression and lower grade repetition. Concerning health, low birth weight, infant mortality, and malnutrition and diarrhea have fallen among participants, while breastfeeding and vaccination rates have increased. In addition, by targeting women as cash recipients, BF strengthened women's financial independence.

Fiscal Cost and Reach of *Bolsa Familia*
(percent of GDP and million of households)



Sources: Ministry of Social Development, IMF Staff estimates.

Brazil: Extreme poverty
(share of population living under the respective povery line)



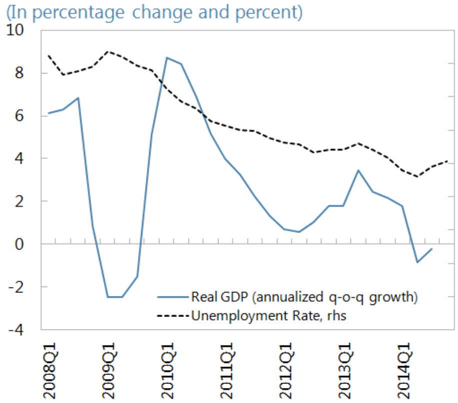
Sources: Ministry of Social Development, IMF Staff estimates.

[1] Prepared by Flavia Barbosa.

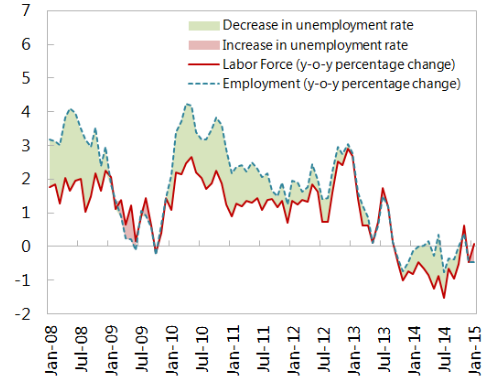
Box 2. Labor Market Dynamics[1]

Brazil has seen a substantial reduction in unemployment during the past decade; but recent declines mask a weakening of the labor market. The unemployment rate[2] reached a record low of 4.5 percent in mid-2014, down from 11.7 percent in 2002, and stands currently at 5.4 percent (January 2015). The most recent declines in unemployment, however, reflect a contraction in the labor force, which masks a halt in employment growth amidst a slowdown in economic activity.

GDP and the Unemployment Rate
(In percentage change and percent)

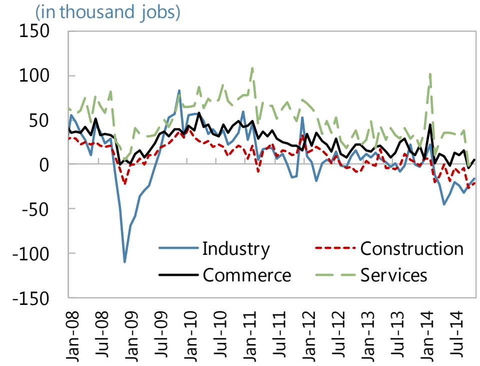


Employment and Labor Force
(Year on year percentage change)



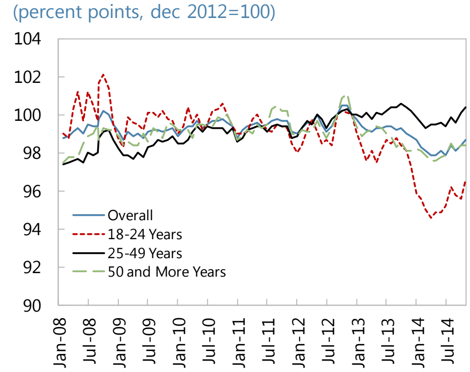
Job creation has slowed sharply. Net employment in the industry and construction sectors has contracted since early-2014. The creation of jobs in the service and the commerce sectors—though still positive—has weakened at the margin on the back of moderating consumption.

Net Job Creation by Sector
(in thousand jobs)



Labor force participation declined from late 2012, but has increased again more recently. Labor force participation rates fell across all age groups. The fall was especially strong for those aged 18–24 years, as Government scholarship financing programs (such as FIES and ProUni) have offered young people the opportunity to access higher education and therefore delay entrance in the labor market. Social programs and policies—such as Minha Casa Minha Vida, and the minimum old age pension—have boosted household's cash and non-cash income, which might have affected reservation wages. However, more recently, participation started again to increase.

Participation Rate by Age Group
(percent points, dec 2012=100)



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[1] Prepared by Fabian Lipinsky.

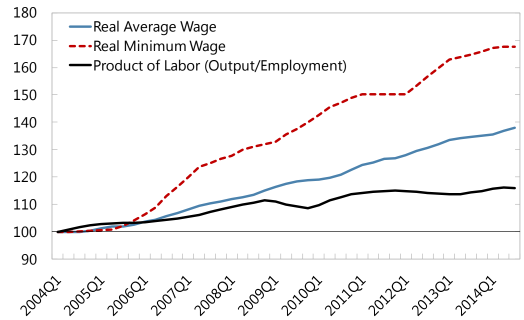
[2] The source for employment, unemployment, labor force and participation data used in the text and charts is, unless where otherwise explicitly stated, the monthly employment survey of the national statistics office (PME/IBGE). Real GDP data is reported by the quarterly national accounts, also by IBGE. All data were seasonally adjusted.

Box 2. Labor Market Dynamics (Concluded)

There is insufficient data to determine whether the most recent movement has cyclical causes, or reflects a correction of what might have been an excessive reaction of participation to the factors mentioned earlier.

Wage pressures remain strong. Real wages have continued to expand above productivity, reflecting in part strong increases in the minimum wage. While some formal sector workers receive exactly one minimum wage, others are also affected. More recently, low labor-force participation has also contributed to the pressure on wages.

Wage and Labor Productivity Growth
(index, 2004 = 100)



Sources: Fund staff estimates and Haver Analytics

Unemployment is likely to increase due to continued weak economic activity and recovering participation. The participation rate already started to increase, causing the unemployment rate to increase in 2014Q3. If the participation rate were to return to its 2008–2014 average of 56.8 percent, the unemployment rate could rise to 6.5 percent, other things constant.

4. **Inflation and inflation expectations remain above the central target.** For several years, headline and core inflation have been near the upper-edge of the 2.5 to 6.5 percent inflation tolerance band, owing in part to sustained wage cost pressures, lingering indexation practices, and, more recently, the ongoing drought. In turn, longer-term inflation expectations have risen on average. Moreover, modest increases in regulated energy and fuel prices helped hold back overall inflation. However, overdue adjustments are underway. In particular, Petrobras raised gasoline and diesel prices in November 2014, and electricity tariffs increased in January 2015, when a new system of color "flags" was introduced to signal when generation costs are especially high; tariffs are expected to increase further. In parallel, tighter financial conditions and the still negative output gap have led to a moderation in the rate of growth of market-determined prices, although new inflation pressures are emerging from the nominal depreciation of the currency.

5. **Financial markets have been volatile, contributing to reduce confidence.** Brazilian asset prices were among the hardest hit following the Fed's "taper" announcement in May 2013. Volatility rose again in the run-up to the October 2014 elections as well as amidst the Russian ruble depreciation in November. During 2014, both the Bovespa stock exchange index and the exchange rate against the U.S. dollar fell by about 7 percent and 14 percent, respectively. The resulting uncertainty has contributed to lower confidence and higher financing costs, reinforcing other headwinds for activity.

6. **Petrobras, the state-controlled oil major, faces unprecedented difficulties because of external and internal factors.** Petrobras' credit rating has been downgraded (one rating agency now classifies it as high yield) and its share price has recently reached multi-year lows. For several years, the slide reflected an expensive domestic content policy for its procurement and persistent delays in domestic product price increases, which amounted to a quasi-fiscal subsidy financed by the company. These policies reduced cashflow from operations, pushing Petrobras into a debt-

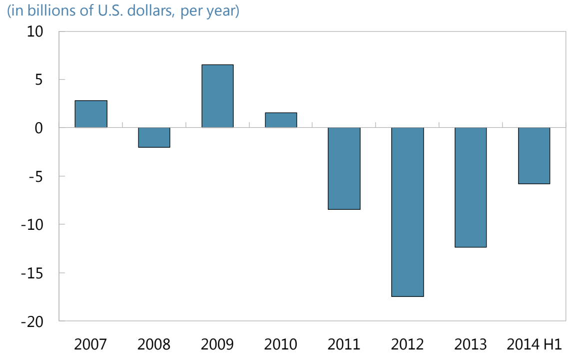
based strategy to finance its expansion plans. In the closing months of 2014, however, Petrobras' difficulties intensified under the combined pressure of diminished oil price prospects and serious governance problems that cut the company's access to external finance (Box 3). Petrobras is at present relying on its cash buffers to finance its expansion projects, and has announced a

Box 3. Petrobras[1]

Petrobras' financial situation has worsened. The recent sharp decline in international oil prices has improved the profitability of downstream operations after several years of losses, but prospects of a sustained period of lower prices and the ongoing corruption investigation are casting a shadow over Petrobras. By end-2014, Petrobras' equity price had fallen by more than 80 percent in U.S. dollar terms over 5 years and its debt levels had increased to be the highest in the industry.

Petrobras: Net Income from the Downstream Segment

(in billions of U.S. dollars, per year)

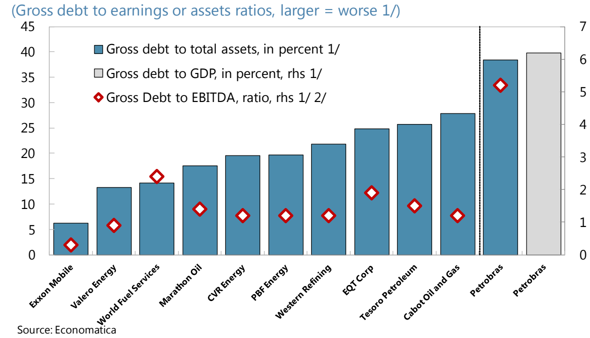


Source: Petrobras

Investment plans may need to be further revisited. According to the 2014–18 business plan, production growth is projected to rise to 3.2 million barrels a day in 2018 (from around 2 million barrels a day in 2013), contingent on capital expenditures of around US$221 billion over 2014–18. However, since formulating this plan, international oil prices have effectively halved, nearing breakeven estimates under the current tax regime. In late January, the company announced a cut in capital expenditure of 20 percent in 2015 reflecting its need to conserve cash and diminished prospects for oil prices. Further revisions to the plan may be needed.

Oil Industry: Leverage Ratios, 2014Q2/Q3

(Gross debt to earnings or assets ratios, larger = worse 1/)



Source: Economatica

1/ Gross debt includes total interest-bearing liabilities.

2/ EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization - a cashflow measure. The ratios represent how many years it would take for a company to repay its debt with all its cashflow if earnings and debt are held otherwise constant.

Access to necessary financing at a sufficiently low cost is a key risk. Financing has become more difficult across the oil industry, with Petrobras' difficulties exacerbated by idiosyncratic factors. Delays in the release of financial statements for the third quarter of 2014 closed access to international markets in early 2015. Uncertainty over asset write-downs has kept the auditor from signing off Petrobras' financial statements. Also, opportunities to secure financing from state-owned banks are limited by already-large exposures to the company. Petrobras had a large cash cushion going into 2015 but needs to regain access to funding to continue expanding beyond 2015.

Adverse spillovers from the corruption probe could be large. The probe involves several of the largest construction companies in Brazil. At present, 27 such companies have been banned from engaging in new contracts with Petrobras. As already seen in one case (OAS), these companies may face difficulties securing financing, possibly impacting their suppliers and creditors (although any impact on banks appears moderate at this point). Perhaps the most important risk is a prolonged period of insufficient access to markets by Petrobras. Such a situation could necessitate financial support from the government—directly and/or indirectly—putting the government's debt reduction objectives under stress.

[1] Prepared by Troy Matheson (WHD).

cut in its capital expenditure program for 2015 (estimated to be a 20 percent reduction), a decision that will bear upon the company's future production and export plans, and for the economy as a whole because Petrobras accounts for about 10 percent of investment in Brazil. Petrobras, which is excluded from the definition of the public sector for the purposes of the fiscal responsibility law, has become a source of fiscal risk.

7. The central bank has intervened in the foreign exchange market, with the aim of limiting volatility by meeting the demand for hedging. In response to a surge in exchange rate volatility following the Fed's taper announcement, the central bank launched a program of pre-announced intervention starting in August 2013. Rather than selling dollars from its reserves in the spot market, the central bank has been selling hedging instruments settled in local currency ("FX swaps").[1] The intervention program has been renewed three times since its inception, and is currently in effect through end-March 2015; the amount auctioned daily (excluding rollovers) has been reduced in two steps and is now one fifth of its initial size. Intervention helped tame the *real's* volatility in the second half of 2013 and early 2014. However, the second extension of the program in June 2014 occurred at a time of relatively low global volatility. The notional amount of outstanding FX swaps at end-2014 was US$110 billion, exceeding short-term external debt on a residual maturity basis.

8. Despite weakening domestic demand, the current account deficit reached 4.2 percent of GDP in 2014 from 2.4 percent of GDP in 2012.[2] The deterioration reflects worsening terms of trade, a drop in exports to Argentina, and an increase in fuel imports necessitated by the drought. The recent depreciation against the U.S. dollar, arising in part from general dollar strength, has not translated one-for-one into gains against competitors in global markets. Moreover, persistently high unit labor costs continue to dampen competitiveness.

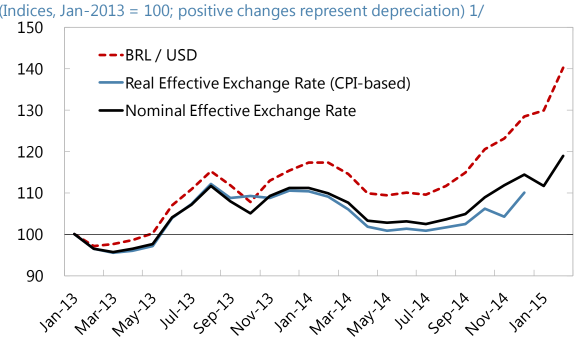
[1] See Selected Issues Paper on "Assessment of Foreign Exchange Intervention".

[2] The authorities are in the process of revising external sector statistics in line with the sixth edition of the Balance of Payments and International Investment Position manual (BPM6). This movement is consistent with the adoption of the new methodology of the System of National Accounts (SNA 2008) in Brazil, due to be published by end March 2015. Revised BOP data are expected to be published in April 2015, with revised external debt data expected in June. As part of this conversion, at least two important revisions will be made: foreign holdings of domestic debt securities will be included in external debt statistics, and its income, up to now reflected jointly with principal outflows in the portfolio account, will be recorded separately in the income account. Staff expects that these changes will lead to upward revisions of both external debt and the current account deficit.

9. As a result, the external position is weaker than desirable, with the *real* still overvalued. Staff estimates that in 2014 the current account was weaker than its level implied by fundamentals and desirable policy settings and the *real* was stronger than indicated by fundamentals by about 10–20 percent *on average during the year*. This assessment is derived using methodologies that estimate the deviation of the current account from norms based on country-specific fundamentals, and identify the correction in the real exchange rate that could close this gap (Appendix I). By December 2014, the *real* had depreciated by 6 percent in real effective terms relative to its 2014 average, implying a corresponding reduction in the degree of overvaluation.[3]

Brazil: Nominal and Real Effective Exchange Rates

(Indices, Jan-2013 = 100; positive changes represent depreciation) 1/



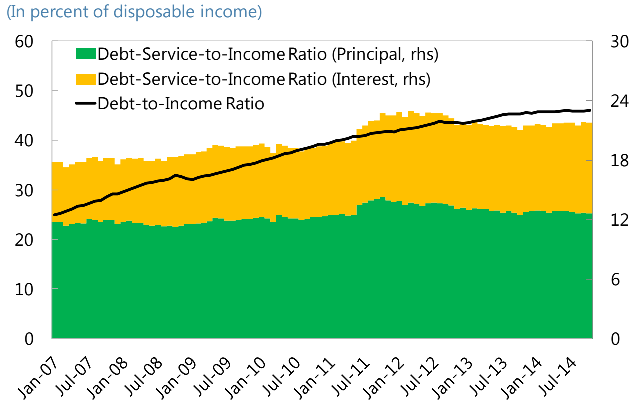
Source: Bloomberg, Haver Analytics and Fund staff estimates.
1/ Monthly averages. Data for the exchange rate and nominal effective exchange rate for February 2015 corresponds to the latest observation by mid-February.

10. International reserves are high and capital flows have remained stable. FDI financed more than 70 percent of the current account deficit in 2014, with intercompany loans accounting for about 60 percent of total FDI.[4] Portfolio inflows have been buoyant since 2013, as the central bank tightened monetary policy and rolled back CFMs on capital inflows (the IOF). At about US$362 billion, gross international reserves (cash concept) are well above the IMF's reserve adequacy metric and other standard benchmarks.

11. The banking system's soundness indicators remain favorable, but sustained low growth and the transition to a low credit growth environment could put bank balance sheets under pressure. Recently, credit growth has decelerated from high rates to 11.3 percent y/y in 2014, driven by a slowdown in credit expansion by public banks, while private bank credit continued to expand at a moderate pace. Real growth in home prices has also slowed down to about 1 percent as of November 2014.

Household Indebtedness

(In percent of disposable income)



Sources: Central Bank of Brazil and Fund staff calculation.

[3] Staff has determined that 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 multiple currency practices (MCPs) subject to Fund approval under Article VIII, Sections 2(a) and 3. Staff and the authorities are discussing the next steps on an appropriate way forward to address this issue.

[4] About 60 percent of intercompany loans reflect proceeds from overseas borrowing by foreign incorporated subsidiaries of Brazilian parent companies which, arguably, carry a risk profile more similar to portfolio debt flows (Appendix I).

- Total and Tier 1 capital ratios remain well above the regulatory minimum at 16.5 and 13.1 percent, respectively, in the third quarter of 2014 (broadly in line with fully-loaded Basel III basis). Banks are also well provisioned (170 percent of nonperforming loans), and liquidity risk for the system as a whole is low.[5] Banks continue to rely mainly on domestic funding sources, with the ratio of foreign funding to total funding at less than 10 percent.

- Household and corporate leverage have increased in recent years, to a large degree as a result of increased borrowing from banks. The rising proportion of mortgages in household borrowing has lengthened average maturities, containing the growth in debt service. Corporate bond issuance has become increasingly important, including overseas borrowing, raising FX exposure but also allowing firms to access credit at longer maturities and lower rates. Leverage–already high by international standards–has edged up without translating into higher capital outlays as firms built cash cushions instead of augmenting their capital stock. In the case of commodity exporters, the decline in commodities is also contributing to raising leveraging by reducing free cashflow and equity growth. While FX debt accounts for about 30 percent of the total, it is largely hedged.[6]

- Against this backdrop, tepid growth, possibly rising unemployment, exchange rate depreciation and tighter financial conditions ahead will likely put strains on private sector balance sheets. Indeed, there are emerging signs of balance sheet pressures. While the overall NPL ratio remains stable at about 3 percent, weak activity has already caused an uptick in NPL ratios for some segments of consumer and corporate loans, such as overdraft, credit card, working capital, and SME loans, particularly by public banks (Appendix II). These segments have, however, been the ones leading the recent deceleration in credit growth in public banks.

12. The macroeconomic policy mix from mid-2013 through 2014 lacked consistency, undermining credibility.

- The fiscal stance turned expansionary. In 2013, the nonfinancial public sector (NFPS) primary balance declined to 1.9 percent of GDP, undershooting its 2.3 percent target. Coming on top of tax breaks introduced over 2012 and 2013, slowing revenue and rapid real expenditure growth (arising in part from structural sources of fiscal pressure such as mandatory minimum spending and minimum benefit rules, and wide-ranging earmarking) brought the primary fiscal balance of the NFPS to -0.6 percent of GDP in 2014, despite one-off measures of about ½ percent of GDP. Policy lending to BNDES edged back up in 2014, including a transfer of 0.6 percent of GDP in December, further raising government borrowing. As a result, gross and net public debt increased respectively to 71 and 37 percent of GDP. In 2014, the net interest bill of the

[5] Liquidity risk is assessed based on the BCB's liquidity index, which is the same concept as the liquidity coverage ratio (LCR)—an index introduced under Basel III. It relates the volume of liquid assets available to the institution to stressed cash flow (disbursement 30 days out in the stress scenario). As of September 2014, the liquidity index is 190 percent. The LCR will be implemented in October 2015 as a regulation.

[6] See Selected Issues Paper on "Non-financial Corporate Sector Vulnerabilities."

nonfinancial public sector was 6 percent of GDP, exceeding the typical volume of spending in education, for example. Declining growth and poor fiscal performance affected Brazil's sovereign credit rating. Standard & Poor's cut Brazil's credit rating to BBB- in March 2014, its first downgrade since July 2002. In September 2014, Moody's revised Brazil's sovereign rating outlook to negative.

- Monetary policy has, however, maintained a tightening bias. In view of persistent inflation pressures, and largely in contrast with the fiscal policy stance, the monetary policy rate (SELIC) was hiked by 375 basis points to 11 percent between April 2013 and April 2014. Policy tightening paused from May through September. But between October 2014 and January 2015, the SELIC was increased by another 125 basis points to prevent second round effects from currency depreciation and the anticipated increases in regulated prices. At times, lending by public banks has been at odds with the thrust of monetary policy, diminishing the latter's effectiveness.

- Macro-prudential policies broadly responded to changes in risks along the credit cycle, but in some instances seemed to go against the grain of monetary policy. In September 2013, the central bank introduced limits on loan-to-value (LTV) ratios for mortgages to prevent potential future vulnerabilities.[7] In July and August 2014, reserve and capital requirements were selectively loosened. The first of these actions aimed at containing liquidity risk in some segments of the banking system. But the second one largely aimed at boosting certain types of consumer loans, notwithstanding the tightening bias of monetary policy and an uptick in delinquencies of unsecured personal loans.[8]

13. Over December 2014–January 2015, a new economic team was brought on board with a mandate to strengthen macroeconomic policies and restore credibility. The team announced an ambitious fiscal adjustment strategy to bring the primary surplus to 1.2 percent of GDP in 2015 and to at least 2 percent of GDP in 2016 and 2017. This strategy, together with the ending of policy lending from the treasury to public banks, aims to stabilize and then reduce gross public debt. The economic team also set the objective of reaching the 4.5 percent inflation target by end-2016. Early measures and announcements include the 125 bps increase in SELIC mentioned above; an increase in the interest rate on subsidized loans (known as "TJLP"); a series of adjustment measures on the fiscal side worth about 0.9 percent of GDP in 2015, notably a tightening of eligibility for unemployment benefits, salary bonuses, and survivor pensions, and the reintroduction of the tax on fuels (Box 4).[9]

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[7] The LTV limits are 90 percent for constant amortization mortgage loans and 80 percent for all other mortgage loans.

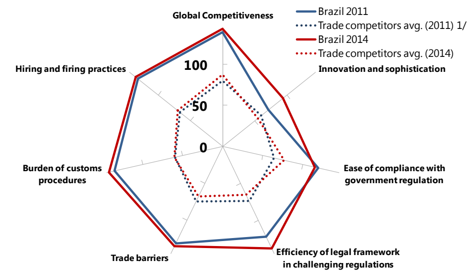
[8] The relaxation of macroprudential measures includes, *inter alia*, (i) reducing the risk weights on vehicle and personal loans; (ii) increasing the fraction of reserve requirements on time deposits that can be met by extending loans or purchasing loan portfolios from other banks; and (iii) allowing banks to use part of their reserve requirements to increase working capital loans.

[9] The estimated yield of measures excludes announcements made after February 25.

14. While efforts to alleviate supply-side constraints and boost the economy's productive capacity have continued, long-standing obstacles to business and intra- and international trade remain unaddressed.

- On the one hand, the government has focused on its program of concessions to involve the private sector in key infrastructure projects in transportation (roads and airports), energy transmission and generation, and telecommunications, increasing the program's flexibility over time to overcome difficulties attracting investor interest. Similarly, in the oil sector, a consortium of Petrobras and international companies were given the rights to explore the Libra pre-salt field, potentially one of the world's largest.

Brazil and Competitors: Competitiveness Indicators, 2011-2014
(Rank out of 144 countries; 1 = best, 144 = worst)



Sources: World Economic Forum Competitiveness Report 2010/11 and 2014/15.
1/ Trade competitors: Argentina, Australia, Canada, China, India, Kazakhstan, Mexico, Russian Federation, South Africa, and United States.

- On the other hand, structural impediments to growth remain rampant. In particular, Brazil remains a relatively closed economy compared to its peers, with limited integration into global value chains; the tax system is uncommonly complex and unit labor costs are high; despite recent initiatives, Brazil's infrastructure and competitiveness indicators have deteriorated in relation to its competitors; and while Brazil has maintained its average applied Most-Favored Nation (MFN) tariff at an elevated level of around 10 percent, several of its peers, such as China and Mexico, have cut taxes on imports and built a large network of preferential trade agreements (Box 5).

Box 4. Fiscal Policy Measures[1]

The new economic team has announced several measures to strengthen the fiscal balances; but additional measures will be needed to ensure the attainment of the primary surplus targets set for 2015 and 2016–17. On the expenditure side, the government announced (i) reduced benefits and tighter eligibility criteria for survivor pensions, unemployment and sickness benefits, and salary bonuses for private employees with low earnings, and (ii) the elimination of electricity subsidies (supported by tariff adjustments). The government estimates these measures will yield about 0.5 percent of GDP savings in 2015. In addition, it introduced tight provisional limits on certain discretionary current spending in its continuing resolution for the initial months of 2015; but this measure will be superseded by the changes to the 2015 budget. On the revenue side, taxes were raised on fuels, household credit operations, car sales, imports, and cosmetics, and a planned revision of PIT brackets was vetoed by the President (yielding 0.4 percent of GDP in total). Furthermore, the decision of halting the Treasury transfers to BNDES, tightening the rates of some subsidized loans, and raising the TJLP will lower the net interest bill. Further efforts are necessary to achieve the government's proposed targets for 2015 because the starting point, given by the 2014 fiscal outcome, is a primary deficit of 0.6 even after some extraordinary revenue is taken into account, and because revenues in 2015 will tend to weaken as a result of the contraction in activity.[2] Possible additional measures are indicated in the Table below.

Box 4. Fiscal Policy Measures (Concluded)

Possible Additional Fiscal Consoditated Measures, Estimated Savings in 2015-19
(Percent of GDP, annualized)

	2015	2016	2017	2018	2019
Revenue measures: Reverse post crisis tax cuts 1/					
Reverse cuts in consumption taxes (excluding fuel taxes) 2/	0.3	0.3	0.3	0.3	0.3
Reverse payroll tax cuts	0.4	0.4	0.4	0.4	0.4
Reverse all other tax exemptions (excluding fuel taxes) 3/	0.9	0.9	0.9	0.9	0.9
Expenditure measures					
Revise formula for minimum benefits to inflation indexation 4/	0.0	0.4	0.9	1.4	1.8
Rationalization of non-mandatory spending to revert to 2011 ratio to GDP by 2019 5/	0.3	0.6	0.8	1.1	1.4

Source: Staff estimates based on data from Federal Tax Admnistration and National Treasury.
1/ Refers to measures implemented since 2010. Estimates are based on the 2014 cost of such measures.
2/ Includes federal tax exemptions over basic consumption basket, and IPI reductions (except on cars, which is already in place since January 2015).
3/ Excludes also the impact of exclusion of the ICMS from the PIS/Cofins tax base on imports, since compensatory measures were already announced.
4/ Implementation in January 2016.
5/ Achieved through removal of budget rigidities and lower revenue earmarking. Expenditure cuts assumed to be phased in gradually, starting in 2015.

In general, fiscal adjustment should fall preferentially on current spending; on the revenue side, the rolling-back of temporary tax breaks would be useful. Curtailing expenditures will bring a lower drag on economic activity than increasing taxes would (see Selected Issues Paper). Given the size of the needed adjustment, however, revenue effort will also be required. The tax exemptions introduced in 2012–13 represent a sacrifice of revenues of 2 percent of GDP; however, they have been largely unsuccessful, and have in fact created new distortions in the treatment of different industries.

A further consideration is to favor adjustment strategies that address sources of long-term fiscal pressure. Spending related to ageing population groups is expected to rise by 3 percent of GDP in the coming 15 years. Structural budgetary reforms that reduce the complex structure of revenue earmarking and mandatory growth requirements for major spending lines, such as health or education, would have long term benefits in terms of increased policy flexibility. About 90 percent of the budget is predetermined at the general government level.[3] The value of the minimum pension is indexed to the minimum wage, which grows roughly at the same rate as the tax base; such indexation makes therefore no allowance for the trend increase in the number of beneficiaries, making this system a permanent source of fiscal pressure.

[1] Prepared by Joana Pereira (FAD).
[2] The estimated yield of measures excludes announcements made after February 25.
[3] Details discussed in the Selected Issues Paper for the 2005 and 2011 Article IV Reports.

OUTLOOK AND RISKS

15. The pace of economic activity will remain subdued in the near term. Staff projects real GDP to contract by 1.0 percent in 2015 and to grow again by 0.9 percent in 2016.

- This projection assumes that policy implementation is in line with recent pronouncements, the infrastructure concessions program functions broadly as programmed, and pre-committed Petrobras' investment projects in the oil sector—as they stand after the cuts announced in late January—proceed largely as planned. The cuts in investment by Petrobras enter the projection with a relatively large multiplier to incorporate collateral effects on Petrobras' contractors and suppliers. Following a prolonged period of low rainfall and diminished reservoir levels in key regions, the specter of water and electricity rationing is already affecting business and consumer confidence.

- Staff estimates that the planned fiscal consolidation in 2015 would be a modest drag on growth, although the adverse impact should be increasingly mitigated by the favorable effect that the adoption of concrete measures and successful adjustment will have on credibility and confidence. Judicious deployment of the large transfer of loanable resources to BNDES in December 2014 should provide some support in 2015; fiscal drag in 2016 is expected to be lower, as some of the additional consolidation should come the from full-year effect of measures adopted in 2015, and thus already internalized in economic agents' decision making.

- Consistent with the policy announcements, staff assumes that policy lending will stop. Staff also expects some moderate additional tightening in the SELIC and the TJLP in 2015, with the monetary policy stance remaining tight until inflation approaches the 4.5 percent target (although, with the hump in regulated-price inflation behind, policy could ease at the margin in 2016).

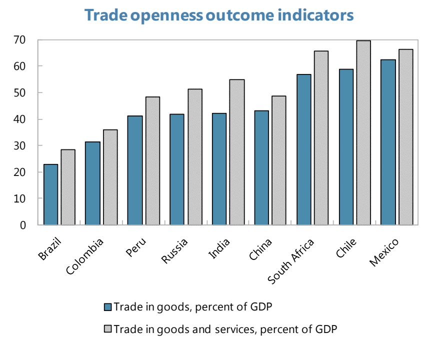
- Investment is projected to contract for a second year running in 2015, reaching its lowest point since 2009, primarily as a result of the change in Petrobras's expansion plans. Investment growth is projected to recover gradually, especially in the latter part of 2015 as policy uncertainty abates and markets gain confidence in the government's reform agenda. The recovery in investment in 2016 also assumes that Petrobras will secure reaccess to financing from capital markets.

- Private consumption growth is projected to stay flat in 2015, reflecting tight financial conditions and some rise in unemployment, while government consumption is assumed to contract as part of fiscal consolidation. Private consumption is projected to regain some strength in 2016, including as a result of investment-related employment and improved confidence. Net exports should make a modest contribution to growth reflecting in part the weaker *real*, despite a challenging external environment.

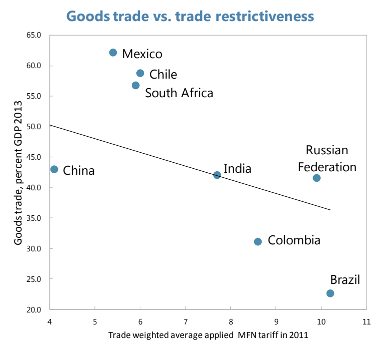
16. Growth should gradually rise over the medium term, but its long term potential will depend on addressing structural constraints. Under a scenario of macroeconomic policy strengthening and implementation of the infrastructure concessions program, but otherwise limited structural reforms, potential growth is projected to reach 2.5 percent by 2020. Despite some expected further weakening in commodity prices, the current account is projected to improve modestly on higher oil production and the more depreciated level of the *real*, although offshore oil exploration plans are assumed to be scaled down at the margin given the diminished prospects for world oil prices.

Box 5. Trade Restrictiveness[1]

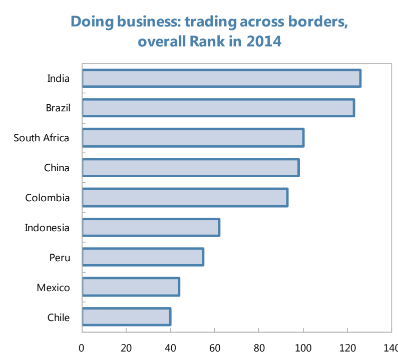
Brazil stands out among its peers for its low degree of integration to global trade. With just above 20 percent of GDP in 2013, Brazil's goods trade is about half the size of that in Peru, Russia, India and China and about a third of the size of trade in Chile and Mexico. Brazil shows the smallest volume of trade in goods and services relative to GDP among the LA5 and BRICS. Brazilian companies are less integrated into global value chains than those in most emerging market peers.[2]



Brazil's relatively restrictive system of trade taxes partly explains the low trade integration. As a founding member of MERCOSUR, Brazil shares a common external tariff with other members, subject to exceptions. Its applied MFN customs tariff is entirely *ad valorem*, with rates ranging from zero to 55 percent. Goods imports face a weighted average applied MFN tariff of around 10 percent according to the WTO, the highest among LA5 and BRICS peers. Moreover, Brazil's network of preferential trade agreements covers a relatively small share of world trade compared to its peers.[3] Besides customs tariffs, imports are subject to a complex system of internal taxes.[4]



Trading across borders is also hindered by significant *behind-the-border* constraints. The World Bank's Doing Business indicators rank Brazil 123rd out of 189 countries in terms of 'trading across borders'. Brazil stands out in terms of the cost of importing and exporting as the well as the number of documents needed to export/import. The authorities recently introduced procedures, such streamlining customs, aiming at reducing bureaucratic hurdles to trade.



Reducing trade barriers and behind-the-border constraints should be a priority. Reducing the level and complexity of the system of trade taxes—including by extending the network of preferential trade agreements—should boost trade volumes and growth, especially when paired with the push towards trade facilitation. Domestic content restrictions could be eased to promote Brazil's inclusion in global value chains.

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[1] Prepared by Christian Saborowski.

[2] See WTO World Trade Report 2014.

[3] MERCOSUR has preferential trade agreements with India and Israel, and three further agreements pending entry into force. Negotiations aimed at creating a free trade agreement with the EU are ongoing.

[4] See 2013 WTO Trade Policy Review for Brazil. Import taxes are also the most restrictive among peers when measured according to the World Bank's overall trade restrictiveness index (OTRI) which takes into account non-tariff measures.

17. Inflation is expected to fall only gradually. Inflation is expected to converge toward the 4.5 percent target over the medium term as a result of tight monetary policies, although the rate of convergence will be affected by the necessary adjustments in regulated prices, high inflation expectations, and lingering indexation, including in wages.

18. Risks to the outlook are significantly tilted to the downside (Appendix III).

- A key domestic risk to activity is that investment, including in the areas of oil production and infrastructure concessions, may be further hampered by the probe into corruption at Petrobras, which involves several of the largest construction companies in the country. Insufficient access to funding by these companies can result in adverse spillovers to their creditors, although the impact on banks would likely be moderate. Prolonged insufficient access to markets by Petrobras itself is a risk to the fiscal adjustment strategy. More generally, there is a risk that the fiscal targets for 2015−16 may not be met. This could undermine market confidence, with implications for growth, debt outcomes, and potentially for Brazil's sovereign rating (Brazil is only one or two downgrades away from losing investment grade, depending on which rating agency one looks at). In turn, this could result in a sell-off of government debt by nonresidents, which could also cause stress in those financial institutions with large exposures to government securities, and affect capital flows to other emerging markets as well. Following a prolonged period of low rainfall and falling reservoir levels in key regions, water and electricity rationing has emerged as a key risk to growth in the near term. Continued low rainfall could result in tightened supply constraints, especially in the Southeast of the country, where a large fraction of GDP originates.

- External downside risks stem from the increase in financial volatility, as well as from further declines in commodity prices. An abrupt surge in global financial market volatility could increase Brazil's risk premium, exert pressure on the *real* (in addition to that coming from the U.S. dollar strengthening), and pose a challenge in financing Brazil's large current account deficit. The impact on balance sheets should be contained as corporate exposures to foreign exchange risk are largely hedged. A protracted period of slower growth in advanced and emerging economies could weaken exports. A combination of a weaker *real* and slow growth would put pressure on private sector balance sheets. Further declines in export commodity prices—such as iron ore and soy beans—resulting from a slowdown in China also remains a key vulnerability. A further decline in oil prices, while a boon in the near term, could affect adversely Petrobras' development plans of high-cost deep-sea oil, as well as prospects for growth and the current account over the medium term, when Brazil is expected to become a net oil exporter. Conversely, a sharp rise in oil prices, as would result from a geopolitical shock, would put pressure on the current account and on Petrobras' cashflow in the near term.

- Deeper downside risks to growth involve a combination of external shocks that are amplified by domestic vulnerabilities. In this environment there is a high probability of a sovereign credit downgrade. Such a scenario would see a larger rise in unemployment, with a likely worsening of social indicators, a sell-off of government debt, and negative repercussions for the financial sector, with adverse spillovers for other countries in the region.

19. Policies implemented in 2014 were partially in line with previous Fund advice. At the conclusion of the 2013 Article IV Consultation with Brazil, IMF Executive Directors welcomed the initiation of the monetary tightening cycle and recommended that monetary policy remained geared at containing inflationary pressures and anchoring inflation expectations. In addition, Directors highlighted the importance of adhering to a primary surplus target that placed public debt on a downward path, while also recommending a gradual reduction of policy lending. The continuation of monetary policy tightening since April 2013, with the goal of containing inflation pressures, took the policy rate to 11.75 percent by December, up from 7.25 percent before the start of the tightening cycle. However, in the fiscal policy area, performance deteriorated, with the primary balance slipping into deficit and policy lending edging back up, resulting in an increase in public debt in 2014.

POLICY DISCUSSIONS

Brazil is in a very tough spot, and policymakers face difficult policy choices that will test the grit and determination of the new government. Economic activity continues to contract with significant downside risks, even as inflation remains above target. There appears to be a limited role for demand support, both because there are emerging supply constraints and there is little policy space, underscoring the need to boost the economy's productivity capacity through supply-side reforms. But this will take time. A key imperative in the near term is to bolster policy credibility, notably through front-loaded fiscal adjustment and monetary tightening, since this is important to boost confidence and, in turn, private demand that would anchor strong and sustainable growth over the medium-term. Adjustment will not be easy; however, any compromise on policy effort could jeopardize medium-term prospects without yielding any significant benefit in the short-term.

Staff Views

Fiscal policy

20. An ambitious and front-loaded fiscal adjustment effort, embedded in a realistic medium-term fiscal plan, is imperative for reducing public debt and bolstering policy credibility. Fiscal policy decisions confront two conflicting objectives: supporting demand and boosting policy credibility. On the one hand, in the context of weakening activity, fiscal policy could be used to bolster demand. On the other hand, however, policy drift and the loss of credibility in policy frameworks in recent years, reflected in plummeting consumer and business confidence, would put a premium on ambitious and front-loaded fiscal adjustment that would anchor strong and sustainable growth over the medium-term, notwithstanding the growth dampening effect such adjustment would have in the near-term. Since current growth woes in Brazil largely reflect supply-side constraints, as evident from limited slack, inflation being at the top end of the band, and the growing need to conserve water and energy, staff is of the view that fiscal policy actions should be geared toward restoring policy credibility.

- Given the weak underlying fiscal position in 2014, rising public debt and deterioration of fiscal policy credibility over the last years, the announced fiscal target for 2015 of a primary surplus of 1.2 percent of GDP for the NFPS is appropriate. However, while the measures announced so far are welcome, additional effort (estimated at 1.2−1.4 percent of GDP, including to offset cyclical effects on revenue from the contraction in 2015) will be needed to meet the target. Additional expenditure containment is expected to be included in the revised 2015 budget (Box 4).

- Going beyond 2015, the new government's target of 2.0 percent of GDP for the primary surplus would begin to reduce public debt in the central macroeconomic scenario; but increasing that target by ½ percent of GDP would help put public debt on a more firmly downward path by reducing the interest bill faster and increasing resilience to shocks and potential fiscal risks.

- From the perspective of the overall fiscal adjustment strategy, tilting the adjustment towards expenditure consolidation may help limit the drag on economic activity, but preserving and even increasing capital spending would be important (Selected Issues Paper). That said, given the size of the required adjustment, revenue measures are also necessary in the short run. To this end, beyond the measures already announced, consideration should be given to a fuller rollback of tax exemptions, as enlarging the tax base this way supports revenues, reduces distortions, and promotes horizontal equity. Going forward, addressing budget rigidities and ageing-related spending pressures is crucial to reduce debt and build fiscal space (Box 4). To the extent that structural fiscal measures that address key sources of long term fiscal pressure can be adopted early (such as the link between benefits and minimum wages), a more gradual adjustment path could be compatible with strengthening sustainability and credibility; but absent such reforms, adherence to the announced primary surplus objectives would remain key.

- Furthermore, anchoring fiscal policies and targets in a medium-term framework would improve fiscal predictability. Staff sees merit in such an institutional framework as well as on publishing a debt-sustainability analysis. Moreover, an independent fiscal council would provide further support to transparency and accountability.

21. The commitment to end policy lending to the development bank and more generally to correct relative prices and reduce subsidies is welcome, and should bolster fiscal credibility. The decision to stop policy lending to BNDES starting this year is bold and will alleviate pressures on the fiscal position, while reducing financial distortions. The discontinuation of general subsidies to electricity, underpinned by tariff increases, is a positive step both for fiscal and economic efficiency reasons. The current context of low international oil prices provides a window of opportunity for recouping the downstream losses incurred by Petrobras in past years, and later for introducing formula-based mechanisms to adjust domestic prices regularly in line with the evolution of import parity benchmarks and reasonable domestic margins. More generally, adopting market-related pricing formulas for administered prices would help preserve the integrity of the balance sheets of large state-owned enterprises and reduce future fiscal risks.

22. Improving transparency of the fiscal accounts and reviewing the strength of governance frameworks in state-owned enterprises (SOEs) is critical. Full disclosure of the underlying fiscal position would boost confidence and help communicate the need for adjustment. The irregularities uncovered in Petrobras point to the need to review and strengthen internal and external oversight mechanisms in Petrobras and possibly in other SOEs, a task of the highest priority.

The recent appointment of a director for governance in Petrobras is a positive initial step. Strong governance and close oversight of parastatals is also key for containing fiscal risks.

Monetary and financial sector policies

23. Bringing inflation to target by 2016 will likely require some further tightening of monetary policy in 2015. While moderate economic activity and planned fiscal consolidation, together with recent increases in the SELIC, should help reduce inflation, the required re-alignment of regulated prices and recent currency depreciation will necessitate monetary policy maintaining a tightening bias to mitigate the second-round effects on other prices and wages.

24. The renewed emphasis in communication on the 4.5 percent inflation target and the readiness to use the policy instruments to prevent second round effects from the ongoing correction of relative prices will bolster the credibility of the monetary framework.

- Beyond the immediate, strengthening the inflation targeting framework would improve the effectiveness of monetary policy. In particular, the accountability and autonomy of the central bank could be enhanced by narrowing the tolerance band around the 4.5 percent target and giving a specific term of office to the central bank's top management, as recommended by the 2002 and 2012 FSAPs (Appendix IV).

- The widespread use of subsidized lending weakens monetary policy transmission and distorts credit markets. Introducing a direct link between the policy rate (SELIC) and the subsidized lending rate (TJLP) would increase the effectiveness of monetary policy. Reducing the gap between the SELIC and the TJLP—675 bps after the recent 50 bps TLJP hike—would also lower the recurrent fiscal cost arising from the cumulative stock of policy lending by government.

25. The exchange rate should remain the main shock absorber in the face of external shocks, with intervention in foreign exchange market being limited to dealing with excessive volatility. The pre-announced intervention program has helped reduce volatility and pre-empted pressures in the spot market at critical times by providing hedging options for economic agents with exchange rate exposures. However, by reducing the cost of hedging, the program may have encouraged excessive risk taking by the private sector; and, while the flexible exchange rate has remained the main shock absorber, prolonged intervention may have slowed the convergence of the exchange rate needed to restore competitiveness. For these reasons, staff considers the reduction in size and duration of the intervention program announced in December 2014 as a positive development. Going forward, the central bank should refrain from extending the intervention program further and, as conditions permit, continue to use the leeway provided by the calendar of rollovers of maturing swaps to temper the stock of swaps outstanding, with the goals of preserving and increasing policy space and supporting convergence of the exchange rate to levels in line with fundamentals.

26. Banking system soundness indicators are encouraging, but private sector leverage and the rapid past expansion of public banks are potential sources of stress requiring vigilance.

- The central bank ran stress tests with scenarios constructed by staff, and the overall outcome was within the parameters of the stress tests published in the central bank's own September 2014 Financial Stability Report—that is, in a high stress scenario, some banks would become noncompliant with capital requirements, but the capital shortfall would be small, less than 0.5 percent of regulatory capital, given existing provisions.[10]

- This said, risks could arise from high private sector leverage and growing FX exposure in an environment of sustained low growth and possibly rising unemployment. The increase in delinquencies of high-risk loans by public banks could generate a demand for additional capital if loan defaults increase, but, more importantly, underscores the need for greater vigilance and close monitoring of the health of bank balance sheets in response to evolving economic conditions.

Policies to bolster the economy's productive potential

27. Broad-ranging structural reforms are critical for improving the economy's productive capacity, notably by reducing the cost of doing business and fostering investment, and to anchor strong, sustained, and balanced growth. Prioritization of these reforms and getting an early start is essential. Reforms should include:

- *Addressing infrastructure bottlenecks*. The infrastructure concessions program is critical for boosting medium-term growth, and should be implemented with greater vigor, notably by assessing factors that have impeded greater private sector participation. In particular, consideration should be given to increasing the program's scope and size, given the significance of infrastructure bottlenecks, while observing high standards of governance and program design, including regarding transfer of risks, to minimize fiscal risks and attract private sector participation. Tilting the composition of public expenditure away from current spending would also free resources for public investment, including in infrastructure.

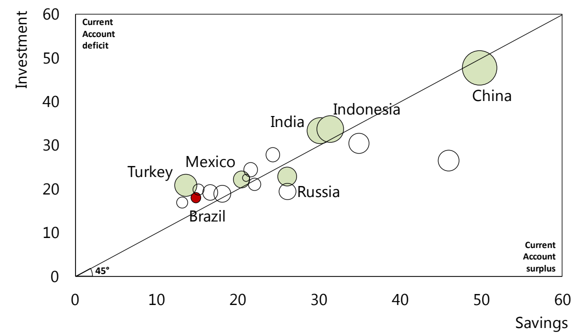
- *Tax reforms*. Brazil's tax system is extremely complex and burdensome, especially with regard to distortionary indirect taxes. In particular, a simplification of the State Tax on the Circulation of Goods and Services (ICMS) would be an important way to reduce the cost of doing business.

- *Opening the economy*. Brazil's trade to GDP ratio is one of the lowest among emerging markets. Reducing applied MFN customs tariffs; continuing trade facilitation efforts; lifting domestic content requirements; and pursuing preferential trade agreements would help increase competition and the efficiency of the economy.

[10] The stress tests indicate that in an extreme scenario designed by staff defaults peak at 5 percent, requiring a recapitalization less than 0.4 percent of regulatory capital in the system as of March 2016. The scenario, which is constructed based on cross-country banking crisis experience, assumes that GDP growth, interest rate, foreign exchange rate, inflation, and unemployment would be -3.1 percent, 14.2 percent, R$3.35/U$, 11.6 percent, and 7.2 percent, respectively, during the 18 months between September 2014 and March 2016.

- *Improving resource allocation*. The banking system's ability to allocate resources efficiently can be improved by reducing the share of earmarked credit. Focusing public banks' activities on missing markets, such as providing guarantees for concessions, would improve the allocation of limited financing. Similarly, reducing budget earmarking would release fiscal space and improve the allocation of limited fiscal resources.

G-20 Saving, Invesment, and Growth, 2011-14
(In percent of GDP) 1/



Sources: WEO and Fund staff estimates.
1/ Average since 2011. Size of bubbles reflects growth of GDP per capita.

- *Pension reform*. Reforming the pension system (beyond the announced tightening of survivor benefits) would mitigate foreseeable fiscal pressures. It could also boost savings, much-needed for funding investment. Revising the indexation of certain benefits, including pensions, to the minimum wage would also help raise public saving.

- *Revising the minimum wage indexation formula, so that it better reflects productivity gains*. The trade-off between employment and high real wage growth would likely reassert itself in a low-economic growth environment (see Selected Issues Paper). The large and sustained rise in unit labor costs has contributed to the erosion of competitiveness. The current formula for minimum wage, by affecting the growth in pension and other benefits, is also a source of fiscal pressure. A reform of the minimum wage indexation formula is critical, but will likely require extensive consultation among stakeholders. Hence, efforts should begin early and in earnest to develop a broad-based consensus in favor of reform.

Authorities' Views

28. The authorities agreed that 2015 will be a difficult transition year, but are determined to strengthen policies. They expect activity particularly in the first half of the year to be subdued, but anticipate a recovery in investment in the second half of the year on the premise that a strengthening of macroeconomic policy will help restore credibility and boost market confidence. Over the year, they see consumption remaining subdued given the drag from tighter fiscal and monetary policies. The authorities expressed in strong terms the commitment of the government to the objectives for fiscal and monetary policy that have been set for the next three years, which they see as providing the necessary foundation for the government's actions to continue improving the living standards of the population. Concerning risks of fallout from the Petrobras probe, the authorities stressed that the investigation was following its course, and that the police and judicial authorities were fulfilling their functions within the framework of the law, illustrating the strength of Brazil's institutions. They also noted that the company is sound, and that the new management that took the helm at Petrobras in February is working closely with the independent auditor to find a prompt resolution to the question of the markdown of assets, which would permit Petrobras to issue audited accounts.

29. The authorities, however, do not concur with staff forecasts, which they consider to be very pessimistic. According to the authorities, staff forecasts for 2015 overstate the impact of fiscal adjustment on public consumption, which is implicitly expected to decline by 6.9 percent, and hence on aggregate demand. They note that the worst decline of this aggregate demand component in more than two decades (1996-2013) was only -1.8 percent in 1996. In addition, contrary to staff's forecast for private consumption growth to be flat, the authorities consider that there are still factors in place that would point to a small positive growth, such as projected real wage and credit growth. The authorities also note that estimates of the output gap may not be entirely consistent with the rest of the forecast.

30. The authorities emphasized their strong commitment to delivering the announced primary surplus target of 1.2 percent of GDP in 2015 and at least 2.0 percent of GDP in 2016 and 2017, with no new policy lending by government to the development bank. They further reiterated the link between these fiscal targets and their focus on the stabilization and subsequent reduction of gross debt. They indicated that their commitment to follow through with the consolidation process without delay was demonstrated by the measures announced since the turn of the year.

31. The authorities indicated that, within the existing constraints, they would seek to minimize the impact on activity of their fiscal adjustment. They explained that the situation was not one of crisis, and so they could implement the full adjustment over two years. They further indicated that fiscal adjustment will have to rely on both expenditure cuts and revenue measures, taking care to avoid cuts in key spending items (such as high-value capital and social spending) and increases in distortionary taxes. The authorities reiterated that they do not plan to continue the Treasury funding for public banks in the form of policy lending. Other costly subsidies are also being revised, notably those to energy, where revisions are already being implemented.

32. While authorities agreed that fiscal policies should aim at ensuring long-term sustainability and be fully transparent, they did not see a strong case for introducing a medium term fiscal framework beyond that provided by the three-year Budgetary Directives Law.

33. The authorities emphasized that ensuring inflation convergence to the 4.5 percent target by the end of 2016 is the key priority for monetary policy. The central bank noted that the monetary policy stance had been adjusted over the past year-and-a-half in line with the evolving inflation outlook, most recently to support a process of relative price adjustment that will contribute to reduce vulnerabilities, while preventing relative price adjustments from affecting general inflation. Moreover, they stressed that, although the headline inflation rate had remained broadly stable during 2014, this masked a gradual improvement in its composition, with a progressively decelerating rate of inflation in freely determined prices offsetting a rise in the inflation of monitored prices. The authorities agreed that the TJLP gap relative to SELIC should narrow over time.

34. The authorities argued that their foreign exchange intervention program has aimed at, and has helped preserve, financial stability, and has had no undesirable side-effects. In particular, they stated that the program had not encouraged overseas borrowing by corporates, and stressed, instead, that the program had prevented capital outflows during episodes of high volatility. The central bank argued that, in addition, the FX swaps helped reduce the cost of carrying international reserves, and that, being settled in local currency, they did not compromise or commit international reserves. They also remarked that the exchange rate had continued, and would continue, to move in response to changing fundamentals and external shocks. Taking all of these factors into account, the authorities indicated that at present the notional value of the hedging contracts outstanding is broadly in line with the economy's hedging needs. The latest extension of the intervention program on a reduced scale and for a shorter period than previous extensions is consistent with this view. Concerning staff's assessment of Brazil's external position, the authorities saw the current account in 2014 as weaker than expected, reflecting in part the drop in key export prices; but they noted that it was still mostly FDI-financed, and that the deficit should narrow over the medium term as a result of ongoing adjustments in relative prices and increases in Brazil's oil exports.

35. The authorities acknowledged staff's concerns over the recent rapid expansion of public banks' balance sheets, but remarked that the pace had moderated significantly and that the NPL ratios in these institutions had remained low. The authorities stressed, furthermore, that the asset quality deterioration was mainly concentrated in non-core segments of these banks' loans, and that the banks were well provisioned for possible loan losses.

36. The authorities reiterated their commitment to advance the implementation of financial reforms. The authorities started to phase-in the implementation of Basel III capital requirement from October 2013.[11] Brazilian banks have progressed well towards the fully-fledged implementation of Basel III, which according to authorities' estimates would require additional capital for only a few banks and be equivalent to 0.3 percent of regulatory capital in the system until 2019. The authorities noted that further progress has been made since the 2013 Article IV consultation in implementing key recommendations from the 2012 FSAP Update, including the introduction of a new framework for Emergency Liquidity Assistance (ELA), and the approval of the updated bylaws of the deposit insurance fund (FGC).

37. The authorities agreed that addressing the infrastructure gaps is essential to boost potential growth and that further domestic private sector participation is needed, given limited fiscal space. They pointed to the recent success of their infrastructure concession program in attracting investors when auctioning the concessions of ports, roads and airports. They added that public banks are expected to continue to play a role in the financing of infrastructure, and that new options to mobilize private financing from capital markets were also under consideration.

[11] Brazilian banks will be required to build 0.625 percent of regulatory capital as conservation buffers from 2016 and the required buffers will increase to 2.5 percent. The possibility of activation of countercyclical capital buffers, equivalent to the size of conservation buffers, will be available from 2016.

38. The authorities agreed that structural reforms would help boost Brazil's potential growth, but remarked that in some cases improvements in fiscal transfer programs (such as better targeting and reduction in abuses) provided incentives for higher labor productivity equivalent to reforms.

- The authorities see great potential benefits from a simplification of the ICMS. However, they indicated that this reform would need time as it involves complex negotiations with state governments and the Senate. The simplification of the PIS/COFINS is also receiving consideration, as is the expansion of SIMPLES, the tax regime that applies to most small enterprises, so it includes some medium-sized enterprises as well.
- The authorities agreed that promoting a more open economy would be beneficial, and highlighted recently introduced procedures for trade facilitation, including in customs, aimed at reducing bureaucratic hurdles to trade.
- The authorities argued that modifying the minimum wage indexation formula was not a pressing need, as the current formula would imply modest increases in the real value of the minimum wage in the next few years, and it had proved a factor of stability in the last two years.

STAFF APPRAISAL

39. The Brazilian economy faces serious challenges in the context of stalling growth and high inflation. The new government must strengthen macro-financial policies and institutions to restore credibility, and use its political capital to embark on much-needed structural reforms that would improve competitiveness and put the economy on a strong and sustainable medium-term growth path.

40. The announced fiscal targets for 2015–17 are welcome, but implementation will be crucial for bolstering market sentiment. An ambitious and front-loaded fiscal consolidation is required for reducing public debt and restoring policy credibility. For these reasons, staff welcomes the government's primary fiscal targets for 2015–17, the authorities' decision to end policy lending, and the emphasis on reducing gross debt. The recent announcements of a series of expenditure and revenue measures have sent an important signal of the authorities' commitment to their policy strategy. Given the weak underlying fiscal position in 2014, the fiscal target of 1.2 percent of GDP for 2015 is appropriate, but further measures will be needed to meet this target. However, starting in 2016, aiming for a primary surplus above the minimum objective of 2.0 percent of GDP in 2016–17 would bolster fiscal sustainability, lower vulnerability to shocks, help reduce the interest bill faster, and strengthen policy credibility. A more gradual path for fiscal consolidation than the one announced should only be considered in the context that reforms addressing structural sources of fiscal pressure are brought forward and pursued with vigor. Moreover, anchoring fiscal targets in an effective medium-term fiscal framework would improve the predictability of fiscal policy.

41. Improving transparency of public finances is critical. Full disclosure of the underlying fiscal position would boost confidence and help communicate the need for adjustment. The weakening of Petrobras' financial position poses a risk to the public finances and to the company's investment plans. In this context, staff welcomes the ongoing investigation, and encourages the authorities to take steps to limit any economic fallout from the probe and to prevent future instances of procurement fraud and corruption.

42. Monetary policy has been appropriately tightened, but bringing inflation to target within the next two years will likely require some further tightening in the near term. While moderate economic activity and planned fiscal consolidation should help reduce inflation, the required re-alignment of relative prices, and the persistent cost-push arising from wage negotiations, will necessitate monetary policy maintaining a tightening bias to deliver a significant reduction in overall inflation by end-2016. Moreover, if currency weakness or the correction of regulated prices were to fuel inflation expectations, monetary policy would need to be further tightened.

43. Staff welcomes the recent scale down of the foreign exchange intervention program. Within the context of the flexible exchange rate regime, intervention can be useful when faced with episodes of excessive volatility, as was the case when the current intervention program was introduced. However, the continuous operation of the program could delay convergence of the exchange rate to a more competitive value. In this context, the recent reduction in the scale of the program should moderate its side effects, and consideration should be given to not renewing the program further.

44. Close monitoring and prudential measures could help deal with latent risks in private sector balance sheets, including banks and corporates. In the current low growth environment, there is a risk of deterioration in the quality of assets on banks' balance sheets, especially commercial loans to SMEs and non-housing consumer loans. Enhanced supervision and the pursuit of targeted microprudential measures would help reduce such risks. Staff welcomes the enhanced on- and off-site supervision of public banks by the central bank. Public banks should also be encouraged to bolster their capital positions, including by retained earnings. Rising corporate leverage, including through overseas borrowing, should be carefully monitored. It is important to continue assessing whether corporates are adequately hedged.

45. Structural reforms are critical for improving the economy's productive capacity and to anchor strong, sustained, and balanced growth over the medium term. Prioritizing these reforms and getting an early start would be essential. Staff welcomes the emphasis placed on the implementation of the infrastructure concessions program, and the intention to address tax inefficiencies related to the ICMS and foster a more open economy in particular. It will be essential to follow through with these efforts, and to consider other areas of reform as well.

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

Table 1. Brazil: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Area (thousands of sq. km)	8,512	Health	
Agricultural land (percent of land area)	31.2	Physician per 1000 people (2010)	1.8
		Hospital beds per 1000 people (2011)	2.3
Population		Access to safe water (2011)	97.2
Total (million) (est., 2013)	198.3		
Annual rate of growth (percent, 2013)	0.9	Education	
Density (per sq. km.) (2012)	23.3	Adult illiteracy rate (2013)	9.7
Unemployment rate (average, 2013)	5.4	Net enrollment rates, percent in:	
		Primary education (2013)	93
Population characteristics (2013)		Secondary education (2013)	54
Life expectancy at birth (years)	75		
Infant mortality (per thousand live births)	15	Poverty rate (in percent, 2013)	15.1
Income distribution (2013)		GDP (2013)	R$4,845 billion
By highest 10 percent of households	41.6		US$2,246 billion
By lowest 20 percent of households	3.2		
Gini coefficient (2013)	49.5	GDP per capita (est., 2013)	US$11,326

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

II. Economic Indicators

				Est.	Proj.					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
				(Annual percentage change)						
National accounts and prices										
GDP at current prices	9.9	6.0	10.3	4.6	6.6	7.6	7.8	7.6	7.7	7.7
GDP at constant prices	2.7	1.0	2.5	0.0	-1.0	0.9	2.2	2.3	2.4	2.5
Consumption	3.6	3.2	2.4	1.9	-1.7	-0.2	1.4	1.5	2.0	2.1
Investment	3.1	-8.8	7.8	-10.1	-0.6	5.6	4.3	3.9	4.0	4.0
Consumer prices (IPCA, end of period)	6.5	5.8	5.9	6.4	7.0	5.4	4.8	4.6	4.6	4.5
					(In percent of GDP)					
Gross domestic investment	19.7	17.5	18.1	16.4	16.5	17.2	17.5	17.8	18.0	18.3
Private sector	17.4	15.0	15.6	13.7	14.2	14.9	15.2	15.4	15.6	15.8
Public sector	2.3	2.5	2.5	2.7	2.2	2.3	2.3	2.4	2.4	2.5
Gross national savings	17.6	15.1	14.5	12.2	12.9	13.6	14.0	14.4	14.6	14.8
Private sector	17.9	15.3	15.1	16.1	15.5	15.4	15.3	15.1	15.1	15.3
Public sector	-0.2	-0.2	-0.6	-4.0	-2.6	-1.8	-1.3	-0.7	-0.5	-0.5
Public sector finances										
Central government primary balance 1/	2.2	1.7	1.6	-0.4	1.0	1.5	1.7	2.0	2.0	2.0
NFPS primary balance	3.1	2.1	1.9	-0.6	1.2	2.0	2.2	2.5	2.5	2.5
NFPS overall balance	-2.6	-2.8	-3.3	-6.8	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
NFPS overall balance (including net policy lending)	-3.6	-4.2	-3.9	-7.9	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
Net public sector debt	36.4	35.3	33.6	37.2	39.3	38.9	38.2	38.1	38.2	37.6
General Government gross debt, authorities' definition	54.2	58.8	56.7	64.2	...	...	...	...	...	...
NFPS gross debt	64.7	68.2	66.2	71.0	72.0	71.4	70.2	69.8	69.7	68.8
Of which: Foreign currency linked	2.7	3.1	3.2	3.9	3.8	3.7	3.7	3.7	3.7	3.7
				(Annual percentage change)						
Money and credit										
Base money 2/	10.8	-13.6	13.1	-4.5	6.6	7.6	7.8	7.6	7.7	7.7
Broad money 3/	18.5	15.9	8.9	15.5	14.8	14.5	14.2	14.1	14.0	14.0
Bank loans to the private sector	20.2	15.8	15.3	11.5	11.6	11.9	12.4	12.8	13.1	13.5
				(In billions of U.S. dollars, unless otherwise specified)						
Balance of payments										
Trade balance	29.8	19.4	2.4	-3.9	9.8	11.1	15.7	22.8	23.7	25.0
Exports	256.0	242.6	242.0	225.1	212.3	221.1	235.1	252.0	262.9	274.5
Imports	-226.2	-223.2	-239.6	-229.0	-202.4	-210.0	-219.4	-229.2	-239.1	-249.6
Current account	-52.5	-54.2	-81.1	-90.9	-73.5	-76.7	-79.2	-79.7	-85.9	-90.1
Capital account and financial account	112.4	70.0	74.2	99.6	73.5	76.7	79.2	79.7	85.9	90.1
Foreign direct investment (net)	67.7	68.1	67.5	66.0	53.9	54.0	52.6	53.8	55.3	56.8
Overall balance	58.6	18.9	-5.9	10.8	0.0	0.0	0.0	0.0	0.0	0.0
Terms of trade (percentage change)	7.8	-5.8	-2.1	-3.7	2.5	-1.2	-1.1	-0.8	-0.6	-0.6
Merchandise exports (in US$, annual percentage change)	26.8	-5.3	-0.2	-7.0	-5.7	4.2	6.3	7.2	4.3	4.4
Merchandise imports (in US$, annual percentage change)	24.5	-1.4	7.4	-4.4	-11.6	3.7	4.5	4.5	4.3	4.4
Total external debt (in percent of GDP)	16.3	19.6	21.4	25.7	28.8	29.5	30.0	30.5	31.0	31.5
Memorandum items:										
Current account (in percent of GDP)	-2.1	-2.4	-3.6	-4.2	-3.6	-3.6	-3.5	-3.4	-3.4	-3.4
Gross official reserves	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	362.3
REER (annual average in percent; appreciation +)	3.5	-10.0	-5.6	-1.0	...	...	...	...	...	...

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

1/ Includes the federal government, the central bank, and the social security system (INSS). Based on 2015 draft budget, recent announcements by the authorities, and staff projections. Assumes no policy change.

2/ Currency issued plus required and free reserves on demand deposits held at the central bank.

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

Table 2. Brazil: Balance of Payments

(In billions of U.S. dollars, unless otherwise indicated)

				Est.	Proj.					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Current Account	**-52.5**	**-54.2**	**-81.1**	**-90.9**	**-73.5**	**-76.7**	**-79.2**	**-79.7**	**-85.9**	**-90.1**
Trade balance	29.8	19.4	2.4	-3.9	9.8	11.1	15.7	22.8	23.7	25.0
Exports (fob)	256.0	242.6	242.0	225.1	212.3	221.1	235.1	252.0	262.9	274.5
Imports (fob)	-226.2	-223.2	-239.6	-229.0	-202.4	-210.0	-219.4	-229.2	-239.1	-249.6
Nonfactor services, net	-37.9	-41.0	-47.1	-48.7	-44.2	-46.4	-49.1	-51.5	-53.8	-56.1
Income, net	-47.3	-35.4	-39.8	-40.3	-41.4	-43.7	-47.9	-53.1	-58.0	-61.2
Of which: Interest	-9.7	-11.8	-14.2	-14.1	-15.9	-16.9	-19.8	-24.0	-27.7	-29.8
Profits and dividends	-38.2	-24.1	-26.0	-26.5	-25.9	-27.2	-28.4	-29.6	-30.7	-31.9
Current transfers, net	3.0	2.8	3.4	1.9	2.3	2.2	2.1	2.2	2.2	2.2
Capital and Financial Account	**112.4**	**70.0**	**74.2**	**99.6**	**73.5**	**76.7**	**79.2**	**79.7**	**85.9**	**90.1**
Capital account	1.6	-1.9	1.2	0.6	0.9	0.8	0.7	0.7	0.7	0.7
Financial account 1/	110.8	71.9	73.1	99.0	72.6	76.0	78.4	78.9	85.2	89.4
Medium- and long-term capital	137.0	88.4	93.2	118.9	86.1	82.4	81.8	85.0	88.7	92.7
Direct investment, net	67.7	68.1	67.5	66.0	53.9	54.0	52.6	53.8	55.3	56.8
Foreign	66.7	65.3	64.0	62.5	56.1	56.5	55.3	56.9	58.6	60.3
Brazilian	1.0	2.8	3.5	3.5	-2.2	-2.5	-2.7	-3.1	-3.3	-3.5
Portfolio investment, net	41.4	8.6	23.1	30.2	23.8	21.5	21.2	22.2	24.9	25.6
Other investment, net	27.8	11.7	2.6	22.7	8.4	6.9	8.0	9.0	8.5	10.3
Commercial credit	-1.2	-0.5	1.3	0.3	0.1	0.2	0.3	0.3	0.4	0.5
Loans and other	29.0	12.1	1.4	22.4	8.3	6.7	7.7	8.6	8.1	9.8
Of which: Monetary authority	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Short-term capital	-26.1	-16.5	-20.2	-20.0	-13.5	-6.4	-3.4	-6.0	-3.6	-3.3
Errors and Omissions	**-1.3**	**3.1**	**0.9**	**2.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Overall Balance	**58.6**	**18.9**	**-5.9**	**10.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum Items:										
Gross reserves (eop) 1/										
In billions of U.S. dollars	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	362.3
Net international reserves (eop)										
In billions of U.S. dollars	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	361.3
In percent of short-term debt (residual maturity)	359.9	413.7	394.8	376.6	355.4	325.7	301.4	277.2	254.6	233.8
Current account (in percent of GDP)	-2.1	-2.4	-3.6	-4.2	-3.6	-3.6	-3.5	-3.4	-3.4	-3.4
Trade balance (in percent of GDP)	1.2	0.9	0.1	-0.2	0.5	0.5	0.7	1.0	1.0	1.0
Merchandise exports (in percent of GDP)	10.3	10.8	10.8	10.4	10.4	10.3	10.4	10.6	10.6	10.5
Merchandise imports (in percent of GDP)	-9.1	-9.9	-10.7	-10.6	-9.9	-9.8	-9.7	-9.7	-9.6	-9.5
Export volume (yoy change, in percent)	2.9	-0.3	3.1	-1.7	1.8	3.5	5.9	6.9	4.3	4.4
Import volume (yoy change, in percent)	8.9	-2.3	8.6	-2.7	-2.2	1.8	3.0	3.3	3.6	3.8
Export price index (yoy change, in percent)	23.2	-4.9	-3.2	-5.4	-7.3	0.7	0.4	0.3	0.0	0.0
Import price index (yoy change, in percent)	14.3	0.9	-1.2	-1.7	-9.6	1.9	1.5	1.1	0.7	0.6
Terms of trade (yoy change, in percent)	7.8	-5.8	-2.1	-3.7	2.5	-1.2	-1.1	-0.8	-0.6	-0.6
Oil price (Brent blend; US$ per barrel)	104.0	105.0	104.1	96.2	50.9	58.8	63.7	66.6	67.8	68.5
Nominal exchange rate (R/US$, annual average)	1.67	1.95	2.16	2.35	...	...	...	...	...	...
REER (annual average in percent; appreciation +)	3.5	-10.0	-5.6	-1.0	...	...	...	...	...	...
GDP in billions of U.S. dollars	2,475	2,248	2,246	2,160	2,040	2,144	2,257	2,371	2,491	2,618

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

1/ Historical numbers include valuation changes.

Table 3. Brazil: Main Fiscal Indicators

(In percent of GDP, unless otherwise indicated)

					Est.	Proj.					
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
FEDERAL GOVERNMENT 1/											
Nonfinancial revenue 2/	**24.4**	**23.9**	**23.9**	**24.3**	**24.1**	**24.1**	**24.2**	**24.4**	**24.5**	**24.6**	**24.6**
Revenue administered by SRF	14.1	15.2	14.7	14.8	14.8	14.9	14.9	15.1	15.1	15.2	15.2
PIT	2.3	2.6	2.7	2.6	2.9	2.9	2.9	3.0	3.0	3.0	3.0
CIT	4.1	4.5	4.2	4.3	4.5	4.2	4.2	4.2	4.3	4.3	4.3
Indirect Taxes	6.7	6.9	6.8	6.8	6.5	6.8	6.9	6.9	6.9	6.9	6.9
Trade taxes	0.6	0.6	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other	0.4	0.5	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	5.6	5.9	6.3	6.3	6.7	6.6	6.6	6.6	6.7	6.7	6.7
Other revenue	4.7	2.8	2.8	3.1	2.7	2.7	2.7	2.7	2.7	2.8	2.8
Total primary expenditure	**22.7**	**21.7**	**22.4**	**22.7**	**24.5**	**23.1**	**22.7**	**22.6**	**22.5**	**22.6**	**22.6**
Current expenditures	20.0	20.4	21.1	21.4	23.0	21.9	21.4	21.3	21.1	21.1	21.1
Personnel	4.5	4.4	4.3	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Transfers	3.5	3.9	3.9	3.8	4.1	4.1	4.1	4.1	4.2	4.2	4.2
Pension benefits	6.8	6.8	7.2	7.4	7.8	7.7	7.7	7.7	7.6	7.6	7.6
Other 3/	5.3	5.3	5.7	6.1	6.7	5.7	5.2	5.1	5.0	5.0	4.9
Capital expenditures	2.6	1.3	1.4	1.3	1.5	1.2	1.3	1.3	1.4	1.5	1.5
Primary balance	**1.8**	**2.2**	**1.7**	**1.6**	**-0.4**	**1.0**	**1.5**	**1.8**	**2.0**	**2.0**	**2.0**
STATES AND MUNICIPALITIES											
Nonfinancial revenue 2/	**11.4**	**11.6**	**12.0**	**12.0**	**12.1**	**12.0**	**11.9**	**11.9**	**11.9**	**11.9**	**11.9**
Own revenues	8.5	8.6	9.0	9.1	9.0	9.0	8.9	8.9	8.8	8.8	8.8
Indirect taxes	7.0	7.1	7.3	7.4	7.3	7.2	7.2	7.1	7.1	7.1	7.0
Other	1.5	1.5	1.6	1.8	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Transfers from the federal government	2.9	3.0	3.0	2.9	3.1	3.0	3.0	3.0	3.0	3.1	3.1
Total primary expenditure	**10.9**	**10.8**	**11.5**	**11.8**	**12.3**	**11.9**	**11.5**	**11.5**	**11.5**	**11.5**	**11.5**
Current expenditures	9.6	9.8	10.4	10.6	11.2	10.8	10.5	10.5	10.5	10.5	10.5
Personnel	4.9	5.0	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Other 3/	4.7	4.8	5.1	5.2	5.8	5.4	5.1	5.1	5.1	5.1	5.1
Capital expenditures and other	1.3	1.0	1.1	1.2	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Primary balance of municipalities	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Primary balance	**0.5**	**0.8**	**0.5**	**0.3**	**-0.2**	**0.2**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
PUBLIC ENTERPRISES											
Primary balance	**0.1**	**0.1**	**-0.1**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
NONFINANCIAL PUBLIC SECTOR											
Primary balance	**2.4**	**3.1**	**2.1**	**1.9**	**-0.6**	**1.2**	**2.0**	**2.3**	**2.5**	**2.5**	**2.5**
Net interest payments of the public sector	5.2	5.7	4.9	5.1	6.1	6.3	6.3	6.1	5.7	5.6	5.6
Overall balance	-2.8	-2.6	-2.8	-3.3	-6.8	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
Policy lending 4/	2.7	1.0	1.5	0.7	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural primary balance 5/	1.4	2.7	2.1	1.6	-0.6	1.7	2.5	2.5	2.5	2.4	2.4
Structural primary including policy lending	-1.3	1.7	0.7	0.9	-1.7	1.7	2.5	2.5	2.5	2.4	2.4
Memorandum items:											
Growth Acceleration Program	0.6	0.7	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Net public sector debt 6/	39.1	36.4	35.3	33.6	37.2	39.3	38.9	38.2	38.1	38.2	37.6
General Government gross debt, authorities' definition	53.4	54.2	58.8	56.7	64.2	…	…	…	…	…	…
NFPS gross debt 7/	65.0	64.7	68.2	66.2	71.0	72.0	71.4	70.2	69.8	69.7	68.8

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

1/ Comprises the central administration; the Central Bank of Brazil; and the social security system.

2/ Excludes proceeds from privatization.

3/ Includes unallocated fiscal consolidation measures in 2015-20

4/ Policy lending to BNDES and other public financial institutions.

5/ Structural primary balance adjusts for output gap and one-off measures in 2009 and 2010 (sale of Eletrobras debt and Petrobras operation).

6/ 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).

7/ 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.

Table 4. Brazil: Depository Corporations and Monetary Aggregates

(End of period, in billions of reais)

	2008	2009	2010	2011	2012	2013	2014 /5
				I. Central Bank			
Net foreign assets	**450.9**	**407.1**	**474.6**	**653.8**	**756.9**	**834.5**	**954.9**
Net international reserves	438.3	409.4	473.2	659.7	762.5	840.7	960.8
Other foreign assets (net)	12.7	-2.3	1.5	-5.9	-5.6	-6.2	-5.9
Net domestic assets	**-245.3**	**-178.2**	**55.9**	**-66.1**	**-248.9**	**-259.9**	**-423.6**
Net claims on public sector	61.8	228.2	292.7	176.4	276.7	266.0	466.4
Net credit to other depository corporations	-271.2	-411.5	-227.4	-288.6	-474.1	-479.0	-842.4
Other items (net)	35.8	-5.2	9.4	-46.2	51.5	46.9	47.6
Base money	**205.6**	**228.9**	**530.6**	**587.7**	**508.0**	**574.6**	**531.3**
Currency issued	115.6	131.9	151.1	162.8	187.4	204.1	199.4
Liabilities to other depository corporations	90.0	97.1	379.4	424.9	320.0	369.0	329.8
Reserve deposits	32.0	34.2	55.7	51.5	45.9	45.5	42.2
Liabilities to other sectors	0.0	0.0	0.0	0.0	0.6	1.5	2.2
				II. Depository Corporations 1/			
Net foreign assets	**343.1**	**349.6**	**378.0**	**488.5**	**527.5**	**638.2**	**707.1**
Net international reserves	438.3	409.4	473.2	659.7	762.5	840.7	960.8
Other foreign assets (net)	-95.2	-59.8	-95.2	-171.2	-235.0	-202.5	-253.7
Net domestic assets	**1,578.8**	**1,885.6**	**2,210.7**	**2,579.4**	**3,028.2**	**3,234.5**	**3,703.6**
Net claims on public sector	974.7	1,147.9	1,225.7	1,210.1	1,368.6	1,346.1	1,435.7
Credit to other financial corporations	247.6	232.0	294.2	342.7	383.7	431.6	498.4
Credit to private sector	1,423.7	1,583.0	2,050.4	2,541.7	3,010.2	3,424.5	3,755.8
Of which: loans to private sector	426.2	515.9	661.0	817.0	966.8	1,126.6	1,246.9
Other items (net)	1,092.8	1,130.0	1,418.3	1,585.0	1,838.2	2,100.1	2,159.1
Capital	514.4	490.1	613.2	631.2	793.4	791.6	829.5
Other liabilities excluded from broad money	578.4	639.9	805.1	953.8	1,044.9	1,308.5	1,329.6
Broad money (M2) 2/	**1,921.9**	**2,235.2**	**2,588.7**	**3,067.9**	**3,555.7**	**3,872.7**	**4,410.7**
Currency in circulation	92.2	105.6	121.7	131.4	149.6	163.9	163.4
Demand deposits	133.9	147.8	165.2	159.8	182.3	189.8	173.0
Quasi-money liabilities	1,695.8	1,981.8	2,301.8	2,776.7	3,223.8	3,519.0	4,074.3
				(Ratio)			
Multiplier (M2/base money)	9.3	9.8	4.9	5.2	7.0	6.7	8.3
				(In percent of GDP)			
Base money	6.8	7.1	14.1	14.2	11.6	11.9	10.5
Broad money (M2)	63.4	69.0	68.7	74.0	81.0	79.9	87.0
M3 3/	62.9	68.0	67.6	73.1	80.1	78.9	84.3
M4 4/	73.9	80.3	80.6	85.7	93.4	90.9	98.8
Financial sector credit to the private sector	47.0	48.9	54.4	61.3	68.5	70.7	74.1
Of which: bank credit	37.2	39.6	41.8	45.8	50.0	52.2	54.3
Memorandum item:							
GDP (in billions of national currency)	3,032	3,239	3,770	4,143	4,392	4,845	5,069

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.

5/ As of November 2014.

Table 5. Brazil: Medium-Term Macroeconomic Framework, Balance of Payments, and External Debt

					Est.	Proj.					
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
MACROECONOMIC FRAMEWORK					In percent of GDP, unless otherwise specified						
GDP growth at constant prices (in percent)	7.5	2.7	1.0	2.5	0.0	-1.0	0.9	2.2	2.3	2.4	2.5
Consumer prices (IPCA, end of period, in percent)	5.9	6.5	5.8	5.9	6.4	7.0	5.4	4.8	4.6	4.6	4.5
Gross domestic investment	20.2	19.7	17.5	18.1	16.4	16.5	17.2	17.5	17.8	18.0	18.3
Private sector	17.9	17.4	15.0	15.6	13.7	14.2	14.9	15.2	15.4	15.6	15.8
Public sector	2.3	2.3	2.5	2.5	2.7	2.2	2.3	2.3	2.4	2.4	2.5
Gross domestic savings	18.0	17.6	15.1	14.5	12.2	12.9	13.6	14.0	14.4	14.6	14.8
Private sector	16.9	17.9	15.3	15.1	16.1	15.5	15.4	15.3	15.1	15.1	15.3
Public sector	1.2	-0.2	-0.2	-0.6	-4.0	-2.6	-1.8	-1.3	-0.7	-0.5	-0.5
External current account balance	-2.2	-2.1	-2.4	-3.6	-4.2	-3.6	-3.6	-3.5	-3.4	-3.4	-3.4
Central government primary balance	1.8	2.2	1.7	1.6	-0.4	1.0	1.5	1.7	2.0	2.0	2.0
Consolidated non-financial public sector											
Primary balance	2.4	3.1	2.1	1.9	-0.6	1.2	2.0	2.2	2.5	2.5	2.5
Overall balance	-2.8	-2.6	-2.8	-3.3	-6.8	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
Public sector net debt 1/	39.1	36.4	35.3	33.6	37.2	39.3	38.9	38.2	38.1	38.2	37.6
General Government gross debt, authorities' definition	53.4	54.2	58.8	56.7	64.2	...	...	...	...	...	...
NFPS gross debt 2/	65.0	64.7	68.2	66.2	71.0	72.0	71.4	70.2	69.8	69.7	68.8
EXTERNAL DEBT 3/ 4/					In billions of U.S. Dollars						
Total external debt	**351.9**	**404.1**	**440.6**	**481.7**	**554.7**	**587.6**	**632.0**	**676.6**	**723.2**	**771.8**	**824.7**
Medium- and long-term	294.6	364.0	408.0	449.1	500.1	546.5	586.0	624.5	664.0	704.7	748.4
Nonfinancial public sector	82.8	77.3	82.2	82.6	87.8	90.5	93.4	97.8	103.3	109.5	118.6
Public sector banks	17.3	20.3	26.3	31.3	34.5	36.5	38.4	40.2	42.0	43.7	45.5
Private sector	194.5	266.4	299.5	335.2	385.3	419.6	454.2	486.5	518.7	551.4	584.4
Short-term	57.3	40.1	32.6	32.6	54.6	41.0	46.1	52.1	59.1	67.2	76.2
Medium- and long-term external debt service	**52.1**	**56.0**	**75.3**	**76.7**	**76.8**	**80.0**	**79.7**	**86.8**	**94.3**	**102.0**	**108.1**
Amortization	36.5	38.0	57.6	57.6	58.3	59.8	58.5	62.8	65.9	69.6	73.3
Interest	15.6	18.0	17.6	19.1	18.5	20.2	21.2	24.0	28.4	32.4	34.7
					In percent of GDP						
Total external debt	**16.4**	**16.3**	**19.6**	**21.4**	**25.7**	**28.8**	**29.5**	**30.0**	**30.5**	**31.0**	**31.5**
Medium- and long-term	13.7	14.7	18.2	20.0	23.1	26.8	27.3	27.7	28.0	28.3	28.6
Nonfinancial public sector	3.9	3.1	3.7	3.7	4.1	4.4	4.4	4.3	4.4	4.4	4.5
Public sector banks	0.8	0.8	1.2	1.4	1.6	1.8	1.8	1.8	1.8	1.8	1.7
Private sector	9.1	10.8	13.3	14.9	17.8	20.6	21.2	21.6	21.9	22.1	22.3
Short-term	2.7	1.6	1.4	1.5	2.5	2.0	2.1	2.3	2.5	2.7	2.9
					In percent of gross international reserves						
Medium- and long-term external debt service	**18.0**	**15.9**	**20.2**	**21.4**	**21.1**	**22.3**	**22.2**	**24.1**	**26.2**	**28.2**	**29.8**
Amortization	12.7	10.8	15.4	16.1	16.0	16.7	16.3	17.5	18.3	19.3	20.2
Interest	5.4	5.1	4.7	5.3	5.1	5.6	5.9	6.7	7.9	9.0	9.6
Short-term debt	19.9	11.4	8.7	9.1	15.0	11.4	12.8	14.5	16.4	18.6	21.0
MEMORANDUM ITEMS:											
Gross reserves (eop) 4/											
In billions of U.S. dollars	288.6	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	362.3
In percent of short-term debt (residual maturity)	302.8	359.9	413.7	394.8	376.6	355.4	325.7	301.4	277.2	254.6	233.8
In months of prospective GNFS imports	11.5	13.9	13.7	13.5	15.3	14.5	13.8	13.2	12.7	12.2	...
Net international reserves (eop) 4/											
In billions of U.S. dollars	288.6	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	362.3
In percent of short-term debt (residual maturity)	302.8	359.9	413.7	394.8	376.6	355.4	325.7	301.4	277.2	254.6	233.8
Short-term debt in percent of total external debt	16.3	9.9	7.4	6.8	9.8	7.0	7.3	7.7	8.2	8.7	9.2
Intercompany debt (in billions of U.S. dollars)	95.1	105.9	127.7	173.1	207.1	231.2	255.6	278.6	301.8	325.3	349.2
In percent of GDP	4.4	4.3	5.7	7.7	9.6	11.3	11.9	12.3	12.7	13.1	13.3
GDP (billion US$)	2,143	2,475	2,248	2,246	2,160	2,040	2,144	2,257	2,371	2,491	2,618

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: Financial Soundness Indicators by Ownership, 2009-September 2014

(In percent)

	2009	2010	2011	2012	2013	2014 Mar	2014 Jun	2014 Sep
					Total banking system			
Capital Adequacy								
Regulatory capital to risk-weighted assets	18.7	16.9	16.3	16.4	16.1	15.4	15.5	16.5
Regulatory Tier 1 capital to risk-weighted assets	15.3	13.7	12.9	11.9	12.6	12.1	12.2	13.1
Capital to assets	11.4	10.3	10.1	10.1	9.3	9.3	9.3	9.3
Gross asset position in financial derivatives to capital	8.2	8.8	7.4	7.8	9.6	9.2	8.5	10.0
Gross liability position in financial derivatives to capital	11.6	10.6	8.0	9.3	10.9	10.3	9.3	12.0
Asset Quality								
Nonperforming loans to total gross loans	4.2	3.1	3.5	3.4	2.9	2.9	2.9	2.9
Provisions to Nonperforming loans	151.4	164.8	151.6	148.7	161.2	154.1	151.8	153.9
Earnings and Profitability								
Return on assets	1.8	1.9	1.7	1.4	1.4	1.4	1.3	1.3
Return on equity	15.8	16.8	16.1	12.9	13.0	13.4	12.7	12.9
Liquidity								
Liquidity assets to short-term liabilities	252.1	185.3	178.6	191.8	158.0	145.4	149.2	186.0
Liquidity assets to total assets	17.8	12.0	11.7	14.9	10.9	10.6	11.3	12.7
Net open position in foreign exchange to capital	0.2	1.1	0.2	-0.6	0.4	0.3	1.3	1.5
External funding to total funding	5.8	7.3	9.2	9.3	8.5	8.6	8.6	9.4
					Public banks			
Capital Adequacy								
Regulatory capital to risk-weighted assets	15.3	15.1	14.3	14.5	14.9	13.9	14.0	15.8
Regulatory Tier 1 capital to risk-weighted assets	11.0	10.7	9.8	9.4	11.3	10.5	10.6	12.1
Capital to assets	6.4	6.8	6.7	6.3	5.6	5.6	5.4	5.4
Gross asset position in financial derivatives to capital	1.5	1.1	0.8	1.0	1.7	1.5	1.2	1.9
Gross liability position in financial derivatives to capital	3.8	3.9	2.1	2.1	3.0	3.0	3.2	2.0
Asset Quality								
Nonperforming loans to total gross loans	2.7	2.0	1.9	1.8	1.9	2.0	2.1	2.1
Provisions to Nonperforming loans	185.0	209.6	214.2	203.3	181.1	164.9	161.2	162.0
Earnings and Profitability								
Return on assets	1.7	1.8	1.7	1.5	1.5	1.4	1.1	1.1
Return on equity	24.4	22.9	21.0	18.7	18.1	17.9	14.2	13.9
Liquidity								
Liquidity assets to short-term liabilities	289.1	214.4	201.1	282.1	214.1	190.7	191.3	206.5
Liquidity assets to total assets	18.6	13.4	12.9	14.2	10.5	10.0	10.1	10.6
Net open position in foreign exchange to capital	0.4	1.6	4.3	0.0	1.4	-1.6	2.7	1.5
External funding to total funding	3.0	2.6	3.2	4.4	4.3	4.3	4.3	4.6
					Private banks (domestic and foreign)			
Capital Adequacy								
Regulatory capital to risk-weighted assets	20.1	17.7	17.3	17.4	16.8	16.3	16.3	16.9
Regulatory Tier 1 capital to risk-weighted assets	17.1	15.0	14.3	13.2	13.3	12.9	13.1	13.6
Capital to assets	14.3	12.2	11.9	12.5	11.8	11.7	12.0	12.1
Gross asset position in financial derivatives to capital	9.9	11.1	9.4	9.9	12.2	11.7	10.9	12.6
Gross liability position in financial derivatives to capital	13.5	12.6	9.8	11.6	13.5	12.7	11.2	15.1
Asset Quality								
Nonperforming loans to total gross loans	5.3	3.9	4.6	4.9	3.8	3.8	3.8	3.8
Provisions to Nonperforming loans	139.9	149.0	133.4	131.6	151.7	148.5	146.5	149.2
Earnings and Profitability								
Return on assets	1.8	2.0	1.7	1.3	1.3	1.4	1.4	1.5
Return on equity	13.4	14.9	14.4	10.8	10.8	11.4	12.1	12.4
Liquidity								
Liquidity assets to short-term liabilities	234.2	170.9	166.8	162.4	135.3	126.7	132.3	176.7
Liquidity assets to total assets	17.4	11.2	11.1	15.4	11.2	11.0	12.2	14.1
Net open position in foreign exchange to capital	0.1	1.0	-1.1	-0.8	0.1	0.9	0.8	1.5
External funding to total funding	7.3	9.8	12.6	12.5	11.8	12.1	12.0	13.4

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

Table 7. Brazil: Statement of Operations of the General Government (GFSM 2001)

(Percent of GDP)

				Est.	Proj.					
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Nonfinancial Revenue	34.5	34.9	35.5	35.2	35.2	35.2	35.3	35.5	35.5	35.5
Taxes	24.2	24.2	24.3	24.2	24.2	24.2	24.3	24.3	24.3	24.3
Social contributions	5.9	6.3	6.3	6.7	6.6	6.6	6.6	6.7	6.7	6.7
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	4.3	4.5	4.9	4.3	4.4	4.4	4.4	4.5	4.5	4.5
Primary Expenditure	31.4	32.7	33.6	35.8	34.0	33.2	33.1	33.0	33.0	33.0
Expense	29.1	30.2	31.2	33.1	31.8	30.9	30.7	30.6	30.6	30.5
Compensation of employees	9.4	9.6	9.6	9.7	9.7	9.7	9.7	9.7	9.7	9.7
Use of goods and services	13.0	13.4	14.2	15.6	14.3	13.5	13.4	13.2	13.2	13.2
Consumption of fixed capital	...	...	...	...	...	...	...	...	...	...
Subsidies	...	...	...	...	...	...	...	...	...	...
Grants	...	...	...	...	...	...	...	...	...	...
Social benefits	6.8	7.2	7.4	7.8	7.7	7.7	7.7	7.6	7.6	7.6
Other expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets	2.3	2.5	2.5	2.7	2.2	2.3	2.3	2.4	2.4	2.5
Acquisitions of nonfinancial assets	...	...	...	...	...	...	...	...	...	...
Disposals of nonfinancial assets	...	...	...	...	...	...	...	...	...	...
Consumption of fixed capital	...	...	...	...	...	...	...	...	...	...
Net Interest Payments	6.2	5.5	5.8	6.6	5.4	5.7	5.7	5.5	5.5	5.5
Gross Operating Balance	-0.9	-0.9	-1.4	-4.5	-1.9	-1.4	-1.1	-0.6	-0.5	-0.5
Net Operating Balance	...	...	...	...	...	...	...	...	...	...
Net lending (+)/borrowing (–)	-3.2	-3.3	-3.9	-7.1	-4.2	-3.7	-3.4	-3.0	-3.0	-3.0
Net acquisition of financial assets	2.0	3.8	0.1	0.0	...	...	...	...	...	...
Domestic	2.0	3.8	0.1	0.0	...	...	...	...	...	...
Currency and deposits	0.6	1.9	-1.0	-1.4	...	...	...	...	...	...
Debt securities	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Loans	1.3	1.9	1.1	1.5	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts receivable	...	...	...	...	...	...	...	...	...	...
Foreign	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Debt securities	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Loans	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts receivable	...	...	...	...	...	...	...	...	...	...
Net incurrence of liabilities	5.0	6.8	3.9	7.1	...	...	...	...	...	...
Domestic	4.9	6.4	3.5	6.2	...	...	...	...	...	...
Currency and deposits	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Debt securities	4.8	6.1	3.1	6.2	...	...	...	...	...	...
Loans	0.1	0.3	0.4	0.0	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	...	...	...	...	...	...	...	...	...	...
Foreign	0.2	0.4	0.4	0.9	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Debt securities	0.4	0.1	0.3	0.0	...	...	...	...	...	...
Loans	-0.2	0.3	0.1	0.9	...	...	...	...	...	...
Equity and investment fund shares	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	...	...	...	...	...	...	...	...	...	...

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

Table 8. Brazil: General Government Stock Positions (GFSM 2001)

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	Est. 2014
Stock positions:								
Net worth	-44.4	-38.8	-42.5	-39.7	-37.1	-36.0	-34.3	...
Nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Net financial worth	-44.4	-38.8	-42.5	-39.7	-37.1	-36.0	-34.3	-37.8
Financial assets	20.0	24.2	24.0	24.7	27.0	31.5	31.3	32.5
Domestic	20.0	24.2	24.0	24.7	27.0	31.5	31.3	32.4
Currency and deposits	18.7	22.1	19.0	17.4	18.9	22.0	21.5	21.5
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	1.2	2.0	5.0	7.2	8.0	9.5	9.8	10.9
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	67.5	66.0	68.9	64.4	64.0	67.5	65.6	70.2
Domestic	61.7	59.2	62.5	57.0	56.9	59.4	56.1	58.8
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	57.3	55.0	59.0	55.9	55.8	58.0	54.5	57.4
Loans	4.3	4.1	3.5	1.2	1.1	1.4	1.6	1.4
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	5.8	6.8	6.4	7.3	7.1	8.2	9.5	11.5
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	4.5	5.1	5.3	6.2	6.2	7.0	8.1	8.9
Loans	1.3	1.8	1.1	1.1	0.9	1.2	1.4	2.5
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other economic flows:								
Change in net worth from other flows	...	...	...	...	...	...	...	...
Nonfinancial assets	...	...	...	...	...	...	...	...
Net financial worth	...	...	...	...	...	...	...	...
Financial assets	...	...	...	...	...	...	...	...
Domestic	...	...	...	...	...	...	...	...
Foreign	...	...	...	...	...	...	...	...
Liabilities	...	...	...	...	...	...	...	...
Domestic	...	...	...	...	...	...	...	...
Foreign	...	...	...	...	...	...	...	...
Memorandum item								
Government gross debt per national definition	58.0	57.4	60.9	53.4	54.2	58.8	56.7	64.2

Sources: Central Bank of Brazil; and Ministry of Finance.

Table 9. Brazil: External Vulnerability

(In billions of U.S. dollars, unless otherwise indicated)

	2009	2010	2011	2012	2013	Est. 2014
Trade						
Exports of GNFS (12-month percent change, US$)	-20.9	29.2	26.0	-4.0	-0.5	-5.3
Imports of GNFS (12-month percent change, US$)	-20.7	39.8	23.8	0.6	7.2	-2.2
Terms of trade (12-month percent change)	-2.6	16.0	7.8	-5.8	-2.1	-3.7
Current account						
Current account	-24.3	-47.3	-52.5	-54.2	-81.1	-90.9
In percent of GDP	-1.5	-2.2	-2.1	-2.4	-3.6	-4.2
Capital and financial account						
Capital and financial account	71.3	99.9	112.4	70.0	74.2	99.6
Portfolio investment (net)	50.4	62.9	35.3	8.8	25.8	28.4
Foreign direct investment (net)	36.0	36.9	67.7	68.1	67.5	66.0
Of which: intercompany loans (net)	11.6	13.2	16.8	23.3	39.2	36.6
Short-term external liabilities of commercial banks	29.4	51.1	38.1	27.4	27.8	30.7
External debt						
Total external debt 1/	277.6	351.9	404.1	440.6	481.7	554.7
In percent of gross reserves	116.4	122.0	114.8	118.1	134.3	152.6
Amortization of external MLT debt (in percent of GNFS exports)	11.7	11.5	13.9	13.7	13.5	15.3
External interest payments (in percent of GNFS exports)	9.2	6.4	6.0	5.8	5.9	5.8
Reserves						
Gross reserves	238.5	288.6	352.0	373.1	358.8	363.6
In months of prospective GNFS imports	15.3	14.5	13.8	13.2	12.7	12.2
In percent of broad money (M2)	10.7	11.1	11.5	10.5	9.3	8.1
In percent of short-term external debt	770.1	503.6	876.8	1,145.2	1,100.5	665.7
In percent of short-term external debt by residual maturity	376.6	355.4	325.7	301.4	277.2	254.6
In percent of IMF metric	158.2	155.1	184.0	186.8	190.3	190.3
Exchange rate						
Exchange rate (R$/US$, period average)	2.00	1.76	1.67	1.95	2.16	2.35
REER (annual average in percent; appreciation +)	-0.8	13.4	3.5	-10.0	-5.6	-1.0

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

Table 10. Brazil External Debt Sustainability Framework, 2012-2020

(In percent of GDP, unless otherwise indicated)

			Est.	Proj.						Debt-stabilizing non-interest current account 6/
	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	**19.6**	**21.4**	**25.7**	**28.8**	**29.5**	**30.0**	**30.5**	**31.0**	**31.5**	**-1.9**
Change in external debt	3.3	1.8	4.2	3.1	0.7	0.5	0.5	0.5	0.5	
Identified external debt-creating flows (4+8+9)	1.5	1.1	3.3	2.5	1.4	1.2	0.9	1.0	1.0	
Current account deficit, excluding interest payments	1.6	2.8	3.4	2.6	2.6	2.4	2.2	2.1	2.1	
Deficit in balance of goods and services	1.0	2.0	2.4	1.7	1.6	1.5	1.2	1.2	1.2	
Exports	12.6	12.5	12.3	12.3	12.2	12.3	12.6	12.5	12.4	
Imports	13.5	14.5	14.8	14.0	13.8	13.8	13.8	13.7	13.6	
Net non-debt creating capital inflows (negative)	-2.5	-2.5	-1.8	-1.4	-1.9	-1.7	-1.8	-1.8	-1.7	
Automatic debt dynamics 1/	2.4	0.9	1.7	1.3	0.7	0.4	0.5	0.6	0.6	
Contribution from nominal interest rate	0.8	0.9	0.9	1.0	1.0	1.1	1.2	1.3	1.3	
Contribution from real GDP growth	-0.2	-0.5	0.0	0.3	-0.2	-0.6	-0.7	-0.7	-0.7	
Contribution from price and exchange rate changes 2/	1.8	0.5	0.8	1.2	-1.2	-0.9	-0.8	-0.8	-0.8	
Residual, incl. change in gross foreign assets (2-3) 3/	1.7	0.7	1.0	-0.5	0.4	0.2	0.4	0.3	0.3	
External debt-to-exports ratio (in percent)	156.0	171.3	208.4	234.1	241.8	243.4	242.7	248.3	254.0	
Gross external financing need (in billions of US dollars) 4/	131.5	158.0	164.3	173.5	167.4	178.4	188.5	205.4	221.3	
in percent of GDP	5.8	7.0	7.6	8.5	7.8	7.9	8.0	8.2	8.5	
Scenario with key variables at their historical averages 5/				**30.5**	**28.0**	**25.4**	**23.2**	**20.9**	**18.9**	**-2.6**
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (in percent)	1.0	2.5	0.0	-1.0	0.9	2.2	2.3	2.4	2.5	
Exchange rate appreciation (US dollar value of local currency, change in percent)	-14.3	-9.4	-8.1	-11.4	-2.3	-2.4	-2.4	-2.4	-2.4	
GDP deflator (change in domestic currency)	4.9	7.6	4.7	7.7	6.6	5.5	5.2	5.1	5.0	
GDP deflator in US dollars (change in percent)	-10.1	-2.5	-3.8	-4.6	4.1	3.0	2.7	2.6	2.5	
Nominal external interest rate (in percent)	4.4	4.3	3.8	3.6	3.6	3.8	4.2	4.5	4.5	
Growth of exports (US dollar terms, in percent)	-4.0	-0.5	-5.3	-5.7	4.2	6.3	7.2	4.3	4.4	
Growth of imports (US dollar terms, in percent)	0.6	7.2	-2.2	-10.5	4.0	4.9	4.9	4.3	4.4	
Current account balance, excluding interest payments	-1.6	-2.8	-3.4	-2.6	-2.6	-2.4	-2.2	-2.1	-2.1	
Net non-debt creating capital inflows	-1.7	-0.7	-0.7	1.4	1.9	1.7	1.8	1.8	1.7	
B. Bound Tests										
B1. Nominal interest rate is at historical average plus one standard deviation				30.5	34.2	37.4	40.8	44.1	47.5	0.9
B2. Real GDP growth is at historical average minus one standard deviations				30.5	31.5	32.4	33.2	34.0	34.9	-1.6
B3. Non-interest current account is at historical average minus one standard deviations				30.5	35.1	39.1	43.3	47.4	51.4	0.5
B4. Combination of B1-B3 using 1/2 standard deviation shocks				30.5	32.0	33.4	34.7	36.1	37.5	-1.6
B5. One time 30 percent real depreciation in 2016				30.5	47.7	48.5	49.3	50.0	50.8	-3.0

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,

e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

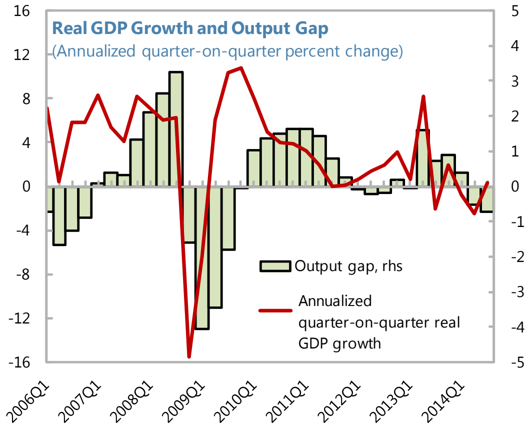
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

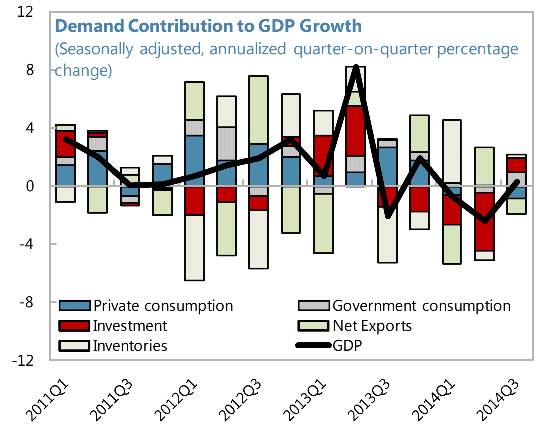
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Brazil: Recent Economic Developments

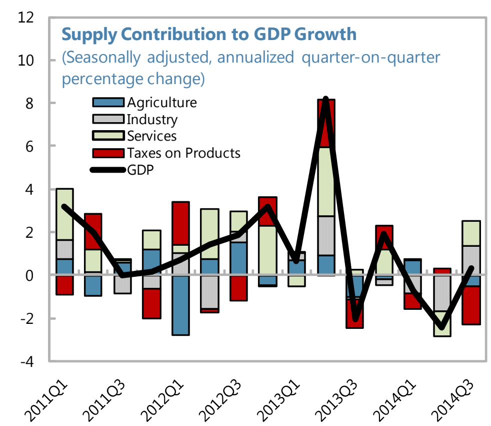
Brazil was in a technical recession during the first half of 2014 and growth was subdued in Q3.



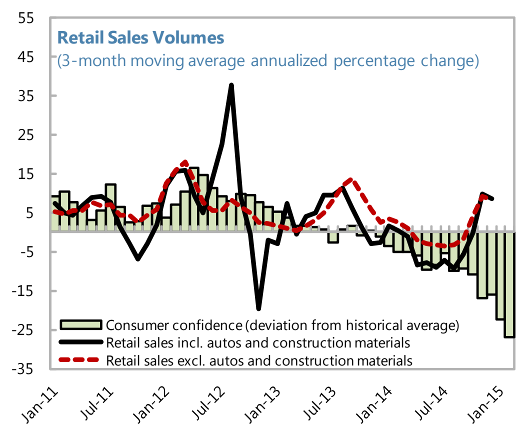
After four quarters of contraction, investment grew moderately in Q3 of 2014 while consumption continued to moderate.



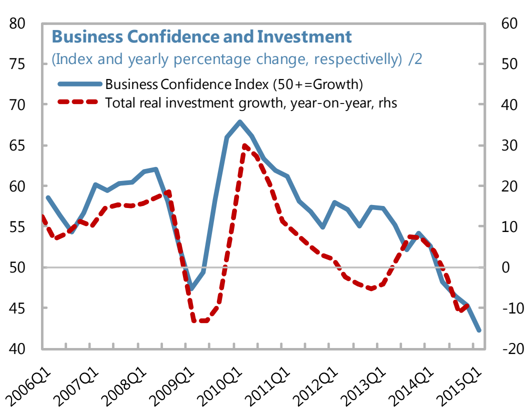
Activity has generally been more subdued on the industry side, but, after contracting in Q2, both industry and services posted moderate gains in Q3.



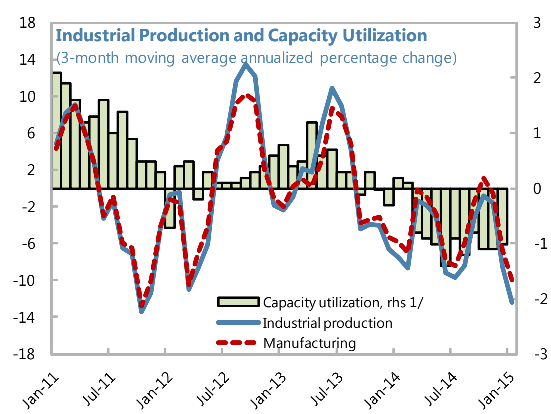
Retail sales have shown some tentative signs of improvement, but consumer confidence continues to deteriorate.



Deteriorating business confidence has contributed to the contraction in investment.



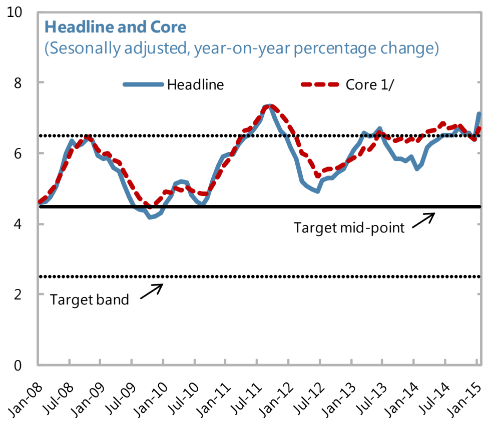
Industrial production is at very low levels and capacity utilization remains well-below historical averages.



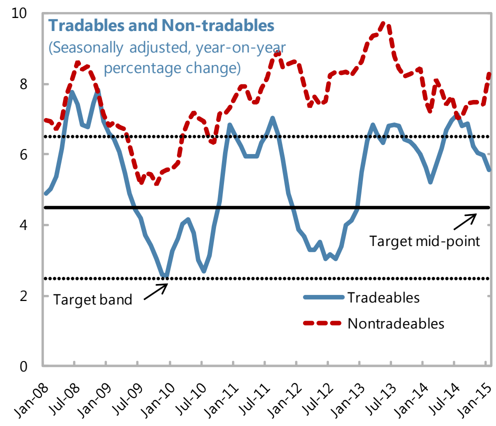
Sources: Haver analytics; IBGE; and Fund staff estimations.
1/ Difference between the current rate and the 10-year average in percentage points.
2/ Data for 2015Q1 is an average of the two first months of the quarter.

Figure 2. Brazil: Inflation

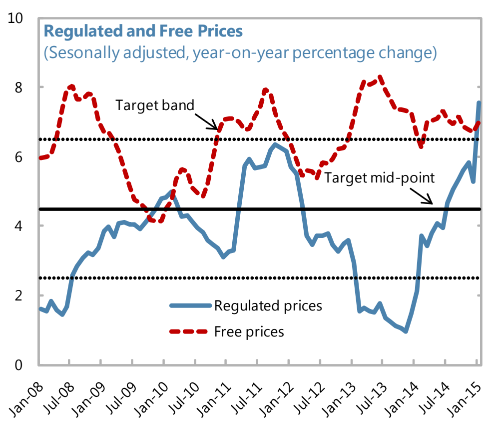
Inflation has risen since mid-2012 and is currently above the upper ceiling of the official target tolerance band.



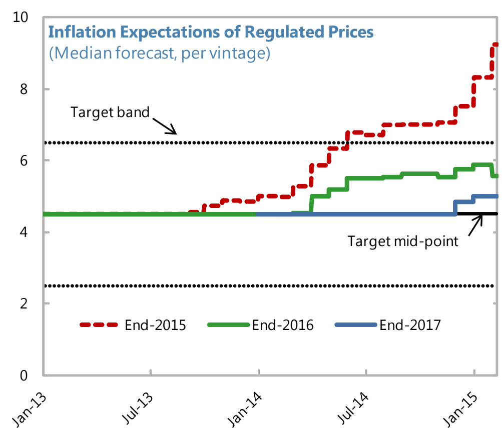
Non-tradable inflation has risen more strongly than tradable inflation since 2010.



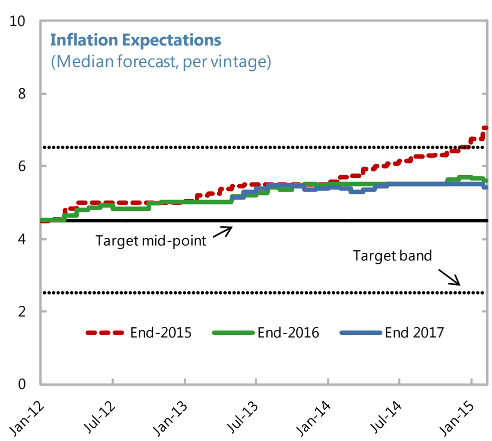
Free-price inflation has begun to moderate from high levels while regulated-price inflation has begun to increase after being subdued for some time.



Markets expect very large adjustments in regulated prices going forward.



Inflation expectations levels hover above the target band for 2015 and well-above the official target mid-point over the medium term...

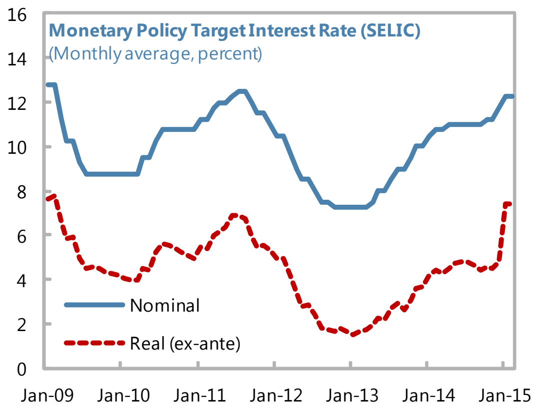


...and wage growth remains strong.

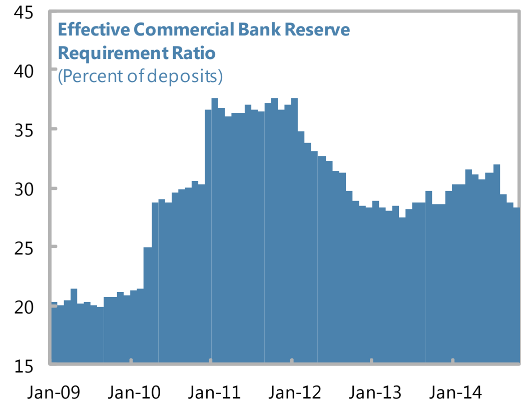
Sources: Haver Analytics, IBGE, and Fund Staff calculations.
1/ Extended Consumer Price Index, Double Weighted (IPCA-DP).

Figure 3. Brazil: Macroeconomic Policies

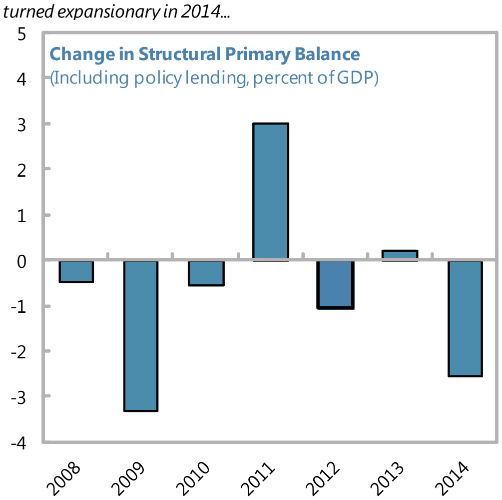
Since April 2013 the policy rate has been raised by 500 basis points...



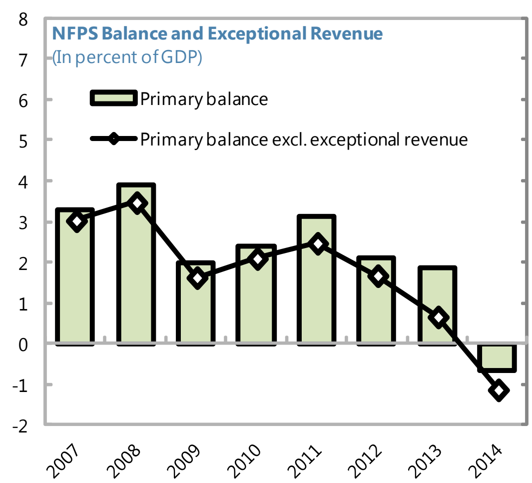
...while macroprudential policies have been tightened, though more recently slightly eased.



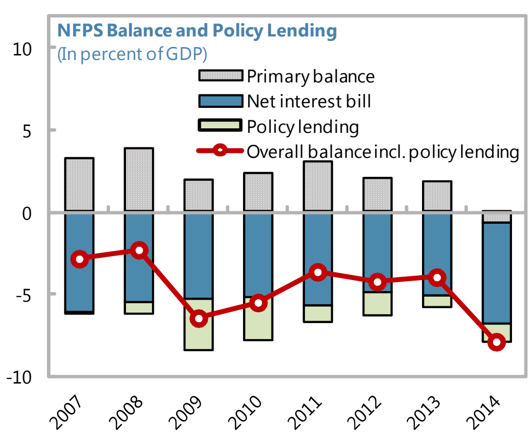
The fiscal stance has remained approximately neutral in 2013, but turned expansionary in 2014...



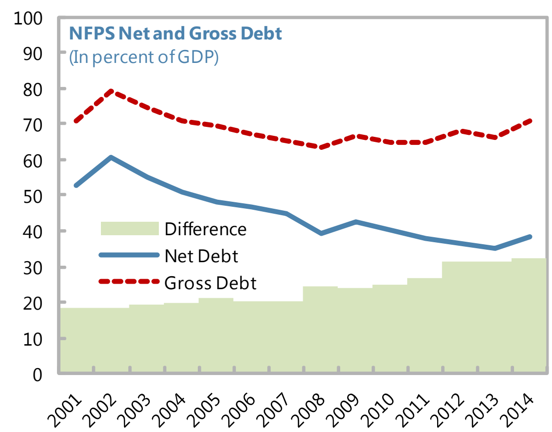
... while primary surpluses have repeatedly relied on exceptional revenue.



The overall fiscal balance remains negative, and has deteriorated recently due to a reduction in the primary balance and increased interest bill.



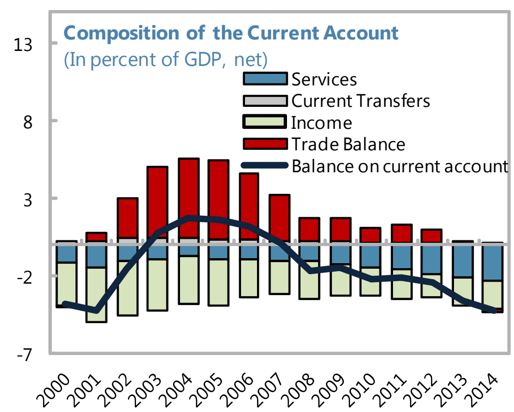
Gross debt has increased to above 70 percent of GDP.



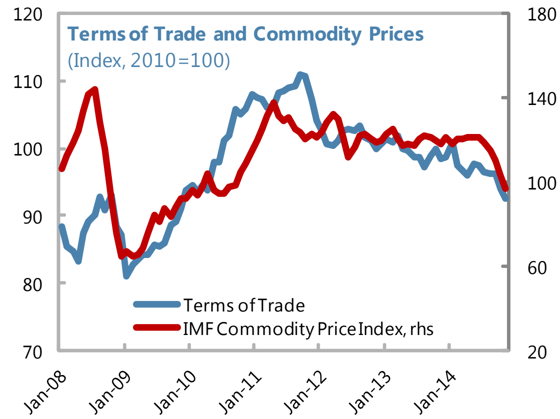
Sources: Central Bank of Brazil, IBGE, Haver Analytics, and Fund staff calculations.

Figure 4. Brazil: External Sector

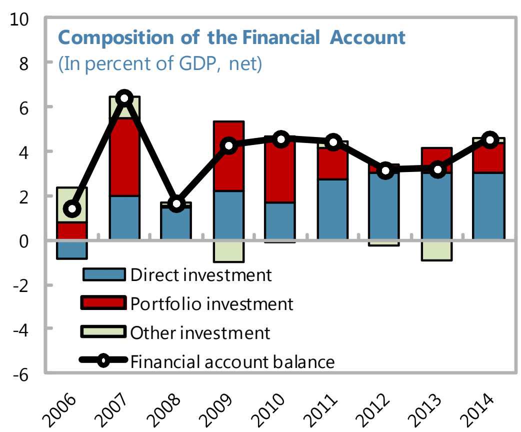
The external current account worsened further in 2014 despite weak growth.



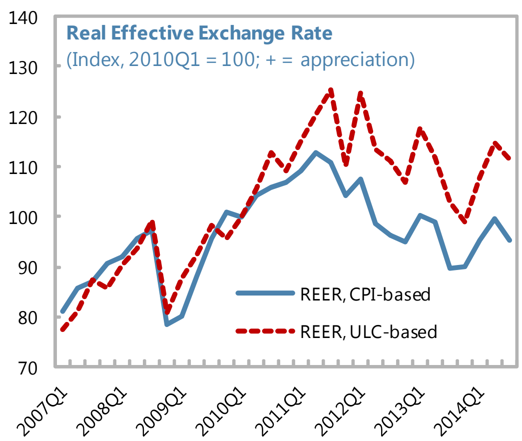
Brazil's terms of trade have deteriorated but remain at a relatively high level.



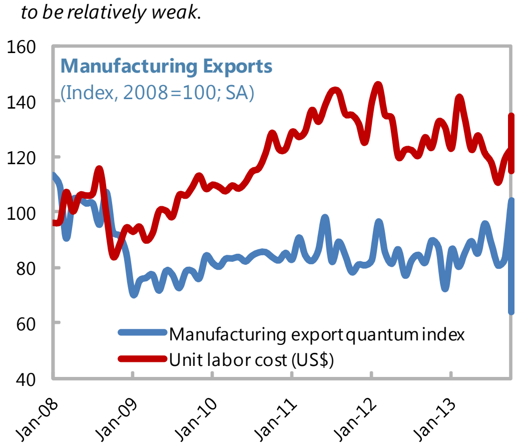
Net capital inflows were broadly stable in 2014 amid strong FDI and portfolio inflows.



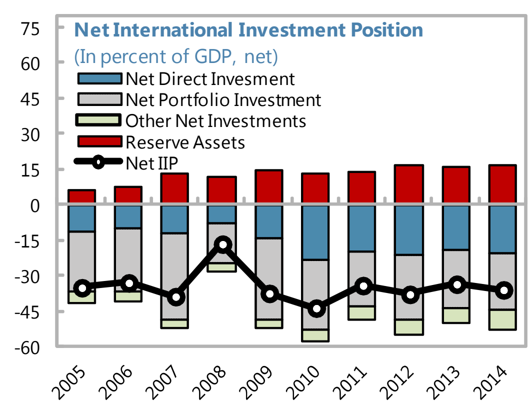
The real effective exchange rate remains elevated, especially when calculated using unit labor costs.



Amid high unit labor costs, manufacturing exports continue to be relatively weak.



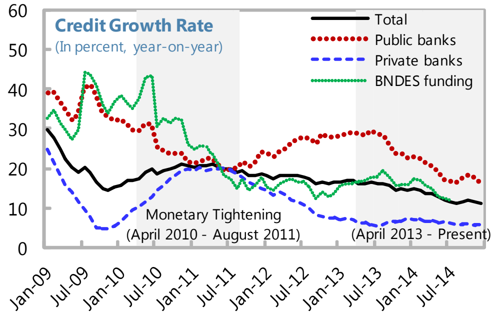
The International Investiment Position is stable.



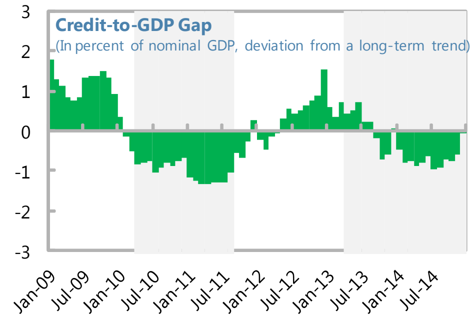
Sources: Central Bank of Brazil; Haver Analytics; and Fund staff calculations.

Figure 5. Brazil: Financial Sector

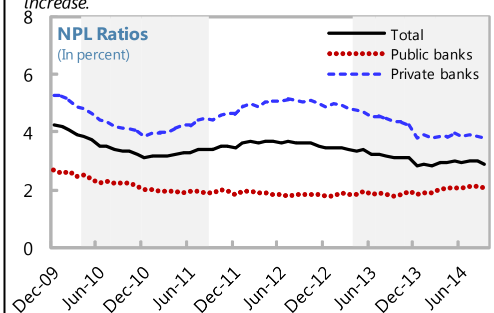
Credit growth decelerated, reflecting both weak loan demand and conservative supply.



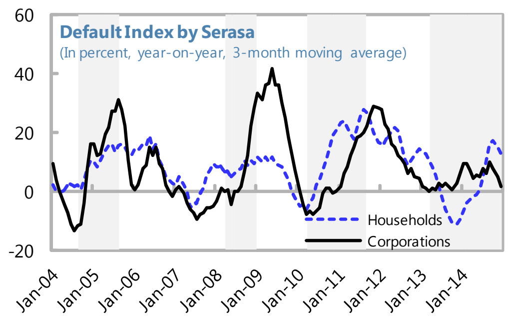
The downturn phase of a credit cycle continued in 2014



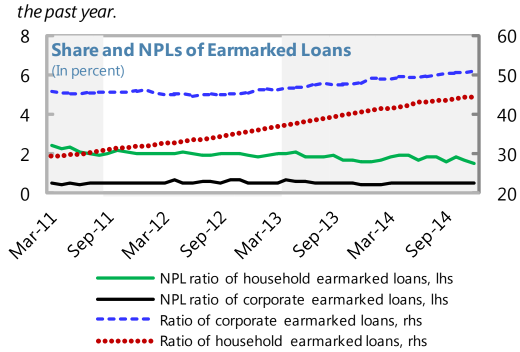
Nonperforming loans (NPLs) have been broadly stable at around 3 percent, but public banks' NPLs have started to increase.



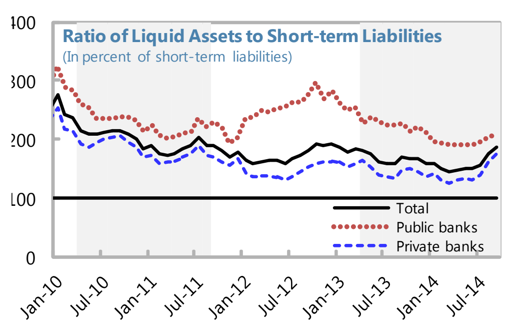
Leading indicators suggest NPLs will rise due to subdued economic activity and tighter financial conditions.



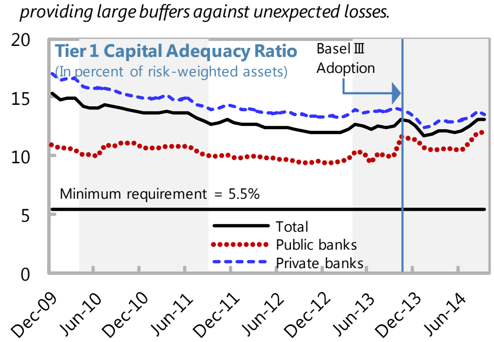
The rise in NPLs is expected to be gradual because the share of earnmarked loans with low NPLs increased significantly over the past year.



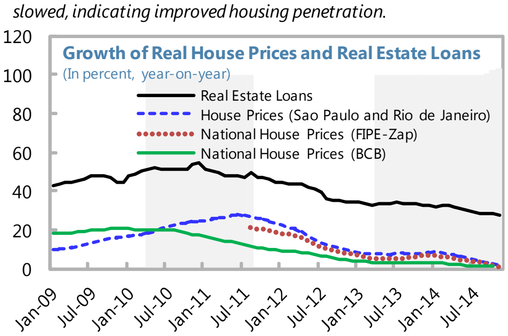
Ample liquidity provides a buffer to funding risks, and...



...capitalization remains above the regulatory minimum, providing large buffers against unexpected losses.



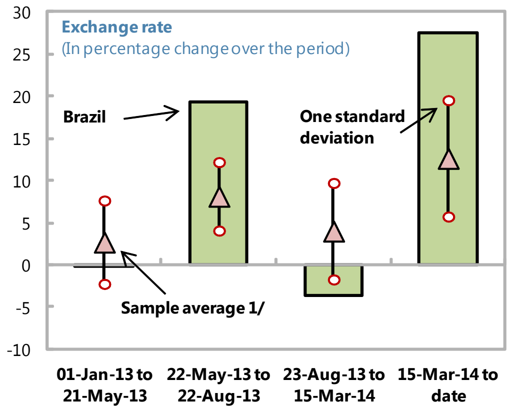
Even with strong mortgage loan growth, house price inflation slowed, indicating improved housing penetration.



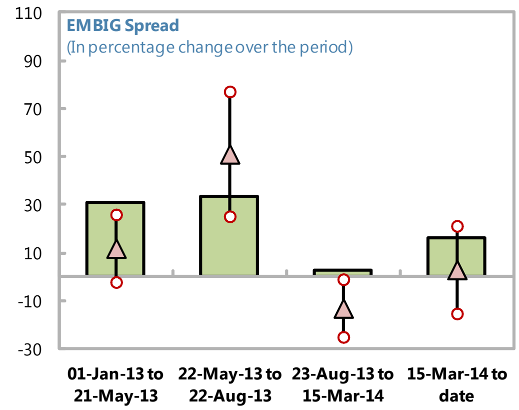
Sources: Central Bank of Brazil, Serasa Experian, and Fund staff calculations.

Figure 6. Brazil: Comparative Financial Sector Indicators

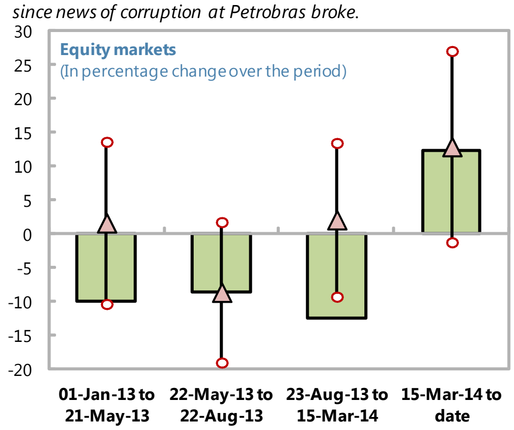
The Real significantly depreciated following tapering talk, recovered after the Central Bank announced its intervention program, but began depreciating again recently.



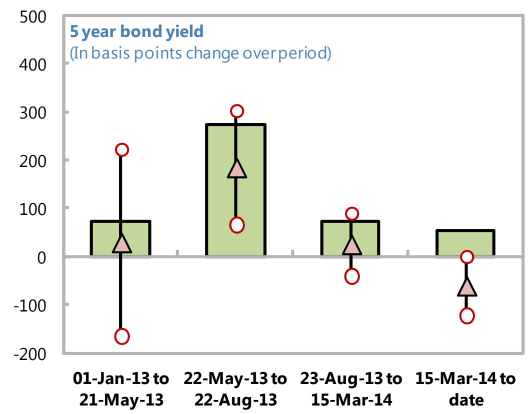
Country risk spreads increased in early 2013 and have also widened again recently.



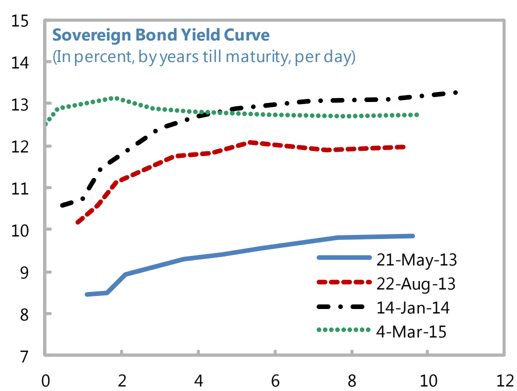
The Bovespa stock exchange index saw losses throughout 2013, began to recover in early 2014, but has lost ground since news of corruption at Petrobras broke.



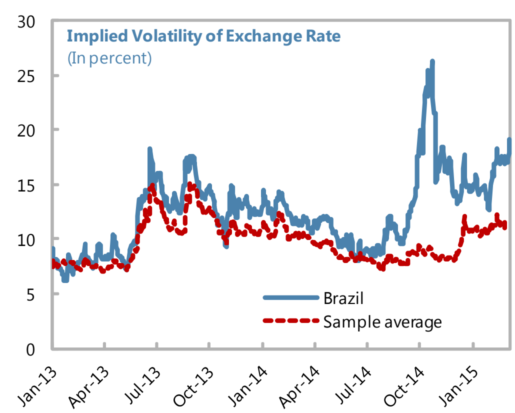
Following tighter global financial conditions and policy rate increases, sovereign bond yields have risen by almost 450 bps.



Following tapering talk, policy rate hikes, and a recession, Brazil's yield curve initially experienced a parallel shift and, more recently, an inversion.

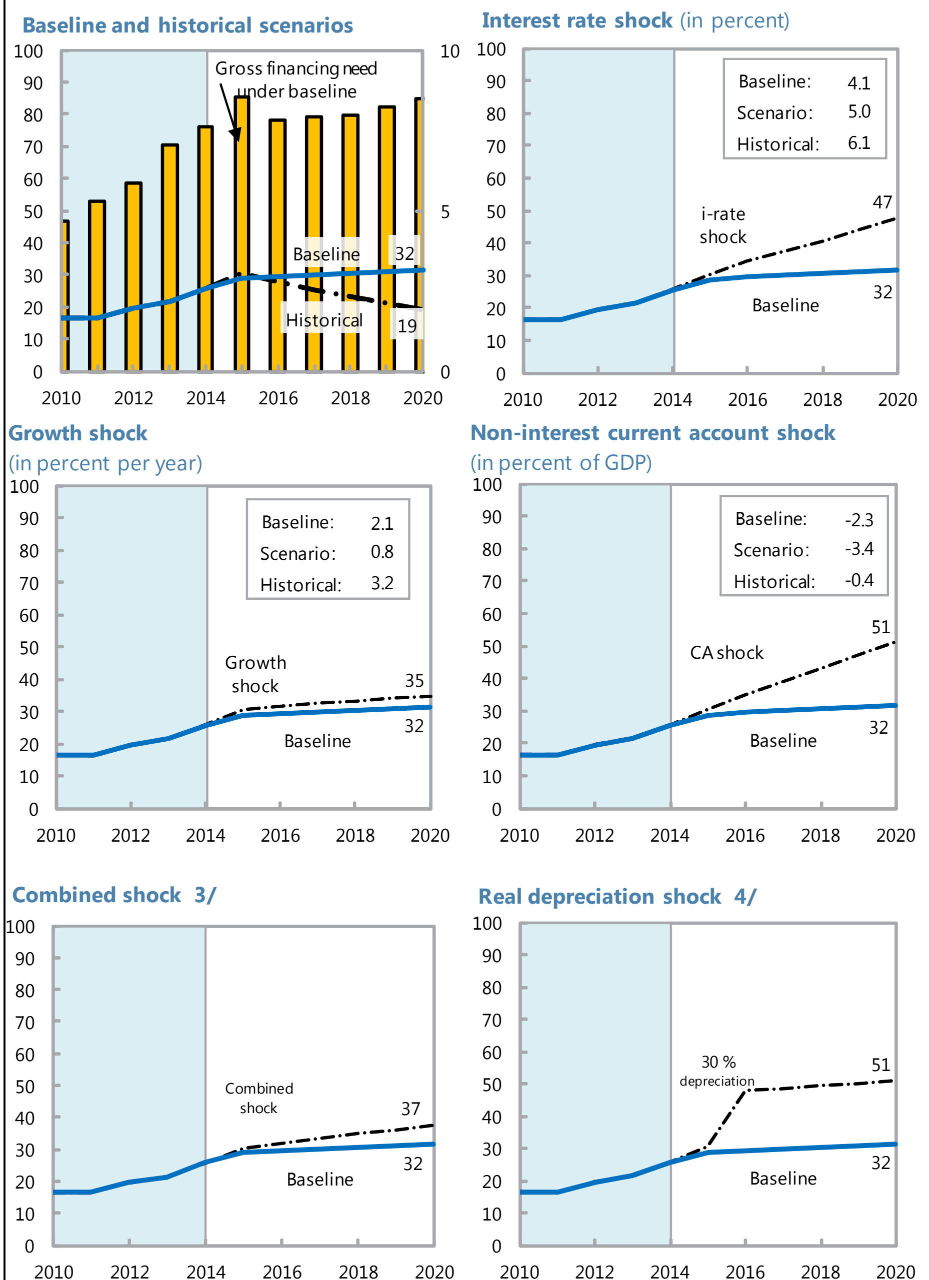


Exchange rate volatility was in line with peers prior to tapering talk and consistently higher thereafter, intensifying during the electoral period.



1/ Selected sample: Mexico, Peru, Colombia, Chile, India, South Africa, Turkey, and Indonesia.
Sources: Bloomberg, and Staff estimates.

Figure 7. Brazil: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Source: National authorities, and Fund 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 2016.

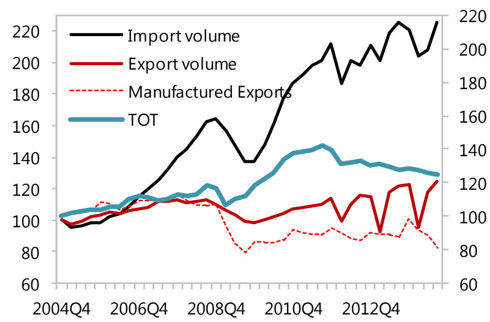
Appendix I. Brazil: External Sector Assessment 2014[1]

Brazil's external position is weaker than the level consistent with medium-term fundamentals and desirable policy settings. Reserves are adequate and FDI continues to cover a significant share of the current account deficit. Further efforts to increase national saving are needed, including by advancing with pension reform and shifting the structure of public spending away from consumption. Foreign exchange intervention, including through the use of derivatives, can be appropriate to address bouts of excess volatility in the foreign exchange market arising from unstable capital flows, but should not be used to resist currency pressures that reflect changes in fundamentals.

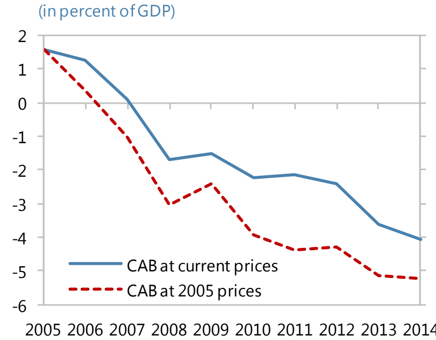
Current account

1. **Brazil's current account turned into deficit over the past decade, despite large terms of trade gains.** Import volumes more than doubled since 2004, supported by strong domestic demand, while export volumes have remained broadly constant. Booming commodity prices sustained exports and helped contain the current account deficit, but the share of manufactured products has declined. As an illustration of the importance of commodity prices, were the terms of trade to return to their 2005 level, Brazil's current account deficit would have reached 5.1 instead of 3.6 percent of GDP in 2013. In recent years, the terms of trade have fallen from record highs, with the current account deficit reaching 4.2 percent of GDP in 2014.[2]

Terms of Trade, Import and Export Volumes
(Index, 2005 = 100)



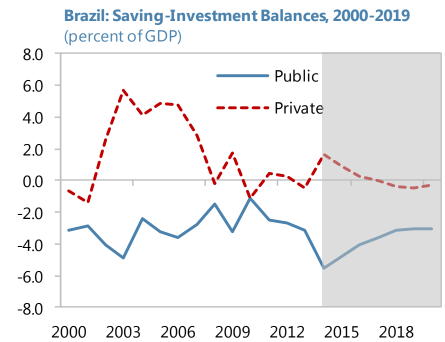
Current Account Balance at Current and 2005 Prices
(in percent of GDP)



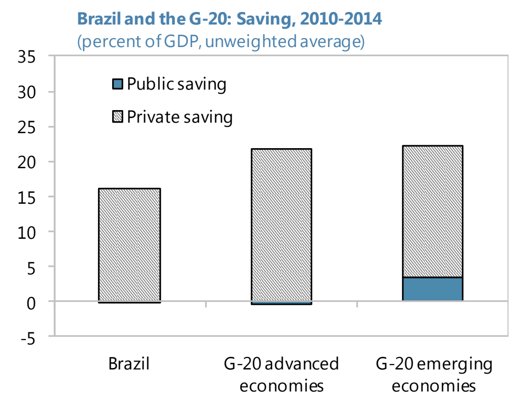
[1] Prepared by Christian Saborowski.

[2] The authorities are in the process of revising external sector statistics in line with the sixth edition of the Balance of Payments and International Investment Position manual (BPM6). This movement is consistent with the adoption of the new methodology of the System of National Accounts (SNA 2008) in Brazil, due to be published by end March 2015. Revised BOP data are expected to be published in April 2015, with revised external debt data expected in June. As part of this conversion, at least two important revisions will be made: foreign holdings of domestic debt securities will be included in external debt statistics, and its income, up to now reflected jointly with principal outflows in the portfolio account, will be recorded separately in the income account. Staff expects that these changes will lead to upward revisions of both external debt and the current account deficit.

2. **The observed worsening of the current account balance reflects low savings.** The challenge to Brazil's external sector outlook from a savings-investment perspective is that both private and public savings are relatively low compared with other emerging economies. Since 2004, consumption has accounted for almost all the growth in Brazil. Increasing domestic savings would help prevent further deterioration in external balances over the medium term and support an increase in investment—which is also relatively low compared to other emerging economies. Policies that could help bolster savings include further steps to reform the pension system and containing the rate of growth of public consumption.



3. **The current account appears weaker than the level consistent with medium term fundamentals and desirable policy settings.** For 2014, staff estimates suggest a current account norm in the range of -2.0 (EBA CA regression approach) to -1.2 percent of GDP (ES approach), broadly consistent with staff's assessment of a norm range of -0.5 to -2 percent of GDP. Combined with a *cyclically adjusted* current account deficit of about 3.8 percent of GDP, the current account gap in 2014 would range between -1.8 to -3.3 percent of GDP.[3]



4. **The current account deficit will improve over the medium term, but terms of trade volatility and offshore oil exploration plans raise uncertainty surrounding projections.** The current account is projected to fall to 3.4 percent of GDP by 2020. This outlook is based on an only modest recovery in domestic demand and some further worsening in the terms of trade. These factors are expected to be more than offset by the weak *real*, a recovery in trading partner growth and the expected boost to the oil balance. Further declines in export commodity prices remain a key vulnerability as iron ore, soybeans and oil alone account for one third of total exports. The development of Brazil's off-shore oil potential will support the current account. The oil balance—oil and distillates exports net of direct oil and distillates imports—is expected to

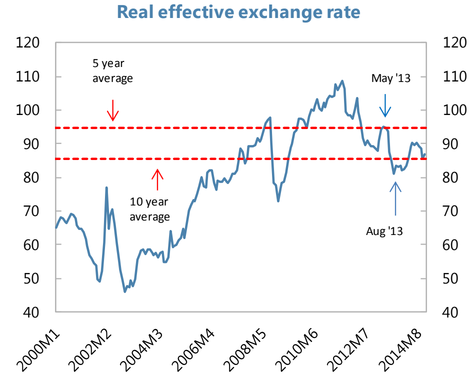
[3] Results are based on EBA estimates updated in January 2015.The staff assessment remains broadly in line with the 2014 EBA.

improve by around 1 percent of GDP by 2020. However, a variety of factors including pressures on Petrobras' balance sheet as part of the recent corruption scandal as well as the price of oil in international markets increase uncertainty surrounding exploration projections. Moreover, imports of machinery and other intermediate goods related to the construction of platforms and the development of the oil fields will partly offset the boost to the current account.

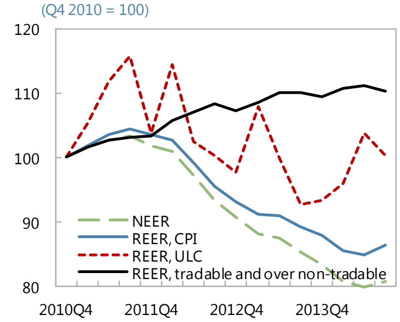
Exchange rate and relative prices

5. **The CPI-based real exchange rate has depreciated since 2010.** The real effective exchange rate (REER) has risen by more than 30 percent since end-2004, but depreciated some 20 percent between end-2010 and December 2014. Following the Fed announcement to taper its asset purchases, the REER depreciated by 14 percent from April 2013 to August 2013, but then appreciated by 6 percent until March 2014 as global market pressures receded. The REER depreciated during the second half of 2014 and is now broadly in line with its long-term (10-year) average level.

Real effective exchange rate



REER, various measures
(Q4 2010 = 100)



6. **Alternative measures of relative prices do not suggest improvements in price competitiveness.** Unit labor costs (ULC) increased markedly in recent years on the back of high nominal wage increases and tight labor market conditions. Despite substantial nominal depreciation, the ULC based real exchange rate did not depreciate since 2010, suggesting stagnating price competitiveness. A direct measure of relative prices based on prices on non-tradables and tradables even points into the opposite direction, illustrating that relative prices have risen by some 10 percent since 2010.

2014 Current Account and REER Gaps

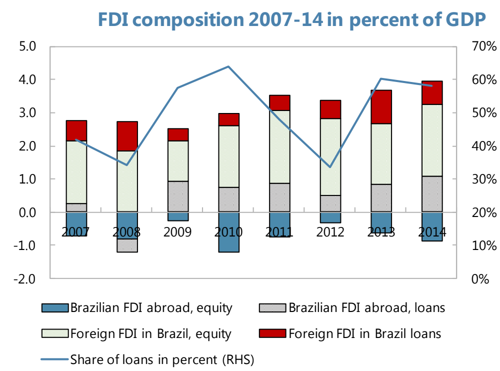
	EBA Methodologies /1		
	Current account	Real effective exchange rate	External Sustainability
Actual Current Account (% GDP)	-4.2		
Cyclically Adjusted Current Account (% GDP) /1	-3.8		
Medium Term Current Account (% GDP) /1			-3.4
Adjusted Medium Term Current Account (% GDP) /1			-3.7
Current Account Norm (% GDP) /1	-2.0		-1.2
Exchange rate gap (+ is over-valuation) /1		-3%	
	Staff Assessment of 2014 CA and REER		
	Lower bound		Upper bound
Current Account Norm (% GDP)	-2.0		-0.5
Current Account Gap (% GDP)	-1.8		-3.3
Exchange rate gap in 2014	10%		20%
as of end-December 2014	-4%		-14%

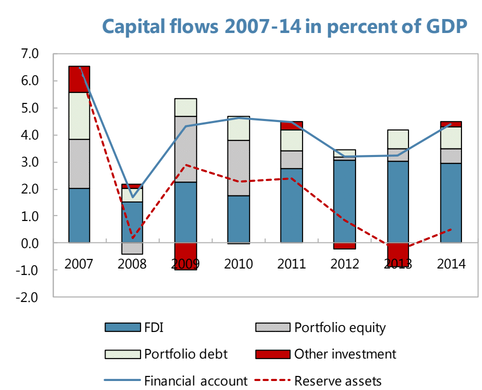
/1 Based on January 2015 EBA estimates.

7. **The real effective exchange rate in 2014 was overvalued by some 10–20 percent on average during the year.** Estimates from the EBA REER approach suggest that the *real* was undervalued by some 3 percent. However, staff assesses the REER approach to be less reliable than other approaches in general, and especially so in the case of Brazil due to the wide dispersion in the evolution of different measures of the REER. Based on the assessment of a current account gap of -1.8 to -3.3 percent, staff's assessment is that the *real* was some 10 to 20 percent over-valued on average in 2014. As of December 2014, the REER had depreciated by some 6 percent compared to its 2014 average. For this reason, staff's assessment is that the REER was approximately 5–15 percent above the level implied by fundamentals and desirable policies at end-2014.[4]

Capital account flows and the policy toolkit

8. **Following the global crisis, Brazil attracted sizable capital inflows that helped finance the current account deficit and contributed to reserve accumulation.** In the crisis' aftermath Brazil experienced large capital inflows amid robust economic growth and high interest rate differentials. The financial account achieved a surplus of 4.1 percent of GDP on average between 2007 and 2014 as reserve accumulation reached 1.9 percent of GDP per year. Following years of particularly strong portfolio flows, FDI has become the largest component in net capital inflows, attaining about 3 percent of GDP per year since 2012. Both FDI and portfolio flows remained buoyant in 2014 as the central bank tightened monetary policy and eased the IOF tax.

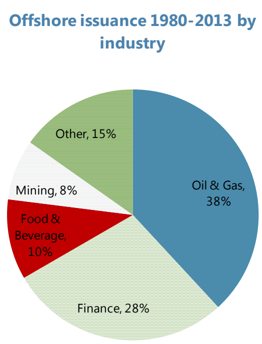


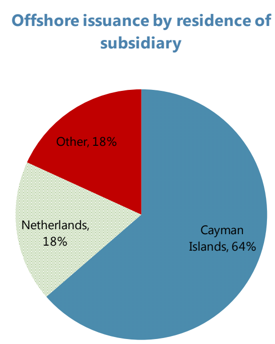


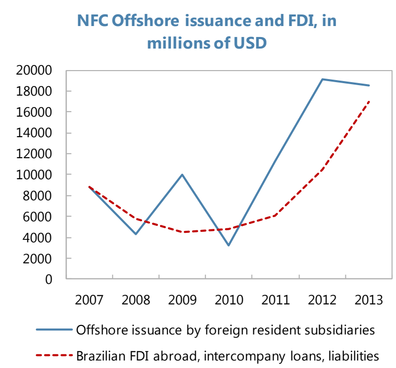
9. **FDI financed more than 70 percent of the current account deficit in 2014, with intercompany loans boosted by offshore issuance by foreign incorporated subsidiaries of Brazilian parent companies.** Intercompany loans accounted for some 60 percent of total FDI in 2014. Interestingly, about

[4] The exchange rate gap estimated based on the EBA REER approach moved from +7 percent to -3 percent between the Spring 2014 and Fall 2014 EBA rounds, partly as a result of revisions in the measurement of Brazil's CPI based REER.

60 percent of total intercompany loans is made up of loans to Brazilian foreign investors extended by their own subsidiaries. A likely cause for such loans is the large offshore debt security issuance by foreign incorporated subsidiaries of Brazilian parent companies. The relevant subsidiaries are largely based in the Cayman Islands and the Netherlands, with the parents predominantly engaged in extractive industries and banking. The striking correlation between offshore issuance by non-financial corporations and intercompany loans to Brazilian foreign investors suggests that the majority of offshore issuance indeed returns to Brazil in the form of FDI (an inflow of intercompany loans resulting from such offshore issuance can be regarded as carrying a risk profile more similar to portfolio debt than other types of FDI inflows).



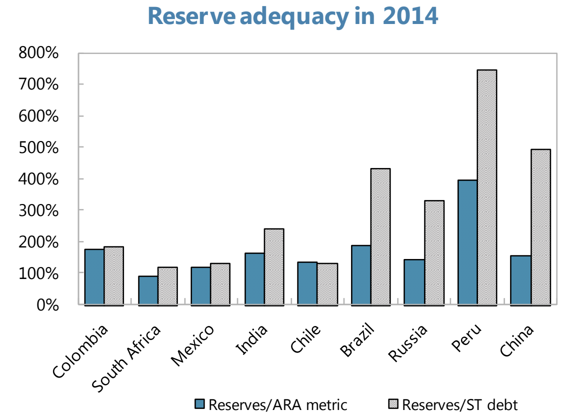


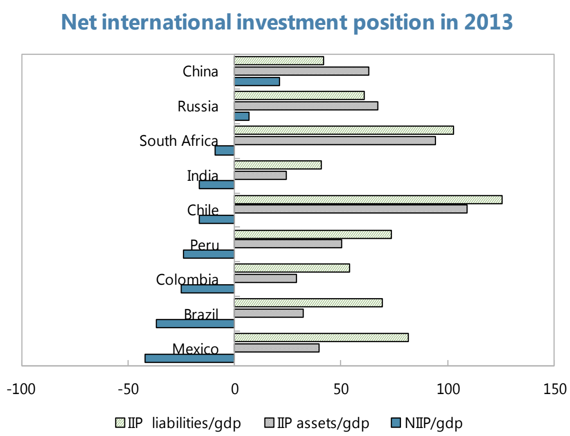


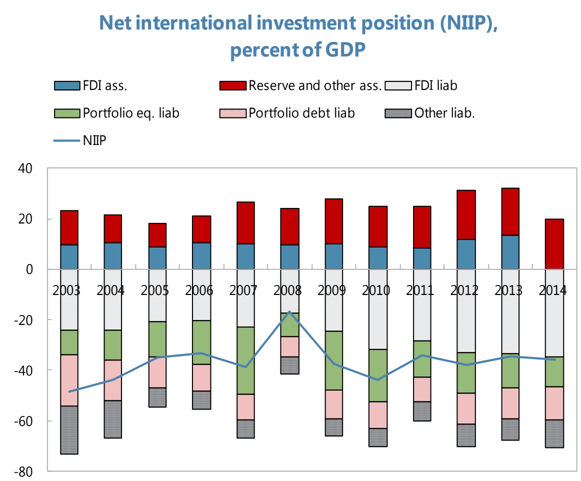
10. **Brazil's flexible exchange rate remains the most important shock absorber, although prolonged intervention may have slowed convergence of the *real* toward more competitive levels.** Brazil has a flexible exchange rate which remained the most important shock absorber, including during the market turbulence since May 2013. The authorities have not conducted any spot market interventions since 2012 but relied on the use of foreign exchange swaps (conventional non-deliverable forwards settled in local currency) and Brazilian foreign exchange repos (conventional foreign exchange swaps) to contain market volatility (see Selected Issues Paper on FX intervention). Intervention can be useful when faced with episodes of excessive volatility, as was the case when the current intervention program was introduced. The program initially served this purpose well, being targeted directly to reducing the cost of hedging during the financial market turmoil following the Fed's tapering announcement but may also have encouraged additional risk taking by the private sector. Moreover, the continued extension of the program may have slowed convergence of the exchange rate to a more competitive value.

International reserves, net international investment position and external debt

11. **International reserves remain above adequate levels.** Central bank intervention has been geared towards reducing volatility and managing capital inflows, which resulted in a large increase of international reserves during 2006 to mid-2011. International reserves have since stabilized, and are considered more than adequate with respect to various metrics, including the IMF's composite adequacy measure. As such, Brazil is well placed to withstand potential external shocks. In addition, Brazil and other BRICS countries signed a treaty to establish the BRICS Contingent Reserve Arrangement (CRA) in July 2014. The CRA involves commitments by members to support each other through currency swaps in case of actual or potential short-term balance of payments pressures.[5]





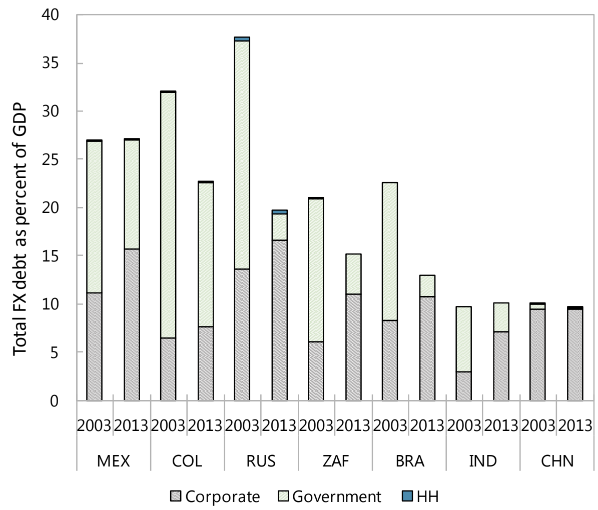


12. **Brazil's net international investment position (NIIP) improved modestly in recent years but is projected to deteriorate.** The NIIP position strengthened from -48 percent of GDP in 2003 to -36 percent in 2014 (with gross assets and liabilities of 36 and 72 percent of GDP,

[5] The initial size of the CRA will be US$100 billion, with individual commitments of US$41 billion by China; US$18 billion by Brazil, Russia, and India; and US$5 billion by South Africa. These committed resources are unencumbered and would continue to count as reserves by individual countries. For Brazil, Russia and India, maximum access will equal their financial commitment to the CRA. Up to 30 percent of a member's maximum access will be available without conditionality and the remainder requires an on-track financial arrangement with the Fund.

respectively). FDI liabilities account for about half of total liabilities. Brazil's NIIP position is high relative to peers but compares reasonably well to the wider spectrum of emerging market economies. However, with the envisaged persistent current account deficit, the NIIP position would worsen over the medium term (at a constant real exchange rate). In the longer run, as Brazil's large "pre-salt" oil reserves come on line, added efforts to increase savings and therefore strengthen the country's NIIP position would be appropriate.

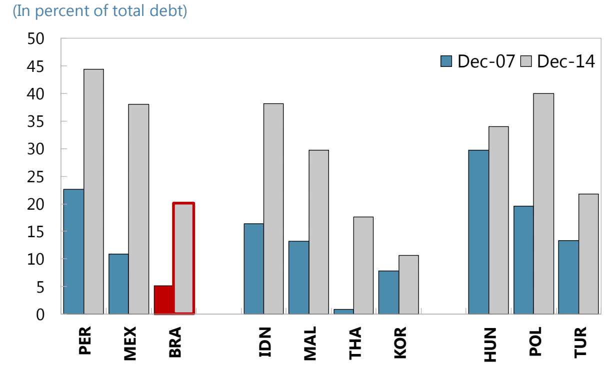
Sectoral breakdown of FX exposure 2003-2013



13. **External debt and foreign exchange exposure remain low although corporate borrowing in foreign exchange has increased.** External debt remains relatively low at about 26 percent of GDP as of 2014. Total foreign exchange exposure is also low in the international comparison and has decreased significantly over the past decade.[6] However, corporate issuance in foreign exchange—though largely hedged—has increased recently, partly offsetting the reduced sovereign exposure (see Selected Issues Paper on corporate vulnerabilities). Foreign holdings of domestic debt securities have increased dramatically in recent years and now account for close to a fifth of outstanding public debt securities and some 8 percent of GDP. While local bond market development and reduced sovereign exposure to foreign exchange debt are welcome, local yields may become more sensitive to global developments as foreign investors take on foreign exchange risk.

Emerging Economies: Foreign Holdings of Local Public Debt

(In percent of total debt)

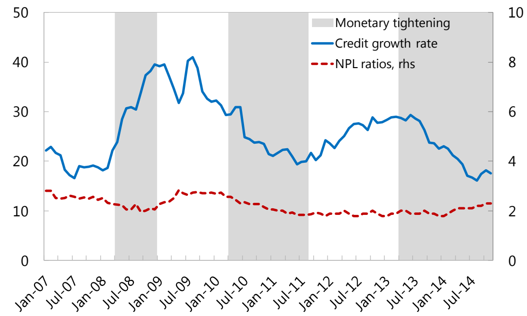


Sources: Haver Analytics; country authorities; World Economic Outlook; and Fund staff calculations.

[6] Non-financial corporate debt in foreign exchange is approximated by the stock of outstanding bonds in foreign exchange (Dealogic) plus domestic loans in foreign exchange (IFS and country authorities) plus cross-border loans to the domestic non-bank sector (BIS).

Appendix II. Nonperforming Loans of Public Banks[1]

Public Banks: Credit Growth and NPL Ratios
(In percent and in percent of total loans by public banks)



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

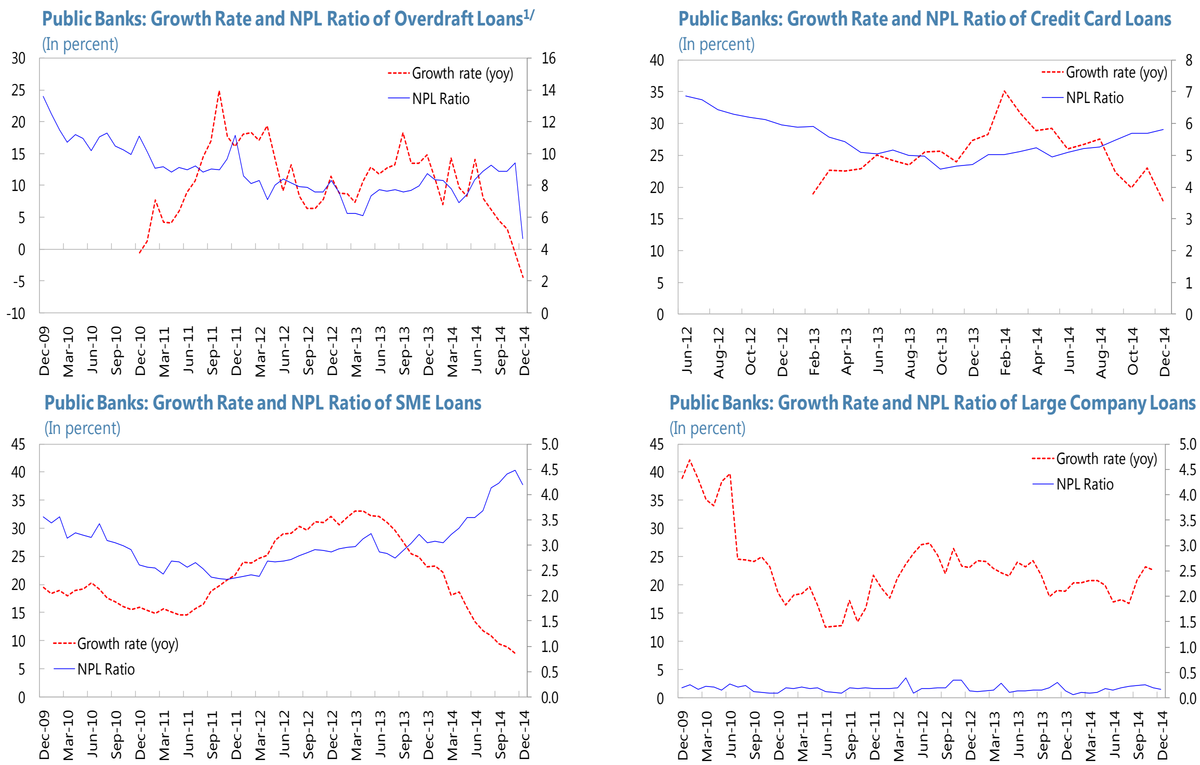
1. **Nonperforming loan ratios at public banks have been around 2 percent in recent years; but these banks now face the risk of a gradual deterioration in loan quality.** Public banks have traditionally specialized in relatively low-risk credit segments: *Caixa Econômica Federal* (Caixa) provides housing loans; *Banco do Brasil* supplies rural credit; and BNDES finances exports, working capital for large firms, and long-term infrastructure projects. Nevertheless, in recent years Caixa has ventured into other, higher-risk credit segments, such as non-payroll personal loans, credit card, and SME loans. Delinquencies at public banks started to pick up in 2014, a trend which is likely to continue, especially in the newer credit segments. This said, credit growth deceleration in public banks in 2014 was most marked in these newer credit segments.

2. **When looking at loan performance, it is clear that traditional business lines have held up their quality over time.** BNDES's NPL ratio has been under 0.3 percent over the past three years, even taking into account the effects of OGX's bankruptcy last year, a much publicized case. Banco do Brasil (BB) reduced the share of non-earmarked loans and replaced it with rural credits and real estate loans, and as a result its NPL by loan vintage has gradually decreased over the past three years. Caixa maintained the quality of its mortgage loans high by applying loan-to-value caps at around 70 percent.

3. **However, some high-risk lines of business have recently shown declining performance.** Delinquencies in these loans are rapidly increasing. Should the deterioration of economic activity persist, the repayment capacity of households and firms will be weakened and thus public banks will need to set aside more provisions, impairing its earnings. Even if this trend does not imply systemic risk given their large loan loss provision and capital buffers (which guard against expected and unexpected losses, respectively), they will need to tighten lending standards to preserve asset quality.

[1] Prepared by Heedon Kang (MCM).

Public Banks: Selected Indicators



Source: Central Bank of Brazil.

1/ NPL ratio of overdraft loans by public banks dropped in December 2014 due to sales of past due loans.

Appendix III. Brazil: Risk Assessment Matrix[1]

Nature/Source of Threat	Likelihood	Expected Impact on Economy	Policy Responses
		Domestic Risks	
Delays in the resolution of the Petrobras corruption probe	***M***	***H.*** Firms under investigation, including Petrobras, could see their access to funding diminished and their investment programs at risk. The infrastructure concession program could be hampered by the ineligibility of construction companies. Pressure would rise to use public funds, possibly through public banks, to support Petrobras' investment.	Strengthen governance standards and anti-corruption safeguards in procurement procedures to ensure the success in attracting private sector participation in the infrastructure program. Ease the requirement that Petrobras' participate in all new oil developments, and domestic content requirements.
Drought and power rationing	***H***	***H***. Growth slowdown from electricity rationing accompanied by inflationary pressures as consumers will have to bear the additional energy cost in the absence of energy subsidies. Water rationing could affect manufacturing as well as agriculture, including in Sao Paulo state.	Keep policies tight to contain spillovers into inflation and refrain from introducing additional Treasury subsidies which will weaken the fiscal outturn. Make sure that prices reflect scarcity to promote the efficient use of resources, while protecting basic level of access for vulnerable households.
Falling short of the fiscal target	***M***	***H***. Fiscal balances would continue to disappoint and fail to stabilize debt. Further loss of confidence would result in lower investment and growth. Inflationary pressures would remain elevated. Brazil could lose its investment grade, which would further dampen confidence and growth, weakening the primary balance and increasing sovereign borrowing costs and public debt. Corporates could be vulnerable to capital flow reversals and exchange rate depreciation. The strains would worsen if banking system soundness deteriorated owing to an increase in NPLs.	Additional fiscal consolidation measures should be identified to restore credibility in the fiscal framework and to ensure debt stabilizes. Focus efforts on boosting competitiveness and productivity. If the sovereign loses its investment grade, triggering economic side-effects, additional policy actions would be necessary, possibly including monetary policy tightening.
Intensified inflationary pressures	***M***	***H***. Worsening inflation expectations and further erosion to the inflation targeting framework.	Further monetary tightening to preserve the credibility of the inflation framework and ensure the convergence of inflation towards the target.

[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 of risks listed 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.

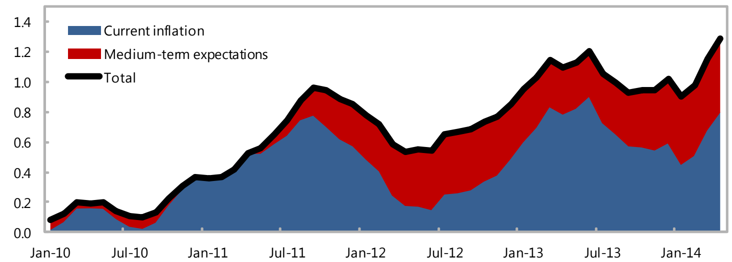
Brazil: Risk Assessment Matrix (Concluded)

Nature/Source of Threat	Likelihood	Expected Impact on Economy	Policy Responses
		External Risks	
Protracted period of low growth	***M***	***H***. Employment destruction would lead to a deterioration of households' balance sheet and income resulting in a rise in delinquencies on consumer loans. Increased financial vulnerabilities among banks with portfolio concentrated in consumer/housing loans. Potential knock on effects on public finances. For example, Caixa extends housing loans to low-income families with a government guarantee. Lower corporate profits may expose some highly leveraged corporates	Monitor for signs of emerging domestic financial and corporate vulnerabilities. Take measures to strengthen the fiscal framework including public debt, and refrain from adding further demand stimulus. Impose targeted prudential measures to reduce risks in weak financial institutions. Smooth out the employment loss by relying on strategies such as reduced hours. Accelerate efforts to improve the business environment and foster investment.
Abrupt surges in global financial market volatility	***H***	***H***. Increasing Brazil's risk premiums, pressures on the real and reversal of capital flows. Increasing yields in domestic bond markets. In particular corporates lacking FX hedging could be exposed.	The flexible exchange rate remains an important capital flow shock absorber. Recourse to FX intervention if FX volatility becomes excessive. Provide FX liquidity and support individual banks if dollar shortages appear. Increase policy rate to ensure adequate external financing. May also need to tighten fiscal policy to further strengthen policy credibility and avoid sell-offs of Brazilian domestic bonds.
Financial imbalances from protracted period of low global interest rates	***M***	***M.*** Building-up vulnerabilities as some corporates may further increase leverage.	Monitor highly leveraged corporate; consider CFMs to discourage shorter-term borrowing. Tighten monetary policy further if financial risk taking becomes excessive.
Protracted period of slower global growth in advanced and emerging economies	***H***	***H***. Worsening current account deficit and weaker growth. Highly indebted corporates could see their profits decline. A sharp decline in commodity prices would have a direct impact on the exporting sector.	Use the exchange rate as first shock absorbers. Limited room for monetary and/or fiscal policy stimulus to smooth shock. Instead, prioritize structural reforms to boost potential growth.
Sharp rise in world oil prices	***M***	***L.*** Mild negative impact on the trade balance in the short-term, but improving current account in the medium term, when Brazil is expected to become a net oil exporter. In the near term, an adverse impact on the finances of Petrobras if domestic fuel prices are not adjusted sufficiently.	Domestic pricing policies should ensure Petrobras obtains an adequate return from commercialization of imported fuel.

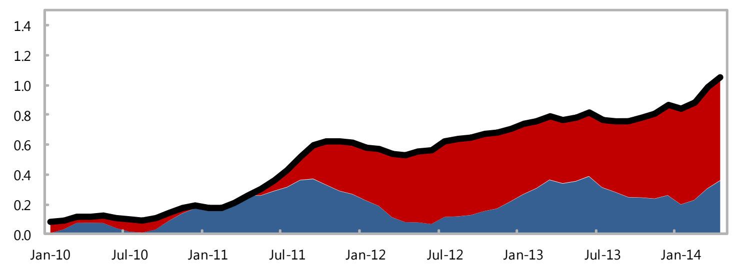
Appendix IV. The Inflation Targeting Framework[1]

1. **Inflation has been above the midpoint of the central bank's tolerance band for several years, and longer-term inflation expectations have risen.** Estimates suggest that inflation expectations (1–3 years ahead) have risen due to both higher inflation outturns and perceptions of higher inflation in the medium term[2], reflecting at particular times foreseeable price pressures, but also some questions about the operation of the policy framework itself.

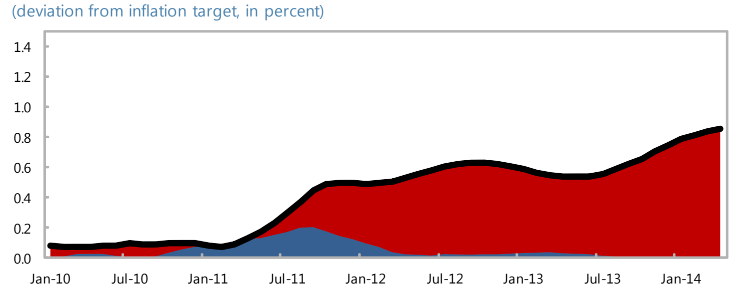
1 Year Ahead
(deviation from inflation target, in percent)



2 Years Ahead
(deviation from inflation target, in percent)



3 Years Ahead
(deviation from inflation target, in percent)



Source: Staff estimates

2. **Brazil's central bank has enjoyed 'de facto' independence since 1999, but it does not have statutory independence.** The central bank currently enjoys what is commonly known as 'instrument independence', choosing how to best meet the inflation target determined by the National Monetary Council. However, as shown in a survey conducted by the Bank of England[3], Brazil's central bank is unique among inflation-targeting central banks for two reasons: (i) it does not have 'statutory independence'—that is, the ultimate objective of the central bank, price stability, is not enshrined in law—and, (ii), the central bank's Governor and Deputy Governors do not have fixed-term contracts and can be dismissed by the president at any time.

[1] Prepared by Troy Matheson.

[2] Inflation expectations data are sourced from Consensus Economics. Contributions to inflation expectations are estimated using a non-linear Kalman filter with time-varying parameters and state constraints. At each horizon h, expectations are modeled as: $\pi_t^h = \alpha_t^h \pi_t + (1-\alpha_t^h)\pi_t^* + \varepsilon_t^h$, where π_t^h is inflation expectations at horizon h, π_t is year-over-year inflation in the IPCA, π_t^* is an unobserved expectation of medium-term inflation, and ε_t^h is an idiosyncratic error. The weight associated with current inflation and medium-term inflation at horizon h α_t^h is restricted to be between 0 and 1.

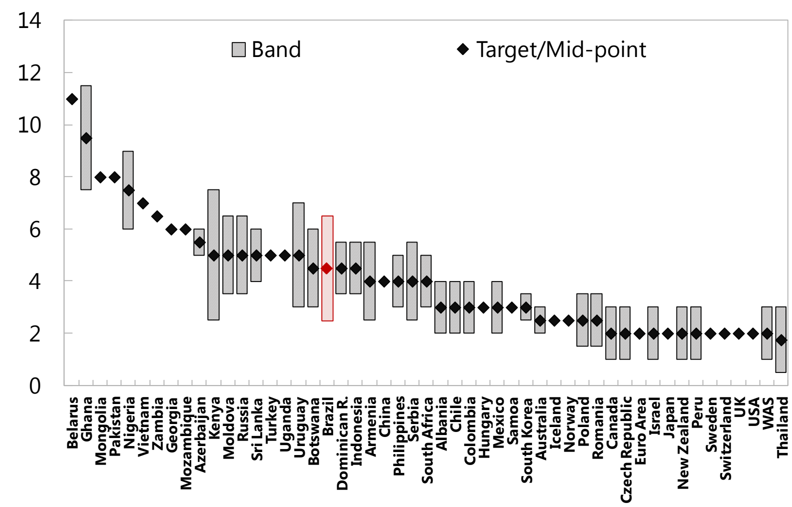
[3] Bank of England, Handbook No. 29, State of the Art Inflation Targeting.

3. **While no institutional framework guarantees success, experience suggests a higher degree of autonomy can help central banks execute their functions more effectively.** Over the medium term, this can make them less prone to episodes where doubts are raised over government influence, particularly when inflation deviates from the midpoint of the tolerance range for some time. In fact, "central bank independence, accountability and transparency" is a core Basel principle of banking regulation.

4. **Brazil's inflation tolerance band is relatively wide and can accommodate persistent inflation deviations from target midpoint.** Brazil has a wide tolerance band relative to other central banks with inflation targets, with a target that allows inflation to range between 2.5 percent and 6.5 percent. Moreover, the inflation target as currently specified (in terms of 12-month inflation in December) allows inflation to be outside the tolerance band for all but one month of the year, unlike other central banks whose targets are specified in a more permanent fashion. This design permits outcomes which, while formally in compliance with the framework, can erode its credibility and contribute to increases in long-run inflation expectations.

Inflation Target Regimes: Cross Country Comparison

(in percent)



Source: IMF country teams

5. **To support the central bank's effectiveness and credibility going forward, further strengthening of the inflation targeting framework would be useful.** The 2002 and 2012 Financial Sector Stability Assessments for Brazil, jointly prepared by the IMF and the World Bank, recommended that the inflation-targeting framework be strengthened further, inter alia, through the passage of legislation providing for the terms of the bank's Board members. At the same time, strengthened autonomy should be complemented with measures that enhance accountability, such as mandating the achievement of price stability as the monetary policy objective (also recommended in the FSAP), narrowing the inflation tolerance band, and better clarifying the medium-term inflation target. Stronger autonomy and accountability for the central bank would bolster the effectiveness of the inflation targeting framework over the long term.

Appendix V. Measurement of Gross Public Debt in Brazil[1]

This Appendix explains in detail the methodological difference between the Brazil's Central Bank (BCB) indicator of General Government Gross Debt (GGGD) and that employed by the Fund, which follows the guidelines in the current Government Financial Statistics Manual (GFSM 2001 and 2014 editions).[2]The key difference between these indicators is the treatment of government bonds held by the BCB and not pledged as security in monetary policy operations, which are counted as part of government debt under GFSM standards, but not under the BCB's definition.

A. Institutional background and the GFSM 2001 conceptual approach

1. **As many other central banks, the BCB performs monetary policy interventions through the use of government securities.[3]** The Fiscal Responsibility Law of 2000 (FRL) prevents the Brazilian central bank from issuing its own debt instruments; thus, the FRL obliges the BCB to retain government securities for the conduct of monetary policy operations. In fact, when the FRL went into effect, the BCB was in possession of a stock of government securities of different kinds acquired over time in different ways. By also banning direct financing of the Treasury by the BCB, the FRL in effect called for special procedures for the central bank to maintain and increase its holdings of government bonds. Between December 2000 and September 2003, the central government issued securities (amounting to 7.8 percent of GDP) which were included in the BCB's restructured portfolio (Figure 1). The issuance of these securities was fully reflected in the increase of central government gross debt reported by the government in its official statistics.

2. **Since 2008, the government can issue securities directly to the BCB, which can be automatically rolled over by the latter.** A 2008 law authorized the direct issuance of securities by the Treasury to the BCB, without a counter-payment by the BCB, consistent with the FRL's principle of no central bank financing for the government (see Box). These direct issuances have the same terms and a similar maturity structure as the bonds in the hands of the public.[4] Since 2008, the accumulation of government securities in the BCB's balance sheet reflects to a large extent

[1] Prepared by Miguel Alves (STA), Izabela Karpowicz (WHD), and Joana Pereira (FAD).

[2] The appendix focuses on differences pertaining to the measurement of gross debt of the General Government only. These differences carry over to the measurement of gross debt of the nonfinancial public sector, which is presented in Table 3 of the Staff Report.

[3] The BCB reduces liquidity by selling government securities under repurchase agreements (REPOs) to money market participants; these securities remain on the balance sheet of the central bank, which effectively uses them as collateral. To increase liquidity, the BCB engages in buy-back transactions of the central government debt securities.

[4] The average maturity of securities held by the public was 4.4 years (average life was 6.1 years) at end-2014.

compensation for unrealized financial losses by the BCB, related to changes in the valuation of international reserves (see Box) and, more recently, losses on FX swaps operations. In addition, the 2008 law foresees that the central bank can automatically roll over the Treasury securities, which in practice the BCB always does to keep an adequate amount of securities available for liquidity management (REPOs).[5]

Box. *Equalização Cambial* and the Evolution of Debt

The legal framework governing the relations between the Federal Government (FG) and the BCB states that whenever the BCB makes a profit, the whole amount must be transferred to the Federal Government through a deposit in the single treasury account. If the BCB makes a loss, the Federal Government must compensate that loss by issuing debt securities to be placed in the BCB's portfolio.

In November 2008, the Law 11803 established a swap operation between the BCB and the National Treasury regarding the financial results of international reserves and financial derivatives operations. The law applies to unrealized and realized gains or losses incurred by the BCB as the holder of those assets.[1] Data on this financial result (positive or negative) are disseminated by the BCB under the item "Equalização Cambial" (EC) on the General Government Debt tables. The authorities consider it in the compilation of the net debt (a positive result decreases net debt; a negative result increases net debt), but not in the gross debt (GGGD) indicator. While profits are transferred semi-annually 10 days after the publication of the budget, recapitalization takes place with some delay.

EC is calculated by the BCB on a daily basis and includes changes in the valuation of reserves, carry cost of reserves, and the result of operations with swaps and derivatives.

[1] At end-2008, the financial result of these operations resulted in a holding gain of R$171.4 billion. Although unrealized, this gain was effectively transferred to the single treasury account (in March 2009). At end-2009 the result was a holding loss of R$52.2 billion, which was compensated by the central government through the issuance of a corresponding amount of securities to be placed in the BCB's portfolio. The end-2014 result was a holding gain of R$65.2 billion.

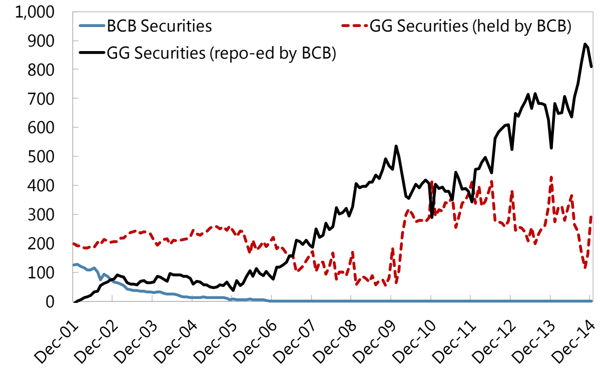
B. The BCB's measure of GGGD: concept and comparative evolution

3. **The BCB's portfolio of government securities is divided in two subsets:** securities currently pledged as collateral under repurchase agreements, and securities not in use as collateral (*free* securities), which the authorities consider of BCB's "outright ownership." The evolution of these securities over time can be seen in Figure 1 and reflects (i) government security issuances for accumulation at the BCB, and (ii) the trend increase in REPO operations. Under the *GFSM 2001/2014*, assets pledged for REPOs remain on the original owner's balance sheet, a criterion consistent with generally accepted accounting practice, and a criterion that had also been followed by the BCB in its own reporting of GGGD until 2008.

[5] An additional 2009 regulation is still in place stipulating that the government will issue new paper to the BCB when its uncollateralized portfolio (see Footnote 3) falls below R$20 billion.

4. **In January 2008, the Brazilian authorities changed the methodology for disseminating GGGD by excluding the government securities that are under the BCB's outright ownership,** while keeping under the new GGGD indicator the securities used as collateral in REPOs. The preference for excluding *free* securities is based on a number of considerations, including the following: (i) the authorities consider that free securities do not represent a claim on government revenue (although interest is accrued, no cash payments take place; instead, new securities are issued to service the liability); (ii) free securities do not affect the market conditions (yield and maturities of normal debt issuances), as those securities are not acquired by the BCB in the market; (iii) they do not reflect the financing needs of the general government; and (iv) these securities do not give rise to refinancing risk. Although true in practice, arguments (i) and (ii) are not relevant for the definition of "liability" under *GFSM 2001/2014*.[6] Neither are arguments (iii) and (iv), which are further discussed below.

Figure 1. Securities Used by BCB for Monetary Policy Purposes
(In billion Brazilian reais)



Source: BCB.

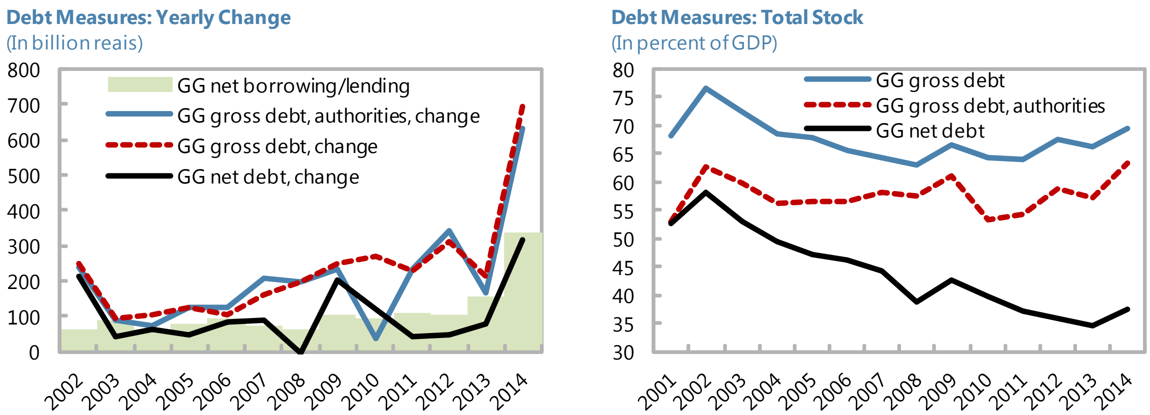
5. **Regardless of whether they were meant to finance a government deficit or not, Treasury securities held by the BCB represent a claim on the general government and are therefore considered part of the GGGD under the *GFSM 2001/2014*.** The GFSM standard defines the BCB as a financial corporation, classified outside the government sector. Consequently, gross transactions and stock positions between the BCB and the government are to be recorded accordingly. In particular, when the government issues securities to the BCB, a financial claim (on the government) is created and recorded at the BCB's balance sheet. The government is obliged to service this debt. From the accounting perspective, a liability of equal value is to be simultaneously incurred by the government as the counterpart of the BCB financial asset. So long as the BCB holds the asset, the liability is part of the GGGD, according to the *GFSM 2001/2014*. It bears noting that, in its own balance sheet, the BCB still counts its total holdings of government securities as part of its assets.

[6] The national definition is nevertheless reported as a memorandum item in the *GFSM* Brazil country Table 8, as well as in Table 3 of the Staff Report.

6. **The wedge between the national and GFSM definitions of gross debt (that is, the stock of *free* securities held by the BCB) has varied considerably over time.** The evolution of the two indicators—GGGD with and without *free* securities—is plotted in Figure 2. Although the difference amounted to over 15 percent of GDP in the past, it has narrowed considerably through November 2014 (to 3.2 percent of GDP), although it increased to 6.1 percent of GDP in December 2014. Incidentally, the two series suggest somewhat different trends in public debt; with the Fund measure showing a clearer declining trend in the pre-crisis years.

7. **By excluding *free* securities, the authorities' measure of GGGD is affected by central bank sterilization operations.** For a given stock of government securities in its portfolio, every time the central bank conducts REPO transactions, the authorities' GGGD indicator will change in equal measure. Thus, by this definition, public debt rises (falls) when the central bank mops up (injects) liquidity. The authorities find this a useful feature of the indicator as it induces lower monthly variation of the GGGD series (because the BCB sterilizes the short-term impact of government operations on market liquidity), even if the same smoothing effect is not observed at a yearly frequency. In any case, neither the Fund's nor authorities' gross debt concept is simply explained by the trajectory of the general government deficit in the last several years owing to the accumulation of government debt issued in favor of public banks (policy lending). Changes in net debt are thus closer to the government's net lending, as both the Treasury Single Account and claims on public banks are netted out.

Figure 2. Evolution of Different Measures of General Government Debt and Net Lending



8. **The negligible refinancing risk of public debt held by the central bank is acknowledged in the discussion of risks in staff's Debt Sustainability Analysis for Brazil.** While there is no legal obligation for the BCB to roll over its holdings of government debt indefinitely, the BCB has always done it, meaning that amortization of this debt does not create a need for financing from capital markets. Thus, actual gross financing needs from the market are lower than those measured by the amortization of total government debt (as measured by *GFSM2001/2014*): about 14 of GDP in public debt will be rolled over in 2015, of which 10.3 percent of GDP in the market.

INTERNATIONAL MONETARY FUND

BRAZIL

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 4, 2015

Prepared By

The Western Hemisphere Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2014)

Membership Status: Joined January 14, 1946; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	4,250.50	100.00
Fund holdings of currency (Exchange Rate)	3,641.68	85.68
Reserve Tranche Position	608.90	14.33
Lending to the Fund		
New Arrangement to Borrow	1,045.04	

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	2,887.08	100.00
Holdings	2,596.22	89.93

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				
	2015	**2016**	**2017**	**2018**	**2019**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	0.16	0.16	0.16	0.16	0.16
Total	**0.16**	**0.16**	**0.16**	**0.16**	**0.16**

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.

Staff has determined that 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 multiple currency practices (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 26, 2013. Brazil is on the 12-month cycle. Joint Fund/World Bank missions visited Brazil in 2002 for the Financial Sector Assessment Program (FSAP), which was discussed by the Board in December 2002. A FSAP Update mission took place in March 2012.

Technical Assistance

Fiscal Affairs Department (FAD). In September 2001, an FAD mission conducted a fiscal ROSC, and in December 2001 a mission provided Technical Assistance (TA) on tax reform. Subsequent missions have discussed the scope for increasing investment in infrastructure within a framework of continued fiscal responsibility, including during a follow-up visit in November 2004. In July 2008, a ROSC on fiscal transparency was undertaken for the state of São Paulo, which also received a seminar on performance budgeting in November 2008. In December 2009 a mission visited São Paulo to examine the state's medium-term expenditure framework with the purpose of improving fiscal performance and the quality of public expenditure. In November 2010, a short-term expert visited São Paulo to provide advice on cost accounting and a long-term advisor was installed in February 2011 to support efforts in this area. In April a follow-up mission evaluated progress in implementing the program budgeting and cost accounting systems. In May 2011, a short-term expert followed-up on the implementation of the program budgeting reforms. Between July 2011 and November 2014, FAD conducted several missions on public financial management, focusing on the review of the cost accounting systems and on improvements to the budgeting system in the State of São Paulo.

Statistics Department (STA). Several missions have visited Brazil during 1998–2014 to provide TA on monetary and financial statistics, annual and quarterly national income accounts, and government finance. These missions also assisted the authorities in the subscription to the SDDS, improving the analytical quality of Brazil's monetary aggregates, the development of quarterly sectoral accounts and balance sheets and the implementation of GFSM 2001. Recent missions have assisted the Ministry of Finance, the Banco Central do Brasil and the Instituto Brasileiro de Geografia e Estatística with the compilation of government finance statistics, price indices and the new national accounts framework, with greater emphasis on the consistency across macroeconomic statistics.

Monetary and Capital Markets Department (MCM). Missions visited Brazil in 2000 to assess observance of the Code of Good Practices on Transparency in Monetary and Financial Policies and compliance with the Basel Core Principles for Effective Banking Supervision. In August and December 2009, missions visited to assist the capital markets regulator (CVM) in considering mutual funds development and regulation, and issues surrounding securitization and valuation of financial securities. A mission visited in August 2009 to work on credit risk modeling for financial oversight. In March 2010 a mission visited the National Treasury to initiate a technical cooperation project on term-structure modeling and debt management. A follow up mission to present preliminary results took place in January 2011. The project was completed in May 2011 with the publication of an IMF working paper (No. 11/113), "On Brazil's Term Structure: Stylized Facts and Analysis of Macroeconomic Interactions."

Resident Representative

The Fund maintains a resident representative office in Brasilia. The Resident Representative is Mr. Fabian Bornhorst, who assumed the post in April 2014.

RELATIONS WITH THE WORLD BANK[1]

The World Bank approved its Country Partnership Strategy (CPS) for Brazil for FY 2012−15 in November 2011. The CPS built on, and deepened, the last FY 2008–11 Country Strategy. The main objective of the World Bank Group (WBG) program during this period has been to make a catalytic contribution to Brazil's efforts to eradicate poverty and to become a more prosperous and inclusive country. The World Bank Group has been a valued partner for Brazil, providing integrated and often multi-sector development solutions tailored to its needs. The Bank has also benefited greatly from Brazil's unique demands, which required the WBG to adapt and learn and provided a broad range of lessons on development for the Global Community in areas ranging from poverty reduction to social inclusion and environmental management.

In August 2014, the World Bank approved the progress report for the CPS. The Progress Report found that, while the rapid growth expected at the outset of the CPS period had been more elusive than expected, Brazil achieved significant success in reducing poverty and promoting shared prosperity in an inclusive and sustainable manner, with the support of Bank programs. Brazil remains one of the World Bank Group's most important partners, drawing on significant financial, knowledge and convening services of all the Bank Group entities; testing innovative new instruments and multi-sectoral approaches to solving development problems.

Brazil's priorities for its partnership with the WBG are focused on second-generation development problems that require innovative solutions. At the request of the government, the FY 12−15 CPS program has continued to strengthen the focus on sub-national entities, combining analytical and technical support at the federal level with the IBRD's largest lending program, implemented mostly through multi-sectoral operations at the subnational level. The program also provides significant knowledge, advisory, convening and South-South activities in order to address second generation development issues and to share the lessons of Brazil across the globe. The Bank's work has focused on supporting catalytic investments and policy reforms whose impact can be enhanced through replication and that benefit from the Bank's unique blend of financial and knowledge services. The heavy emphasis on multi-sector approaches reflects the multi-dimensional nature of addressing key development problems presented by the needs of country counterparts. The key building blocks of the strategy—its 4 strategic objectives and 14 results areas—remain relevant to, and well aligned with government priorities. The strategic objectives are focused on addressing key development challenges and are mutually reinforcing. They are: (i) increasing the efficiency of public and private investment; (ii) enhancing service provision to poorer segments of the population; (iii) reducing regional economic disparities; and (iv) improving sustainable natural resource management and climate resilience.

[1] Prepared by the World Bank.

IBRD lending program was US$2.019 billion for FY 14, and is programmed at US$1.5 billion for FY 15. While this is in line with previous years, it is equivalent to less than 0.3 percent of total public expenditures. IFC's investment program is forecast at about US$1.7 billion in FY 15, a minute fraction of total private sector investment. Thus, the WBG impact in Brazil cannot be derived exclusively from the size of its financial contributions, which are bound to be small with respect to the country's own resources. Rather, the WBG is seeking to have a development impact in Brazil through the knowledge contributions that it will embed in its various activities. In particular, the Bank Group deploys its resources according to the following principles. Flexibility: Adjusting areas of engagement and instruments to better respond to the country's evolving needs. Selectivity: Focusing on areas where Brazil faces second-generation development challenges and can benefit most from the Group's knowledge and experience. Innovation: Supporting innovative investments and policy reforms that can be replicated locally and internationally, and offering innovative services and instruments (e.g. result-based and multi-sector loans, partial credit risk and other guarantees). Leveraging: Increasing the use of leveraged resources from government, the private sector and other development partners, to maximize development impacts.

IFC will continue responding to the needs of a rapidly-evolving private sector with a suite of competitive financial and advisory products. IFC's investment portfolio in Brazil now stands at US$4.3 billion, including US$1.7 billion from syndications, making it the Corporation's third largest country program. IFC new commitments totaled US$2 billion in FY 13, including an IFC member-state record of US$514 million in equity. In FY 14 they reached US$1.8 billion. Looking forward, the commitment target for FY 15 is US$1.7 billion with investments geared toward: infrastructure, telecom, health, education, agribusiness and financial institutions, supporting the country in financial inclusion, urbanization, competitiveness and sustainable management of natural resources. In addition to its investment projects, IFC has provided Brazil's fast-growing private sector with various advisory services, including a partnership with BNDES for public-private partnerships (PPP).

MIGA has recently processed its first exposure transaction in Brazil since FY 09. While MIGA has had no exposure in the Brazil in recent years, it views Brazil as a target market, where it can support the government's agenda of meeting the country's massive infrastructure requirements, through the provision of guarantees of Non-Honoring Financial Obligations (NHSFO) in respect of financial payment obligations of the sovereign, sub-sovereign and state-owned enterprises. These products provide credit enhancement to borrowers to enable them to (i) reduce their funding costs, (ii) increase their access to long-term financing, and (iii) diversify their financing sources. A case in point is the São Paulo Sustainable Transport Project. MIGA's NHSFO guarantee, which was approved by the Executive Directors in April 2014, will mobilize long-term commercial bank financing on competitive terms, by guaranteeing the State of São Paulo's financial obligations under such bank financing. Brazil will also be the first IBRD beneficiary of the Bank Group's effort to take advantage of synergies across the balance sheets of World Bank Group entities. Brazil will gain about US$100 million in additional IBRD lending headroom through an exchange of existing IBRD exposure to Brazil, where MIGA has the capacity to assume higher exposure, for MIGA exposure to Panama, a country where IBRD has available capacity.

Brazil: World Bank-Fund Country Level Work Program Under JMAP	Provisional Timing of Missions	Expected Approval / Delivery Date
World Bank work program in the next 12 months		
A. Development policy lending		
1. Manaus Service Delivery - Development Policy Lending (DPL)		May-15
2. Sergipe 2nd - Development Policy Lending (DPL)		Jul-15
3. Piauí Productive and Social Inclusion - Development Policy Lending (DPL)		Sep-15
4. Recife Municipal - Development Policy Lending (DPL)		Nov-15
B. Investment Lending 1/		
1. Dedicated Grand Mechanism (DGM) for Indigenous people - Investment Project Financing (IPF)		Feb-15
2. Brazil Investment Plan - Investment Project Financing (IPF)		Feb-15
3. ProCerrado Federal Project - Investment Project Financing (IPF)		Feb-15
4. Alagoas Poverty Inclusion - Investment Project Financing (IPF)		Apr-15
5. Salvador Social Project - Investment Project Financing (IPF)		May-15
6. Teresina Municipal - Investment Project Financing (IPF)		May-15
7. Pernambuco Education SWAP - Investment Project Financing (IPF)		May-15
8. Bahia Regional Transport Development - Investment Project Financing (IPF)		Jul-15
9. Piauí Service Delivery - Investment Project Financing (IPF)		Aug-15
10. Paraíba Sustainable Rural Development - Investment Project Financing (IPF)		Jul-15
10. Fortaleza Sustainable Urban Development - Investment Project Financing (IPF)		Dec-15
11. Bahia State Entrepreneurship and Economic Autonomy Among Women - Investment Project Financing (IPF)		Dec-15
12. Market Instrument for Brazilian Climate Change Policy - Investment Project Financing (IPF)		FY 16
13. Environment Regulations of Rural Lands in the Cerrado - Investment Project Financing (IPF)		Feb-15
D. Analytical Advisory Services		
1. World Without Poverty (WWP) Learning Initiative - Programmatic Approach (PA)		Jun-15
2. Brazil Post-2020 Policy Scenarios for Emissions Reductions - Technical Assistance (TA)		Mar-15
3. Pensions Brazil - Technical Assistance (TA)		May-15
4. Urban Violence Prevention Brazil - Technical Assistance (TA)		Jun-15
5. Brazil Rural Water Supply - Technical Assistance (TA)		Jun-15
6. South-South Cooperation - Technical Assistance (TA)		Jun-15
7. Development of Systems to Prevent Forest Fires - Technical Assistance (TA)		Jun-15
8. Institutional and Financial Development Model for the São Francisco Waterway - Reimbusable Technical Assistance (RAS)		Feb-15
9. Involuntary Resettlement - Reimbusable Technical Assistance (RAS)		Mar-15
10. Fed Logistics and High Speed Train - Reimbusable Technical Assistance (RAS)		Apr-15
11. São Paulo Public Private Partnerships (PPP) - Reimbusable Technical Assistance (RAS)		Jun-15
12. Sustainable Vision for Rio Metropolis - Technical Assistance (TA)		Aug-15
13. Brazil – Extension of the School Day - Technical Assistance (TA)		Aug-15
14. 3rd Baixo do Irece Irrigation Project Reimbusable Technical Assistance (RAS)		FY 16
15. Brazil RAS Dam Safety - Technical Assistance (TA)		FY 16
16. Brazil Agriculture Risk Management - Programmatic Approach (PA)		FY 16
Country Studies Pipeline		
1. Brazil Urban Poverty and Vulnerability - Economic and Sector Work (ESW)		Feb-15
2. Metropolitan Governance - Economic and Sector Work (ESW)		Mar-15
3. RDC Study - Economic and Sector Work (ESW)		Mar-15
4. Brazil Skills and Jobs - Economic and Sector Work (ESW)		Apr-15
5. Brazil Drought Preparedness and Climate - Economic and Sector Work (ESW)		May-15
6. Brazil Chronic Disease and Health System - Economic and Sector Work (ESW)		May-15
7. Trust Fund (TF) - Pacto Pela Vida PSIA		Jun-15
8. Tocantins Rural Roads - Impact Evaluation (IE)		Mar-15
9. Recife Teacher Effectiveness - Impact Evaluation (IE)		Jun-15
10. Multi-sector Knowledge at the Service of the Favelas (Impact Evaluation)		Dec-15
11. Brazil: Systematic Country Diagnostic (SCD)		Aug-15
IMF work program in the next 12 months		
A. Staff visit	May-15	
B. Article IV mission	Oct-15	Dec-15

1/ All lending is subject to confirmation from new authorities

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK[1]

The IDB's Country Strategy with Brazil was approved on May 9, 2012. This was established for the period 2012–14 and is comprised of six strategic objectives: (1) stimulate social and productive inclusion; (2) improve the condition of the country's infrastructure; (3) promote the development of sustainable cities; (4) improve the institutional capacity of public entities; (5) increase the sustainable management of natural resources and climate change mitigation and adaptation actions; and (6) promote development through the private sector. A new Country Strategy with Brazil for the period 2015–18 is under preparation, and it is expected to be approved in the second semester of the current year.

For 2015, the total loan approvals are projected to reach US$1,856.0 million. Loans with sovereign guarantee make the bulk of the operations, amounting to US$1,609.0 million, while operations with the private sector are expected to total US$247 million.[2] In addition, the IDB program in the period estimates approvals of US$4.8 million in grants for Technical Cooperation.

In 2014, the IDB approved 30 loans amounting to US$2,947.8 million, including 21 sovereign guarantee operations for US$2,240.8 million. Half of the lending went to support productivity and infrastructure (50 percent), stimulate social and productive inclusion (22 percent) and institutional strengthening and modernization of the state (20 percent) and lending to subnational governments corresponded to 71 percent of total lending to Brazil. Among the major operations approved, some highlights are: (a) São Paulo State Road Investment Program Phase II (US$480.1 million), (b) Strengthening the Unified Health System in Salvador (US$200 million), (c) Road Program for Logistic and Integration Ceará Phase IV (US$200 million), and (d) Program of Environmental Sanitation of CAESB[3] (US$170.8 million).

Brazil: Loans Approved by the Interamerican Development Bank in 2014
(In million USD) 1/

	Subnational Gov.	Central Gov.	Private sector	**Total**
Stimulate social and productive inclusion	482	-	-	**482**
Improve the condition of the country's infrastructure	1,104	-	-	**1,104**
Promote the development of sustainable cities	171	-	-	**171**
Improve the institutional capacity of public entities	285	150	-	**435**
Increase the sustainable management of natural resource	-	-	-	**-**
Promote development through the private sector	48	-	707	**755**
Total value of loans	2,091	150	707	**2,948**
Total number of loans	20	1	9	**30**

1/ Based on the IDB's Strategy Areas for the period 2012–2014.

[1] Prepared by the Inter-American Development Bank.

[2] Private sector values does not include loans by the Inter-American Investment Corporation (IIC) and with the Multilateral Investment Fund (MIF) operations, both members of the IDB Group.

[3] Federal District Environmental Sanitation Company.

Brazil is the largest IDB borrower. The current active portfolio consists of 123 loans to the public sector (US$11,382 million) and 8 loans to the private sector (US$734.5 million). Brazil's outstanding debt with the IDB amounts to US$14,531 million (as of end of December 2014) and from the current portfolio US$8,932.7 million have not been disbursed yet (as of January 8, 2015).

STATISTICAL ISSUES

(As of January 30, 2015)

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: The national accounts estimates are compiled based on the guidelines of the *1993 System of National Accounts*. The availability of annual and quarterly supply and use tables also contribute to the development of consistent national accounts estimates. The series (data and supporting methodological notes) are available on the internet (http://www.ibge.gov.br) and in *International Financial Statistics* (IFS). The IBGE is in the process of changing the base year of the national accounts and implementing the *System of National Accounts 2008*. It is also participating in the G-20 Data Gaps Initiative regarding recommendation 15, which calls for developing a strategy to promote the compilation and dissemination of the balance sheet approach, flow of funds, and sectoral data on a quarterly and annual basis.

Price Statistics: Since July 1999, the official consumer price index 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. Wholesale price indices are compiled only by the Getúlio Vargas Foundation (FGV). The export price data include total unit values of exports, and unit values and wholesale prices of coffee exports. The IBGE compiles a monthly producer price index of manufacturing activity with a December 2009 base.

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) 2001* presentation. The reported statistics include the statement of government operations and financial balance sheet for the consolidated central government (comprising the National Treasury and Social Security) as well as financing operations and the financial balance sheet for the general government. The reported data are compiled by converting the nationally published data, which still broadly follow the *GFSM 1986* framework. The data reflect the movements of the single treasury account and are on a cash basis except for interest. The gross debt indicator excludes government securities under the central bank's outright ownership, making international comparisons difficult.

In 2009, the Brazilian authorities developed a migration plan for the full implementation the *GFSM 2001*. This plan comprises the introduction of a new accounting framework based on the International Public Sector Accounting Standards (IPSAS), which merges the traditional budgetary approach, the accrual based accounting, and some additional internal controls into a single system. This new accounting framework significantly enhances the usefulness of the Brazilian public sector accounting information, which will be a significant step towards the compilation of complete *GFS* in a systematic way, and is expected to be in place in 2015.

<table>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance (Concluded)</th></tr>
<tr><td colspan="2">Monetary and Financial Statistics: The BCB compiles and publishes monetary and financial statistics, with concepts, definitions, and classification that are broadly in line with the Monetary and Financial Statistics Manual (MFSM) 2000. In close cooperation with STA, the BCB introduced the standardized report forms based on accounting data in March 2013. However, the institutional coverage of the other financial corporations needs to be expanded to include insurance corporations, open pension funds, capitalization funds, and exchange houses.

The BCB regularly reports quarterly FSIs to the IMF for publication. Currently, the BCB reports all core and 18 encouraged FSIs, with data beginning in Q1 2005. Plans are under way to compile the rest of the encouraged FSIs.</td></tr>
<tr><td colspan="2">External Sector Statistics: Brazil disseminates quarterly data on the balance of payments and international investment position. External data are compiled according to the fifth edition of the Balance of Payments Manual. The BCB is supplementing the registry of the foreign exchange system with surveys on transportation, insurance, and other services. Compilation of reinvested earnings and undistributed branch profits item in the current account and reinvested earnings item in the financial account could be improved, as the registry of the foreign exchange system does not capture these transactions. The BCB publishes the data for monthly balance of payments and the Data Template on International Reserves and Foreign Currency Liquidity with a lag of one month. Brazil reports quarterly total external debt position data with a three-month lag to the World Bank's Quarterly External Debt Statistics database. The authorities are in the process of revising external sector statistics in line with the sixth edition of the Balance of Payments and International Investment Position manual (BPM6). This movement is consistent with the adoption of the new methodology of the System of National Accounts (SNA 2008) in Brazil, due to be published by end March 2015. Revised BOP data are expected to be published in April 2015, with revised external debt data expected in June. As part of this conversion, at least two important revisions will be made: foreign holdings of domestic debt securities will be included in external debt statistics, and its income, up to now reflected jointly with principal outflows, will be recorded separately.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>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, external position and flow statistics, real estate price indexes, general government statistics, and sectoral accounts.</td><td>No data ROSC is publicly available.</td></tr>
</table>

Brazil: Table of Common Indicators Required for Surveillance
As of January 30, 2015

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	1/29/15	1/30/15	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	1/28/15	1/30/15	D	D	D
Reserve/Base Money	Nov 14	1/30/15	M	M	M
Broad Money	Nov 14	1/30/15	M	M	M
Central Bank Balance Sheet	Nov 14	1/30 /15	M	M	M
Consolidated Balance Sheet of the Banking System	Nov 14	1/30/15	M	M	M
Interest Rates[2]	1/30/15	1/30/15	D	D	D
Consumer Price Index	December 14	1/09/15	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	December 13	9/30/14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	December 14	1/30/15	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 14	1/30/15	M	M	M
External Current Account Balance	Dec. 14	1/23/15	M	M	M
Exports and Imports of Goods and Services	Dec. 14	1/5/15	M	M	M
GDP/GNP	Q3 2014	11/28/14	Q	Q	Q
Gross External Debt	Dec 14	1/23/15	M	M	M
International Investment Position[6]	Q4 14	1/23/15	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

March 4, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS[1]

Approved By
Krishna Srinivasan and Tamim Bayoumi

Prepared by the Staff of the International Monetary Fund

CONTENTS

[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.

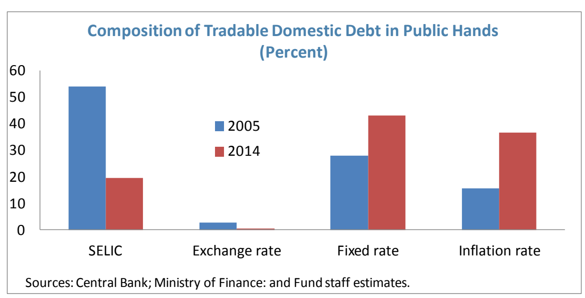
PUBLIC DEBT SUSTAINABILITY ANALYSIS

Gross debt of the nonfinancial public sector (NFPS) has remained high in recent years, reaching 71 percent of GDP in 2014, whereas net debt has declined by 13 percentage points of GDP in the last decade to 37.6 percent of GDP in 2014. The debt maturity profile and composition have improved over time, but spreads on government bonds remain somewhat elevated and external financing requirements are large. Primary surpluses around 1.6 percent of GDP (excluding interest revenue) are needed simply to keep gross debt from growing as a ratio to GDP, and larger primary balances will be needed to put the gross debt-to-GDP ratio on a downward path. In the baseline scenario, which is consistent with the government's announced targets for 2015−17, gross debt decreases by 2.2 percentage points to 68.8 percent of GDP by 2020. The trajectory of gross debt is sensitive to growth and fiscal policy underperformance given the pressure arising from high borrowing costs.

A. Background

Debt coverage. Brazil's gross debt statistics cover the NFPS, defined to exclude Petrobras and Eletrobras and consolidate the Sovereign Wealth Fund. The NFPS debt includes Treasury securities on the central bank's balance sheet, including those not used under repurchase agreements. At end-2014, the gross debt amounted to 71 percent of GDP.[2] The (consolidated) public sector has a large stock of assets, amounting to 39.1 percent of GDP in 2014, which include 19.4 percent of GDP in international reserves. Although net debt reported by the government corresponds to the public sector, defined to include the central bank, in this Debt Sustainability Analysis (DSA) we use net debt of the NFPS to maintain consistency. Non-financial public sector assets amount to 32.5 percent of GDP (see Box). Brazil's debt is reported at nominal value.[3]

Debt profile. Brazil's Federal government (FG) domestic tradable securities account for 92 percent of total NFPS gross debt in 2014, of which 2/3 were held by the public.[4] Active debt management in recent years has improved the profile of these instruments,



[2] The national definition of gross debt includes the stock of Treasury securities used for monetary policy purposes by the central bank (those pledged as security in reverse repo operations), but excludes the rest of the government securities held by the central bank. According to the national definition, gross debt of the general government amounted to 64.2 percent of GDP at end-2014.

[3] The nominal value is calculated by discounting future interest and principal payments at the existing contractual interest rate(s), and generally differs from face value.

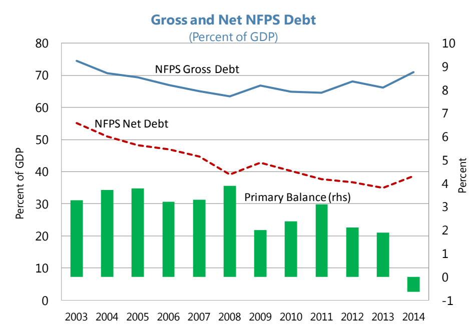
[4] The rest is held by the central bank on its balance sheet. The central bank uses over half of its holdings as security in liquidity-draining operations with the banking system.

which now display longer maturities, of about 4.4 years on average, up from less than 3 years in 2008. Still, a large share of domestic tradable securities, nearly 25 percent of total, matures within 1 year.[5] The government has the objective of raising average maturity to 5.5 years and bringing total short term debt (on both original and residual maturity basis) down toward 20 percent of all debt. Fixed-rate and inflation-linked domestic bonds have gradually replaced foreign-currency linked instruments and floating-rate bonds. Zero-coupon bonds with original maturities over one year constitute slightly more than half of FG domestic tradable securities held by the public, or 21.7 percent of GDP. Foreign holding of domestic debt has increased and amounted to 17 percent of total at end-2014.

In addition to tradable securities, other NFPS debt consist of liabilities issued by SOEs and subnational governments, as well as direct bank lending to the FG. Foreign currency denominated debt of the NFPS accounted for only 5 percent of the total in 2014, representing slightly more than 4 percent of GDP. Gross financing needs have tended to be high, above 15 percent of GDP. However, this figure overstates rollover risk, as a large fraction of the federal government debt (about 20 percent of GDP, with a maturity profile in line with that of overall debt) is held by the central bank, which follows a policy of automatic rollover of its holdings of government securities.

Box. Non-Financial Public Sector Debt and Assets

Although gross non-financial public sector (NFPS) debt has declined only marginally over the past decade, net debt has been on a mostly downward path. Brazil has made important strides in improving the debt profile, now displaying longer maturities, lower foreign exposure, and a higher share of fixed-rate instruments. Yet, while gross debt has hovered above 65 percent of GDP over the past decade, net debt was reduced significantly, supported by strong accumulation of assets. *What lies behind this evolution of assets and liabilities?*



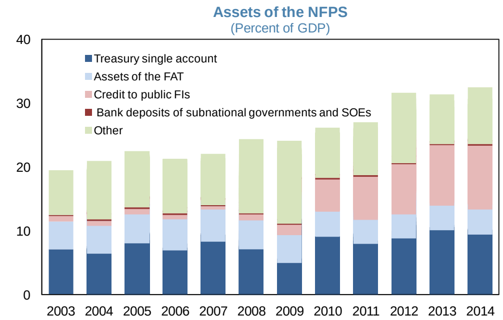
Sources: Central Bank; Ministry of Finance; and Fund staff estimates.

Lending through development banks and sterilization of capital inflows have been the main drivers of the widening wedge between gross and net debt. The build-up of assets has reflected the countercyclical policy followed in response to the global crisis, which was based on lending through development banks. In addition, sterilization of large foreign inflows that has resulted in an increase in international reserves has had as a counterpart growing Treasury cash holdings at the central bank (TSA). The TSA balances hit 11.9 percent of GDP in 2014 (compared to 7.1 percent in 2003) while credit to public financial institutions, mainly the national development bank (BNDES), increased from 0.5 percent of GDP before the global crisis to 10.8 percent of GDP in 2014. In addition, a large share of assets of the Workers' Assistance Fund (FAT)—now amounting to 4 percent of GDP, are mainly invested in the BNDES since, by its constitution, at least 40 percent of FAT's annual revenues must be transferred to

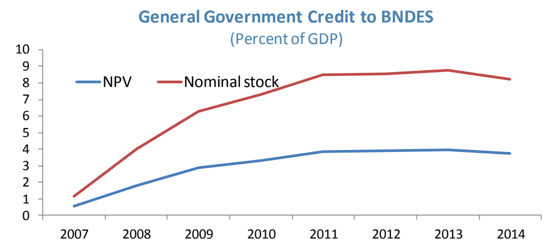
[5] This is broadly a recurring situation. At original maturity, short-term debt is very small, amounting some 2 percent of total NFPS debt.

Box. Non-Financial Public Sector Debt and Assets (Concluded)

finance programs promoting economic development.[1] Other assets include hybrid instruments of capital and debt (1.1 percent of GDP) and investment in funds and programs (2.8 percent of GDP) while the remaining share encompasses tax float, pension fund assets, and sight deposits of subnational governments. (This last group of assets has remained broadly stable during the period.) What are the risk and liquidity profiles of the NFPS' assets and what is their economic value?



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



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

There is no risk associated with TSA balances and their liquidity is high;[2] in the case of loans to BNDES, their liquidity and risk are low, but so is their economic value. The BNDES extends through direct credit one third of its resources to large and highly competitive foreign and domestic companies, mainly operating in the area of infrastructure, industry, and services, which must meet stringent eligibility criteria. BNDES also on-lends government resources through other major public and private banks, which channel credit and bear the risk of such lending operations. The repayment profile of BNDES loans is very favorable, with terms as long as 40 years, and grace periods of up to 20 years for the principal repayment and 5 years for interest. The interest rates BNDES charges on its loans are linked to the long-term interest rate (the TJLP), set by the National Monetary Council, which has been around 5−6 percent in since 2009. Reflecting attractiveness of BNDES loans to firms and high loan portfolio quality, historical default rates on BNDES loans have been below 3 percent and NPLs have more recently been near 0. From the government's perspective, despite the low risk profile of its loans to BNDES, their liquidity is by construction low because these loans are not in the form of a negotiable security. Their economic value is below their book value because the government borrows at the SELIC rate and earns the TJLP on its loans to BNDES.[3] Thus, the grant element implicit in government loans to BNDES is about 52 percent. The NPV of the stock of credit to BNDES, calculated with the government's borrowing cost as the discount factor, was below 4 percent of GDP at end-2014, less than half its nominal value.

There may be scope for achieving a better balance between gross debt and assets in the near future. Because assets have low liquidity or value (loans to BNDES) or must be maintained at reasonable precautionary levels (cash), gross debt remains the most useful indicator; thus, lowering the gross debt ratio is an important policy objective. Transfers from the Federal Government to BNDES are expected to stop, although BNDES will remain involved in funding of investment, including in infrastructure, by recycling its funds, and fostering capital market development including through guarantees. However, a sustained decline in gross debt will in any case have to be based on ambitious primary surpluses.

[1] The NFPS includes the FAT. Because there is no pre-defined amortization schedule, FAT's claims on BNDS can be considered as quasi-equity.

[2] Moreover, the TSA is remunerated at an average rate interest paid by the federal government securities in the central bank's portfolio, about 10−11 percent during the same period.

[3] BNDES is subject to Basel III requirements as other financial institutions in Brazil.

B. Baseline Scenario

Macroeconomic assumptions. The projections assume a real GDP contraction of -1 percent in 2015, a slight recovery in 2016, and a gradual return to potential growth of 2.5 percent by the end of the projection horizon. The assumed fiscal adjustment brings the primary balance to 2.5 percent of GDP by 2018, which implies an improvement of 3.1 percentage points of GDP during 2015–18. Policy lending is projected to stop from 2015. The nominal interest rates on new borrowing are between 11 and 13 percent over 2015–20, bringing the effective interest rate below 12 percent on average.[6] The DSA also assumes that deposits are made into the TSA held at the Central Bank to keep its balances constant at 11.9 percent of GDP (the latest observation) throughout the projection period. The baseline scenario assumes policy strengthening and implementation of the infrastructure concessions program, but otherwise limited structural reforms and a modest world output recovery. In this baseline, gross debt increases to 72 percent of GDP in 2015 before it declines to 68.8 percent of GDP in 2020. Gross financing needs are projected to remain above the high risk threshold of 15 percent of GDP on average over the medium term. The primary balance required to stabilize debt in the baseline scenario is 1.6 percent of GDP (excluding interest revenue).[7]

Past forecast errors. There is no evidence of a systematic projection bias in the baseline assumptions that would undermine the assessment of sustainability and the projected fiscal adjustment is in line with other countries' experiences. The median forecast error for GDP growth and the primary balance is below 1 percent and in line with other countries' forecast errors.

Realism of projections. Brazil's projected fiscal adjustment (an improvement of about 3 percentage point in the cyclically-adjusted primary balance/GDP over the medium term) is ambitious, but it appears achievable. The magnitude of adjustment is also in line with other countries' experiences, with a 3-year adjustment in cyclically-adjusted primary balance at the 20 percentile among all surveillance countries.[8]

C. Shocks and Stress Tests

- *Growth shock.* The impact on the debt-to-GDP ratio of the 1 standard deviation shock (2.6 percent) to real GDP growth is large. Over 2016-17, real GDP growth rates become negative while inflation declines by 150 bps in each year. The primary balance worsens before recovering in 2018; interest rates increase by 55 bps for each percentage point decline in output growth. In

[6] Interest rates on new borrowing are projected to behave in line with the latest yield curve of each instrument augmented for the change in the DI curve.

[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 (3.1 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 1.6 percent of GDP quoted in the main text.

[8] The interaction between growth and inflation are Brazil-specific and were estimated through a macro-model by desks. The estimates of the fiscal multipliers and persistence are part of the 2015 Article IV Selected Issues Paper. The fiscal multiplier and the persistence are estimated at 0.3 percent.

this scenario, gross debt increases above 81.5 percent of GDP by 2019 and stabilizes at 81.1 percent in 2020 while gross financing needs reach almost 23 percent of GDP.

- *Primary balance and real interest rate shocks*. In the primary balance shock consolidation is delayed by one year. In the interest rate shock borrowing costs increase by 200 bps in the first projection year and remain the same over the medium term. The impact of these shocks on debt and gross financing needs is modest, pushing up debt-to-GDP by 2 percentage points above the baseline in 2020.

- *Combined macro-fiscal shock and contingent liabilities shocks*. The macro-fiscal shock combines the growth and interest rates shock and a primary balance shock as in the standard examples above, together with the real exchange rate shock consistent with a maximum movement of the real exchange rate over the past 10 years and a pass-through coefficient of 0.25. The contingent liability shock simulates a loss of 10 percent of banking system assets, in line with the experience with past banking crises in other countries, and assumption of contingent liabilities by the public sector. The latter results in a primary deficit of -3.6 percent of GDP in 2016 and a 1 standard deviation shock to GDP growth in 2016 and 2017. The effect of these shocks on debt ratios and gross financing needs is large and reflects in particular the sensitivity of debt to growth shocks, which make the largest contribution to the change in the debt path. Debt-to-GDP reaches about 85 percent by 2020 in both shocks.

- *Heat map*. In addition to the vulnerabilities from shocks discussed above, the heat map suggests that the premium asked by the market on government borrowing, the reliance on external financing, and the share of short-term debt are all high pointing to risks to the debt profile. As noted earlier, however, the gross financing need indicator overstates actual rollover risk as a result of the policy of continuous rollover maintained by the Central Bank, which holds a significant amount of FG bonds.

Figure 1. Brazil: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(Percent of GDP unless otherwise indicated)

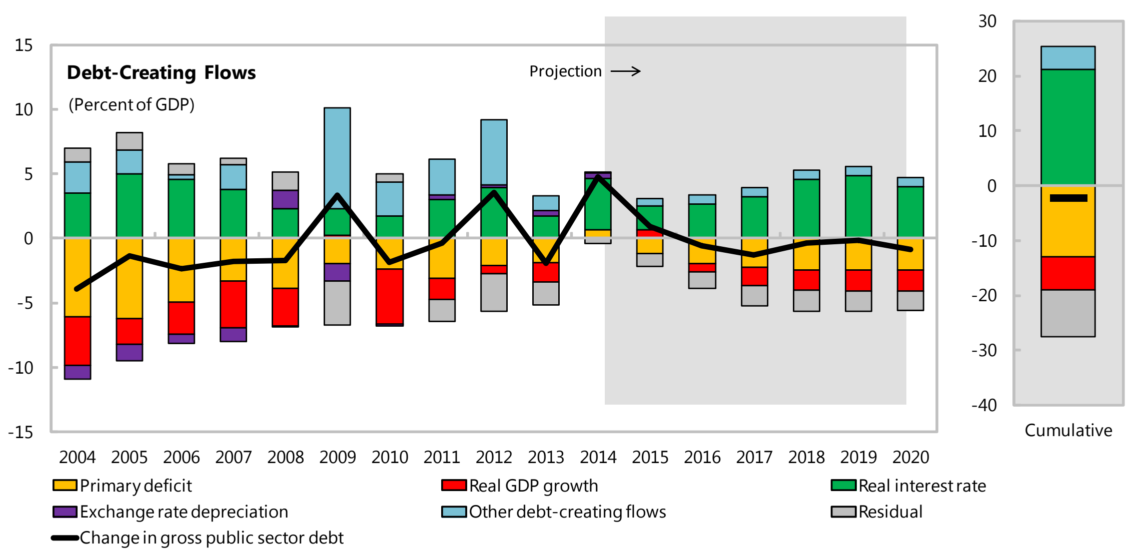
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2007-12 2/	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	65.5	66.2	71.0	72.0	71.4	70.2	69.8	69.7	68.8
Public gross financing needs	16.0	15.4	18.9	14.4	15.2	14.1	17.3	16.8	18.8
Real GDP growth (in percent)	3.7	2.5	0.0	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation (GDP deflator, in percent)	6.9	7.6	4.7	7.7	6.6	5.5	5.2	5.1	5.0
Nominal GDP growth (in percent)	10.9	10.3	4.6	6.6	7.6	7.8	7.6	7.7	7.7
Effective interest rate (in percent) 4/	11.9	10.6	11.0	10.3	10.7	10.5	12.4	12.7	11.4

As of January 23, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		297
5Y CDS (bp)		198
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB-	BBB+
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-12	2013	2014	2015	2016	2017	2018	2019	2020	Cumulative	Debt-Stabilizing Primary Balance 9/
Change in gross public sector debt	0.2	-1.9	4.8	0.9	-0.5	-1.3	-0.3	-0.1	-0.9	-2.2	
Identified debt-creating flows	1.1	-0.2	5.2	1.9	0.8	0.2	1.3	1.5	0.6	6.3	
Primary deficit	-2.8	-1.9	0.6	-1.2	-2.0	-2.3	-2.5	-2.5	-2.5	-13.0	3.1
Primary (noninterest) revenue and grant	34.9	36.4	36.0	36.0	36.0	36.1	36.2	36.3	36.3	216.9	
Primary (noninterest) expenditure	32.1	34.5	36.6	34.8	34.0	33.9	33.7	33.8	33.8	203.9	
Automatic debt dynamics 5/	0.6	0.6	4.4	2.5	2.1	1.8	3.1	3.2	2.4	15.1	
Interest rate/growth differential 6/	0.6	0.2	4.0	2.5	2.1	1.8	3.1	3.2	2.4	15.1	
Of which: real interest rate	2.8	1.7	4.0	1.8	2.7	3.2	4.6	4.8	4.0	21.2	
Of which: real GDP growth	-2.2	-1.5	0.0	0.7	-0.6	-1.5	-1.5	-1.6	-1.6	-6.1	
Exchange rate depreciation 7/	-0.1	0.4	0.4	…	…	…	…	…	…	…	
Other identified debt-creating flows	3.4	1.1	0.1	0.6	0.7	0.7	0.7	0.7	0.7	4.2	
Privatization	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	
Policy lending and TSA	3.4	1.1	0.1	0.6	0.7	0.7	0.7	0.7	0.7	4.2	
Residual, including asset changes 8/	-0.9	-1.8	-0.4	-1.0	-1.3	-1.5	-1.6	-1.6	-1.5	-8.5	
o/w Interest revenue	-1.6	-1.4	-0.8	-1.4	-1.4	-1.6	-1.7	-1.7	-1.5	-9.2	



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.

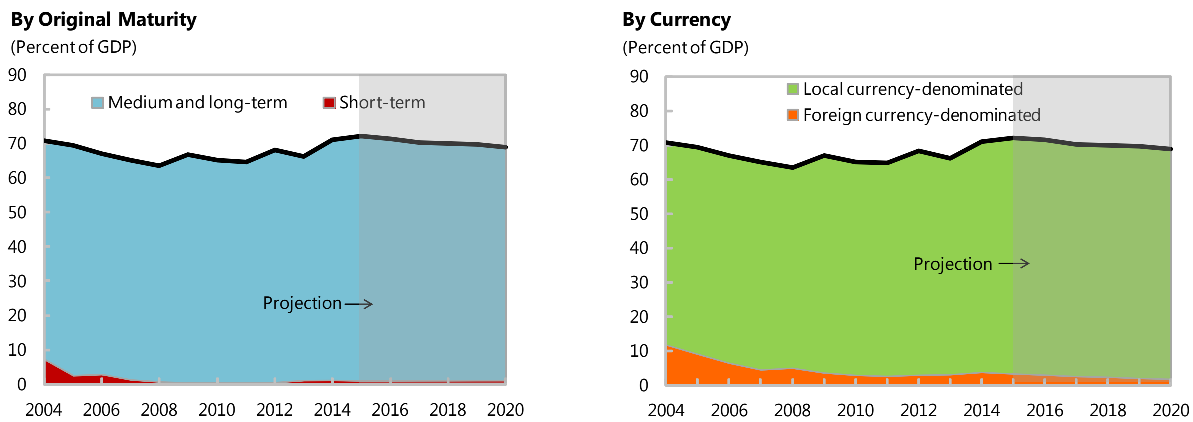
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

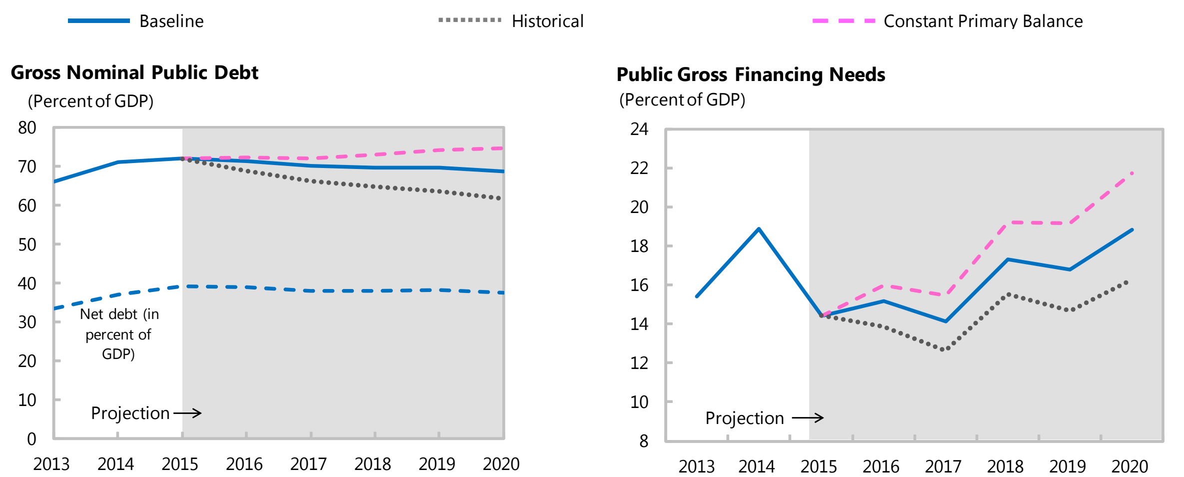
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year. Up to 2020, the primary balance shown is a non-interest balance, with interest income showing in the residual, but from 2021 onwards interest income counts toward the required primary balance.

Figure 2. Brazil: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



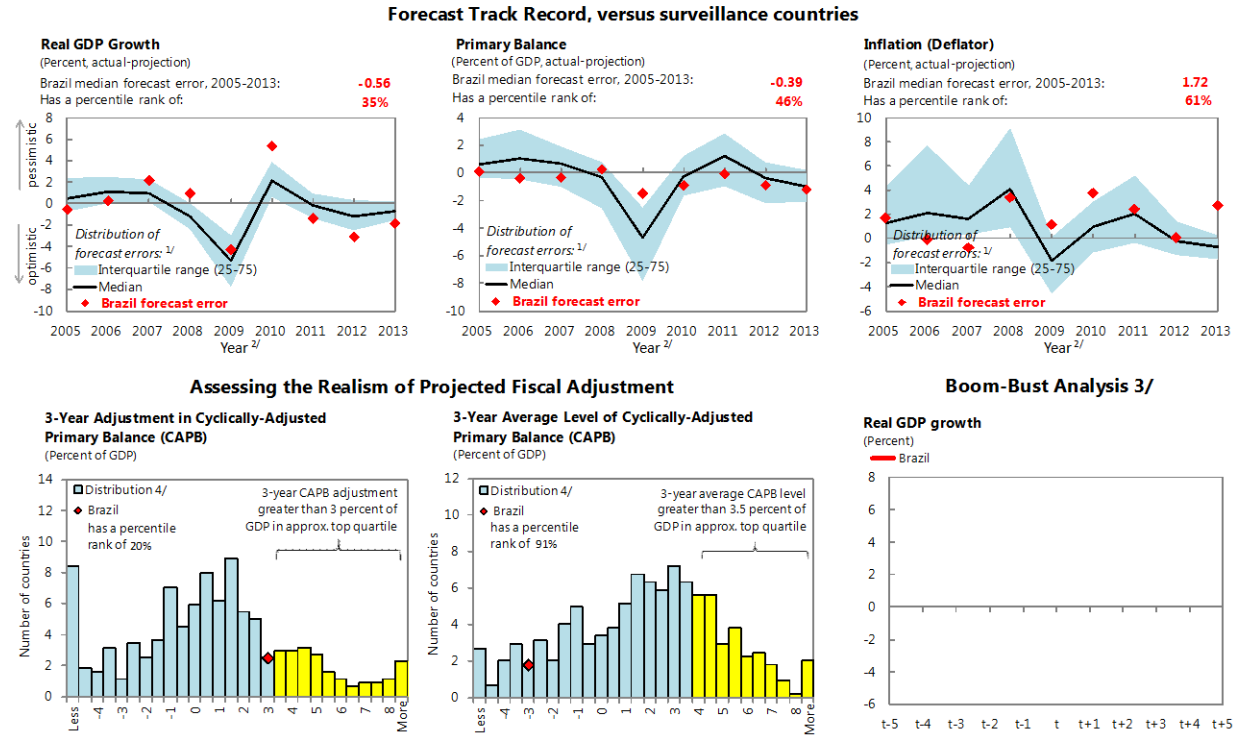
Underlying Assumptions
(Percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation	7.7	6.6	5.5	5.2	5.1	5.0
Primary Balance	1.2	2.0	2.3	2.5	2.5	2.5
Effective interest rate	10.3	10.7	10.5	12.4	12.7	11.4
Constant Primary Balance Scenario						
Real GDP growth	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation	7.7	6.6	5.5	5.2	5.1	5.0
Primary Balance	1.2	1.2	1.2	1.2	1.2	1.2
Effective interest rate	10.3	10.7	10.5	12.3	12.5	11.3

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-1.0	3.2	3.2	3.2	3.2	3.2
Inflation	7.7	6.6	5.5	5.2	5.1	5.0
Primary Balance	1.2	2.9	2.9	2.9	2.9	2.9
Effective interest rate	10.3	10.7	10.5	12.4	12.7	11.4

Source: IMF staff.

Figure 3. Brazil: Public DSA—Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

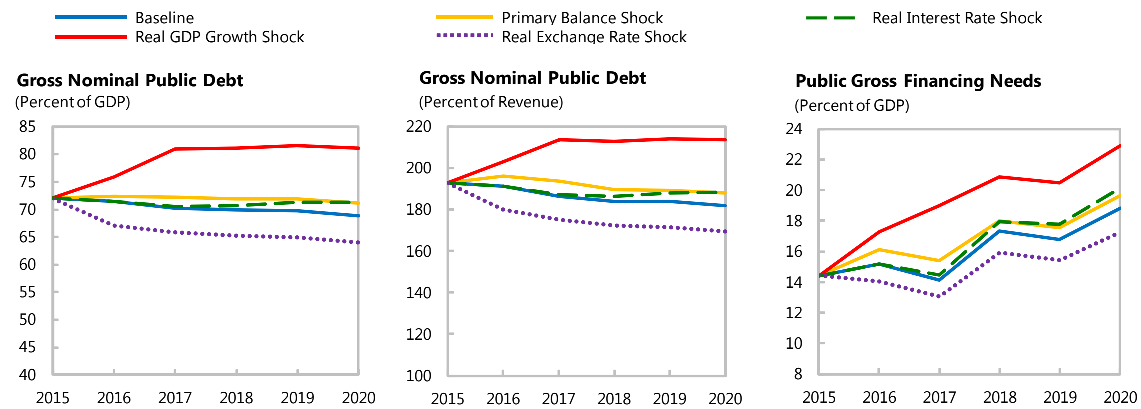
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Brazil.

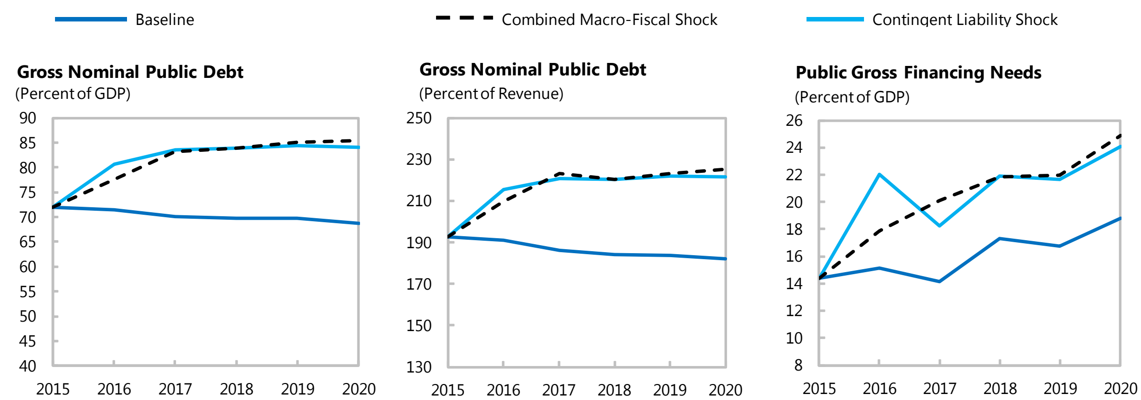
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Brazil: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation	7.7	6.6	5.5	5.2	5.1	5.0
Primary balance	1.2	1.1	1.3	2.5	2.5	2.5
Effective interest rate	10.3	10.7	10.6	12.4	12.6	11.4
Real Interest Rate Shock						
Real GDP growth	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation	7.7	6.6	5.5	5.2	5.1	5.0
Primary balance	1.2	2.0	2.3	2.5	2.5	2.5
Effective interest rate	10.3	10.7	11.0	13.1	13.7	12.6
Combined Shock						
Real GDP growth	-1.0	-1.7	-0.4	2.3	2.4	2.5
Inflation	7.7	5.1	4.0	5.2	5.1	5.0
Primary balance	1.2	0.1	-1.1	2.5	2.5	2.5
Effective interest rate	10.3	10.7	10.9	13.0	13.5	12.5

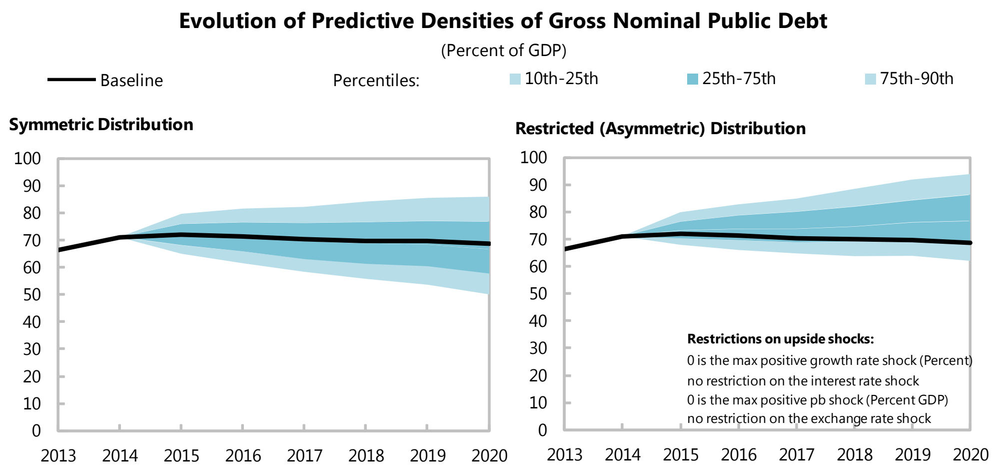
Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-1.0	-1.7	-0.4	2.3	2.4	2.5
Inflation	7.7	5.1	4.0	5.2	5.1	5.0
Primary balance	1.2	0.6	-0.6	2.5	2.5	2.5
Effective interest rate	10.3	10.7	10.7	12.7	12.8	11.5
Real Exchange Rate Shock						
Real GDP growth	-1.0	0.9	2.2	2.3	2.4	2.5
Inflation	7.7	15.1	5.5	5.2	5.1	5.0
Primary balance	1.2	2.0	2.3	2.5	2.5	2.5
Effective interest rate	10.3	10.7	10.4	12.3	12.6	11.3
Contingent Liability Shock						
Real GDP growth	-1.0	-1.7	-0.4	2.3	2.4	2.5
Inflation	7.7	5.1	4.0	5.2	5.1	5.0
Primary balance	1.2	-3.6	2.3	2.5	2.5	2.5
Effective interest rate	10.3	11.4	11.3	12.7	12.7	11.4

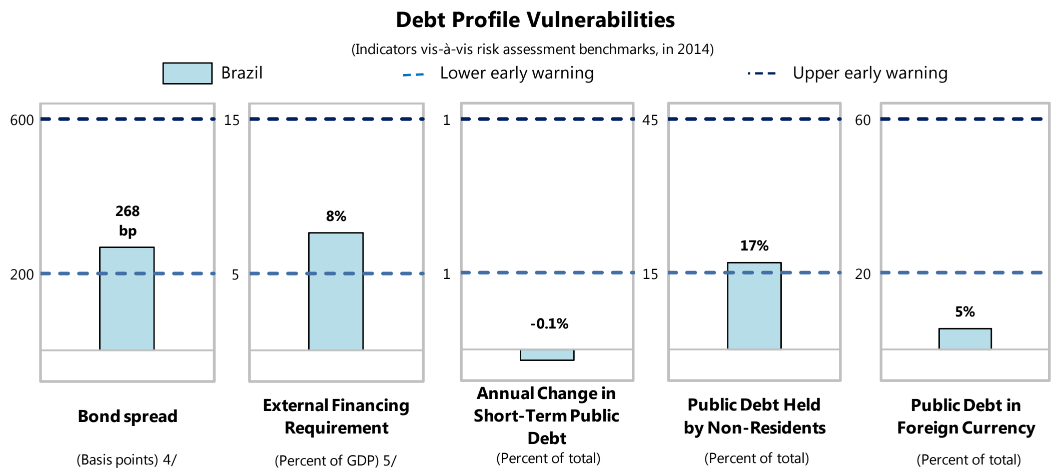
Source: IMF staff.

Figure 5. 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





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, 25-Oct-14 through 23-Jan-15.

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.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 15/167
FOR IMMEDIATE RELEASE
April 10, 2015

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Brazil

The Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with Brazil on March 16, 2015.

Starting in 2015, the new government has been introducing a series of measures to strengthen macroeconomic policies and restore credibility following a period in which Brazil's growth has surprised on the downside. Determined implementation of these measures should help restore confidence and foster a recovery in growth and investment in due course.
Brazil's growth has decelerated in recent years.[2] The boost from decade-old reforms, expanding labor income, and favorable external conditions, which enabled consumption and credit-led growth and underpinned sustained poverty reduction, has lost steam. Investment has been sluggish, reflecting eroding competitiveness, a worsening business environment, and lower commodity prices. Consumption has also moderated despite strong wage increases, as job creation has halted and financial conditions have tightened, affecting household income and consumer confidence.

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[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.

[2] References to GDP (including ratios to GDP) do not reflect the revised national accounts issued by IBGE in March 2015.

In recent years, headline and core inflation have been near the upper-edge of the inflation tolerance band, owing in part to sustained wage cost pressures, lingering indexation practices, and, more recently, the ongoing drought. In turn, longer-term inflation expectations rose since 2011, although they have edged down since end-2014. Meanwhile, modest increases in regulated energy and fuel prices helped hold back overall inflation for some time. But overdue adjustments in regulated prices are now underway, while inflation in market-determined prices is moderating reflecting tighter financial conditions and subdued economic activity. New inflation pressures are emerging from the Real's nominal depreciation.

The central bank hiked the monetary policy rate 375 basis points to 11 percent between April 2013 and April 2014. Policy tightening paused from May through September 2014. Between October 2014 and March 2015, the rate was again increased by a cumulative 175 basis points to prevent second round effects from currency depreciation and the anticipated increases in regulated prices.

Despite weakening domestic demand, the current account deficit reached 4.2 percent of GDP in 2014, up from 2.4 percent of GDP in 2012. The deterioration reflects worsening terms of trade, a drop in exports to Argentina, and an increase in fuel imports necessitated by the drought. The recent depreciation against the U.S. dollar, arising in part from general dollar strength, has not translated one-for-one into gains against competitors in global markets. Moreover, persistently high unit labor costs continue to dampen competitiveness. As a result, the external position is weaker than desirable, with the real still overvalued at end-2014.

International reserves are high and capital flows have remained stable. FDI financed more than 70 percent of the current account deficit in 2014, and portfolio inflows have been buoyant. At about US$362 billion, gross international reserves (cash concept) are well above the IMF's reserve adequacy metric and other standard benchmarks.

The banking system's soundness indicators remain favorable. Although private sector leverage and past expansion of public bank lending are potential sources of stress, banks' indicators are encouraging, showing adequate levels of capitalization and provisioning as confirmed by stress tests.

In 2013, the non-financial public sector primary balance declined to 1.9 percent of GDP, undershooting its 2.3 percent target despite one-off revenue measures. Coming on top of tax breaks introduced over 2012-2013, rapid real expenditure growth and slowing revenues brought the primary fiscal balance of the nonfinancial public sector to -0.6 percent of GDP in 2014, despite one-off measures of about ½ percent of GDP. Policy lending to public banks also edged back up. As a result, nonfinancial public sector gross debt increased to 71 percent of GDP. Declining growth and weak fiscal performance affected Brazil's sovereign credit rating in 2014. Standard & Poor's cut Brazil's credit rating to BBB- in March 2014, its first downgrade since July 2002. In September 2014, Moody's revised Brazil's sovereign rating outlook to negative.

Since January 2015, the government began introducing a series of important measures to strengthen macroeconomic policies and restore credibility. The linchpin of the new strategy is an ambitious fiscal adjustment to bring the primary surplus of the nonfinancial public sector to 1.2 percent of GDP in 2015 and to at least 2 percent of GDP in 2016 and 2017. The measures aim first to stabilize nonfinancial public sector gross debt and then put it in a downward trajectory.

Fund staff projects negative output growth of 1 percent in 2015, with some drag from tighter fiscal and monetary policies and from the cuts in investment by Petrobras adding to the downward momentum in activity carried over from 2014. Successful implementation of the fiscal adjustment strategy and other policy actions should contribute to strengthen confidence and help reinvigorate investment in the latter part of 2015, providing the basis for a return to positive growth in 2016. The outlook is subject to significant downward risks, including drought-induced rationing of energy and water, the possible fallout from the Petrobras case, and a more adverse international environment.

Executive Board Assessment[3]

Executive Directors underlined the success of the Brazilian authorities in reducing unemployment, poverty, and inequality in recent years. Directors noted that stalling growth, high inflation, and deteriorating public finances pose difficult challenges, while external downside risks also weigh on the outlook. In this context, they emphasized the need to further strengthen policy credibility and market confidence, boost investment and competitiveness, and reinforce the foundation for strong, balanced, and sustainable growth.

Directors welcomed the newly announced fiscal strategy, which includes targets for 2015−17, the decision to end policy lending to public banks, and the emphasis on reducing gross debt ratios. They stressed that achieving the budget targets would require ambitious, front-loaded measures. They supported the focus on cuts in current expenditures and tax exemptions to make room for priority spending on investment and social programs. Many Directors pointed to the benefits of targeting a higher primary surplus over the next two years in further strengthening policy credibility and the fiscal position, although some cautioned about the growth impact of such adjustment. Directors saw a need for continued fiscal reforms to reduce budget rigidities, simplify the tax system, and address structural sources of fiscal pressure more broadly, including the pension and wage indexation systems.

Directors encouraged strengthened governance frameworks in state-owned enterprises. They considered it an immediate priority to address the problems at the state-owned oil company and welcomed the authorities' commitment to find a swift resolution.

Directors generally agreed that monetary policy should remain tight. They welcomed the authorities' commitment to the announced inflation target and their readiness to take additional action so as not to jeopardize that target. Directors recommended further efforts to improve monetary policy transmission and the inflation targeting framework over time.

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[3] 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.

Directors noted that Brazil's flexible exchange rate has an important role to play as the main shock absorber. They welcomed the recent scale-down of the foreign exchange intervention program and recommended that its use remain limited to smoothing out excessive volatility, thereby allowing a further depreciation of the exchange rate in line with fundamentals and promoting external competitiveness.

Directors recognized the soundness of the banking system, with adequate capital buffers, provisioning, and liquidity. They stressed the importance of monitoring banks' balance sheets and corporate leverage in the current low-growth environment. Enhanced bank supervision, including for public banks, as well as targeted microprudential measures, would help mitigate potential risks. Directors were encouraged by the significant progress being made in implementing key recommendations of the Financial Sector Assessment Program.

Directors considered supply-side reforms as critical for boosting the economy's productive capacity and growth potential. They recommended that priority be placed on infrastructure investment and initiatives to enhance tax efficiency, improve the business climate, and foster international trade. Prioritization of reforms and greater private sector participation will be key to success.

Brazil: Selected Economic and Social Indicators

I. Social and Demographic Indicators

Area (thousands of sq. km)	8,512	Health	
Agricultural land (percent of land area)	31.2	Physician per 1000 people (2010)	1.8
Population		Hospital beds per 1000 people (2011)	2.3
Total (million) (est., 2013)	198.3	Access to safe water (2011)	97.2
Annual rate of growth (percent, 2013)	0.9	Education	
Density (per sq. km.) (2012)	23.3	Adult illiteracy rate (2013)	9.7
Unemployment rate (average, 2013)	5.4	Net enrollment rates, percent in:	
Population characteristics (2013)		Primary education (2013)	93
Life expectancy at birth (years)	75	Secondary education (2013)	54
Infant mortality (per thousand live births)	15	Poverty rate (in percent, 2013)	15.1
Income distribution (2013)		GDP (2013)	R$4,845 billion
By highest 10 percent of households	41.6		US$2,246 billion
By lowest 20 percent of households	3.2	GDP per capita (est., 2013)	US$11,326 billion
Gini coefficient (2013)	49.5		

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

II. Economic Indicators

	2011	2012	2013	Est. 2014	Proj. 2015	2016	2017	2018	2019	2020
National accounts and prices				(Annual percentage change)						
GDP at current prices	9.9	6.0	10.3	4.6	6.6	7.6	7.8	7.6	7.7	7.7
GDP at constant prices	2.7	1.0	2.5	0.0	-1.0	0.9	2.2	2.3	2.4	2.5
Consumption	3.6	3.2	2.4	1.9	-1.7	-0.2	1.4	1.5	2.0	2.1
Investment	3.1	-8.8	7.8	-10.1	-0.6	5.6	4.3	3.9	4.0	4.0
Consumer price index (IPCA, end of period)	6.5	5.8	5.9	6.4	7.0	5.4	4.8	4.6	4.6	4.5
				(In percent of GDP)						
Gross domestic investment	19.7	17.5	18.1	16.4	16.5	17.2	17.5	17.8	18.0	18.3
Private sector	17.4	15.0	15.6	13.7	14.2	14.9	15.2	15.4	15.6	15.8
Public sector	2.3	2.5	2.5	2.7	2.2	2.3	2.3	2.4	2.4	2.5
Gross national savings	17.6	15.1	14.5	12.2	12.9	13.6	14.0	14.4	14.6	14.8
Private sector	17.9	15.3	15.1	16.1	15.5	15.4	15.3	15.1	15.1	15.3
Public sector	-0.2	-0.2	-0.6	-4.0	-2.6	-1.8	-1.3	-0.7	-0.5	-0.5
Public sector finances				(In percent of GDP)						
Central government primary balance 1/	2.2	1.7	1.6	-0.4	1.0	1.5	1.7	2.0	2.0	2.0
NFPS primary balance	3.1	2.1	1.9	-0.6	1.2	2.0	2.2	2.5	2.5	2.5
NFPS overall balance	-2.6	-2.8	-3.3	-6.8	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
NFPS overall balance (incl. net policy lending)	-3.6	-4.2	-3.9	-7.9	-5.1	-4.3	-3.8	-3.2	-3.1	-3.1
Net public sector debt	36.4	35.3	33.6	37.2	39.3	38.9	38.2	38.1	38.2	37.6
GG gross debt (authorities' definition)	54.2	58.8	56.7	64.2	...	...	...	...	...	...
NFPS gross debt	64.7	68.2	66.2	71.0	72.0	71.4	70.2	69.8	69.7	68.8
Of which: Foreign currency linked	2.7	3.1	3.2	3.9	3.8	3.7	3.7	3.7	3.7	3.7
Money and Credit				(Annual percentage change)						
Base money 2/	10.8	-13.6	13.1	-4.5	6.6	7.6	7.8	7.6	7.7	7.7
Broad money 3/	18.5	15.9	8.9	15.5	14.8	14.5	14.2	14.1	14.0	14.0
Bank loans to the private sector	20.2	15.8	15.3	11.5	11.6	11.9	12.4	12.8	13.1	13.5
Balance of payments				(In billion of U.S. dollars, unless otherwise specified)						
Trade balance	29.8	19.4	2.4	-3.9	9.8	11.1	15.7	22.8	23.7	25.0
Exports	256.0	242.6	242.0	225.1	212.3	221.1	235.1	252.0	262.9	274.5
Imports	-226.2	-223.2	-239.6	-229.0	-202.4	-210.0	-219.4	-229.2	-239.1	-249.6
Current account	-52.5	-54.2	-81.1	-90.9	-73.5	-76.7	-79.2	-79.7	-85.9	-90.1
Capital account and financial account	112.4	70.0	74.2	99.6	73.5	76.7	79.2	79.7	85.9	90.1
Foreign direct investment (net)	67.7	68.1	67.5	66.0	53.9	54.0	52.6	53.8	55.3	56.8
Overall balance	58.6	18.9	-5.9	10.8	0.0	0.0	0.0	0.0	0.0	0.0
Terms of trade (percentage change)	7.8	-5.8	-2.1	-3.7	2.5	-1.2	-1.1	-0.8	-0.6	-0.6
Merchandise exports (in US$, annual pct. change)	26.8	-5.3	-0.2	-7.0	-5.7	4.2	6.3	7.2	4.3	4.4
Merchandise imports (in US$, annual pct. change)	24.5	-1.4	7.4	-4.4	-11.6	3.7	4.5	4.5	4.3	4.4
Total external debt (in percent of GDP)	16.3	19.6	21.4	25.7	28.8	29.5	30.0	30.5	31.0	31.5
Memorandum items										
Current account (in percent of GDP)	-2.1	-2.4	-3.6	-4.2	-3.6	-3.6	-3.5	-3.4	-3.4	-3.4
Gross official reserves	352.0	373.1	358.8	363.6	358.3	358.8	359.6	360.4	361.2	362.3
REER (annual avg., in pct. change; appreciation +)	3.5	-10.0	-5.6	-1.0	...	...	...	...	...	...

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

1/ Includes the federal government, the central bank, and the social security system (INSS). Based on 2015 draft budget, recent announcements by the authorities, and staff projections. Assumes no policy change.

2/ Currency issued plus required and free reserves on demand deposits held at the central bank.

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

Statement by Paulo Nogueira Batista, Executive Director for Brazil, Ivan Oliveira Lima, Alternate Executive Director, and Fabio Najjarian, Advisor to Executive Director
March 16, 2015

1. We would like to thank staff for the report and the accompanying papers as well as for the fruitful interaction with the authorities during the visit to Brazil. The Article IV mission took place in the first fortnight of December 2014 – in the middle of a government transition – when many policy measures were still being formulated and the new economic team was not yet in office. In 2015, Brazil embarked on an ambitious economic consolidation program. Tight macroeconomic policy objectives were set to correct the deterioration of the fiscal and external positions that occurred especially in 2014 and steer inflation back to the midpoint of the target range. The authorities expect that this will lay the ground for a new cycle of growth and further rises in living standards, as fiscal and monetary indicators improve and market confidence builds up.

Economic activity

2. Economic activity will remain subdued in the near term, but the authorities foresee a recovery already in the fourth quarter of 2015. They expect the economy to gain more steam in 2016, as business and consumer confidence improve in response to the implementation of the adjustment program.

3. As indicated in paragraph 29 of the staff report, the Brazilian authorities disagree with staff's growth forecasts for 2015 and 2016, which they consider to be overly pessimistic. Some of the assumptions behind staff's projections seem exaggerated, such as the weight that appears to have been attributed to possible water and energy rationing and the impact of the reduction in investment by Petrobras, the state-controlled oil company. The tariff realignment should have an impact on the demand for energy, and recent rainfall has resulted in some increase in reservoir levels in the regions most affected by a severe drought. Staff's projections are worse than current market readings: the most recent central bank's survey of market expectations presents medians of -0.78 percent and 1.3 percent for GDP growth in 2015 and 2016, respectively.

4. Regarding Petrobras, it is important to note that the company is fundamentally sound. In 2014, Petrobras registered a record production of 2.67 Mbpd of oil and natural gas, with the new pre-salt production areas responding for about ¼ of total output. In 2015, the company is expected to benefit from higher production, larger refining capacity, higher domestic prices and lower import prices. The Brazilian securities and exchange commission (*Comissão de Valores Mobiliários* – CVM) is in dialogue with its counterparts abroad and Petrobras' external auditors in order to accelerate the publication of an audited financial statement.

Fiscal and monetary policy objectives for 2015-2017

5. President Dilma Roussef was reelected in October 2014 and started her second mandate on January 1st, 2015. In December 2014, the economic team appointed to take office at the start of her new term announced some of its macroeconomic policy objectives. On the fiscal policy side, the goal is to reach a primary surplus of 1.2 percent of GDP in 2015 and at least 2.0 percent of GDP in 2016 and 2017. It was also announced that the Treasury would not provide new policy lending for public banks, which will help stabilize and subsequently reduce the gross public debt to GDP ratio. On the monetary policy front, end-2016 was established as the horizon for inflation to converge to the 4.5 percent midpoint of the target range.

6. Staff's call for higher primary surplus targets and additional monetary policy tightening does not seem entirely persuasive. Planned fiscal consolidation is already very strong. The staff report itself estimates that the structural primary deficit of 0.6 percent of GDP in 2014 will be converted into a 2.5 percent surplus in 2016 – a swing of more than 3 percentage points of GDP in only two years (table 3). Staff's estimate of the planned adjustment is even larger if policy lending is included in the calculation of the structural primary balance.[1] Moreover, the central bank has already undertaken and is continuing to undertake significant monetary tightening. All this is being done in a scenario of weak growth.

7. The authorities are facing difficult trade-offs. Fiscal consolidation includes an adjustment of relative prices that is taking a toll on inflation in the short run. Exchange rate depreciation should benefit the current account balance but is also having an impact on inflation. Monetary tightening, in turn, implies a higher cost for servicing public debt, making the objective of reducing the public debt ratio more difficult. Despite these challenges, the authorities are forging ahead with their adjustment program.

Fiscal policy

8. The above mentioned objectives are already being translated into concrete measures, as shown in Box 4 of the staff report. Since the report was issued, one of the possible additional measures listed there is in the process of being submitted to Congress under urgency procedures. We refer to the reversal of payroll tax cuts, which is estimated to yield 0.4 percent of GDP savings per year.

9. The design of fiscal adjustment measures was guided by long-standing government goals. Thus, social spending is being preserved, in the pursuit of further gains in the

[1] The structural primary balance including policy lending is estimated to rise from a deficit of 1.7 percent of GDP in 2014 to a 2.5 percent surplus in 2016 (table 3).

reduction of poverty and social inequality. The authorities have also given attention to improving the balance between current expenditure and investment, with a view to increasing the share of investment in output and fostering long-term economic growth.

10. In order to ensure that limits on discretionary expenditures will be observed in 2015, the government preventively set lower ceilings for these expenditures until the approval by Congress of the Annual Budget Law. The Federal Government also established an inter-ministerial working group to monitor and evaluate public spending.

11. Fiscal consolidation at the sub-national level will be pursued through enhanced control procedures. This will include a review of regulations, a tightening of the criteria for authorization for new domestic borrowing, and stricter limitations on the granting of warranties on external loans. Moreover, revenues from the *Imposto sobre Circulação de Mercadorias e Serviços* (ICMS), which is collected by state governments, are expected to increase due to the recent realignment of energy and fuel prices.

Public debt

12. Staff estimates that the gross public debt to GDP ratio will rise slightly in 2015 and gradually decline as of 2016 (table 3). It should be noted, however, that there is a significant difference between the Fund's and the authorities' definitions of gross public debt. The former includes in gross public debt all treasury securities held by the Central Bank of Brazil (BCB). The latter excludes the treasury securities that are held by the BCB and only accounts for those held by the public – including as collateral for BCB's liquidity-mopping repos. The authorities' definition is widely used by financial markets, including major international banks, and by the three largest rating agencies in their debt sustainability analyses.

13. As can be seen from table 3 of the staff report, the divergence between the two definitions is far from negligible. Under the Fund's approach, the ratio of gross public debt to GDP was nearly 7 percentage points higher in 2014. The Fund's methodology also leads to an overestimation of gross financing needs, as the rollover risk of securities held by the BCB is insignificant – something that staff now recognizes. Despite this recognition, the debt sustainability analysis is entirely based on the Fund's inappropriate definition of gross public debt.

Monetary policy and FX swaps

14. The BCB is determined to bring inflation back to the 4.5 percent midpoint of the target range by the end of 2016. After having raised the policy rate by 375 basis points from April 2013 to April 2014, the BCB resumed monetary tightening last October, increasing the policy rate by a further 175 basis points, totaling a 550 basis-point increase. This will help cope with the second-order effects on inflation arising from two important adjustments in

relative prices currently underway: i) the realignment of tradables prices vis-à-vis those of non-tradables; and ii) the realignment of administered vis-à-vis market-based prices.

15. The authorities have stressed that the floating exchange rate regime remains the first line of defense. The exchange rate has moved in response to changing fundamentals and external shocks. A FX swap program was put in place in August 2013 to mitigate financial risks arising from monetary policy normalization in the U.S. and has helped preserve financial stability by allowing economic agents to hedge their foreign exchange positions. As they are settled in local currency, the FX swaps do not compromise or commit international reserves. The BCB considers that the notional value of FX swap contracts outstanding is broadly in line with the hedging needs of the private sector. As indicated in the staff report, the latest extension of the FX swap program on a reduced scale and for a shorter period is consistent with this view.

16. Staff's argument that the swap program, by lowering the cost of hedging, encouraged excessive risk taking is debatable. Actually, lower costs facilitate access to hedging and therefore a reduction and a better distribution of risks.

Financial sector

17. Data in table 6 of the staff report indicate that the Brazilian financial system has ample liquidity, is well-provisioned and holds adequate capital levels. Financial sector regulation and supervision are recognized to be strong, both in terms of on-site and off-site monitoring.

18. The BCB is confident that credit expansion in recent years did not create fragilities in the banking system. Staff's assessment of the risk of deterioration of banks' balance sheets in a scenario of low growth seems exaggerated. We note that stress tests conducted by the central bank with extreme scenarios proposed by staff only pointed out to some – yet limited – need for additional capital.

19. Staff emphasizes the need for close monitoring of the health of bank balance sheets in response to evolving economic conditions without sufficiently recognizing the extent to which the BCB is able to exercise its supervisory mandate. In particular, the BCB's credit registry system tracks 99 percent of banking credit, allowing for early identification of asset quality deterioration, an aspect that the staff report should have taken into account.

20. The level of non-performing loans (NPLs) in the banking system as a whole remains low. The ratio of NPLs to total loans has been stable at less than 3 percent since 2013. At 2.1 percent as of September 2014, the NPL ratio of public banks continues to be significantly lower than that of private banks (table 6).

External Sector

21. The current account deficit has widened and is expected to have reached 4.2 percent of GDP in 2014, compared to 3.6 percent in 2013[2]. Brazil's attractiveness to foreign investors, however, remains strong. Foreign direct investment (FDI) in 2014 surpassed USD 60 billion, enough to cover more than ¾ of the current account deficit. Brazil accounted for 4.4 percent of global FDI inflows and ranked among the top five FDI host economies in UNCTAD's 2014 World Investment Report. The BCB expects FDI flows to remain broadly stable in 2015, around USD 65 billion.

22. The rise in the current account deficit is in part due to exogenous factors, such as a worsening in the terms of trade and a reduction in demand from important trading partners. The ongoing realignment of the exchange rate, with further real effective exchange rate depreciation in late 2014 and early 2015, will help reduce the current account deficit going forward. Moreover, the authorities expect that the recovery in the U.S. will have a positive impact on Brazilian exports.

23. Brazil's foreign reserves are one of the country's main strengths, a point perhaps insufficiently stressed by staff. Reserves closed 2014 at USD 364 billion, the equivalent of 377 percent of short-term debt at residual maturity and more than 15 months of prospective imports of goods and non factor services (table 5 of the staff report). Nonetheless, the high level of reserves is not taken into account in staff's analysis of external risks; it is not even mentioned in the report's Risk Assessment Matrix (Appendix III).

Investment program

24. Brazil's investment program covers three key areas: (i) removal of regulatory obstacles to investment, especially to infrastructure investment; (ii) adoption of coordinated policy measures for increasing competiveness; and (iii) improvement of labor force skills and promotion of innovation in order to boost productivity and lift potential growth.

25. For each of these areas, specific measures have been planned to address Brazil's policy gaps and challenges. Those measures include: i) an infrastructure investment package of USD 40 billion in the form of concessions and public-private partnerships already negotiated, and projects in the pipeline totaling USD 110 billion; ii) a new regulatory framework for small and medium enterprises to reduce red tape and improve their access to capital markets and export credit; iii) trade facilitation through the integration of all foreign trade procedures under a new single window system; and iv) implementation of the National Education Plan and the National Program of Knowledge Platforms.

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[2] It should be noted, however, that part of the increase in the current account deficit as a proportion of GDP reflects the impact of exchange rate depreciation on GDP expressed in dollar terms.

New investment instruments have been developed to facilitate private sector participation in infrastructure projects, such as the infrastructure debentures (fixed-income securities linked to infrastructure projects). As of December 2014, the outstanding volume of these debentures surpassed 15 billion reais, with maturities ranging from 5 to 17 years.

Social programs

26. In 2014, Brazil's social programs continued to advance firmly in line with their main objectives: universal coverage of social protection through the application of well-defined criteria; economic inclusion of the poorest; and reduction of income, gender, color, and regional inequality.

27. The main instrument to achieve these objectives has been *Bolsa Família* (BF), the conditional cash transfer program created in 2003. In 2011, the target of overcoming extreme poverty in Brazil started to be more directly addressed with the creation of the *Brasil Sem Miséria* social program.

28. Box 1 of the staff report provides a useful summary of the two programs, but we add further information to emphasize some of their most important features:

- Close attention is given to efficient program implementation. In spite of its wide scope – currently reaching 54 million people or 14 million families – BF's budget, at around 0.5 percent of GDP, is relatively low, and administrative costs represent less than 5 percent of the total.

- Program monitoring is strong. Around 1.3 million people were excluded from BF in 2014 (an election year), either for not having fulfilled the requirement for biannual update of their data; for not having continued to meet the conditionalities (regularly checked against information provided by the educational and health systems); or for no longer meeting the revenue criterion (monitored through cross-checking of data with several other official databases).

- BF's national reach is ensured by the participation of all states and municipalities, which has also been key to the development of the Single Registry of Social Programs of the Federal Government. This centralized database, in turn, has provided support for several initiatives under *Brasil sem Miséria*, such as the enrollment of 1.8 million people in the professional training program *Pronatec* and the formalization of 1.2 million micro-entrepreneurs, in addition to far-reaching initiatives for the improvement of water and energy supply, prevention and the treatment of the most common diseases among children, and the expansion of day care, which now reaches 700 thousand children registered in BF.

29. As a result of these concerted actions, the rate of chronic poverty in Brazil has fallen from 1.8 percent of the population in 2011 to 1.1 percent in 2014; and the country has left the map of world hunger of the Food and Agriculture Organization of the United Nations.