

**EXECUTIVE
BOARD
MEETING**

SM/21/122
Correction 5

July 22, 2021

To: Members of the Executive Board
From: The Secretary
Subject: **2021 External Sector Report—Chapter 3**

Board Action:

The attached correction to SM/21/122 (7/1/21) has been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

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Questions:

Mr. Leigh, RES (ext. 34747)
Mr. Rabanal, RES (ext. 36784)

Table 3.4. Brazil: Economy Assessment

Overall Assessment: <i>The external position in 2020 was broadly in line with the level implied by medium-term fundamentals and desirable policies. In the wake of the COVID-19 shock, the CA deficit contracted due to the large currency depreciation and improvements in the service and income balances. The trend is expected to persist in 2021.</i>						
Potential Policy Responses: Policies that would help keep the CA in line with its norm include desirable fiscal consolidation, accompanied by measures to support public and private investment, including structural reforms to improve efficiency and reduce the cost of doing business. FX intervention, including using derivatives, may be appropriate to alleviate disorderly market conditions in the FX market.						
Foreign Asset and Liability Position and Trajectory	<p>Background. Brazil's NIIP was -38 percent of GDP at the end of 2020, moderately stronger than at the end of 2019 (-42 percent of GDP) mainly due to valuation effects associated with the currency depreciation (assets are predominantly denominated in FX while liabilities are more concentrated in local currency). At the end of 2020 external debt declined by about 5 percent in nominal terms compared with 2019, accounting for about 44 percent of GDP and 303 percent of exports, against a value of 36 percent of GDP and 299 percent of exports in 2019, with the large increase in the external-debt-to-GDP ratio in 2020 driven by the significant output contraction when measured in US dollars.</p> <p>Assessment. Brazil's NIIP has been negative since 2001. Short-term gross external financing needs are significant, at about 11 percent of projected 2021 GDP, with capital flows and the exchange rate particularly sensitive to global financing conditions.</p>					
2020 (% GDP)	NIIP: -38.53	Gross Assets: 63.5	Res. Assets: 24.8	Gross Liab.: 102.0	Debt Liab.: 44.63	
Current Account	<p>Background. The CA deficit contracted from -3.5 percent of GDP in 2019 to -1.7 in 2020 due to improvements in the trade, service, and income balances, supported, respectively, by the currency depreciation, the contraction in tourism and transportation service imports, and lower distribution of profits and dividends. In 2021 the trade balance is expected to continue to improve on the back of a recovery in economic activity in trading partners that would boost exports, more than offsetting the rebound in imports. Overall, the IMF staff projects a CA balance of about -0.4 percent of GDP for 2021.</p> <p>Assessment. In 2020 the cyclically adjusted CA balance was -1.6 percent of GDP. EBA estimates suggest a CA norm in 2020 of -2.4 percent of GDP. The IMF staff assesses a CA norm between -1.9 percent of GDP and -2.9 percent of GDP. Thus, after adjusting for the transitory impacts of the COVID-19 crisis on the oil; travel services, including tourism; and medical goods sectors (resulting in an impact on the CA balance of 0.3 percent, -0.3 percent, and 0.1 percent of GDP, respectively), the IMF staff CA gap is assessed at 0.9 percent of GDP. The medium-term outlook for the CA is still difficult to assess, given the unfolding COVID-19 crisis and related policy response.</p>					
2020 (% GDP)	CA: -1.7	Cycl. Adj. CA: -1.6	EBA Norm: -2.4	EBA Gap: 0.8	COVID-19 Adj.: 0.1	Other Adj.: 0.0
Real Exchange Rate	<p>Background. After remaining broadly stable in 2019 (-1.9 percent), the REER depreciated sharply in 2020 (-20.6 percent), driven by large capital outflows in the first half of the year. Depreciation pressures have subsided since mid-May 2020. As of end-May 2021, the REER had depreciated by 3.5 percent compared with the 2020 average.</p> <p>Assessment. The IMF staff CA gap implies a REER gap of -7.1 percent in 2020 (applying an estimated elasticity of 0.13). The REER index (-36.6 percent) and level (-21.3 percent) methodologies point to some possible overshooting of the nominal exchange rate. Overall, the IMF staff assesses the REER gap at the end of 2020 to be closer to the REER gap implied by the IMF staff CA gap. Therefore, considering the CA norm standard error of 0.8 percent, the IMF staff assesses the REER gap to be in the range of -14.6 to 0.4 percent, with a midpoint of -7.1 percent (undervaluation).</p>					
Capital and Financial Accounts: Flows	<p>Background. Net FDI has fully financed CA deficits since 2015 (averaging 3.2 percent of GDP during 2015-20, while CA deficits averaged -2.2 percent), despite net portfolio outflows (0.6 percent of GDP, on average, during 2015-20). In 2020 net FDI stood at 3.5 percent of GDP against a CA deficit of 1.7 percent. Net portfolio outflows accelerated sharply in the first half of the year before easing in the third quarter and then partly recovering in the fourth quarter, recording a balance of -0.9 percent of GDP over the year (-1 percent of GDP in 2019). Net FDI was stronger than in 2019 due to divestment abroad that more than compensated for lower FDI inflows.</p> <p>Assessment. The composition of capital flows is expected to remain favorable over the medium term, with positive net FDI inflows outweighing negative portfolio outflows that started in 2016 following the sovereign's downgrade to below investment grade. Nevertheless, the high degree of uncertainty about the scarring effects of COVID-19 on the global economy make it challenging to assess the medium-term prospects for capital flows. A renewed spike in international risk aversion, linked to a potential second wave of COVID-19, or a sudden tightening of global financing conditions could trigger a new bout of capital market volatility.</p>					
FX Intervention and Reserves Level	<p>Background. Brazil has a floating exchange rate. In 2020 the central bank sold FX in the spot, repo, and FX swap markets in the amount of US\$44.5 billion to dampen excess exchange rate volatility associated with the COVID-19 shock. Nevertheless, reserves remained high at US\$356 billion at the end of 2020.</p> <p>Assessment. The flexible exchange rate has been an important shock absorber. Reserves are adequate relative to various criteria, including the IMF's reserve adequacy metric (161 percent as of the end of 2020) and serve as insurance against external shocks. The authorities should retain strong external buffers, with intervention limited to addressing disorderly market conditions.</p>					