

**EXECUTIVE
BOARD
MEETING**

SM/21/153
Correction 2

September 17, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Brazil—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/153 (8/24/21) have been provided by the staff:

Evident Ambiguity

Page 5

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

Pages 7, 12, 60, 61, 62, 64

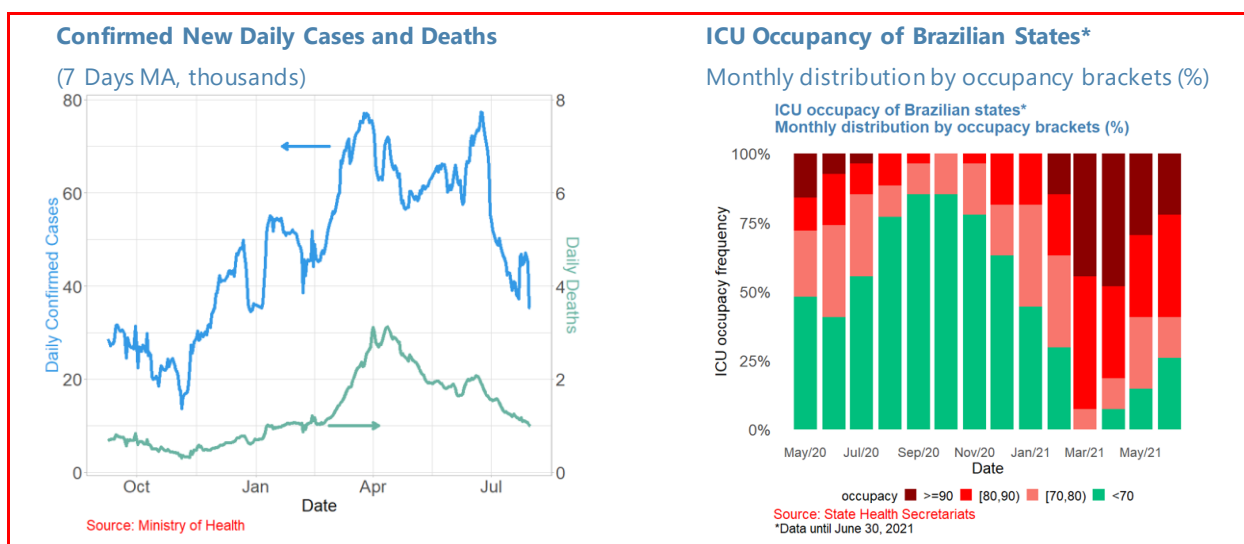
Questions:

Ms. Lim, WHD (ext. 37872)

CONTEXT

1. New COVID-19 cases are on a downward path following a second wave early this year (Figure 1). The emergence of a more contagious and lethal variant of the virus, coupled with near pre-pandemic social mobility levels in late-2020, pushed daily infections and fatalities to new highs in April. However, renewed lockdowns and the rollout of vaccination have helped bring down infections since April. New daily cases have declined to 45,000 and daily deaths have more than halved to 1000. Tragically, more than 550,000 Brazilians have died and average life expectancy at birth has fallen by 1.3 years¹.

2. Vaccinations are progressing well. The vaccination campaign, which started in mid-January, has accelerated since March after local production of vaccines was scaled up. As of end July, 50 percent of the population and more than 90 percent of those over 60 had received at least a first dose. The government has procured sufficient doses to inoculate the adult population in 2021, with the most vulnerable populations expected to be fully inoculated by the fall.

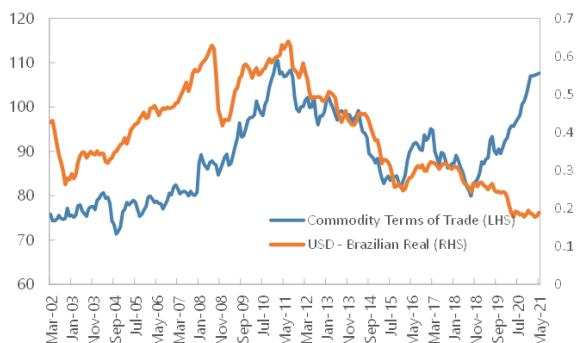


3. Sustained by strong policy support, the economy withstood well the health crisis. Real GDP declined by 4.1 percent in 2020, less than in most advanced and emerging economies and the smallest contraction among the major Latin American economies (Box 1). The fall in private consumption was cushioned by about 4 percent of GDP in cash transfers to vulnerable households and informal workers (Box 2). At the same time, substantial liquidity support and capital relief measures ensured the financial system was resilient and banks remained profitable. Private sector credit grew robustly, buoying housing demand and residential construction, while a sharp decline in imports led to a positive contribution to growth from net exports. After contracting by 6.1 percent in H1 2020, the economy returned to its pre-pandemic level by Q1 2021. The recovery has been led by industry and agriculture, with the service sector still struggling (Figure 2).

¹ Castro, M.C., Gurzenda, S., Turra, C.M. *et al.* Reduction in life expectancy in Brazil after COVID-19. *Nat Med* (2021). <https://doi.org/10.1038/s41591-021-01437-z>

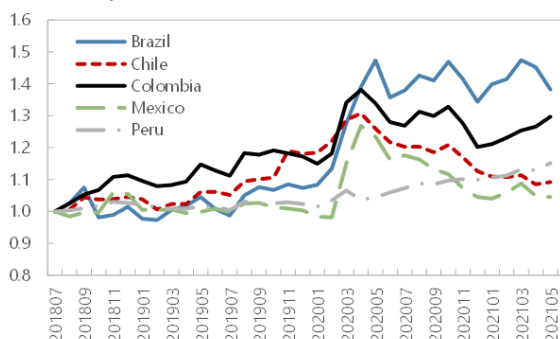
BCB intervened to dampen excessive volatility.³ Reserves remain adequate (above the upper bound of the recommended range for the ARA metric, Annex I) and the upcoming SDR allocation will increase gross reserves by 4 percent. The 2020 external position is judged to be broadly in line with the level implied by medium-term fundamentals and desirable policies (Annex I).

Brazil: Commodity Terms of Trade and Exchange Rate



Source: Haver and Fund staff calculations.

Latin American Exchange Rates versus USD
(Index, July 2018 = 1)



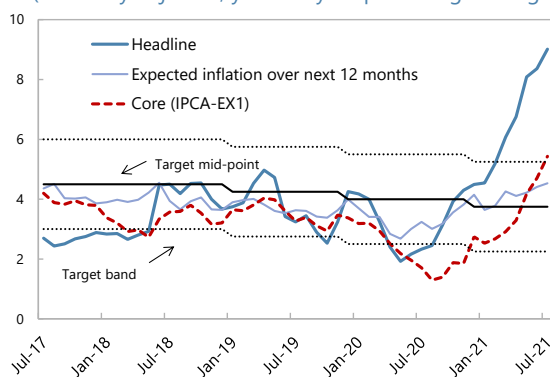
Source: Haver and Fund staff calculations.

6. Inflation has risen above the target-range, prompting the BCB to tighten policy.

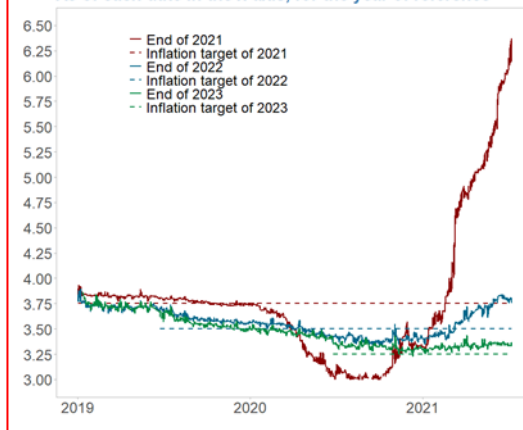
Headline inflation has been above target⁴ since November 2020, reaching 9 percent in July 2021, reflecting higher fuel and commodity prices as well as supply disruptions and demand pressures (Figure 4, Box 4). Core inflation was 5.4 percent in July. Near-term inflation expectations have risen sharply but are anchored at a longer-horizon. The BCB hiked the policy rate by 325 bps between March and August, raising the SELIC from 2 to 5.25 percent.

Headline and Core Inflation

(Seasonally adjusted, year-on-year percentage change)



Expected CPI-inflation rate (mean)
As of each date in the x-axis, for the year of reference

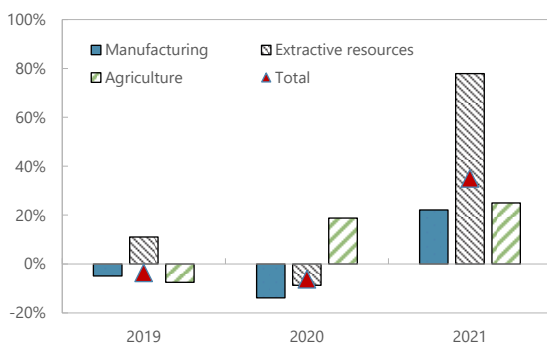


³ During the acute first wave of the pandemic in March-June 2020, the BCB increased the outstanding stock of FX swaps—non-deliverables and settled in local currency—by US\$18 billion and undertook US\$19 billion in spot intervention. In early 2021, when the second wave hit and fiscal risks moved into focus during the budget discussions, the stock of FX swaps rose by a further US\$18 billion.

⁴ The target rate is 3.75 percent for 2021 and 3.5 percent for 2022, with tolerance intervals of +/- 1.5 percent.

term, the recovery in imports is expected to increase the current account deficit (to around 2.5 percent of GDP, close to its norm). External debt is assessed to be sustainable over the medium term, but subject to risks as the debt path remains sensitive to real exchange rate shocks (Annex II).

Brazil: H1 Nominal Export Growth by Export Category
(year-on-year)



Source: SECEX and Fund staff calculations.

Brazil: External Sector Overview

	Actual		Projection
	2019	2020	2021
<i>In billions of USD</i>			
Gross External Financing Needs	243	181	139
of which CA deficit	65	26	-7
of which amortization of external debt	178	155	146
Available Financing	216	159	158
of which FDI (net)	46	48	58
of which disbursement of external debt	168	159	144
of which equity portfolio investment (net)	-10	-17	-11
Change in Reserves	-18	-1	-2
Gross International Reserves (end of year)	357	356	353
GIR/ARA (in percent)	147	161	159
<i>Memo items</i>			
Implicit Debt Rollover Rate (percent)	95	102	98
Annual Change in Nominal Exports (percent)	-6	-7	33
Annual Change in Nominal Imports (percent)	2	-10	15

9. Uncertainty around the baseline is significant but risks to growth are viewed as being broadly balanced (Annex III). A delayed vaccine rollout or new virus variants would hinder the recovery of the service sector and the ongoing normalization of labor markets, posing a first order risk to activity (Box 5). A drought-induced rationing of energy and/or a spike in electricity prices also represent important downside risks. However, the recent strong momentum in activity and a waning effect of the pandemic on economic outcomes both provide an upside to the outlook. A reassessment of market fundamentals—which could arise from concerns over the implementation of the fiscal policy framework, realization of contingent liabilities (¶14), and electoral uncertainties—and/or a tightening of global financial conditions could lead to capital outflows, a higher cost of budget financing, a weaker currency, and additional inflationary pressures. In confronting these risks, the flexible exchange rate regime remains an indispensable shock absorber. These risks are further mitigated by a sound banking system, a large stock of international reserves, and a low share of foreign currency public debt.

Authorities' Views

10. The authorities agreed that the baseline economic outlook looks favorable. The BCB pointed to the resilience of private consumption despite the COVID-19 resurgence and the temporary interruption in emergency aid benefits and agreed that the normalization of the household savings rate will continue to boost consumption. The Ministry of Economy highlighted that Brazil is one of the very few countries in which market friendly structural reforms have been moving ahead despite the pandemic. The authorities attributed the strong economic recovery as a validation of their approach to shift from state-driven to private sector-led growth. Current measures to preserve employment and income, recent progress in the vaccination campaign, and high prices of commodity will continue to support the economic recovery.

Annex V. Implementation of Key FSAP Recommendations¹

Brazil: Key FSAP Recommendations		
Recommendations	Time	Authorities' Actions
Microprudential and macroprudential institutional arrangements		
Establish a multi-agency high-level committee, with an explicit mandate for macroprudential policy and the power to issue policy recommendations on a comply-or-explain basis.	ST (Short Term)	The BCB has – in agreement with CVM, Previc and SUSEP – finalized a draft bill named the “Financial Stability Coordination Law”, which is now being discussed with the Ministry of Economy.
Strengthen the crisis management institutional arrangements for inter-agency cooperation and exchange of information, including for contingency planning.	MT (Medium Term)	This proposal is directly related to the above-mentioned “Financial Stability Coordination Law”. According to the draft bill proposed by BCB, the “Financial Stability National Committee” would have authority over macroprudential policy and crisis management (including contingency plans/crisis management). The BCB’s Contingency Plan has already been implemented.
Strengthen legal protection of all supervisors (BCB, SUSEP) through clear rules, including fixed term, condition of dismissal, public disclosure of reasons for dismissal and qualification criteria for appointments. Strengthen the independence of the BCB.	ST	<p>Two bills of law that tackle BCB autonomy <u>were under discussion in Congress. One bill has been approved by Congress and addresses the Central Bank mandate</u> are currently under discussion in Congress. One bill has been approved by the Senate, which addresses the Central Bank mandate, including the criteria for the appointment and the dismissal of Governors, and sets four-year tenures (with one renewal) for the Board of Governors. Their tenures do not match the presidential term to avoid a wholesale change whenever a President is elected.</p> <p>This bill has moved to the lower house. The <u>approved law also includes several features of the</u> second bill <u>(which is no longer under consideration), such as submitted to the lower house, is broader and proposes legal protection of BCB staff, defines</u> aspects of operational autonomy, addresses the delegation of decisions about other monetary policy and macroprudential tools from CMN to BCB, and enhances policy transparency, such as through the publication of inflation and financial stability reports. <u>However, it does not establish legal protection of BCB staff which had been included in the second bill. This bill has stalled due to COVID and has yet to be evaluated in the specialized committees before a plenary vote.</u></p> <p>The Bank Resolution bill – submitted to the lower house and currently being discussed by a special congressional committee – also provides for protection of public agents. As it stands, this bill includes both a provision for legal protection of public agents and for legal defense by the General Counsel on BCB expenses.</p> <p>The insurance supervisor (SUSEP) Board has drafted a bill to merge SUSEP with the pension funds supervisor (Previc), addressing, among other issues, the structure of the new authority. This draft bill has not yet been approved by Congress. However, it is worth noticing that the Decree n° 9.727/2019 has established qualification criteria for appointments to strategic positions in the Administration.</p>
Increase resources of CVM and SUSEP.	ST	The CVM budget was reduced to R\$ 22 million during 2019 from R\$ 30.5 million at the beginning of the year. The total discretionary budget for 2020 was R\$ 27.7 million. The budget for 2021 currently amounts to R\$ 26 million.

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

Brazil: Key FSAP Recommendations (Continued)

Recommendations	Time	Authorities' Actions
		Notwithstanding the studies underway to merge and restructure SUSEP and PREVIC, budget constraints, throughout the Federal Government currently impose limits to any proposal in this regard.
Increase resources of CVM and SUSEP.	ST	<p>The CVM budget was reduced to R\$ 22 million during 2019 from R\$ 30.5 million at the beginning of the year. The total discretionary budget for 2020 was R\$ 27.7 million and the expected budget for 2021 was R\$ 31.3 million.</p> <p>Notwithstanding the studies underway to merge and restructure SUSEP and PREVIC, budget constraints, throughout the Federal Government currently impose limits to any proposal in this regard.</p>
Systemic risks		
Use Pillar 2 capital requirements to handle bank-specific risk profiles to boost their resilience as needed and to mitigate risks.	ST	Structured and by Reference Add-ons are implemented in our supervisory methodology. The Structured Add-on is in its third year of application to all banks (segments from S1 to S4). The Add-on by Reference is applied to banks allocated to Segment S1 and includes metrics for credit concentration risk and IRRBB since 2020. Technical studies to include Banks allocated to S2 Segment in Add-on by Reference process are scheduled in place .
Financial sector oversight		
Upgrade the banking sector's regulatory and supervisory approach to credit risk—including identification and definitions, limits, and reporting requirements—for related party exposures and transactions, large exposures, country and transfer risk and restructured loans.	MT	<p>The following actions have already been completed:</p> <p>(i) The National Monetary Council (CMN) has issued Resolution 4,677/2018 (Basel III reform on Large Exposure Limits), establishing limits and report requirements for single client and large exposures. Rules have been applied for Prudential Segments S1 and S2 since January 2019 and will apply for Segments S3, S4 and S5 since from January 2020. The Report on Operational Limits—DLO (Circular Letter 3,926) was adapted to include information on large exposure limits; (ii) The CMN issued Resolution 4.693/2018 addressing credit operations between related parties; (iii) The BCB issued Circular Letters 3,819/2017 and 3,857/2017 on reporting requirements of restructuring of financial instruments, applicable to all financial institutions since May 2018).</p> <p>For the current resolution (Res 4,693 of Oct / 18), accounting items were created to collect information from Related Parties (data from Jan / 19), in which financial institutions will report the greatest exposure to related parties (natural person and legal entity) and other exposures with related parties (natural person and legal entity). A field was also included in the SCR (as of Jan / 19) to inform whether the contracted operation is being carried out with related parties.</p> <p>A number of other initiatives are under analysis or being drafted:</p> <p>(i) Regulation on prudential treatment for transactions with related parties.</p> <p>(ii) Amendment to the regulation establishing specific requirements for country and transfer risks, with specific treatment of indirect risks.</p>

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	Time	Authorities' Actions
		<p>(iii) Requirement of producing concentration risks data on a regular basis.</p> <p>(iv) Structured assessment of country, transfer and indirect risk</p> <p>(v) IFRS9 implementation, which will enhance the credit risk framework definitions, including the definition of credit risk exposure.</p>
Strengthen enforcement function of CVM by raising the level of sanctions and ensuring adequate resources for prosecution; strengthen cooperation allowing CVM proper oversight of ANBIMA's SRO activities in the investment fund sector.	ST	<p>An analysis to expand<u>The expansion of</u> the scope of the agreement with ANBIMA is ongoing, to include the subject of supervision of (1) mandate (portfolio breaches) and (2) liquidity management. About 555 funds <u>ruled by CVM instruction 555</u> (which represent more than 85% of industry) will be affected. We expect to have a new version of this agreement <u>was adopted</u> in the first half of 2021.</p> <p>On regulation, CVM Instruction 607 was issued to regulate the new Law that expanded the CVM's enforcement power. That is, the new regime is totally applicable and in effect.</p>
Implement (BCB, ANS and SUSEP) consistent group-wide supervision of insurance groups and conglomerates with joint rulemaking, implementation, and on-site inspections and granular data sharing.	MT	The granular data sharing depends on legal provisions and on the establishment of partnerships among the supervisors. In the BCB's view, the creation of the "Financial Stability National Committee" would partially bridge this gap.
Crisis management and bank resolution, safety nets		
Revise the draft resolution law in line with the FSAP team's recommendations and promptly enact it.	ST	The draft bill was submitted to the National Congress in December 2019. The Bill of Law 281 of 2019 is pending appreciation by the Lower Chamber.
Revise the ELA framework to provide for a solvency test tied to enhanced supervision, remedial plans, and possibly restructuring measures, and allow for ELA in systemic circumstances upon a MoF indemnity.	ST	While solvency analysis is important for ELA assessment, the BCB does not agree that being solvent on a point-in-time basis should be the main determinant of ELA approval. The systemic impact of a negative response to an ELA request is also relevant, so the BCB prefers to retain the flexibility to decide, with its discretionary power. The recommendation of indemnity of the MoF in case of ELA in systemic circumstance will not be implemented since it may increase moral hazard risk and the current BCB capital structure is public (which means the National Treasury will have to indemnify the BCB anyway, in case of BCB balance sheet loss). The BCB deployed Temporary Liquidity Facilities (ELA for the COVID-19 crisis) in April 2020. Implementation of new permanent liquidity facilities is undergoing, and that project is in the BC# Agenda, with a deadline in November 2021.
Put in place mechanisms to ensure lending from the deposit insurance fund is not used to maintain weak or insolvent banks in operation; and transform FGC into a fully owned public institution.	ST; MT	The FGC has already amended its by-laws to establish communication to the BCB prior to each assistance operation. The process to establish the "Financial Stability National Committee" is ongoing. The BCB has signed a MoU with the FGC to grant access to detailed information on financial institutions that are members of the FGC, in order to facilitate the Fund's assessment and avoid the use of lending to maintain weak or insolvent banks in operation. The recommendation to transform the FGC into a fully public-owned institution will not be implemented.

Brazil: Key FSAP Recommendations (Continued)		
Recommendations	Time	Authorities' Actions
		<p>Regarding FAEP, the provisional act has lapsed without approval of Congress. Nevertheless, BNDES is still focused and committed to support the States and Municipalities in their privatization efforts, providing project preparation services in all modalities, including concessions, public-private partnerships (PPP) and privatizations, and sharing knowledge with the public sector. As of September 2020, there were 74 projects being structured by BNDES in its portfolio: 31 federal, 30 state and 13 at municipal level in several sectors such as water and sanitation, ports, highways, street lighting, power distribution among others. As Successful auctions haves occurred in the sanitation sector, with the participation of many private players in the bidding process, and the major part of the portfolio is expected to be auctioned by 2022.</p> <p>Strategic guidelines for this topic include contributions to the financial sustainability of the entities in the Federation, promoting regulatory security for leverage investments and competitive auctions, and supporting the public sector in structuring long-term partnerships to make feasible private investments in projects of public interest. The bank is also stimulating the opening of the Brazilian infrastructure market, promoting the entry of new national and international players, including operators and financial investors.</p> <p>Regarding the capital markets initiatives, in the second semester of 2019 Fund Manager for the Infrastructure Bonds Special Purpose Vehicle (FDIC Debêntures de Infraestrutura) was selected. However, due to the interest rate curve structure in 2020, the fund is currently not active.</p> <p>(ii) On the other hand, the Sustainable Energy Fund, launched in 2016 and implemented in 2018, with assets under management of R\$500 million in infrastructure projects private bonds related to a low-carbon economy, is currently in its investment phase. Since it was launched over 50 primary investment opportunities for the Fund's portfolio have been analyzed, resulting in the subscription of 12 different project debentures. The annualized return over September 2019-September 2020 (last 12 months) was 19.4% per year and the annualized volatility (last 12 months) over the same period was 3.95% per year. The fund's annualized return, from Sep / 2018 to Dec / 2019, was 18.85% per year.</p> <p>(iii) A new and relevant initiative in the Brazilian Capital Markets was launched in May 2020: an RFP process for the selection of FDICs for SMEs as one of the emergency measures to support SMEs during the COVID crisis. The Bank pre-selected 12 FDICs, of which 10 will receive funds up to R\$ 5 billion to offer credit for small businesses, helping to diversify the fund sources and improve access to credit.</p>
Focus Caixa on core activities, improve governance, and invite a strategic investor.		<p>Focus Caixa on core activities:</p> <p>CAIXA is repositioning its credit operations, prioritizing the granting of loans to the segments linked to microenterprises, to the promotion of housing loans, maintaining its operations in "Minha Casa Minha Vida" and expanding operations to the middle class through resources from savings and increase in the payroll loans portfolio.</p> <p>Improve governance:</p> <p>CAIXA continues to improve its corporate governance practices, seeking to become a reference in the adoption of good management strategies, in line</p>