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10:45 a.m., July 15, 2019

3. Brazil—2019 Article IV Consultation

Documents: SM/19/178 and Correction 1; and Correction 2; and Supplement 1; and Supplement 1, Correction 1; and Supplement 2; and Supplement 2, Correction 1; SM/19/182

Staff: Spilimbergo, WHD; Kramarenko, SPR

Length: 1 hour, 18 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
	F. Sylla (AF)
	J. Di Tata (AG)
	G. Johnston (AP)
A. Tombini (BR)	
Z. Jin (CC)	
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
H. de Villeroché (FF)	
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	M. Psalidopoulos (IT)
T. Tanaka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
	V. Rashkovan (NE)
T. Ostros (NO)	
	L. Palei (RU)
M. Mouminah (SA)	
	K.Tan (ST)
P. Inderbinen (SZ)	
S. Riach (UK)	
M. Rosen (US)	

H. Al-Atrash, Acting Secretary
S. Maxwell, Summing Up Officer
R. Smith Yee, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Fiscal Affairs Department: M. Soto Abril. Legal Department: R. Berkhout, G. Otokwala. Research Department: M. Chamon. Strategy, Policy, and Review Department: V. Kramarenko, A. Roitman. World Bank Group: F. Davanger. Western Hemisphere Department: V. Flamini, A. Husain, Y. Li, A. Spilimbergo, F. Toscani.

Executive Director: M. Raghani (AF). Alternate Executive Director: R. Alkhareif (SA), P. Fachada (BR), A. McKiernan (CO), B. Saraiva (BR). Senior Advisors to Executive Directors: Z. Abenoja (ST), A. Muslimin (ST), P. Braeuer (GR), K. Karjanlahti (NO), M. Maidi (AE), Z.Mohammed (BR), G. Vasishtha (CO). Advisors to Executive Directors: M. Albert (FF), D. Cools (NE), M. Coronel (BR), O. Diakite (AF), K. Florestal (BR), A. Maciá (BR), A. Park (AP), D. Vogel (AG), A. Zaborovskiy (EC), Y. Zhao (CC), F. Antunes (BR), A. Tola (SZ).

3. BRAZIL—2019 ARTICLE IV CONSULTATION

Mr. Tombini submitted the following statement:

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

Reforms to restore sustainability and unleash potential growth

Brazil is on the verge of approving a major social security reform that will be instrumental to reestablishing fiscal sustainability. The social security system in Brazil is distortionary, inequitable and is the reason for the shortfall in the public sector primary balance. Revamping social security is a politically complex enterprise in any country. In Brazil this reform has been a top priority in the past several years. The new administration assigned the highest importance to the social security reform and submitted a comprehensive and ambitious constitutional amendment bill to Congress. The proposal is estimated to yield savings of above R$1 trillion over a period of ten years and stabilize social security spending relative to GDP, even as population ages. The Lower House has already taken decisive steps and an amended proposal that retains the bulk of the savings has been approved at the committee level and is currently being considered for plenary vote.

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

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

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

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

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

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

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

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

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

External and financial resilience

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

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

Final remarks

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

Mr. Ostros, Ms. Karjanlahti and Mr. Damgaard submitted the following statement:

We thank staff for the well-written report and Mr. Tombini for his informative buff statement. Brazil's economic recovery after the severe 2015-16 recession has been slow, with growth rates just above 1 percent in 2017 and 2018. Growth has also been on the soft side in the beginning of 2019, partly driven by weak investments resulting from fiscal and political uncertainty. Fiscal risks are significant, and despite the government's intentions to re-start consolidation in 2020, public debt is still growing and is projected to reach 96 percent of GDP in 2024. We encourage the authorities to firstly approve and implement the pension reform package and further continue their efforts to consolidate public finances and to strengthen market confidence in debt sustainability. Moreover, we encourage the implementation of structural reforms to boost productivity and potential growth. We broadly agree with staff's appraisal and offer the following points for emphasis.

The high and increasing level of public debt needs to be addressed to strengthen debt sustainability and market confidence. We strongly encourage the authorities to approve and implement the government's ambitious pension reform proposal to curb the unsustainable and rapidly increasing pensions spending. The authorities should prepare other fiscal measures that could be implemented immediately if the pension reform is diluted in Congress. In addition, we agree with staff that more fiscal efforts are needed, notably lowering the public wage bill, to stabilize debt and create fiscal space for critical infrastructure investments while also protecting effective social programs. Any windfall revenue from oil should be used exclusively to consolidate public finances.

The accommodative monetary stance is appropriate given the substantial output gap and anchored inflation expectations. Since fiscal consolidation is necessary, the authorities should monitor the economic developments closely and stand ready to loosen monetary policy if needed. Further, we welcome the new law clarifying the transactions between the Central Bank and the Treasury, which will bolster the credibility of monetary policy.

The Brazilian banking sector is well capitalized, profitable, and liquid, but inefficiency in the sector is a drag on growth. While we welcome the resilience of the banks, we also take note of the high interest rate margins, signaling limited competition. We encourage the authorities to provide a regulatory framework that allows for open and fair competition in the banking sector as well as reduces the role of the government in the sector. It is essential for economic growth that SMEs and households get access to credit at reasonable terms. At the same time, we commend the authorities for the progress that has been made on financial supervision based on the 2018 FSAP recommendations. We note that staff has recommended to bring the deposit guarantee fund into the public sector whereas the authorities prefer to keep it as a private entity. Could staff elaborate on its reasoning for this recommendation when deposit insurance seems to work well as a private entity in other countries? How does Brazil differ from other countries in this respect?

We encourage the authorities to implement structural reforms to boost productivity and strengthen governance. Brazil remains one of the most closed economies with merchandise imports around 10 percent of GDP. The trade agreement reached last month between Mercosur and the EU is an important step towards openness, which will increase the competitiveness of the Brazilian economy through specialization and transfer of knowledge. We encourage the authorities to ratify the agreement and to seek new trade deals with other countries. We also encourage the authorities to simplify the tax code and to reduce the costs of doing business to promote further capital deepening. We welcome the authorities' focus on fighting corruption by strengthening the institutional setup and encourage the authorities to continue the implementation of preventive measures. Specifically, we agree with staff that finalization of the National Risk Assessment (NRA) and enhancing the collection of beneficial ownership information should be key priorities in the preparation for the next FATF/GAFILAT assessment. Finally, privatization of certain SOEs, including in the financial sector, could have positive effects on productivity by ensuring that these entities are managed according to market principles.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for a set of comprehensive reports, which highlight the Brazilian authorities' commendable goals of unleashing growth potential and achieving fiscal consolidation, through an ambitious reform agenda, in a low growth and high public debt environment. We support staff's call for the sequencing of the reforms to give due consideration to Brazil's debt dynamics and business cycle conditions. In his informative buff statement, Mr. Tombini provides helpful insights into the government's comprehensive structural reform policies, which appropriately prioritize the social security reform—the main structural adjustment required to reestablish fiscal sustainability. We share Mr. Tombini's sentiment that the social security reform will create momentum for the passing of the remaining reforms and take positive note of the fact that the expectations of the bill's passage pushed Brazil's financial markets to historic highs, as the lower house of Congress began final debates last Wednesday.

The proposed pension reform is estimated to yield savings of above R$1 trillion over a period of ten years and stabilize social security spending relative to GDP, even as the population ages. The staff report indicates that the reform would also make the system more equitable. Although pension reform is a crucial first step, the authorities and staff agree that lowering other current expenditures will be needed to comply with the constitutional expenditure ceiling over the next few years. To this end, the authorities aim to limit the autonomous growth of major mandatory expenditures, such as the salary allowance and the government payroll. They are also considering a review of tax expenditures and a revenue-neutral tax reform (aiming at simplifying and harmonizing the tax system), as well as a legislation to improve the collection of tax arrears. Can staff comment on the extent to which the aforementioned measures are fleshed out and ready to be implemented, and whether they would allow the authorities to reach their fiscal target? We fully agree with staff that fiscal consolidation should preserve effective social programs, including Bolsa Familia, and support public investment.

Monetary policy is appropriately accommodative, given the large output gap and anchored inflation expectations. We share the authorities' view on the importance of preserving the high level of foreign reserves, which has supported the credibility of the central bank's interventions in the foreign exchange market during periods of high market volatility. We see merit in staff's recommendation to enshrine central bank independence into law to further improve the inflation-targeting regime. The staff report indicates that banks are well-capitalized, profitable and liquid, and we concur with staff that the authorities should build on recent efforts to continue to implement the 2018 FSAP recommendations. We welcome the new law, which regulates financial transactions between the central bank and the Treasury. By providing a reserve account, where gains from foreign reserve valuation and swap operations are booked to cover for future losses, the law will strengthen the monetary framework and its transparency, as noted in the Selected Issues Paper.

Structural reforms are essential to raise productivity and potential growth, and prioritizing and sequencing them will be important. In addition to pension reform, the authorities' wide-ranging reform agenda includes trade liberalization, privatization, and measures to improve the business environment. We trust that the next staff report will further elaborate on progress in these areas. The fact that a Mercosur-EU trade agreement was found after twenty years of negotiation attests to the authorities' commitment to trade liberalization, as noted in the buff. We support the planned privatization program, which will reduce public debt, while improving the provision of infrastructure services and enhancing competition and productivity growth.

Ms. Levonian and Ms. Vasishtha submitted the following statement:

We thank staff for their report and Mr. Tombini for the insightful buff statement. Brazil's external position is quite strong relative to other emerging markets, owing mainly to substantial foreign reserves and a contained current account deficit fully financed by large FDI flows. However, the recovery from the 2015-16 recession is being held back by subdued aggregate demand, low productivity, and recently weak labor force growth. We concur with staff that the main domestic risks to growth stem from potential slippages in fiscal consolidation, given the high and rising public debt. In this context, we welcome the new administration's bold reform agenda, which prioritizes social security reform along with much-needed measures to boost potential growth, including tax reforms, trade liberalization and improving the business environment. We broadly agree with the staff appraisal and offer the following comments for emphasis.

Social security reform is the main structural adjustment needed to mitigate risks arising from high public debt. Under staff's baseline, which assumes compliance with the constitutional expenditure ceiling, gross public debt is expected to peak at 96 percent of GDP in 2024 (from the current 88 percent). This baseline is predicated on the approval of the landmark pension reform which is critical to establish fiscal sustainability. While this assumption is in line with the government's priority and market expectations, we are concerned that a potential failure to pass the pension reform by a fragmented Congress would adversely affect financial markets and undermine confidence in the reformist agenda. Could staff elaborate on how their forecast would change should the pension reform not be passed this summer, which is the main risk identified by staff? Also, do the authorities have contingency plans to make up for the lost fiscal savings in the event the pension reform is not passed, or its main provisions are significantly watered-down in the legislative process?

Additional measures are needed to stabilize debt and adhere to the expenditure ceiling. While we commend the authorities' commitment to comply with the expenditure ceiling as a valuable anchor for fiscal consolidation, we note that the savings from the proposed pension reform would account for only a third of the fiscal adjustment needed to comply with the ceiling by 2024. As such, the authorities should consider introducing other measures to reduce current expenditures in pursuing fiscal consolidation. These could include reducing the wage bill, which would also help lower the gap between public wages and private compensation. Likewise, introducing rolling, targeted spending reviews for large and growing budgetary programs would also help contain spending. However, such measures would need to be carefully balanced with the need to protect social programs that are effectively delivering services to the poor.

The current accommodative monetary stance is appropriate given existing economic slack, inflation close to the mid-point of the target range, and well-anchored inflation expectations. We support staff's view that monetary policy should stand ready to provide additional stimulus to offset potential contractionary effects from fiscal consolidation, as long as inflation expectations remain anchored. Regarding the monetary policy framework, we welcome the new law that regulates and reduces financial transactions between the central bank and the Treasury. Legislative efforts underway to enhance central bank independence are also welcome steps towards strengthening monetary policy credibility.

Structural reforms to simplify the tax system, enhance trade integration, and close the infrastructure gap are critical for addressing stagnant productivity and raising potential growth. Given Brazil's relatively high tax burden, efforts should focus on simplifying the complex and distortive tax system in a revenue-neutral fashion, which would make compliance less costly and boost much-needed private investment.

The authorities rightly note that simplifying the tax system is also a precondition for successful trade liberalization, which in turn is essential to improve Brazil's competitiveness. To foster trade integration, we encourage the authorities to continue to undertake measures to reduce non-tariff barriers, particularly anti-dumping measures, and pursue adherence to OECD codes. Efforts to close the large infrastructure gap would also help improve resource allocation and the business climate, ultimately fostering productivity gains.

We welcome the notable progress in implementing financial sector reforms recommended in the 2018 FSAP. We encourage the authorities to continue to make progress on banking sector reforms which would potentially generate large productivity gains. Further, we agree with staff that accession to the OECD's codes of liberalization of capital movements would promote international integration of financial services and help improve the efficiency of financial intermediation.

Finally, we commend the authorities for their continued efforts to enforce anti-corruption and anti-money laundering measures. We join staff in urging the authorities to expedite the finalization of the National Risk Assessment and enhance collection of beneficial ownership information. Strengthening governance and transparency is essential for sustainable and inclusive economic growth in Brazil.

Ms. Riach, Mr. Johnston, Ms. Preston and Mr. Hemingway submitted the following statement:

We thank staff for the papers and Mr. Tombini for the informative buff.

While the economy has stabilized, Brazil's recovery from the 2015-16 recession remains anemic and economic performance has continued to disappoint. Following the recession, monetary policy and a flexible exchange rate have played critical roles in stabilizing the economy. However, growth has remained low. Indeed, real GDP is expected to grow at just 0.8 percent in 2019, significantly below the forecast of 2.5 percent in last year's Article IV.

Furthermore, risks to the recovery remain significant. We note that staff forecasts continue to see an acceleration of the recovery just over horizon – growth is expected to pick up to 2.4 percent in 2020, while the modest fall in the unemployment rate since the 2017 peak of 12.8 percent is also forecast to accelerate. In the Risk Assessment Matrix, staff rightly identify the risk the recovery remains weak and we endorse their high-level recommended policy response. However, we would be grateful if staff could expand on their suggested approach were this risk to materialize, including how the recommendation differs from the central policy advice staff provide in the report.

Slow growth has amplified underlying fiscal challenges, where the pension reform remains critical. We agree with staff that failing to deliver these reforms this is the most important risk, though note the commitment to that reform from the authorities. Staff also highlight the need to go beyond the pension reform to ensure fiscal sustainability and meet the expenditure ceiling. We emphasized the need to ensure the quality of the fiscal adjustment and its sustainability.

Action to sustainably raise potential growth is also essential. We see a shift towards a more outward looking growth model, including through trade liberalization and opening up to more foreign investment, as an important driver of productivity in its own right and a mechanism to deliver other important reform objectives. This includes helping finance efforts to close the infrastructure gap and greater competition to drive change in the business environment. We welcome the steps taken to date, including the recently agreed EU-Mercosur trade agreement, and emphasize the significant scope to go further in Brazil given it remains a relatively closed economy.

We thank staff for the detailed coverage of measures taken to strengthen anti-corruption and anti-money laundering frameworks. Experience has highlighted the macro-critical nature of these issues in Brazil. We welcome the continued efforts by the authorities to improve the effectiveness of their systems, including recognizing the need to finalize the national risk assessment.

Finally, we thank staff for their follow up to the 2018 FSAP. Some important reforms have been put in place responding to some recommendation, including steps to strengthen the legal protection of supervisors and upgrade financial sector oversight. We emphasize the importance of maintaining momentum on reforms in the financial sector, noting staff comments on the potentially large productivity gains from banking sector reforms and the scope for greater competition through opening up Brazil’s financial service sector.

Mr. Lopetegui and Mr. Di Tata submitted the following statement:

We thank staff for the well-written report and Mr. Tombini for his insightful buff statement.

The new administration that took office in January has an ambitious reform agenda to address Brazil’s main obstacles to economic growth. As an important pillar of this agenda, Congress is in the process of approving a major social security reform that requires constitutional amendments. As noted in Mr. Tombini’s statement, although this reform constitutes a key priority, the government’s comprehensive agenda comprises other fiscal reforms, privatization, trade liberalization, and measures to improve the business environment.

Brazil’s recovery from the 2015-16 recession has been sluggish, with real GDP growing by a modest 1.1 percent in 2017 and 2018 and the investment rate falling to a historical low in 2018 owing to prevailing political uncertainties and adverse shocks. Headline inflation has declined to 4 percent, with the central bank holding its policy rate at a historic low since March 2018; the current account deficit (0.8 percent of GDP in 2018) and the exchange rate level are broadly consistent with fundamentals and desirable policies; and international reserves remain at a comfortable level. At the same time, external vulnerability is low, with public debt (88 percent of GDP) predominantly denominated in local currency, FX debt in the private sector mostly hedged, and low external rollover needs. The unemployment rate has fallen but is still elevated, and income inequality and the number of people living in poverty has increased. Going forward, the growth projection for 2019 has been revised down to 0.8 percent and staff estimates potential growth at only 2.2 percent a year owing to stagnant productivity, low investment rates, and recently low growth of the labor force. Main downside risks include a sudden tightening of global financial conditions, a global slowdown, and possible difficulties in implementing the planned fiscal consolidation.

We commend the authorities for their ambitious pension reform proposal, which is expected to address sustainability issues, improve equity, and help restore the investment capacity of the public sector. We fully agree with Mr. Tombini that approval of the reform will remove an important source of uncertainty, providing a confidence boost that could have positive effects on activity not only in the medium term but also in the short run.

The authorities are taking additional measures to achieve fiscal sustainability. We support the medium-term fiscal path and welcome the authorities’ commitment to proceed with fiscal adjustment based on expenditure restraint, which is anchored by the constitutional expenditure ceiling, including by containing real increases in the wage bill while protecting targeted social programs. We also welcome the authorities’ intention to reduce tax expenditures, subsidies, mandatory expenditures, and the scope of earmarked revenues, as well as to use any extraordinary federal revenues to reduce deficits and the public debt. At the same time, we agree with staff on the need to avoid any further deterioration of the structural balance in 2019 and upgrade procurement and investment practices and encourage the authorities to move ahead with their plans to enhance the powers of the tax administration to collect arrears and transition toward a medium-term budget framework. The authorities are also encouraged to adopt a cautious approach toward fiscal decentralization to avoid any duplication of expenditures. Could staff elaborate on the total magnitude of tax expenditures in Brazil and the extent of indexation of spending items? We would also appreciate staff's comments on the feasibility of implementing other reforms to strengthen the structural balances of states and review the institutional framework of subnational borrowing. We take positive note of the expected recurrent increase in government revenues from pre-salt oil production.

We concur with the authorities and staff that the current monetary stance is appropriately supportive, with headline inflation close to target and anchored inflation expectations. We also share the view that going forward, to the extent that fiscal consolidation is contractionary, the authorities could consider loosening monetary policy further provided inflation expectations remain anchored. We welcome the authorities' commitment to maintain a market determined exchange rate and limit FX interventions to addressing episodes of disorderly market conditions. In addition, we take positive note of the new law regulating financial transactions between the central bank and the treasury, which will strengthen the monetary framework and its transparency, as well as of the draft bill enshrining central bank independence. Could staff explain what is meant at the end of paragraph 30 by indicating that the authorities are planning to make the real fully convertible within two to three years?

The banking system is well capitalized, profitable, and liquid, but additional actions are needed to further strengthen it. Financial soundness indicators have improved since the 2015-16 recession and notable progress has been made in implementing financial sector reforms recommended in the 2018 FSAP, including by strengthening risk-based bank supervision and contingency plans for crisis management. BNDES lending is being scaled back and credit subsidies are being reduced, and the authorities plan to further improve the bank resolution framework and establish a committee responsible for macroprudential policy and crisis management. Looking ahead, further efforts are needed to improve bank intermediation and efficiency, as intermediation margins remains high owing to high operating costs, bank concentration, and the still high share of subsidized lending. In this regard, could staff elaborate on the share of subsidized credit and the subsidies involved? We agree with staff that further actions are also needed to bring the deposit guarantee fund into the public sector, and to downsize and refocus public banks. We welcome the growing role of Fintech, which is driving down costs in the industry.

As noted earlier, the authorities plan to implement other bold reforms to raise Brazil's growth potential. Staff notes that increasing potential growth to 3 percent would require raising productivity growth and investment rates well above the levels experienced in recent years. The authorities' agenda comprises reforms aimed at reviewing tax expenditures and simplifying the tax system (after approval of the pension reform); pressing ahead with the privatization program, including the divestment of shares owned by BNDES and PETROBRAS subsidiaries; and improving the business climate by simplifying regulations and enhancing legal certainty. In addition, we welcome the government's commitment to open Brazil to trade, as demonstrated by the recent Mercosur-EU trade agreement and support the ongoing negotiations with the OECD to comply with the codes of liberalization of capital movements by 2020. The efforts under way to fight corruption and money laundering should also be recognized. In this regard, we encourage the authorities to continue focusing on preventive measures, effective enforcement, and legislative improvements to strengthen the AML/CFT framework and to expedite the completion of the national anti-money laundering risk assessment.

With these comments, we wish the Brazilian authorities every success in their future endeavors.

Mr. Inderbinen and Mr. Tola submitted the following statement:

Progress with structural reforms is necessary to increase growth. We thank staff for a good set of papers and Mr. Tombini for his well-written buff statement. We take good note of the new administration's important reform agenda and the authorities' commitment to fiscal adjustment. Rapid progress in implementing the structural reforms aimed at reducing the government's role in the economy, increasing productivity, and supporting higher investment will be instrumental in boosting potential output.

We concur with staff's proposed reforms sequencing, which puts the implementation of the pensions reform in the forefront. The approval of the pension reform by Congress will be necessary to boost confidence in the reform agenda more broadly. Potential reform setbacks represent the main risks to the economic outlook. In addition to their impact on growth and inflation, setbacks would increase the uncertainty about the feasibility of other key reforms needed to comply with the expenditure ceilings and to stabilize debt. In this sense, it is worrisome that some elements are seemingly being diluted. Based on private sector estimates, the pension reform bill that is now before the Lower House's Special Commission includes amendments that would lower the expected savings over the first ten years by around 30 percent. Could staff comment on the impact that these amendments would have on the pension reform proposal, and on how feasible the adoption of the additional fiscal measures mentioned in paragraph 41 of the report is?

Additional decisive fiscal and growth-oriented reforms are needed to create a clear inflection point in public debt dynamics over the next decade. The pension reform alone will not be sufficient to attain fiscal sustainability and boost growth. Also, the NFPS primary balance remains far from the level needed to stabilize public debt. We also note that the debt trajectory remains extremely sensitive to shocks, as illustrated by the DSA. The authorities' commitment to fiscal consolidation is thus welcome. In light of worsening social indicators, fiscal consolidation should preserve effective social programs, such as Bolsa Familia.

The current monetary stance remains appropriate, given the large output gap and well-anchored inflation expectations. A further loosening should be data-dependent. Given the contractionary impact of fiscal consolidation and assuming that structural reforms should help contain price pressures, room for loosening could emerge. We welcome the authorities' commitment to exchange rate flexibility.

Increasing competition in financial intermediation would help reduce the cost of banking services and improve the access to credit. While we acknowledge the progress in improving bank intermediation efficiency, high interest margins point to unduly high borrowing costs, which adversely affect investment and consumption. The ongoing efforts of the authorities to reduce state intervention in credit markets and measures to address banks' cost generated by delinquencies are steps in the right direction.

Mr. Kaya and Mr. Zaborovskiy submitted the following statement:

We thank staff for the informative reports, including two very useful Selected Issues Papers, and Mr. Tombini for his insightful buff statement. The Brazilian economy continues to expand, albeit at a subdued pace. Accelerating sustainable growth while reducing the budget deficit and debt is high on the authorities' agenda. We agree with the thrust of staff's appraisal and policy recommendations.

Pursuing expenditure-based fiscal consolidation and public financial management reforms is critical for fiscal and debt sustainability. We commend the authorities for their ambitious pension reform and plans to press ahead with much-needed fiscal consolidation. Staff rightly points out that, while urgently needed, the pension reform alone is not enough to put public finances on a more sustainable footing and additional measures, mainly on the expenditure side, are warranted to comply with the authorities' expenditure ceiling by 2024. While we broadly favor expenditure-driven consolidation, we emphasize the importance of recalibrating budget spending in a growth-friendly manner with due emphasis on boosting public investments in infrastructure and human capital. We support staff's call for strengthening the overall fiscal framework, including at the federal and regional levels, making it more forward-looking and less rigid, introducing rolling spending reviews for sizable budgetary programs. It is also important to advance fiscal risk management, keeping contingent liabilities from the state-owned banks and state-owned companies under the firm control at the national and subnational levels. On the revenue side, we see merit for simplifying the existing tax system, improving tax administration, and prudently using one-off revenues.

Staff's recommendations on the monetary, external, and financial sectors provide appropriate and well-tailored guidance for advancing reforms. An accommodative monetary stance remains appropriate and the banking system is broadly resilient. Nevertheless, the data on credit growth show that the transmission of the accommodative monetary policy appears to be curtailed by high bank spreads and structural weaknesses of the state-owned banks. In this regard, we support staff's call for reforms in the banking sector to improve financial intermediation, facilitate competition, and gradually wind down subsidized lending. Mr. Tombini confirms in his buff statement that these priorities are shared by the authorities and positive developments are taking hold. Considering Brazil's strong external position, the intention to make the real fully convertible within two to three years is encouraging. In this regard, could staff elaborate more on the authorities' plans to phase out two existing capital flow management measures and their effectiveness in achieving the goals for which they were introduced? We commend the authorities for their commitments to de jure central bank's independence, redesigning the relationship between the Treasury and the central bank, and the notable progress made in implementing financial sector reforms as recommended in the 2018 FSAP. We also positively note that the authorities are well-advised by staff on the further steps needed to enhance oversight of the banking sector and strengthen the AML/CFT framework.

The steadfast implementation of the government's reform priorities of reducing the footprint of the state in the economy, lowering trade barriers, and tackling corruption is key for boosting growth potential. We appreciate the Box 4 of the staff report, elaborating on the sensitivity of potential GDP growth for Brazil. This analysis proves that supporting higher private investments which, in turn, reinforce productivity remains critical to lift the Brazilian growth potential. The latter requires more incentives for the private sector by enabling a conducive environment for doing business, including robust governance and anti-corruption frameworks. While the authorities' policy priorities appear focused on these issues, the staff report indicates that there is some uncertainty about the government's capacity to steadfastly execute reforms. We would welcome staff's views on how to realize and build on the current reform momentum? Since the positive spillovers for growth from these reforms will take time to materialize, we encourage the authorities to decisively press ahead with the implementation of their reform agenda.

With these remarks we wish the authorities every success in their reform endeavors.

Mr. Merk and Mr. Braeuer submitted the following statement:

We thank staff for an informative set of reports and Mr. Tombini for his helpful buff statement. We broadly concur with the thrust of the appraisal. The Brazilian economy continues to struggle after the recession: Low GDP growth, a high output gap, increasing public debt and more difficult social conditions such as elevated unemployment rates weigh on the economy. Brazil is in need of ambitious reforms. Given the limited progress on reforms in the past, especially on the fiscal front, and a fragmented Congress, the risk of setbacks in policy measures is high. We thus encourage the authorities to strengthen reform efforts in order not to undermine the confidence in the reformist agenda, which could adversely affect financial markets.

Staff's baseline growth outlook seems fairly optimistic. We take note of staff's baseline projections which assume an increase of GDP growth from currently 0.8 percent to 2.4 percent next year. However, we would like to point out that these projections are built on the important assumption of successful fiscal reforms. In light of the mixed track record of reform implementation, we would like to call for continued vigilance regarding growth prospects.

Substantial fiscal reforms are needed in order to bring the Brazilian economy back on a sustainable path, with a major reform of the pension system deserving highest priority. As staff notes, the NFPS primary balance is still far from the surplus which is required to stabilize public debt. Public pension spending is relatively high due to a high replacement ratio and special regimes for civil servants and the armed forces, rendering the fiscal stance unsustainable and inequitable, also with regard to population aging. In light of this, we welcome the government's draft bill for a new social security system and strongly encourage the authorities to quickly implement it. However, it seems that states and municipalities are excluded from the draft law, even though the urgency of reforms is even higher on the state- and municipality-level. We would welcome staff's comments on related risks and possible effects on growth prospects.

A successful pension reform does however not suffice to resolve risks to fiscal sustainability. According to staff's estimates, additional reforms are required to consolidate fiscal expenditures in line with the constitutional expenditure ceiling while preserving programs for the poor. We therefore echo staff's call to reduce current expenditures while at the same time protecting targeted social assistance programs. In addition, we agree with staff that a comprehensive tax reform would be important. In this context, we would like to draw attention to staff's policy assumption underpinning the baseline scenario: staff assumes that public debt will peak in 2024 at 96 percent, before it starts to decline in 2025. However, this analysis is based on the assumption that pension expenditures will decrease by 1.2 percentage points, the wage bill will decrease by 1 percentage point and other expenditures will decrease by 1.7 percentage points. We wonder about downside risks to this baseline scenario, given the magnitude of the adjustments and the mixed track record of reform implementation. Our concerns are reinforced by staff's comment that "Even if a robust pension reform is approved, fiscal risks remain since additional fiscal measures are needed to comply with the constitutional expenditure ceiling". Further elaboration on this issue by staff would be welcome.

Reducing public funding in various companies and investment funds could decrease fiscal expenditures. We notice that the loan portfolios of Caixa and Banco do Brasil have not changed markedly. We therefore consider it to be particularly important to reduce state intervention in credit markets by lowering subsidized lending in order to improve bank intermediation efficiency and facilitate fair competition in the financial market.

With regard to the financial sector, continued vigilance is warranted. As staff outlines, macro-financial, profitability and interest rate shocks could significantly increase debt at risk in the private sector. In addition, the Brazilian banking sector is highly concentrated and dominated by a few, very profitable banks. Even though this might not pose a major threat to financial stability at the moment, the low competition is also a likely explanation for the – in international comparison – high cost of credit. While we welcome the progress in implementing financial sector reforms recommended in the 2018 FSAP, we concur with staff that further action is needed to strengthen the banking sector. Therefore, we agree with staff's recommendations, including on further strengthening the independence and legal protection of the BCB.

Structural reforms are essential, given that Brazil's economy suffers from low productivity, low investment rates, low growth of the labor force and high poverty rates. Among emerging markets, Brazil's potential growth is one of the lowest, projected to further decrease. The economy ranks among the most closed of major economies worldwide, weighing on trade. The complicated tax system causes inefficient fragmentation of firms in the private sector. In light of this, we take positive note of the authorities' provisional measures taken so far. However, like staff, we encourage the authorities to undertake ambitious reform efforts in order to improve the business environment, ultimately resulting in lower poverty (which has increased in the recent years).

We also take positive note that the authorities are working with the OECD to be compliant with the OECD Codes of liberalization of Capital Movements by 2020.

As already stressed in previous Article IV consultations, the implementation of effective anti-money laundering and anti-corruption measures remains highly important.

Finally, we strongly encourage the authorities to consent to the publication of the report. A timely release of the report can help the effectiveness of Fund surveillance.

Mr. Villar submitted the following statement:

We thank staff for its comprehensive report and Mr. Tombini for his helpful buff statement. Brazil is gradually emerging from the recession of 2015–16, yet still faces a sizable challenging economic environment, with lackluster growth, high indebtedness, and a weak labor market. We welcome the administration's commitment towards addressing these challenges as well as regarding them as an opportunity to embrace structural reforms to promote productivity-enhancing policies and lift durable and strong economic growth. We are in broad agreement with staff's analysis and policy recommendations and offer the following comments for emphasis.

Fiscal consolidation is warranted to tackle macroeconomic imbalances and restore confidence. We take note of the authorities' commitment to implement the planned fiscal adjustment guided by the constitutional expenditure ceiling and prioritizing the pension reform. The new social security framework is key to reestablish fiscal sustainability. We feel encouraged by Mr. Tombini's assertion that Congressional passage of the pension reform is on the verge of being approved. Still, as pointed out in the report and well recognized by authorities, these endeavors are appraised as insufficient to comply with the expenditure ceiling and must be complemented with other measures to attain and ensure fiscal and debt sustainability, including reduction in tax expenditures, subsidies, mandatory expenditures and the scope of earmarked revenues. Could staff expand on the government's plans for fiscal reforms in the upcoming months, further than the pension reform? How does staff perceive the possibility of those reforms being approved in Congress?

The monetary policy stance has supported well-anchored inflation expectations and should be prepared to provide stimulus to offset the negative effect of fiscal consolidation. We also consider that monetary policy should remain data dependent and be carefully calibrated in the face of the Argentinean political uncertainty and of the prolonged trade tensions between Brazilian's main trading partners: United States and China. We agree with staff that formalizing the central bank's independence is a cornerstone to strengthen monetary policy effectiveness.

We concur with staff's assessment that flexible exchange rate is a milestone to maintain a strong external balance and a first line of defense against external shocks. In this context, interventions should be limited to episodes of disorderly market conditions. We would like to thank staff for the very informative note on BCB FX interventions indicating that they lean against temporary excessive movements of the exchange rate.

The financial system has demonstrated resiliency despite periods of turbulence, yet we encourage authorities to continue their efforts to improve bank efficiency. Progress in implementing the financing sector reform agenda aligned with FSAP recommendations is welcome. We concur with staff's appraisal that a more developed private financial market is required to enhance the flow of savings into more efficient projects. Thus, we see merit in the initiatives to foster greater financial intermediation by reducing state intervention in credit markets. The proposed laws on corporate bankruptcy and electronic collateral registration would also reduce bank costs from delinquencies and help reduce the still high intermediation margins. Could staff provide more insights into how this process is to be undertaken and the potential operative difficulties in its implementation?

In the context of historical low investment rates, the productivity agenda becomes the main engine of growth in the longer term. We agree that the process of accession to the OECD is a one-step catalyst to a wide-ranging agenda for a more open and competitive economy. We will appreciate if staff could elaborate on what the internal political environment on this accession is and if it seems feasible in the short run. Regardless of this process, we agree that reforms for liberalization of capital movements and trade are of utmost importance to produce a friendly business environment and raise potential growth. We feel encouraged by the buff statement highlighting progress in the direction of unlocking the Mercosur-EU trade agreement and the announcement of adhesion to the Madrid Protocol on trademarks and patents.

While social programs should be strengthened, preserving permanent monitoring on the labor market is essential for more equitable and sustainable growth. We take note that while the headline unemployment rate fell recently, levels of underemployment are still very high. This may impact also productivity growth vis-à-vis inefficient reallocation to that segment of the economy. Lastly, we underscore the importance of maintaining and supporting effective social programs such as Bolsa de Familia.

Mr. Psalidopoulos and Ms. Lopes submitted the following statement:

The Brazilian economy has been witnessing lackluster growth, after its most severe recession. However, yesterday's approval by the lower house of the pension reform is a very positive development; it constitutes an opportunity to change the economic sentiment and to kick start the remainder of the reform agenda. This approval, even if not sufficient, is crucial to ensure the sustainability of the fiscal accounts and, as uncertainty lifts, economic agents' confidence should increase. We thank staff for the insightful reports and Mr. Tombini for his helpful buff statement. We broadly agree with the staff appraisal and offer the following comments for emphasis.

The key challenge of the Brazilian economy is to foster a stronger medium-term growth outlook – as a potential GDP growth of just above 2 percent is low for an emerging economy. This is important not only to improve the living standards of the population but also to achieve fiscal sustainability. In this context, we welcome the reform agenda that includes measures to improve the business environment and liberalize trade. Going forward, we would encourage staff to do more analysis on the potential benefits of further integration in the global economy; this has become even more relevant in light of the Mercosur-EU trade agreement.

We note with concern that even incorporating the pension reform in the baseline – as staff did in the report – debt will only stabilize in 2024 at over 96 percent of GDP. Furthermore, debt coverage does not include state-owned enterprises' debt (Petrobras and Electrobras), which represents a risk of contingent liabilities. In this context, we would be careful in having further fiscal loosening in 2019 and encourage the authorities to be cautious in their fiscal policy implementation. Regarding the pension reform, we would ask staff to provide further details on what were their assumptions for the reform, and whether they diverge significantly from the ones included in the approved document. Going forward, we note that the authorities will implement an adjustment based on expenditure restraint. In this regard we encourage them to also focus on the public wage bill, so that further room is created to tackle the significant infrastructure needs. On the revenues, we understand the authorities consider that the current tax burden is adequate, however there is room for simplifying the tax system which should also foster trade liberalization and investment.

Privatizations are also part of the reform agenda. We note that staff considers that, more than generating fiscal resources, this program can improve productivity as these companies would be then managed following market principles. Nonetheless, we wonder whether staff considers this to be a good case to use a balance sheet approach? Furthermore, we would ask staff whether the legal framework to implement the program is in place.

We welcome staff's positive assessment of banks' resilience as well as the recognition that notable progresses to implement last year's FSAP have been made. However, we note that the draft Bank Resolution Bill is still under consideration by the office of the President – we encourage the authorities to move promptly to approve and enact it. We would also encourage the authorities to move forward with the draft bill to ensure the protection of its staff and the independence of Banco Central do Brazil (BCB).

Mr. Raghani, Mr. Diakite and Ms. Nankunda submitted the following statement:

We thank staff for the well-written report and Mr. Tombini for his informative buff statement.

Brazil has made progress in restoring macroeconomic stability since the recession of 2015-16, with inflation around target, and an external position broadly in line with medium-term fundamentals and desirable policies. However, real GDP growth remained modest in 2017-2018 and should stay sluggish in 2019, and public debt remains elevated. While the medium-term outlook indicates a pick-up of growth, this hinges strongly on the implementation of decisive fiscal and structural reforms to enable a solid economic upturn. We broadly concur with the main policy recommendations in this regard and provide the following comments for emphasis.

Sustained fiscal consolidation and reform of the pension system are essential to foster market confidence in public finances and debt sustainability. The elevated public debt is an important source of macroeconomic vulnerability and stabilizing and bringing it down to a sustainable path will require bold fiscal consolidation over the medium term. In this respect, we note the authorities' intention to continue reducing public expenditures in the medium term in compliance with the constitutional ceiling on expenditures. Given that the consolidation plan appears to lean towards expenditures cuts, we would appreciate staff's elaboration on the authorities' programs to protect vulnerable populations from the adjustment measures. The provision of additional fiscal space should also be supported by revenue measures. In this connection, we note positively the efforts to strengthen tax compliance through cooperative compliance arrangements and support the measures envisaged to enhance the collection of tax arrears.

The fiscal consolidation efforts must also be associated with important structural fiscal reforms, notably the reform of the pension system. We therefore encourage the legislative approval of this reform which will help generate savings and restore confidence in the future path of public finances and debt. With the need to foster investments and economic growth, further efforts should be made to improve public financial management, including public procurement and investment management. To this effect, authorities should enact as soon as possible the new procurement law aimed at improving the process of project appraisal and selection and providing the highest economic returns for the Brazilian economy.

With inflation expectations anchored and fiscal consolidation planned, the monetary policy stance should continue to support economic recovery. In the current economic cycle, we agree that monetary policy should help provide impetus to economic growth as long as inflation expectations continue to be well anchored. We encourage close coordination between fiscal and monetary policies as the outcome of the pension reform could affect the currency and the conduct of monetary policy. More broadly, we support the new law regulating the institutional relationship between the Treasury and the central bank which should enhance the transparency and effectiveness of the monetary policy framework.

We take positive note that the banking sector is resilient and encourage further efforts to strengthen its oversight. We welcome the indication that the banking system is well capitalized and shows appropriate levels of profitability and liquidity. However, the high leverage of corporations and debt-service to income ratio of households constitute vulnerabilities in the private sector, and the authorities should remain vigilant about them. We appreciate the progress made in implementing the FSAP recommendations and support further efforts to strengthen macroprudential policies, as well as the safety net, and crisis management frameworks. In this regard, the enactment as soon as possible of the legislations envisaged by the authorities on the financial sector would be an important step for strengthening the resilience of the financial sector. We also note the commendable measures taken to ensure that the AML/CFT framework is in line with international standards.

The authorities should continue to deepen structural reforms to break the trend of slow economic growth and raise potential growth. In addition to the reforms of the pension and tax systems, a pick-up of growth would also entail reforms to enhance labor productivity and skills, openness to international trade as well as privatization of SOEs. The authorities should address the infrastructure gap, notably by improving the quality of public investment and continuing their efforts to improve the business environment which is essential for boosting private investments and job creation.

With these remarks, we wish the Brazilian authorities success in their future endeavors.

Mr. de Villeroché, Mr. Castets and Ms. Albert submitted the following statement:

We thank staff for its clear report and Mr. Tombini for his informative buff statement. In a context where activity remains lackluster, notably due to a confidence effect linked to debt sustainability and challenging regional and international environment, advancing a comprehensive range of reforms appears warranted to put growth on a strong and sustainable path. The pension reform, as well as decisive actions to tackle the high level of wealth inequality and improving governance stand as priorities, and we note positively the recent approval of the base text at the lower house of Congress. We also consider that giving a more prominent role to the private sector would enhance efficiency, competitiveness, and thus boost investment, which is paramount. Finally, we encourage the authorities to seize the opportunity of the EU-Mercosur deal to increase trade openness and potential growth. We share the thrust of staff's appraisal and offer the following comments for emphasis:

Economic outlook

The lackluster growth and relatively low potential growth are a source of concern. Growth went into the negative territory in the first quarter and should reach only 0.8 percent this year. Staff's forecasts have been repeatedly optimistic since 2014 as shown in the Figure 2 in the DSA, and we wonder if the estimation of the potential growth at 2.2 percent is not still on the ambitious side. The demographic transition will act as a drag on the potential growth in the future, and the interesting box 4 shows that without significant reforms, maintaining a potential growth above 2 percent is unlikely.

In the context of the trade tensions between China and the United States, Brazil has benefited from positive trade diversion effects, as soy exports increased significantly to China. Could staff elaborate on these effects and how the country could be impacted by the non-end or the end of the trade dispute?

On the external side, we welcome that vulnerabilities remain low due to the existing buffers. We would be interested in staff assessment on the weak impact of the sharp 2018 exchange rate depreciation on the NIIP (from -32.1 percent of GDP in 2018 after -34 percent in 2017).

Fiscal policy

The public debt trajectory warrants swift measures. The public debt to GDP has been deteriorating rapidly since 2013 and should continue to increase to reach 96 percent in 2024, including in the baseline scenario that integrates the adoption of the pension reform.
Gross financing needs should rise to over 30 percent of GDP by 2024. We also note the significant weight of the interest bill in the overall fiscal balance. In order to counter this trend, we see the adoption of the pension reform as crucial, which will also play a key role in terms of signal for investors, but more will be needed to be done for fiscal sustainability. Indeed, this reform will only represent a third of the fiscal adjustment needed to comply with the expenditure ceiling in 2024. We note from p 8 the significant size of the mandatory government spending compared to its peers and encourage the authorities to make efforts in this area. We also urge

them to adopt quickly the necessary tax reform, as the simplification of tax code and the limiting exemptions should help to improve the efficiency of the complex tax system. We also encourage the authorities to find a better balance between the direct taxation and the high indirect taxation so as to improve the redistributive impact, and to ensure the protection of the most vulnerable. Could staff comment on their recommendations to protect the most vulnerable households from the impact of the reforms?

Structural reforms

We appreciate staff's efforts to design a clear sequencing of the reforms and note the limited progress so far on the implementation of past Fund advice on the structural front.

First, as the country is characterized by one of the lowest investments to GDP ratio among the emerging countries (15.4 percent), investment in infrastructures appears as a top priority to boost potential growth. Fiscal space is limited but we see room to reduce bottlenecks, by improving the business climate and cut the red tape to improve productivity. Privatization could also lead to improved fiscal sustainability and bring more efficiency in energy and banking sectors.

Second, we understand that opening further the economy to international trade might be difficult, but it would help to boost potential growth and we strongly encourage the authorities to make progress in this area. Could staff provide its analysis regarding the impact on trade and growth of the recent EU-Mercosur deal on the Brazilian economy?

Third, we thank staff for their interesting box about the pre-salt oil as a potential "game changer".

Finally, we regret the absence of development in the report about poverty and inequality as they remain at a persistently high level. According to the last World Bank estimates, the income share held by the highest 10 percent was about 42 percent of total income and poverty reached 25.4 percent in 2017 (less than US$ 5.5 PPP per day). We encourage staff to cover that dimension in upcoming reviews.

Monetary and financial markets

We agree with staff recommendations and see room for a monetary easing as inflation is under control. This would help to stimulate growth in a context where fiscal space is limited. In this regard, reforms aiming at improving the transmission channel of monetary policy and at reducing the high intermediation margins appear as priorities. We welcome the refocus of BNDES lending towards infrastructures, but we encourage the authorities to pursue their efforts to let private banks play a more active role in that field.

We commend the authorities for limiting FX interventions doe cases of disorderly market conditions. We thank staff for their interesting selected issues about FX interventions as the BCB has used currency swaps to manage the exchange rate volatility over the past few years. As interventions through derivatives in emerging economies is more and more common, could staff identify the benefits and drawbacks with the use of such instruments compared to spot interventions?

Staff mentions that the government is planning to make the real fully convertible. Could staff develop its analysis about the benefits of this measure?

Mr. Alkhareif, Mr. Tan, Mr. Anwar and Mr. Alhomaly submitted the following statement:

We thank staff for a set of well-written reports and Mr. Tombini for his insightful buff statement. While Brazil's economic recovery remains subdued, we note that growth is projected to improve from 2020 onwards. Nevertheless, the remaining external and domestic risks require steadfast implementation of ambitious structural reforms, accommodative monetary policy, and sustained fiscal consolidation while protecting public investment and social spending. Against this backdrop, we are in broad agreement with staff's analysis and policy recommendations and would like to make the following comments for emphasis.

On the fiscal side, we consider the planned expenditure-based gradual consolidation from 2020 onwards to be appropriate, given the already high tax burden. To this end, we support the authorities' ambitious agenda, particularly on pension reform. However, more needs to be done to ensure debt sustainability over the medium-term, including further reforms in revenue administration, building on the recent progress made to strengthen tax administration. In this context, we are encouraged by the authorities' efforts to reduce public debt and create additional fiscal space, notably by containing discretionary spending, in line with the expenditure ceiling. We also share staff's view on the need to strengthen the fiscal framework to ensure the quality of the adjustment. In the same vein, we see the need for following flexible and simple rules within the medium-term fiscal framework while preserving discipline and continuing with the consolidation efforts to ensure debt sustainability.

At the same time, Brazil needs significant investment going forward to address the infrastructure gap. Given that fiscal space is assessed to be at risk, priority should be given to upgrading the procurement practices and enhancing public investment efficiency, while also putting in place effective measures to crowd-in private sector capital. Here, we take positive note of the new procurement law and encourage the authorities to address the remaining issues, highlighted in paragraph 14 of the staff report. On the same note, we support the authorities' privatization plan to reduce the public sector economic footprint, enhance the efficiency of SOEs, and reduce their fiscal burden. This would also help generate short-term revenue to mitigate fiscal pressures in the near-term.

Monetary policy should be appropriately calibrated to evolving market conditions to preserve low and stable inflation. We commend the authorities' stance to maintain prudent monetary policy which is consistent with the inflation targeting regime that has served the economy well. In this regard, we support the authorities' efforts to enshrine the independence of the central bank into law to further improve the inflation-targeting regime. We welcome the authorities' institutional framework enhancement, particularly on the relationship between the Treasury and the Central Bank, to strengthen the monetary framework and its transparency as shown in the recent bill. Looking ahead, given inflation expectations are anchored and inflation is close to the mid-point of the inflation target range, we concur with staff and the authorities that accommodative monetary policy remains appropriate to provide additional stimulus to offset the potential headwinds from fiscal consolidation. We encourage the authorities to remain clear on their communication framework, including policy objectives, strategy to achieve them, and the toolkit to be used to contribute to the effectiveness of policies.

Continued strong commitment to flexible exchange rate is warranted to absorb shocks and preserve macroeconomic stability. We take positive note that exchange rate policies were in line with the Fund advice. We commend the authorities for allowing their exchange rate to be determined by the market, thus supporting monetary transmission and acting as a buffer against external shocks. We note that exchange rate movements did not pose financial stability concerns for Brazil, but encourage the authorities to continue limiting FX intervention only in the case of disorderly market conditions. Persevering adequate international reserves to enhance resilience cannot be overemphasized. As rightly highlighted by staff, this is particularly important in light of the sluggish recovery and to mitigate the risks associated with public debt sustainability and possible large and volatile capital flows.

Strengthening stability and efficiency of the financial sector is crucial to further boost market confidence and economic resilience. We commend the authorities for making notable progress in implementing financial sector reforms recommended in the 2018 FSAP. We take positive note that financial conditions are easing after markets rebounded in the aftermath of the 2018 elections. We concur with staff that efforts to improve bank intermediation efficiency should be continued. We encourage the authorities to further enhance the oversight of the banking sector to help shelter the financial sector against risks in the future. We notice that staff's and the authorities' views continue to differ on the transformation of the Fundo Garantidor de Créditos (FGC) into a public institution and the implementation of emergency liquidity assistance to financial institutions. Staff's comments are welcome. We look forward to the authorities' assessment of the impact of the current position on both FGC and ELA.

We encourage the authorities to accelerate their structural reform agenda to boost potential growth. In light of the wide-ranging reforms, careful prioritization and sequencing, as well as proper communication are essential to their successful implementation. Pension reform should be given the highest priority and we look forward to its implementation this year. We share the authorities' view that pension reform will remove an important source of uncertainty and provide a confidence boost with immediate positive effects on productivity. We take note in the buff statement that staff is overestimating the direct short-term impact of the reform on demand, as the increase in savings will accrue over time. We invite staff to comment. In addition, we encourage the authorities to press ahead with their ongoing reforms to improve the investment environment, building on the recent efforts made to strengthen the regulatory framework and simplify the import licensing process and the start-up procedures to register a business.

The authorities' continued efforts to fight corruption and improve transparency are commendable. We are reassured by their commitment to continue their efforts in this area and by their plan to strengthen the anti-money laundering framework. Nevertheless, we join staff in calling on the authorities to ensure timely finalization of the national risk assessment to support their ongoing efforts to fight corruption and illicit finance.

With these comments, we wish the authorities all the success.

Mr. Rosen, Ms. Pollard and Mr. Vitvitsky submitted the following statement:

We thank staff for an excellent Article IV report and the Selected Issues papers, particularly the chapter on foreign exchange (FX) intervention. We appreciated Mr. Tombini's buff Statement, which clearly laid out Brazil's comprehensive reform agenda. We support the authorities' vision and ambition for structural reforms, and we recognize that Brazil is beginning to implement several IMF recommendations going back many years. Brazil's economy now faces an important crossroads amid sluggish growth, rising public debt, and needed policy adjustment. Implementation of the reform agenda, particularly pension reform, will be critical to ensure debt sustainability, restore confidence, and boost potential growth. We agree with the recommendations laid out in the Article IV.

We concur with staff that pension reform is necessary and welcome the recent progress in the lower house of Congress. We acknowledge the difficult political dynamics and were pleased to read Mr. Tombini's statement that Brazil is on the verge of approving major social security reform. However, more is needed to restore debt sustainability and stimulate investment. Pension reform itself will likely stabilize Brazil's already high public debt, while other expenditure reforms will be needed to bring public debt to sustainable levels. Rebuilding fiscal space through pension and expenditure reform will also allow the authorities to focus on addressing Brazil's large infrastructure gap. Investor and business confidence hinge on successful implementation of pension reform as well.

We agree with staff that the current moderate accommodative monetary stance is appropriate amid low inflation and stable inflation expectations. We also concur that the exchange rate has acted as an important shock absorber, and that FX intervention should remain limited. In this context, the analysis in the SIP on "Profitability and Determinants of FX Intervention in Brazil" is insightful and helps to assess the appropriate level of FX intervention amid temporary excessive movements of the exchange rate. We would encourage staff to do more work along these lines to better understand when intervention is addressing "disorderly market conditions." Could staff comment on whether this technique is applicable to other countries?

Additionally, we note that weak bank intermediation and high credit costs are limiting corporate investment and consumer borrowing. We are encouraged by the authorities' plans to address high costs through the establishment of credit information bureaus and legal reforms. At the same time, we would have appreciated a more fulsome discussion in the Article IV on the causes of stubbornly high borrowing costs in Brazil.

Finally, we support staff calls and the authorities' plans to implement structural reforms to boost potential growth, which at around 2.2 percent, is among the lowest of emerging market peers. We welcome plans to improve the business climate, continue cracking-down on corruption, and liberalize trade. Brazil's tariff and non-tariff barriers remain higher than in comparable economies, and previous IMF research has indicated the large potential benefits from trade liberalization in Brazil on investment and productivity. We welcome current plans to lower important trade barriers.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for a well-focused set of papers on Brazil and Mr. Tombini for highlighting the authorities' challenging reform agenda. We broadly agree with staff's analysis and recommendations.

In 2015-2016 the economy of Brazil went through a deep recession with a cumulative decline in GDP of about 7 percent. Subsequent recovery remains rather anemic with annual growth rates close to 1.1 percent over the past two years. According to staff's estimates potential growth in Brazil is about 2.2 percent. In order to achieve higher growth rates, the authorities will have to implement complex and politically difficult fiscal consolidation and substantially deepen structural reforms. Potential growth is an important, albeit very uncertain estimate. The estimates are frequently affected by the staff judgement, for example, on the likely effects of structural reforms. For some countries staff add these (sometimes very large) effects to their estimates of potential growth in the medium-term projections, while for other they refuse to do that. Hence, in our opinion, it would be useful to have a "reality check" to supplement estimates presented in the chart on page 16 of the report with the average actual growth rates, say, over the past 5, 10, and 20 years. Moreover, when staff compare growth rates over a long period of time, it would be informative to compare GDP growth in per capita terms, so that the large differences in population growth are taken into account. We ask staff to provide such a table for the countries used in the chart.

In the fiscal area, the authorities are facing major challenges. According to Mr. Tombini, the shift in the structure of expenditures from public investment to social security and social assistance was one of the key drivers in growth slowdown. These developments also raised questions about the worsening public debt dynamics in Brazil. We welcome the recent progress in the Brazilian legislature on the pension reform, since, if approved, it may close about one third of the current fiscal gap in Brazil. Recent events point to the authorities' willingness to spend political capital on necessary reforms and their ability to secure sufficient support in the legislature. We agree with the authorities and staff that additional efforts are essential for securing fiscal accounts in a sustainable and growth-friendly manner. In this respect, we would be interested in a discussion of specific fiscal measures and their estimated yields, so that the Brazilian authorities would be able to choose from a menu of plausible and effective solutions.

We note that the structure of the public debt, including its denomination in national currency, makes the Brazilian economy resilient to a variety of external shocks. At the same time, the peak level of gross public debt is projected to reach 96 percent of GDP by 2024. For any economy this is a very high level of public debt, and this projection underlines the urgency of fiscal consolidation in Brazil. Such a high level of public debt, together with recent fiscal trends, leave little or no fiscal space in Brazil to stimulate the economy. More likely, the authorities will be forced to conduct procyclical fiscal policy, which will further delay the economic recovery.

In the absence of countercyclical fiscal tools, the monetary policy in Brazil should remain accommodating and, at the same time, focused on keeping inflation close to target and inflation expectations well anchored. From this point of view, we welcome the current monetary policy stance. Maintaining the good track record of successful inflation targeting and further strengthening the Central Bank's credibility is a priority. Additional efforts to ensure the monetary authorities' formal independence would facilitate this task. We look forward to progress in this area.

The Central Bank has adequate foreign exchange reserves, which currently correspond to about 180 percent of the ARA metric. Given the challenging domestic conditions in many emerging market economies, the risks stemming from the very uncertain external environment, and the incomplete Global Financial Safety Net, we believe that the previously estimated range of 100-150 for the ARA metric may need to be revisited. It may not be a reliable guide on the adequacy of foreign exchange reserves. Hence, we encourage the Brazilian authorities to continue their vigilant approach to maintaining external buffers.

We also note the authorities' positive experience with foreign exchange interventions, as it is described in Chapter 1 of the SIP. This study should contribute to the growing body of evidence on the proper use of monetary, macroprudential and foreign exchange policies. We support the ongoing work at the Fund on these matters and look forward to the eventual Board discussion.

The authorities have a broad and ambitious agenda of structural reforms. They need to make social assistance more targeted and effective. Challenges in the area of education and healthcare remain formidable. We noted that staff favored reducing the footprint of the state in Brazil. Are there any estimates of the size of this footprint and of the main areas in need of close attention? The role of the state banks in financial intermediation needs careful reevaluation. In light of limited funds available for public investments, further improvements in the effectiveness of public investments and SOEs would be particularly beneficial. According to staff report, fiscal federalism in Brazil also needs carefully designed and negotiated reforms.

We encourage staff and the Brazilian authorities to maintain active dialog on structural reform priorities, including through the Fund's technical assistance. We recall that, in 2017, the authorities completed and published the Fiscal Transparency Evaluation report. We would appreciate an update on the implementation of key recommendations in this report. We also welcome the recent completion and publication of the PIMA. In the report staff devoted a separate section to the anti-corruption framework. Did staff provide any technical assistance in this area?

With these remarks, we wish the Brazilian authorities success in their reforms.

Mr. Mahlinza, Ms. Maidi and Mr. Garang submitted the following statement:

We thank staff for a well-written set of papers and Mr. Tombini for his informative buff statement.

Although at a slow pace, Brazil's economy continues to recover, with real GDP growth reaching 1.1 percent in 2017 and 2018. The outlook however, remains subject to downside risks, including a sudden tightening of global financial conditions and a deeper global economic slowdown. Against this background, we urge the authorities to prioritize fiscal consolidation and the implementation of structural reforms to raise potential growth and productivity. We broadly concur with the staff appraisal and offer the following comments for emphasis.

Fiscal consolidation should remain high on the agenda to ensure debt sustainability. To this end, we welcome the authorities' plan to use constitutional expenditure ceiling as an anchor to guide fiscal consolidation starting in 2020. Further, pension reforms, which the authorities regard as a game changer, need to be undertaken to move the economy to the next frontier. We also welcome authorities' commitment to embark on tax reform, including simplifying fiscal decentralization toward states and municipalities as indicated in the buff statement, and reviewing revenue earmarking while paying close attention to issues around downsizing and consolidating earmarked resources. Going forward, we urge the authorities to rationalize fiscal rules as well as prioritize the transition toward a medium-term budget framework. We would welcome staff comments on whether the new administration is committed to continue with Bolsa Familia, one of the largest cash transfers in the world. In addition, we are encouraged by the authorities' commitment to using any extraordinary federal revenues to reduce public debt and deficits.

We concur with the staff that monetary policy stance should remain accommodative and data-dependent. In this regard, we see merit in maintaining a monetary policy stance that is supportive to providing a moderate stimulus to offset potential contractionary effects of fiscal consolidation. Further, with inflation closer to the mid-point of the target, and the output gap remaining negative, the current monetary policy stance is justified. We are encouraged by the authorities' commitment to a market determined exchange rate and limiting FX interventions to address disorderly market conditions. Going forward, we urge the authorities to continue to strengthen the monetary framework while making efforts to embed transparency and streamline cash flows between the Banco Central do Brasil (BCB) and the Treasury to enhance independence.

Decisive actions are required to strengthen the financial sector resilience. While we are encouraged by the profitability and liquidity in the banking sector, we remain concerned about persistent vulnerabilities in the corporate and household sector. Given high leverage in the corporate sector and high household debt service, we urge the authorities to make efforts to reduce debt service on households to support aggregate demand and enhance economic opportunities for all while also enhancing risk-based supervision in the financial sector. In this regard, we welcome the notable progress made so far to implement the financial sector reforms as recommended in the 2018

FSAP. Further, we urge the authorities to remain vigilant and continue to build on recent efforts aimed at enhancing the crisis management and macroprudential framework in the banking sector. Relatedly, we welcome the approval of the registry law, which aims to facilitate the collection of positive credit information.

Key structural reforms, including trade liberalization and improving the business environment, remain essential to raising potential growth. Against this backdrop, we commend the authorities for pursuing negotiations with the OECD to be compliant with the OECD codes of liberalization by 2020. This will enhance competitiveness. Further, supporting private sector development to improve the business environment, closing the infrastructure gap, eliminating multiple indirect taxes and harmonizing tax regimes, and enforcing anticorruption and anti-money laundering frameworks, would support Brazil's medium-to-long term growth. We further welcome efforts by the Brazilian authorities to improve the AML/CFT frameworks and align them with the international best practices, including the legislative amendments.

Mr. Kaizuka and Mr. Nagase submitted the following statement:

We thank staff for informative papers and Mr. Tombini for his helpful buff statement. We welcome that Brazilian economy is expected to turn upwards and the GDP growth will reach 2.4 percent in 2020, while Brazil has experienced historically low growth after the recession in 2015-16. To realize this estimation, we encourage the authorities to make continuing efforts to accelerate fiscal consolidation and structural reforms, including ambitious social security reform, tax reforms, privatization, trade liberalization and improvement of bank intermediation. We also put emphasis on importance of tackling corruption and the effective implementation of anti-money laundering and anti-corruption measures. As we broadly concur with the thrust of the staff appraisal, we will limit our comments to the following points:

Fiscal Policy

To ensure debt sustainability and contain fiscal risks, further efforts are needed. We welcome that the authorities sent an ambitious pension reform proposal to Congress, which is projected to stabilize pension spending over the next decade and make the system more equitable. However, we take note that the reform is still not sufficient to ensure the fiscal sustainability, and additional measures are needed to comply with the expenditure ceiling. On the expenditure side, for example, authorities should reduce major mandatory expenditures, such as social security benefits, salary allowance and government payroll. On the revenue side, authorities need to simplify the current tax system including current multiple indirect taxes, and to improve the collection of tax arrears. In this regard, could the staff share views on the impacts that if the pension reform proposal not be approved by Congress this year?

Monetary Policy and Exchange rate policy

Given low inflation and anchored inflation expectations, the current accommodative monetary policy stance would be appropriate. We welcome the recent bill regulating financial transactions between the Treasury and the Central Bank which will strengthen the monetary framework and its transparency. Regarding the exchange rate, we agree with the staff that the flexible exchange rate is important to absorb shocks and intervention should continue to be used only to address disruptive market volatility.

Financial Sector Policy

We encourage the authorities to enhance oversight of banking sector. As the staff point out, in order to help shelter the financial sector against risks in the future, the prudential crisis management, safety net, and macroprudential frameworks should be enhanced. To improve bank intermediation efficiency, a proposed corporate bankruptcy law, which will reduce delinquency costs for bank and a credit registry law, which was recent approved and will improve banks' access to positive credit information should be fully implemented.

Structural reform

To raise potential growth, structural reforms are indispensable. We welcome that the authorities' plans to implement structural reforms including pursuing privatization, lowering trade barriers, tackling corruption, and simplifying taxation to improve the business climate and boost productivity.

Mr. Jin and Ms. Zhao submitted the following statement:

We thank staff for the well-written reports and Mr. Tombini for the helpful buff statement. We take positive note that the external position remains broadly consistent with fundamentals and inflation is around target thanks to the flexible exchange rate and the inflation targeting regime. Considering the sluggish recovery and elevated public debt, it is essential for the authorities to make steadfast reform efforts, including the pension reform, tax reform, and trade liberalization reform, to achieve higher and more inclusive growth. As we broadly agree with the thrust of staff's appraisal, we would like to focus our comments on the following for emphasis.

Fiscal consolidation is essential to ensure fiscal sustainability and strengthen market confidence. We welcome the authorities' ambitious pension reform proposal that would help to stabilize pension spending and make the system more equitable. Besides pension reform, additional expenditure measures are needed to comply with the expenditure ceiling over the next few years. We encourage the authorities to continue revenue administration reforms to generate additional fiscal space. Given the need to bridge the large infrastructure gap to unleash growth potentials, we encourage the authorities to streamline current spending to increase space for capital spending and mobilize more private capital.

An accommodative monetary policy and flexible exchange rate regime will continue to support growth. As inflationary pressures are well-anchored, we agree with staff that the current accommodative monetary policy is appropriate to support aggregate demand and close the negative output gap. We are encouraged that the movements in the exchange rate do not pose financial stability concerns given that FX debt in the private sector is mostly hedged. Could staff elaborate on the reasons for such high FX hedging rate and explain to what extent it could attribute to highly-developed FX derivatives markets? What experiences could be drawn for other EMs in terms of the hedging toolkits and market development?

Further actions are needed to enhance efficiency of the financial system. It is good to note that the financial system remains stable and banks are well capitalized and profitable. Nonetheless, it is essential to improve bank intermediation efficiency and reduce the high intermediation margins. We take note that the corporate bond issuance only accounts for a small share of overall borrowing and welcome staff to elaborate on the main constraints facing the corporate bond market as well as policy recommendations.

Structural reforms are needed to improve business and investment environment. The complicated and distortive tax system should be reformed to make compliance less costly and catalyze private investment. Trade liberalization is essential to improve competitiveness. We welcome staff's comments on the effect of international trade tensions on Brazil's economy. We take positive note of the recent EU-Mercosur trade agreement. Could staff elaborate what major adjustments Brazil needs to make to comply with the high standard of the agreement? We also note the authorities' plan to make the real fully convertible within two to three years, which will be conducive to lowering the cost of cross-border trade and investment. Are there any specific measures to be taken to make the real fully convertible? At the same time, what measures should be taken to mitigate related risks, including greater exposure to foreign shocks?

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Rashkovan and Mr. Cools submitted the following statement:

We thank staff for the excellent set of papers and Mr. Tombini for his insightful buff statement. We agree with the thrust of the report. The Brazilian economy is going through an economic slowdown, and private investment is at a low level. Since the beginning of this year, the GDP forecast for 2019 by the Central Bank of Brazil has been downgraded in several consecutive announcements from 2.5 percent to the current 0.85 percent. To increase potential growth, the authorities are committed to structural reforms and free trade, while pursuing fiscal consolidation efforts in a difficult political climate.

We endorse the authorities' fiscal consolidation efforts. We concur with staff that pension reform is the first crucial step, and we are comforted to see that the Lower House of the Brazilian Parliament has approved the social security and pension reform described in Mr. Tombini's buff statement. We hope that this reform will include all sectors of society, including the army as well as federal and state police.

Fiscal consolidation, however, should be complemented by improved spending efficiency, as promoted in the IDB Report 'Better spending for better lives - How Latin America and the Caribbean Can Do More with Less'[1]. This report shows how fiscal consolidation can be achieved while protecting public investment. Improving spending efficiency will be instrumental to safeguard the continuous improvement in social development metrics, needed to support sustainable long-term economic growth.

To boost potential growth, structural reforms are paramount. In line with the empirical estimations of the 2018 Article IV consultation, we believe that further banking reform should be a priority. In light of this, we commend the broad financial sector reform program described in Mr. Tombini's buff

[1] Better spending for better lives, Inter-American Development Bank (2019).

statement. Banking reform benefits from strong popular support and could lead to strong total factor productivity growth. More efficient financial intermediation and increased competition should be the main goals. Rising efficiency of banks would boost productivity and the investment environment in the country.

Staff recommends that the Brazilian deposit guarantee fund be brought into the public sector to help prevent conflicts of interest and to retain the mandate for financial stability in the public sector, as described in the 2018 FSAP Technical Note on Bank Resolution, Financial Sector Safety nets, Crisis Prevention and Management. Brazil, however, is not the only country with a private deposit guarantee scheme. We wonder whether the challenges identified by staff can be remedied without requiring bringing the deposit guarantee scheme in the public sector. We also wonder whether the advice to bring Brazil's deposit guarantee scheme in the public sector is supported by any international standard. Staff's comments are welcome.

Finally, we welcome staff's endorsement to increase trade liberalization. A great milestone has been reached with the recent announcement of a political agreement between the EU and Mercosur on a free trade agreement. This trade enhancement would be a gain for both parties in a currently fragile external trade environment.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a set of well-written papers and Mr. Tombini for his candid buff statement. As we are in broad agreement with the thrust of the staff appraisal, we limit ourselves to a few key issues.

The watershed pension reform is not only key to ensuring fiscal sustainability over the longer run, it is also a major confidence boost to government policies to build the foundation for higher sustained growth over the medium term by increasing investment and lowering the cost of capital. It also addresses the long-standing inequities in the social security system across the skills, urban-rural, and public-private sector divides. Although the projected savings from the pension reform are substantial, the reforms will only stabilize pension expenditure in relation to GDP over the next decade. While fiscal discipline will be anchored by the constitutional expenditure ceiling starting 2020, adherence to the ceiling implies that the primary deficit should gradually narrow and move into a surplus by 2023-2024. Mandatory government spending in Brazil is high compared to peers in LA6 (page 8). How would the ranking be affected by excluding pension expenditures?

Clearly, other current spending should be curtailed to stay on the fiscal path. In staff estimate, how much savings could be reasonably generated by lowering the wage bill (¶11)? Increasing the efficiency of public investment and procurement practices, strengthening the medium-term fiscal framework, and requiring fiscal adjustment by subnational governments in return for temporary support are also important steps in arresting expenditure growth. On the revenue side, we welcome the authorities' intentions to embark on a revenue-neutral tax reform and enforce collection of tax arrears. We also welcome their intention to use any oil revenue windfall to reduce the deficit and/or pay down debt and encourage them to move judiciously with their privatization program.

One of the challenges facing the authorities is to raise potential real GDP growth that is currently one of the lowest among Brazil's peer group. The pension reform is expected to raise investment and labor supply and hence potential growth, directly and indirectly, but efforts are also needed to raise stagnant productivity. The analysis in Box 4 is interesting in that even raising the productivity growth and the investment ratio (to reduce the infrastructure gap) well above their historical levels, potential growth increases to only around 3 percent that would still be low relative to those of peers. In staff view, is Brazil in a low growth trap? And what are the implications for a country with high levels of unemployment and poverty? Poverty, income inequality, and environmental degradation in the Amazon region are serious concerns in Brazil. We would have expected the staff report to dwell more on these issues. Staff comments and additional information would be appreciated.

We agree with staff that the current slight accommodative stance of monetary policy is appropriate as inflation is around the mid-point of the target range, and there is a sizable negative output gap. The stimulus could even be increased to support aggregate demand as fiscal consolidation takes hold, but as long as inflation expectations are firmly anchored.

The exchange rate flexibility has been supportive of economic activity and Brazil's sizable external reserves provide additional comfort. It is important that foreign exchange market interventions are confined to smoothing disorderly market conditions. Could staff comment on steps that the government is planning on to make the currency fully convertible in 2-3 years?

Finally, we wish a speedy completion of Brazil's OECD accession process that would be the culmination of its institution building efforts over many years.

We wish the authorities continued success.

The Acting Chair (Mr. Furusawa) made the following statement:

Brazil's economic recovery has been sluggish. Growth is expected to stay subdued this year and pick up in 2020. Directors have noted in their gray statements that the main risk to the outlook stems from fiscal consolidation setbacks, and in that regard highlighted pension reform as critically important. Directors also agreed on the need to maintain accommodative monetary policy to offset the impact of a tighter fiscal stance given anchored inflation expectations.

Another theme emerging from the gray statements is the importance of implementing reforms to boost potential growth, including by simplifying the tax system, reducing trade barriers, and improving the business environment to foster inclusive growth.

Mr. Tombini made the following statement:

I take the opportunity to thank staff for the fruitful dialogue, which is highly appreciated by the Brazilian authorities. Let me underscore that there is a broad alignment of views between staff and the authorities despite the persistence of small divergences on a few issues.

In past Article IV discussions, I had said that there were two game changers in the reform agenda in Brazil. The first was the spending ceiling delivered in 2016. The other leg was the pension reform to rein in the explosive path of primary current expenditures. Social security is responsible for the primary deficit in Brazil. If it were not for the social security deficit, the public sector primary balance last year would have been a surplus of 3.8 percent of GDP instead of a deficit of 1.7 percent of GDP.

I am glad to announce that last Friday the social security reform passed perhaps its most critical hurdle in the legislative process—the first vote in the House with an overwhelming majority, 379 members of parliament supported the reform, and the super majority needed was 308 votes. It is now expected to move quickly to the Senate in early August after the Congress recess.

The version approved by the Lower House preserves the bulk of the savings, which are now estimated in the order of 900 billion reals in a period of 10 years. There is actually an important upside risk, as the Senate may reinsert states and municipalities in the reform, boosting savings significantly. It is estimated to be an additional 350 billion if states and municipalities are on board in this reform in the 10-year period.

The pension reform removes a source of uncertainty that has been holding up investment in Brazil, one of the key factors behind this slow recovery. In addition, progress in approving the reform by itself has contributed to easing financial conditions. Last week alone the real appreciated by more than 2 percent, and the five-year credit default swap declined by 11 percent. Also, the interest rate in the longer segment of the yield curve is now 400 basis points lower than one year ago.

Having said that, the authorities are well aware of the fact that the pension reform alone will not do the job. Nonetheless, the pension reform provides critical momentum for the broad agenda to promote productivity, efficiency, competition, and ease of doing business. I will touch on a few points of this agenda.

First, a revenue-neutral tax reform to simplify and streamline taxation, which is long overdue, is already under consideration by the Congress and will now become a legislative priority with the passage of the social security reform hopefully in August. Hopefully, in the next Article IV consultation with Brazil, we will have good news on this front, too.

Second, several Directors have mentioned the importance of reforming the financial sector. The banking sector is sound, broad, inclusive, competitive, and profitable. Nonetheless, the central bank is engaged in a program to reduce the high interest margins, enhance accelerated credit growth, and enhance the transmission channel of monetary policy. Indeed, past initiatives to restrain verticalization and increase competition and payment arrangements have already borne important fruits. In the past three years, for instance, the participation of minority credit card providers in the market has doubled. Adequate regulation and financial infrastructure are promoting the use of receivables to raise finance. Facilitation of the execution of collaterals will address one of the main costs of banking credit in Brazil. Fintech is being regulated with a view to strengthen competition while protecting consumers and financial stability.

While Brazil is transitioning away from earmarked subsidized credit to free credit from private providers, capital markets are also being forced to pick up the slack in investment finance. All in all, this is an agenda with broad initiatives that will deliver over time an even more competitive, inclusive, and efficient financial market.

Finally, a word on this administration's commitment to deepening the integration of the Brazilian economy into the global economy. The Mercosur-European Union (EU) agreement is a testimony of this strong will. Most importantly, trade openness will be propelled by unilateral liberalization initiatives that are already taking place, such as the reduction in tariffs of capital goods and information technology projects that were recently implemented.

To conclude, looking forward, the combination of fiscal sustainability, privatization, cheaper credit, and trade openness will support boosting potential growth in the Brazilian economy.

The staff representative from the Western Hemisphere Department (Mr. Spilimbergo), in response to questions and comments from Executive Directors, made the following statement:[2]

Staff has already responded to all technical questions, and I will focus my comments on two issues, the latest developments and the speed of the recovery, and second, on structural reforms, which play a key role.

On the latest developments, the second-quarter data have been soft so far. Confidence has been very low, the lowest since the election, and central bank activity indicators contracted in April, as in every month in 2019. On the other hand, investment in machinery and equipment grew robustly in May. A labor market recovery continues. Financial conditions have evolved favorably in Q2. At this point, it is too early to say whether Brazil can avoid a technical recession, defined as two consecutive quarters with negative growth, in the first half of 2019, but we can safely say that the recovery is not yet as strong as we would like.

Staff's growth path assumes for the remainder of the year a pickup in the second and especially in the third and fourth quarters. This pickup is predicated on the grounds that with the reforms that the government has

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

implemented, confidence will continue, will be restored, and active economic activity and especially investment will pick up.

There are two interpretations about the sluggishness of this recovery. The first is that there was simply a series of negative shocks, mostly demand-driven, such as the strike of truck drivers in May and the election issue in Argentina. The second explanation is that in reality, the sluggishness of the reform is due to some deep structural reason, and until we deal with this deep structural reason, the economy cannot really take off. Both the authorities and the staff concurred that the structural issues play a key role, and we should address this issue to have sustained growth, and only sustained growth can ensure fiscal sustainability. This leads one naturally to speak about what the government has done on structural reforms, and this is very important to recognize that in the last month or so, two key reforms were done—one on trade, and the other on pensions.

On Mercosur, on trade, the EU-Mercosur agreement could be historical. It is a first big trade agreement signed by Mercosur outside the region since it was formed in 1991. It creates a market of 800 million people for goods and services, comprising almost a quarter of the world GDP. It will be the largest deal that the EU has done. However, this has to be ratified, and there is a long transition period in the present formulation, which could take up to 10 to 15 years. However, this could be a game changer for Brazil given the closeness of the economy now.

Last but not least, this trade agreement would play on Brazil's comparative advantages. But the most interesting development is about pension reform. This pension reform was in the making for a few years, and the vote on July 10 in the Lower House was key for the progress. The key elements are the introduction of a minimum retirement age, 62 for women and 65 for men. Brazil was lagging other countries in this. Second, a longer contribution period to accrue full pension, and less generous pension benefits, especially for civil servants. As we highlighted last year, this was a major reason for inequality, the generosity of the pension system that benefited the relatively rich people or public servants.

It is too early to make an assessment because this was just the first passing. It has to go to a second passing in the Lower House, which is currently scheduled for August, after the recess. After that, it will have to go to the Senate with two passages, and provided that no major changes are done, it will be approved. If major changes are done, it has to go back to the Lower

House. But still, it is a key reform that finally put pension reform on the right track.

There are two final considerations. First, about the political indication of pension reform, usually the major initiative starts from executive power and goes to Congress for discussion. Congress and the executive power have to reach an agreement in the Congress. This time, Congress shows that it has the ability to form its own strong reform agenda, and so the reform really reflected this broad majority of the Parliament. This bodes well for the next set of reforms, namely the pension reform, the tax reform.

Second, all the reforms that Brazil is doing in the last few years—the labor reform in 2017, the pension reform, hopefully this year, the trade agreement in the next few months, and the future tax reform, which is scheduled for the summer—are key. But their effects will show over time. The main hope we have is that the confidence effect will be such that this will boost investment in the short run. The central bank claims that there are a lot of potential investments which will be posted in the next few months. Staff in their projection buys the story, but we highlight that this could take more time.

Mr. Ostros made the following statement:

I thank staff for an excellent set of reports and a very interesting discussion in the outreach to our office. I would also like to thank Mr. Tombini for his last buff statement for Brazil, at least here in the Board. I must say that you have been an outstanding Board member, and I wish you the best of luck in your future capacity. I am glad that you will be here for a few more weeks. I would like to highlight three priorities that are vital for Brazil to fully unleash its large economic potential.

First, I welcome the news that the pension reform cleared the first vote in the Lower House of Congress last week. Passing this key reform should facilitate the confidence boost required for a stronger recovery. However, in light of high debt vulnerabilities, we urge the authorities to keep to the medium-term consolidation path and also stand ready to do contingency measures, to implement them if the pension reform is voted down on its way through the Congress. It is very important to avoid that the market lose confidence in debt sustainability.

Second, Brazil’s main challenge in the medium-term is the meager potential growth. Staff has included several recommendations on structural reforms in the report, in particular tax reform, trade integration, privatization, reducing state intervention in credit markets, and tackling corruption. We agree with all those recommendations. Nevertheless, I would like to highlight the reform potential on the trade front.

In the current environment with increasing global trade tensions, I am delighted to see that the EU and Mercosur were recently able to send a more positive signal by reaching a trade agreement. Not only is the signal important, as a relatively closed economy, Brazil could face new opportunities by opening up itself much more to the world while getting a much-needed productivity boost from open trade.

Third, I commend the authorities for their efforts to improve the anti-corruption and anti-money laundering framework. It will be crucial to remain committed and deepen this agenda in the coming years.

Mr. de Villeroché made the following statement:

I thank staff for this very interesting report, and I thank Mr. Tombini for his buff statement and today’s remarks. I will start with the medium-term outlook, and I must say that we have some concern over the recent slow growth performance in Brazil. The recovery after the recession is a slow recovery, and it is raising, as staff has explained again, some structural issues and the need to go forward with structural reforms. We see the Brazilian economy as having a very dynamic potential. However, maybe because it is quite a closed economy, the competition issue is something I would like to raise. We also would like to raise the question of efficiency in the education sector, and more broadly the very low investment-to-GDP ratio, which is one of the lowest of emerging economies.

However, there are very positive signals. The EU-Mercosur trade deal is very encouraging. It could boost growth. It could lead to a more open economy and to more competition and to structural progress in the economy.

On the fiscal situation, we see the fiscal situation as a legacy of the recession, and the high public debt and the high fiscal deficit need to be addressed, and we commend the authorities for the pension reform. It is an important step forward. Although it is not already definitively passed, it is very encouraging, but we know that it is not sufficient to fix the fiscal situation. More measures would be needed. We have this spending cap, which can help in the medium run with the assessment, but to be sustainable, identifying spending measures will be important.

We see the tax reform as contributing to the position, although it is revenue neutral, but maybe an improved tax system, a less complex tax system, can pave the way for further reforms in terms of revenues as well.

I will end with the importance of flagging climate change issues for Brazil. We have many expectations regarding this, regarding the importance of the country, and we think it is important that Brazil remains committed to the Paris Agreement.

Mr. Jin made the following statement:

We thank staff for the well-written reports and Mr. Tombini for the very helpful buff statement. We take positive note that the external position remains broadly consistent with fundamentals, and inflation is around target, thanks to the flexible exchange rate and the inflation targeting regime. Considering the sluggish recovery and elevated public debt, it is essential for the authorities to make steadfast reform efforts, including the pension reform, tax reform, and the trade liberalization reform, to achieve higher and more inclusive growth.

We are encouraged that the movements in the exchange rate do not pose financial stability concerns given that foreign exchange debt in the private sector is mostly hedged. Brazil has very advanced foreign exchange derivative markets among the emerging market economies. We thank the staff for its response to technical questions on this issue and encourage staff to draw experiences from Brazilian authorities regarding developing foreign exchange derivatives markets and providing effective hedging instruments. We take positive note of the recent EU-Mercosur trade agreement. Since the agreement is comprehensive and covers a broad range of issues beyond economic fields, we encourage staff to do more in-depth research on its impact and the necessary reforms Brazil needs to take to comply with the agreement and to improve the overall competitiveness.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Di Tata made the following statement:

We thank staff for the excellent report and Mr. Tombini for his insightful buff statement. The new administration that took office in January has an ambitious reform agenda to address Brazil’s main obstacles to economic growth. As part of this agenda, Congress is likely to approve shortly a comprehensive social security reform, which constitutes a major achievement.

Real GDP grew at a moderate rate in 2017 and 2018, with the investment rate falling owing to prevailing political uncertainties and adverse shocks. Headline inflation has declined to 4 percent, the external position is broadly consistent with fundamentals and desirable policies, international reserves remain at a comfortable level, and external vulnerability is low.

Going forward, the authorities' key economic priority is to increase the country's growth potential, which is adversely affected by stagnant productivity, low investment rates, and recently the low growth of the labor force. We issued a comprehensive gray statement, but I would like to emphasize a few points.

First, we commend the authorities for the ambitious pension reform, which is expected to address sustainability issues, improve equity, and help restore the investment capacity of the public sector. We fully agree with Mr. Tombini that approval of the reform will remove an important source of uncertainty, providing a confidence boost that could have positive effects on activity, not only in the medium term but also in the short run.

Second, the authorities are taking additional measures to achieve fiscal sustainability. In this regard, we welcome their commitment to proceed with fiscal adjustment based on expenditure restraint as well as to reduce tax expenditures, subsidies, mandatory expenditures, and the scope of earmarked revenues, and use any extraordinary federal revenue to reduce the public debt. At the same time, we would emphasize the importance of transitioning toward a medium-term budget framework and implementing reforms to strengthen the structural balances of the states.

Third, we concur with the authorities and staff that the current monetary stance is appropriately supportive, and that going forward, to the extent that fiscal consolidation is contractionary, a further loosening of monetary policy could be considered, provided that inflation expectations remain anchored. We welcome the authorities' commitment to maintain a market-determined exchange rate, the new law regulating financial transactions between the central bank and the treasury, and the draft bill enshrining central bank independence. Notable progress has been made in implementing financial sector reforms recommended in the 2018 Financial Sector Assessment Program (FSAP), but further efforts are needed to improve bank intermediation and efficiency and continued downsizing and refocusing the public banks.

Lastly, the government's agenda comprises other important reforms to increase the country's growth potential. We support the authorities' plans to reform the tax system, press ahead with privatizations and concessions, and improve the business climate. In addition, we welcome the government's commitment to open Brazil to trade, as demonstrated by the recent Mercosur-EU trade agreement.

With these comments, we wish the Brazilian authorities every success in their endeavors.

Mr. Rosen made the following statement:

I thank staff for an excellent set of papers and also Mr. Tombini for his very insightful buff statement and comments. I would also like to add my congratulations to Mr. Tombini on his new position. Your valuable contributions will be much missed at the Board.

The authorities have an ambitious economic vision and reform agenda, which we strongly support, and which is much needed. Brazil has built up large internal imbalances over years. Public debt is high. Private investment to GDP is among the lowest of emerging markets, and productivity growth is sluggish. The economic recovery has been slower than expected, as we have heard this morning. However, Brazil's macroeconomic situation has a number of inherent strengths. Inflation is under control. The country has a high level of foreign exchange reserves, and the public debt is mainly in local currency, and so external debt is low. In this context, the potential growth dividends from reform implementation are substantial, as demonstrated in these reports. As we have heard this morning, pension reform looks now like it has got a good prospect of happening after the first positive vote in the Lower House. If it goes through, the government can move on to their plans for tax reform, privatization, further opening of the Brazilian economy, while reducing tariffs and non-tariff barriers, lowering the government wage bill, and the government will then have the resources to increase investment.

As Mr. Tombini said, pension reform is a game changer because it will drive the whole reform process along, reducing government debt, and will instill confidence both internationally and domestically, improving the business climate and could help unleash investment, both domestic and foreign, and drive productivity growth. As someone who has done business in

Brazil for more than 25 years, I am optimistic that this government has the right set of economic policies to turn the country around, but implementation is key.

Finally, we thank staff for the analysis of foreign exchange intervention in Brazil. Exchange rate flexibility has served Brazil well, helping the economy adjust to shocks. Yet the topic of foreign exchange intervention under disorderly market conditions has received less attention, and we are glad to see staff conduct research on it. We wish the authorities success with the reform agenda.

Mr. Mahlinza made the following statement:

We also thank staff for the comprehensive papers and Mr. Tombini for his insightful buff statement, as well as his remarks this morning. We have issued a gray statement and would like to make a few comments for emphasis. Brazil has made progress in restoring macro stability since the 2015-16 recession, bringing inflation closer to the target and ensuring that the external position remains broadly in line with the medium-term fundamentals and desirable policies. That said, significant downside risks exist. In this respect, we urge the authorities to move forward with their bold reform agenda.

We commend the authorities for their initial progress on the pension reform bill. This signals the authorities' strong reform commitment, which will go a long way to ensure fiscal sustainability and enhance market confidence. We would urge the authorities, though, to move forward with their reforms, including the simplification of the tax system.

We also are also encouraged by Mr. Tombini's assurances that the system reforms are already under consideration by Congress. Like other Directors, we concur that the current accommodative monetary policy stance is appropriate, given that a substantial output gap exists, and the inflation expectations remain anchored. That said, the authorities should stand ready to loosen the monetary policy stance should conditions change while relying on data for policymaking and pursuing credibility of the monetary policy.

Finally, we would like to encourage the authorities to prioritize key structural reforms, including lowering trade barriers, improving the business environment, and upgrading their Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime to boost growth potential. To this end, we would like to associate ourselves with Mr. Villar's statement in which he stated that the process of accession to OECD is a one-step catalyst to a wide-ranging agenda for a more open and competitive economy. With these remarks, we wish the Brazilian authorities success in their reform endeavors.

Mr. Mouminah made the following statement:

We thank staff for the set of well-written reports and Mr. Tombini for his insightful buff statement and his opening remarks. We congratulate him also for his new position, and we wish him all the best, and like others, we think your valuable contribution to the Board would be missed. We issued a joint detailed gray statement with Mr. Tan, so I have only a few remarks.

On the fiscal front, we consider the planned expenditure-based gradual consolidation to be appropriate given the already high tax burden. To this end, we support the authorities' ambitious agenda, particularly on pension reforms, and we are reassured by Mr. Tombini's update on the progress on this reform. In our view, pension reform should be given the highest priority, and we look forward to its implementation this year. However, more needs to be done to ensure debt sustainability over the medium term, including further reforms to strengthen revenue administration. At the same time, Brazil needs significant investment to address the infrastructure gap. Therefore, priority should be given to upgrading the procurement and public investment practices while putting in place effective measures to crowd in private sector investment.

We encourage the authorities to accelerate their structural reforms agenda to boost potential growth and also welcome the update provided by Mr. Tombini on this front. In light of the wide-ranging reforms, careful prioritization and sequencing, as well as proper communication, are essential for the successful implementation.

We also welcome the trade agreement between Mercosur and the EU and hope this will help Brazil and other members of the Mercosur to benefit from this and boost potential growth in the long term.

Finally, we are reassured by the authorities' commitment to continue their efforts to tackle corruption. In this connection, we urge them to ensure timely finalization of the national risk assessment to support their ongoing efforts to fight corruption and illicit finance. With these comments, we wish Brazil all the success.

Ms. Levonian made the following statement:

We thank staff for their candid report and excellent selected issues paper and Mr. Tombini for his insightful buff and opening statement. I, too, want to add my congratulations and best wishes. Your contribution here and our Caribbean collaboration will be greatly missed.

Although Brazil is gradually emerging from the severe recession of 2015-16, it is still facing a challenging macroeconomic environment, particularly on the fiscal front. We commend the new administration's ambitious reform agenda, which is clearly articulated in Mr. Tombini's buff statement. The authorities are rightly prioritizing pension reform, and the recent progress in the Lower House of Congress is a very positive development. We have issued a comprehensive gray statement, so I will focus on two issues.

First, we strongly support the authorities' push for fiscal consolidation to address Brazil's historically low growth and high public debt. In our view, the current reform plan is likely not sufficient for fiscal sustainability, raising potential growth, or for addressing potential risks arising from uncertainty around global financial conditions and trade. We support staff's recommendations, and from the remarks, the authorities seem to also support further fiscal measures. Advancing trade liberalization and maintaining a responsive monetary policy will be very important.

Secondly, given that Brazil remains a highly closed economy, we welcome the authorities' focus on trade liberalization. As noted in the buff statement and Mr. Tombini's remarks, the recent Mercosur-EU trade agreement is an important positive step toward openness. We also welcome other current plans to lower trade barriers. With that, I wish the authorities well.

Mr. Raghani made the following statement:

We thank staff for a comprehensive report and Mr. Tombini for his helpful buff statement and for his opening remarks. I congratulate Mr. Tombini on his new position and also extend our appreciation to Mr. Tombini for his valuable contribution to the Board activities, as well as for the excellent collaboration that our offices have been developing.

We have issued a gray statement, and we would like to add the following comments for emphasis. First, we welcome the positive developments on the pension system outlined by Mr. Tombini in his opening remarks, and we encourage the authorities to steadfastly implement this reform when it is approved by parliament. This reform would be an important step in strengthening market confidence on the future path of public finances and debt.

Second, while the banking system is sound, the authorities should continue their efforts to enhance oversight and be cautious about vulnerabilities emerging notably from the private sector. In this connection, the strengthening of macroprudential policies and timely enactment of the financial sector legislation contemplated by the authorities would help to reinforce resilience.

Finally, we welcome the effort made to tackle deep structural reforms to raise potential growth and ensure a strong recovery. We therefore encourage further efforts to raise the productivity of the labor force, improve the quality of public investment and infrastructure, and create an environment conducive to private-sector development. With these remarks, we wish every success to the authorities in the implementation of their policies and reforms.

Mr. Kaya made the following statement:

We thank staff for the informative report and selected issues paper and Mr. Tombini for his informative buff statement and introductory remarks today, and we also congratulate him on his new position. His contribution to the Fund, to this Board, and the collaboration with our chairs will be remembered with a great respect.

We welcome the authorities' comprehensive and ambitious reform agenda and broad concurrence with the thrust of the staff's advice. The challenge of achieving fiscal consolidation while supporting economic growth is significant and requires a well-sequenced, balanced, and comprehensive strategy. In this regard, we would like to stress two points in addition to our written statement.

First, the macroeconomic policy mix should be as growth-friendly as possible. We agree with staff that a somewhat restrictive fiscal stance could be at least partially offset by a more accommodative monetary policy. However, like Mr. Inderbinen, we stress the importance of data-dependent decisions on the monetary front, while the transmission of this loosening to the credit market should not be underestimated. In this regard, the quality of fiscal consolidation measures is critical for robust growth outcomes. In addition to the policies outlined in the staff report, this requires structural fiscal measures such as strengthening the overall fiscal framework, fiscal risk management, and carefully designed and negotiated reforms of fiscal federalism. We welcome that the authorities have set out a clear roadmap of priorities and are already progressing with many of these reforms.

Second, it is essential to maintain the reform momentum and garner broad public support. We acknowledge the difficulty of pushing this ambitious reform agenda through to legislative bodies, but timely structured reforms are essential to support growth. We are encouraged that the pension reform already passed the first vote in the Lower House with a large majority, while work on tax reform is already progressing. Like many other Directors, we see merit in complementing these efforts by expanding more targeted social safety nets and pressing ahead with measures to protect the most vulnerable to ensure the much-needed broad public support for the reform agenda. With these remarks, we wish the Brazilian authorities success in their reforms.

Mr. Beblawi made the following statement:

We issued a statement in which we welcome the Brazilian authorities' ambitious reform agenda aimed at unleashing growth potential. The reforms are being appropriately sequenced, and we commend the authorities for prioritizing the social security reform, which is the main structural adjustment required to reestablish fiscal sustainability. We take positive note of the fact that the expectation of the bill's passage pushed the Brazil financial markets to historical highs, as the Lower House of the Congress began financial debate last Wednesday, and we congratulate the authorities for the adoption of the reform by the House on Friday.

Building on past efforts, we encourage the authorities to continue the implementation of the 2018 FSAP recommendations, as well as pursue additional structural reforms to reduce the government's footprint in the economy, lower trade barriers, and improve the business environment. We welcome Mr. Tombini's comments in this regard.

Finally, I take this opportunity to congratulate Mr. Tombini for his new position, wishing him all the best.

Mr. Mojarrad made the following statement:

We thank staff for a concise report and Mr. Tombini for his candid buff statement and his introductory remarks. Like other colleagues, I also would like to take this opportunity to congratulate Mr. Tombini for his new position at the Bank for International Settlements (BIS) and wish him all the best.

We issued a gray statement and raised a few questions which the staff probably did not have time to consider. I will raise one of them again, which we feel is important. But before that, like other Directors, we would like to underscore the importance of early passage of the pension legislation and its criticality for fiscal and debt sustainability. Beyond that, while fiscal discipline will be anchored by the constitutional expenditure ceiling, discretionary current expenditures would need to be further trimmed to meet the ceilings. Also important will be increasing the efficiency of public investment and procurement practices and strengthening the medium-term fiscal framework, as well as introductory revenue-neutral tax reforms.

Outside the realm of fiscal policy, we feel that the monetary policy stance is appropriate and exchange rate flexibility, ample external reserves, and a resilient banking sector, as confirmed by the 2018 FSAP risk analysis, provide strong buffers against external shocks.

One of the key challenges facing the authorities is to raise the economy's potential growth, which is currently one of the lowest among peers. Box 4 is interesting, and it suggests that even with raising the investment ratio and productivity growth above historical levels, real potential GDP growth only ticks up to about 3 percent. This is still low relative to peers. In staff's view, is Brazil in a low-growth trap, and what are its implications for unemployment and poverty alleviation? Poverty and income inequality, particularly in urban areas, and environmental degradation, particularly in the Amazon region, are of concern. We would have expected a more thorough analysis of this issue, and I appreciate staff's comments.

Finally, we commend the authorities for the significant progress in fortifying the institutions that is reflected in Brazil's pending application to the OECD, and we wish the authorities all the success.

Mr. Villar made the following statement:

I thank staff for an excellent report, as well as Mr. Tombini for the buff statement and the opening remarks. I also want to congratulate Mr. Tombini on his new position, although we will miss his contributions at the Board very much.

We issued a detailed gray statement, so I just want to highlight a few points for emphasis. First, I would like to congratulate the Brazilian authorities for the comprehensive set of structural economic reforms that they are undertaking. The success of Brazil is key for all other countries in Latin America and especially for South America, where my own country, Colombia, is located. In particular, I would like to congratulate the government for the passing of the very important pension reform law through the House and wish them success in the Senate later in the year.

Finally, I would like to highlight three important steps in the process of reform that have already been mentioned by staff and by other Directors. The first is starting of the process of OECD accession. The second is the reform of the financial sector through reduced public sector participation to reduce the interest rate margins. The third is the opening up of the economy, which has traditionally been a very closed economy and is reflected in the opening of the Mercosur and the EU agreement. With this, I wish the authorities the best.

Mr. Inderbinen made the following statement:

We join others in thanking staff for the good set of papers and also Mr. Tombini for his very readable buff, and I associate myself with colleagues who have extended congratulations.

We take note of the new reform agenda, and we also welcome the authorities' commitment to fiscal adjustment, and in this sense we welcome and are encouraged by the favorable outcome of the pension system's reform in the first reading that it received in the Lower House, and this will certainly be an important step in Brazil's transition away from an unsustainable fiscal path toward a more open and competitive economic framework, as is stated in the buff statement.

Pension reform alone will not be sufficient to obtain fiscal sustainability and to boost growth, and additional measures are needed, including on the fiscal front. We were also encouraged by and acknowledge the progress on improving bank intermediation efficiency and take note of the ongoing efforts of the authorities to reduce the state's footprint in credit markets, and it is also encouraging that the authorities are entertaining plans to ensure full convertibility of the currency, albeit in the medium to long term. Furthermore, we encourage the removal of the two capital flow management measures (CFMs). While the measures have been gradually relaxed, which is welcome, there is no intention of the authorities to remove them in the medium term, as we learn in written responses to technical questions.

On a more general point, it would have been good to have a bit more explicit mention of these measures in the report, particularly as they do relate to important efforts of the authorities to increase efficiency of financial intermediation and deepen financial markets, as elaborated on by Mr. Tombini earlier, and they also relate to the efforts the authorities are undertaking to integrate the Brazilian economy more closely into the global economy. As we learned from the informational annex, one of the CFMs, the financial transaction tax, does constitute a multiple currency practice, and in general, we would suggest that staff reports contain appraisals of such restrictions in the future, particularly as the Board will need some background on whether they are meant to take a decision on the multiple currency practices. Rather than just having a readout at the end of the meeting stating that a country is an Article VIII member, and no decision is proposed, it would be good to have something in the staff report on why this is the case.

Mr. Merk made the following statement:

We thank staff for the informative set of reports and Mr. Tombini for his insightful buff statement. We will miss your contributions at the Board, but we certainly join others in congratulating you on your new position.

We are encouraged by the remarks of Mr. Tombini and staff this morning that the pension reform had a good start in the lower House. The pension reform does, however, not resolve risk to fiscal sustainability. As we have elaborated in our gray statement, additional reforms are required to consolidate fiscal expenditure while preserving programs for the poor. Furthermore, structural reforms are essential given that Brazil's economy suffers from low productivity, low investment rates, low growth of the labor force, and high poverty rates. The economy ranks among the most closed of major economies worldwide, weighing on trade. The Mercosur-EU trade agreement in that sense sends a very strong signal for rules-based trade and will contribute to strengthen growth potential in Brazil out of Mercosur countries and the EU.

Mr. Palei made the following statement:

I thank staff for a well-focused and well-balanced report. Staff not only praised the authorities for their important achievements, including the progress with the pension reform, but also point to many remaining challenges in different areas, and I found it refreshingly balanced.

We commend the authorities and staff for close collaboration in various areas of TA. This is important because many of the reforms are complex, and some of the measures are well-known, but their implementation requires many efforts. I note that the authorities recently completed and published a TA report on Public Investment Management Assessment (PIMA). Then they also did the fiscal transparency evaluation, and those are just two of the high-profile products the Fund is helping to popularize and make more effective.

We asked the question on the implementation of the recommendations in the fiscal transparency evaluation report. We just had an Article IV discussion on Russia, and there we had a selected issues paper on this topic, and we find this work together with the Fund to be very important and also very useful. I would encourage staff to take a look into this area and at the time of the next Article IV consultation, maybe use it as a selected issues paper chapter or just pay more attention to specific recommendations in this report. For Brazil, it would be particularly useful given the challenges in the fiscal area.

I would like to raise a related issue on the specific fiscal measures and the yield from each measure. Staff referred us to the document published by the previous administration, and I do understand that this is a not new topic, and the estimates are similar, but in the future it would be useful to have an annex with a table just to refresh the memory of Directors on the key measures that could be used by the authorities to shore up their fiscal situation.

We also asked for more charts on GDP growth, and I thank staff for providing these charts. I agree that they do not change the essence of recommendations on structural reforms, and they need to upgrade the potential growth. However, there are many insights in these charts. For example, I noticed that Argentina had a higher growth rate than Chile and Colombia over the past 20 years, but there is also another side to this estimate, which goes to the heart of the estimates of potential growth. Some of the countries in the region have very high estimates for potential growth, and we feel that they are exaggerated, or they do not have a good base. This is not just on Brazil. This is broader comment on the regional surveillance and estimates.

Finally, the Brazilian authorities have a challenging agenda in the area of structural reforms, and the progress with the pension reform is encouraging, and it exceeded the gloomy observations of quite a few observers, so I congratulate the authorities on the progress already achieved. But at the same time, I agree with staff that this reform requires a huge investment of political capital from the authorities, and this side of the agenda may be challenging going forward, so caution is appropriate, but I do wish the authorities all the best in the future.

Mr. Tanaka made the following statement:

I am very privileged and honored to work with all of you. We thank staff for the informative papers and explanations. I also would like to express appreciation to Mr. Tombini for his candid statement and everlasting contribution to the Fund, and express congratulations on assuming his new post.

We broadly concur with the thrust of the staff appraisal. We welcome that the Brazilian economy is expected to turn upward, and GDP growth will reach 2.4 percent in 2020, while Brazil has experienced historically low growth after the recession in 2015 and 2016. To realize this estimation, we encourage the authorities to make continuing efforts to accelerate fiscal consolidation and structural reforms, including ambitious social security reform, tax reforms, including international taxation, privatization, trade liberalization, and improvement of bank intermediation.

From this perspective, it is encouraging that progress has been made on pension reforms. We also put emphasis on the importance of tackling corruption and the effective implementation of anti-money laundering and anti-corruption measures.

The staff representative from the Western Hemisphere Department (Mr. Spilimbergo), in response to further questions and comments from Executive Directors, made the following additional statement:

Thank you for the interesting questions. I will group my answer in four broad topics: potential growth, social, environment, and fiscal sustainability.

On potential growth, Brazil has grown 2.5 percent per year since 1980, which is very low growth for emerging market, benefitting from a large demographic bonus. Growth performance has been even worse in the last 10 years. Growth per capita has been almost zero in the last 10 years on average. Brazil is a bad case in terms of growth. Authorities have recognized this for many years and have tried a number of measures. In the past, they tried import substitution. It did not work. They tried regional agreement, Mercosur. It did not work as much. They tried subsidized credit with a huge development bank. It did not work. Public companies played a big role in fostering investment. Did not work. A new set of macro policies were implemented about 10 years ago, called Nova Matrix. Did not work. Education was highly subsidized and pushed, and that did not work either. This is in the sense that education increased quite a bit, but the return on education did not deliver the promise as expected. Staff has worked quite hard on this issue, and there is a consensus that there is no silver bullet on growth. There are a set of policies of structural reforms, they should be all implemented, looking at the labor market, capital market, product market, openness, and so on. This was the subject of a book that staff produced together with leading analysts and academics this year, and now there is a consensus on this, and the new administration is trying to push one by one for these reforms. As I said, I do not believe there is one silver bullet.

On social factors, we know from the literature that low growth means a problem with social aspects because in the long-term healthy growth can deliver good social outcomes. That said, Brazil had two positive developments on the social side. First, during the first decade of the 2000s, the commodity super cycle produced some growth, and this was used to reduce social inequality. This was very important.

Second, a very successful program called *Bolsa Familia*—which is quite cheap, it is less than 0.5 percent of GDP, but it is one of the largest cash transfers in the world—worked quite well in reducing poverty, and there is a consistent body of evidence on this. It is very important that looking forward with the fiscal consolidation, this program is kept alive and well financed.

On the environment, the EU agreement had explicit clauses on protection of the environment, which is quite important because this was a concern. There were clauses not only on environment, but also on social rights, workers' rights and protection. It is very much at the center of the EU-Mercosur agreement.

On the fiscal side, as the report points out, pension reform is just a first step, but fiscal consolidation should proceed. Staff has identified public wages and employment as a key area where savings are possible. Staff has estimated a saving of about 0.6 percent at the federal level and 2 percent considering the sub-nationals. This should deliver a big chunk of the necessary consolidation.

We have done some work to show that this, if done properly, would not damage the delivery of services, and so far, comparing to other countries, there is space for improvement to do more with less. Fiscal consolidation would not only imply cutting public expenditure but should be accompanied by a reform of public expenditure, and this could be possible.

Mr. Tombini made the following concluding statement:

I would like to begin by thanking my colleagues for their written contributions to the discussion, which was productive and lively, and also for the kind words. It has been a very productive three years from my standpoint, and I enjoyed the collaboration here at the Board of the Fund. I will convey to my authorities this lively discussion we had today.

First, a piece of information, Mr. Spilimbergo mentioned the IBC-Br, which is a proxy for the GDP that the central bank does monthly, and he mentioned the contraction in April. Today the number for May was released, and it is the first positive number, 0.54 month-over-month in May, so it is an encouraging early sign.

On the issue of the pension reform, we had the first vote at the House, and there is this possibility of reintroducing states and municipalities in the Senate. They are looking at ways to do this without having to have the whole package going back to the Lower House afterward, so they are thinking about some separation of the two matters, so we can go with the bulk of the reform if it is not changed in the Senate in a more expedited way.

On the issue of Brazil's growth, we essentially agree with what the mission chief has mentioned, and this is the view of the authorities. A number of initiatives are in the pipeline now, some of them are already being discussed in Congress, but I just wanted to put it in perspective. Brazil is a continental country. It is a large mass of land. It has 210 million inhabitants, and to have the full picture, we have a very competitive agribusiness sector, one of the most competitive around the world, so this has been generated in the context of our many experiences in the recent economic past. This is an issue. Another one is, as Mr. Spilimbergo mentioned, we have done away with hunger and extreme poverty with *Bolsa Familia*, which is one of the largest cash transfer programs around the world.

Brazil has been consistently the third- or fourth-largest destination of foreign direct investment around the globe, so even with low growth, there is an attraction in terms of being positioned in this large South American market. Just to put it in perspective, the comparators are large countries such as the United States, India, China, in terms of openness. When we talk about openness, this is identified as a problem, and we are even willing to do an unconditional liberalization of trade because this has potential implications for productivity and potential output growth. But, nonetheless, these large countries usually have much lower degrees of openness because of the size of the domestic economy.

I just wanted to add that the authorities have indicated that we will soon receive the formal authorization for publication. With these words, I thank my colleagues again.

The Acting Chair (Mr. Furusawa) noted that Brazil is an Article VIII member and maintains a multiple currency practice subject to the Fund approval under Article VIII, Section 2(a) and 3. Staff was not recommending approval of that measure, therefore, no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They concurred that the pace of the economic recovery has been sluggish and is subject to downside risks stemming from uncertainty on fiscal consolidation and structural reforms.

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

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

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

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

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

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

APPROVAL: May 13, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and risks

1. ***Could staff provide its analysis regarding the impact on trade and growth of the recent EU-Mercosur deal on the Brazilian economy?***

- The agreement still needs to be ratified, which could be a lengthy process. Available information suggests that it will have growth and trade effects for Brazil, but not immediately (and possibly small effects in the very near term) since most of the implementation is going to be gradual, over a period of 10 to 15 years. In addition, Brazil will need encompassing economic reforms (in line with the ones envisaged by the authorities) to be able to successfully compete in a new big(ger) market.

2. ***In the Risk Assessment Matrix, staff rightly identify the risk the recovery remains weak and we endorse their high-level recommended policy response. However, we would be grateful if staff could expand on their suggested approach were this risk to materialize, including how the recommendation differs from the central policy advice staff provide in the report?***

- Staff recommendation is to accelerate the implementation of structural reforms—in particular tax reform, trade integration, privatization, reducing state intervention in credit markets, and tackling corruption. Accelerating the implementation of the government's investment in infrastructure through concessions would also lift potential while boosting aggregate demand. As noted in the risk matrix, monetary policy should remain accommodative and the exchange rate should be allowed to depreciate to boost exports.

3. ***We welcome the government's draft bill for a new social security system and strongly encourage the authorities to quickly implement it. However, it seems that states and municipalities are excluded from the draft law, even though the urgency of reforms is even higher on the state- and municipality-level. Could the staff comment on related risks and possible effects on growth prospects?***

- The original text that implied automatic adoption of the law parameters by the subnational governments has been excluded from the draft currently under consideration. If this is not retaken by the senate, each state legislature would have to adopt measures in line with the reform. The main risks are for the structural finances of the subnational governments, which absent reforms would continue to deteriorate and could offset some of the positive impact of the federal government pension reform.

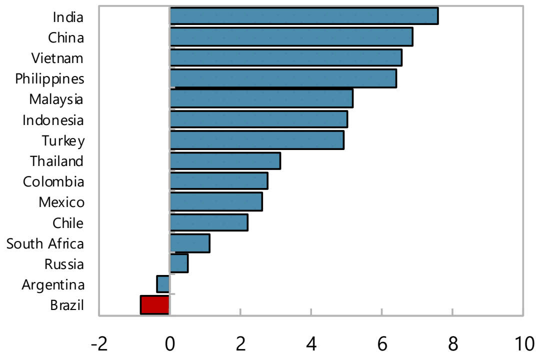
4. ***In the context of the trade tensions between China and the United States, Brazil has benefited from positive trade diversion effects, as soy exports increased significantly to China. Could staff elaborate on these effects and how the country could be impacted by the non-end or the end of the trade dispute?***

- Ongoing trade tensions pose at least 2 types of headwinds for Brazil. First, high trade (global) uncertainty amplifies the ongoing global slowdown, which reduces external demand for Brazil. Second, there is uncertainty about which sectors would be most affected (i.e., cars, soy) either positively or negatively depending on the imposition of potential additional tariffs, hence discouraging investment in Brazil. Both channels contribute to Brazil's low growth and weak recovery.
- Effects can be decomposed into price and quantity effects. In the near term, price effects dominate and favor Brazil for goods exported from Brazil to China and/or the US, as in the case of soy. But effects depend on the specific tariffs (between the US and China) imposed or lifted on specific goods. For example, in the case of cars, there is very little impact for Brazil.

5. ***Potential growth is an important, albeit very uncertain estimate. The estimates are frequently affected by the staff judgement, for example, on the likely effects of structural reforms. For some countries staff add these (sometimes very large) effects to their estimates of potential growth in the medium-term projections, while for other they refuse to do that. Hence, in our opinion, it would be useful to have a "reality check" to supplement estimates presented in the chart on page 16 of the report with the average actual growth rates, say, over the past 5, 10, and 20 years. Moreover, when staff compare growth rates over a long period of time, it would be informative to compare GDP growth in per capita terms, so that the large differences in population growth are taken into account. We ask staff to provide such a table for the countries used in the chart.***

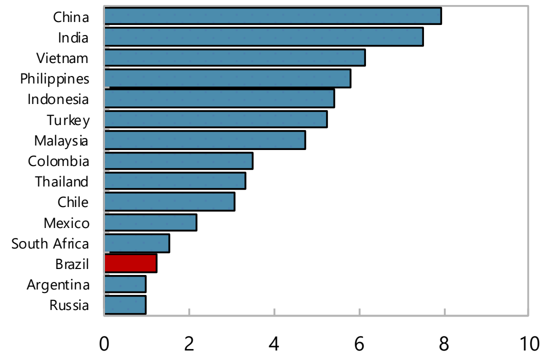
- Looking at actual GDP growth over a longer horizon and considering per capita GDP growth does not change staff assessment summarized in the chart in page 16. Please see requested charts below.

Real GDP Growth
(Percent, average over the past 5 years)



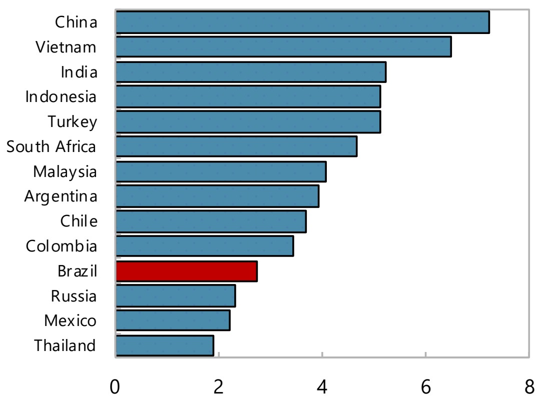
Sources: World Economic Outlook.

Real GDP Growth
(Percent, average over the past 10 years)



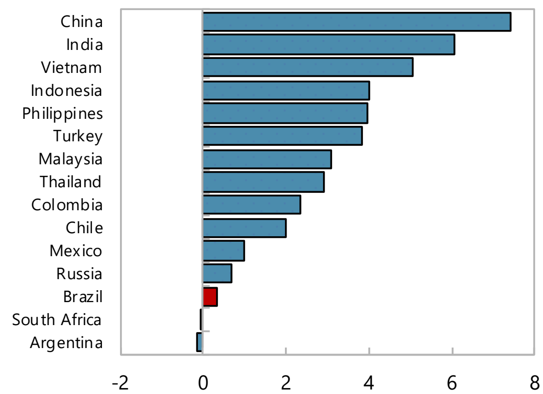
Sources: World Economic Outlook.

Real GDP Growth
(Percent, average over the past 20 years)



Sources: World Economic Outlook

Real Per Capita GDP Growth
(Percent, average over the past 10 years)



Sources: World Economic Outlook.

Fiscal Policy

6. ***The authorities aim to limit the autonomous growth of major mandatory expenditures, such as the salary allowance and the government payroll. They are also considering a review of tax expenditures and a revenue-neutral tax reform (aiming at simplifying and harmonizing the tax system), as well as a legislation to improve the collection of tax arrears. To what extent are the aforementioned measures fleshed out and ready to be implemented, and whether they would allow the authorities to reach their fiscal target?***

- This year the government is expected to meet the constitutional expenditure ceiling and the deficit target. However, other critical medium-term fiscal reforms are on hold until the passing of the pension reform. The options to comply with the expenditure ceiling in the medium term are well-known. For example, the previous administration produced a document with specific measures and yields in line with staff estimates. How quickly these could be rolled out varies. Some measures, such as the control of the government payroll and limiting the growth of social benefits are embedded in the budget guidance for 2020. Other reforms can take more time. For example, various proposals to simplify the tax system are being analyzed by congress but a definite proposal is yet to make serious progress.

7. ***Could staff elaborate on how their forecast would change should the pension reform not be passed this summer…? Also, do the authorities have contingency plans to make up for the lost fiscal savings in the event the pension reform is not passed, or its main provisions are significantly watered-down in the legislative process?***

- Please note that the pension reform already passed the first vote in the lower house with a large majority, drastically reducing the likelihood that the reform is not approved. Should the pension reform not be passed, the primary deficit would increase to about 2 percent of GDP (compared to a surplus of 1 percent of GDP) and gross public debt would exceed 100 percent of GDP by 2024. The authorities have not disclosed any contingency plan so far. Staff recommendation in case of setbacks in the approval of a pension reform are outlined in paragraph 41 of the Staff Report.

8. ***Potential reform setbacks represent the main risks to the economic outlook. In addition to their impact on growth and inflation, setbacks would increase the uncertainty about the feasibility of other key reforms needed to comply with the expenditure ceilings and to stabilize debt. In this sense, it is worrisome that some elements are seemingly being diluted. Based on private sector estimates, the pension reform bill that is now before the Lower House's Special Commission includes amendments that would lower the expected savings over the first ten years by around 30 percent. Could staff comment on the impact that these amendments would have on the pension reform proposal, and on how feasible the adoption of the additional fiscal measures mentioned in paragraph 41 of the report is?***

- The Lower House's special committee approved a revised version of the pension reform bill, with an estimated fiscal impact of BRL 933 billion, down from the BRL1.2 trillion expected in the government's initial proposal. Provisions which could not gather enough support in congress were dropped, including cuts in social assistance for low-income households, the elderly and people with special needs. Discussions are currently ongoing at the Lower House and will then shift to the Senate, with possible additional amendments affecting the final impact of the bill. However, a robust reform is still expected. To achieve fiscal sustainability and comply with the expenditure ceiling, fiscal consolidation measures beyond the pension reform plan are necessary; more so if the reform is weakened. Many of the recommended adjustments are currently being considered by the government.

9. ***Staff assumes that public debt will peak in 2024 at 96 percent, before it starts to decline in 2025. However, this analysis is based on the assumption that pension expenditures will decrease by 1.2 percentage points, the wage bill will decrease by 1 percentage point and other expenditures will decrease by 1.7 percentage points. We wonder about downside risks to this baseline scenario, given the magnitude of the adjustments and the mixed track record of reform implementation. Our concerns are reinforced by staff's comment that "Even if a robust pension reform is approved, fiscal risks remain since additional fiscal measures are needed to comply with the constitutional expenditure ceiling". Could the staff elaborate on this issue?***

- If approved, the pension reform under consideration is expected to stabilize pension spending as a share of GDP. While this would be a notable achievement, it would not be enough to stabilize public debt. Further measures, including containing public wages, curtailing tax expenditures, and limiting the growth of other social benefits (which are linked to the minimum wage) while protecting targeted social assistance programs are needed to stabilize public debt by the mid-2020s in line with the constitutional expenditure ceiling.

10. ***Regarding the pension reform, we would ask staff to provide further details on what were their assumptions for the reform, and whether they diverge significantly from the ones included in the approved document.***

- The main aspects of the proposed reform (changing retirement ages, contribution time, and replacement rates) have been broadly preserved thus far. However, the modifications in congress can shave some R200-300b from the originally estimated savings. This would imply considerable savings of near R900-1,000b, still higher than in the original proposal by the previous administration.

11. ***Could staff expand on the government's plans for fiscal reforms in the upcoming months, further than the pension reform? How does staff perceive the possibility of those reforms being approved in Congress?***

- The government plans to advance proposals in the near term for tax reform, including with a simplification of indirect taxes, changes in federalist relations, and privatization. It also aims to review budget rigidities, such as earmarking and indexation laws.

12. ***Could the staff share views on the impacts that if the pension reform proposal not be approved by Congress this year?***

- The direct fiscal impact in the short term is limited, as most of the fiscal savings from the pension reform accrue over time. However, failing to pass a pension reform can affect confidence in debt sustainability, introducing risks from abrupt reactions from financial markets, investment, and economic growth as noted in the Risk Assessment Matrix.

13. ***Could staff elaborate on the total magnitude of tax expenditures in Brazil and the extent of indexation of spending items? Could the staff comment on the feasibility of implementing other reforms to strengthen the structural balances of states and review the institutional framework of subnational borrowing?***

- The federal government estimates tax expenditures are about 4 percent of GDP per year. In the subnational governments, estimates of tax expenditures from ICMS is estimated at about 1.2 percent of GDP. About 90 percent of primary federal spending cannot be modified without legal changes. This includes spending related to constitutional rights (pensions, personnel expenditure) and spending with constitutional earmarks (health and education), and social benefits for vulnerable populations (Bola Familia). Of these, social benefits are generally indexed to the minimum wage and the minimum earmarks for health and education are indexed to inflation. Reforms that affect the structural balances of the states would be politically challenging, and their progress would depend on the strength of the government after the passing of the pension reform.

14. ***Given that the consolidation plan appears to lean towards expenditures cuts, we would appreciate staff's elaboration on the authorities' programs to protect vulnerable populations from the adjustment measures.***

- It is important to note that many of the reforms under consideration are intended to reduce inequities. For example, the pension reform aims to reduce the pensions of those with higher earnings and fuller careers (who can typically retire early accounting for their years of contributions) and of government employees (who receive a relatively generous pension). Lower income workers with intermittent careers will see relatively lower reductions to their lifetime pension wealth. In addition, containing public wages also tends to reduce inequities as over 80 percent of federal government employees are in the top two quintiles of the income distribution. Furthermore, the authorities are committed to maintain targeted programs such as Bolsa Familia program which are crucial for the most vulnerable.

15. ***Could staff comment on their recommendations to protect the most vulnerable households from the impact of the reforms?***

- On the tax side, the main recommendation by staff is to reform the distortive tax system in a revenue-neutral manner, including eliminating multiple indirect taxes by moving toward a single broad-based VAT, harmonizing the fragmented federal and state tax regimes, and removing distortionary tax exemptions. Removing these distortions should improve equity by providing room for lower indirect tax or payroll rates.

16. ***We agree with the authorities and staff that additional efforts are essential for securing fiscal accounts in a sustainable and growth-friendly manner. In this respect, we would be interested in a discussion of specific fiscal measures and their estimated yields, so that the Brazilian authorities would be able to choose from a menu of plausible and effective solutions.***

- The options to comply with the expenditure ceiling in the medium term are well-known. For example, the previous administration produced a document with specific measures and yields in line with staff estimates.

17. ***We would welcome staff comments on whether the new administration is committed to continue with Bolsa Familia, one of the largest cash transfers in the world.***

- The government has expressed commitment to continue the Bolsa Familia program, recognizing its effectiveness.

Monetary and exchange rate policies

18. ***Could the staff elaborate more on the authorities' plans to phase out two existing capital flow management measures and their effectiveness in achieving the goals for which they were introduced?***

- We understand there are no plans to remove these measures in the near term.

19. ***Could the staff explain what is meant at the end of paragraph 30 by indicating that the authorities are planning to make the real fully convertible within two to three years?***

- The authorities have recently announced an intention to make changes to the FX regulatory regime that would make the Real fully convertible. In practice this requires adjustments to regulations that currently make the Real non-deliverable offshore (i.e. which limit the ability to transact Real for FX outside of Brazil) as well as regulations that limit the ability of domestic entities to trade Real for FX in the spot market for trading, hedging or speculative purposes. These issues were covered in the 2018 FSAP – see IMF Country Report No 18/339 para 61 and IMF Country Report No 18/345 paras 8, 44-48. No timeline has been specified.

20. ***Staff mentions that the government is planning to make the real fully convertible. Could staff develop its analysis about the benefits of this measure?***

- The 2018 FSAP discussed the merits of this type of reform as it would help improve the resiliency of the overall FX market by enabling growth and development of the FX spot market in Brazil – which is relatively small compared to the much more developed FX derivative markets. A specific benefit is that a better developed spot FX market would give investors alternatives to price and manage risks when derivatives markets are not available. See IMF Country Report No 18/345 paras 8, 44-48 for a relevant discussion.

21. ***We also note the authorities' plan to make the real fully convertible within two to three years, which will be conducive to lowering the cost of cross-border trade and investment. Are there any specific measures to be taken to make the real fully convertible? At the same time, what measures should be taken to mitigate related risks, including greater exposure to foreign shocks?***

- Full convertibility requires adjustments to regulations that currently make the Real non-deliverable offshore (i.e. which limit the ability to transact Real for FX outside of Brazil) as well as regulations that limit the ability of domestic entities to trade Real for FX in the spot market for trading, hedging, or speculative purposes. These issues were covered in the 2018 FSAP – see IMF Country Report No 18/339 para 61 and IMF Country Report No 18/345 paras 8, 44-48. The FSAP noted that while Brazil seems relatively well placed to proceed with FX liberalization as it has well developed FX derivatives-based hedging markets, changes to the regime need to be carefully considered and timed (see paragraph 48 of IMF Country Report No 18/345). The FSAP noted that the Fund could offer technical assistance to help work through specific considerations and develop a robust alternative regime and transition path (also paragraph 48 of the same report).

22. ***As interventions through derivatives in emerging economies is more and more common, could staff identify the benefits and drawbacks with the use of such instruments compared to spot interventions?***

- Most empirical work on the issue suggests that both instruments ultimately have a similar impact on the level and volatility of the exchange rate. Central Banks might have several motives for choosing derivatives over spot interventions, such as filling a market gap for hedging instruments or setting up automatic intervention rules through derivatives. Drawbacks of using derivatives could be enhanced risks if they lead to a leveraged Central Bank balance sheet. Since accounting balance sheet impacts of derivatives may be quite small, disclosures of derivative positions are key for an accurate picture.

23. ***Could staff elaborate on the reasons for such high FX hedging rate and explain to what extent it could attribute to highly-developed FX derivatives markets? What experiences could be drawn for other EMs in terms of the hedging toolkits and market development?***

- Brazil has only a small share of foreign currency denominated debt relative to other emerging market economies. The vast majority of debt is denominated in reais. For the portion of debt that is FX denominated, information from the Brazilian central bank indicates that most corporates have a high degree of hedging, thanks to a combination of natural and financial hedges. Regarding natural hedges, the central bank monitors the revenue of exporting firms and tracks it against their FX loan exposures. FX derivative markets complement natural hedges and the central bank monitors corporates' derivative positions closely.

24. ***The analysis in the SIP on "Profitability and Determinants of FX Intervention in Brazil" is insightful and helps to assess the appropriate level of FX intervention amid temporary excessive movements of the exchange rate. We would encourage staff to do more work along these lines to better understand when intervention is addressing "disorderly market conditions." Could staff comment on whether this technique is applicable to other countries?***

- The analysis can be extended to countries that intervene in the FX market with derivative instruments (since it is important to have a maturity date to compute the profitability of each FX operation) and for which there are reliable surveys about interest rate and exchange rate expectations.

External Sector

25. ***On the external side, we welcome that vulnerabilities remain low due to the existing buffers. We would be interested in staff assessment on the weak impact of the sharp 2018 exchange rate depreciation on the NIIP (from -32.1 percent of GDP in 2018 after -34 percent in 2017).***

- Nominal depreciation in 2018 (relative to 2017) was around 14 percent and its associated valuation effect in the NIIP was around 2.8 percent of GDP.

Financial Sector

26. ***We note that staff has recommended to bring the deposit guarantee fund into the public sector whereas the authorities prefer to keep it as a private entity. Could staff elaborate on its reasoning for this recommendation when deposit insurance seems***

to work well as a private entity in other countries? How does Brazil differ from other countries in this respect?

27. ***We notice that staff's and the authorities' views continue to differ on the transformation of the Fundo Garantidor de Créditos (FGC) into a public institution and the implementation of emergency liquidity assistance to financial institutions. Staff's comments are welcome***

28. ***Staff recommends that the Brazilian deposit guarantee fund be brought into the public sector to help prevent conflicts of interest and to retain the mandate for financial stability in the public sector, as described in the 2018 FSAP Technical Note on Bank Resolution, Financial Sector Safety nets, Crisis Prevention and Management. Brazil, however, is not the only country with a private deposit guarantee scheme. We wonder whether the challenges identified by staff can be remedied without requiring bringing the deposit guarantee scheme in the public sector. We also wonder whether the advice to bring Brazil's deposit guarantee scheme in the public sector is supported by any international standard. Staff's comments are welcome.***

- The recommendation to bring the deposit guarantee fund into the public sector is a standard recommendation. The main rationale of bringing the deposit guarantee fund into the public sector is that the mandate for financial stability is with the public sector. Other considerations relate to the needs for confidentiality and information sharing. In the case of the Brazilian deposit insurance, the Credit Guarantee Fund (FGC) has limited access to bank data and no access to supervisory reports. While there are informal mechanisms of cooperation with the Banco Central do Brasil (BCB), information sharing faces some inherent constraints. This is of concern as the FGC provides open bank assistance (emergency liquidity assistance) without an effective analysis of risks, thus raising the potential for weak banks to remain in the system. As a result, the FGC cannot prepare in advance for a bank failure, which may contribute to slow depositor payout. The FGC has few means of countering incentives for supervisory forbearance as it has no formal voice in the review and oversight of a weak bank.
- Regarding the ELA, one of the IMF's recommendations is to make emergency liquidity assistance subject to a solvency test that is tied to a remedial plan and to restructuring measures. In particular, the rules could be revised to specify that the ELA can be provided only to viable but illiquid institutions. By contrast, the authorities value the discretion afforded under the current framework.

29. ***Looking ahead, further efforts are needed to improve bank intermediation and efficiency, as intermediation margins remains high owing to high operating costs,***

bank concentration, and the still high share of subsidized lending. In this regard, could staff elaborate on the share of subsidized credit and the subsidies involved?

- The share of subsidized (or "earmarked") credit has declined notably in recent years, driven mainly by the retrenchment of the national development bank BNDES. Earmarked credit now accounts for about 45 percent of total credit. Subsidies are provided in a number of ways, including: (1) direct subsidies in which the government reimburses banks for lending under certain programs at below-market interest rates; (2) a number of funds at the federal or regional government level, including the Workers' Support Fund, Severance Indemnity Fund, and Regional Development Constitutional Funds; (3) Treasury lending at below-market interest rates; (4) tax exemptions on savings accounts and real estate and agricultural letters of credit.

30. ***The proposed laws on corporate bankruptcy and electronic collateral registration would also reduce bank costs from delinquencies and help reduce the still high intermediation margins. Could staff provide more insights into how this process is to be undertaken and the potential operative difficulties in its implementation?***

- Delinquency costs are a major driver of high intermediation margins in Brazil, reflecting a very low recovery rate from delinquent loans by international comparison and a lengthy recovery process. More efficient use of collateral and a more efficient corporate bankruptcy process would reduce the cost from delinquencies for banks by raising the recovery rate and shortening the recovery period. The authorities are actively working on improving the use of collateral, for example through a centralized registry for collateral and efforts to move from paper-based to digital invoices that can be used as collateral.

31. ***We take note that the corporate bond issuance only accounts for a small share of overall borrowing and welcome staff to elaborate on the main constraints facing the corporate bond market as well as policy recommendations.***

- Corporate bond issuance has picked up in Brazil in recent quarters, helped by the retrenchment of subsidized credit. That said, the overall size of the market is still relatively small. A notable factor that has held back a more rapid expansion of corporate bond issuance is the lack of standardization in the covenants of bonds. This makes it more difficult for investors to price bonds appropriately and hinders inclusion in benchmark indices, which would represent an additional source of demand. A policy recommendation is to work towards greater standardization of debt instruments.

Structural reforms

32. ***While the authorities' policy priorities appear focused on these issues, the staff report indicates that there is some uncertainty about the government's capacity to steadfastly execute reforms. We would welcome staff's views on how to realize and build on the current reform momentum?***

- The authorities are committed to the reform agenda and have set out a clear roadmap of priorities. Encouragingly, in parallel to the pension reform discussion, work on tax reform, for example, is already progressing with technical plans being formulated and discussions in Congress.

33. ***We agree that the process of accession to the OECD is a one-step catalyst to a wide-ranging agenda for a more open and competitive economy. Could the staff elaborate on what the internal political environment on this accession is and if it seems feasible in the short run?***

- The authorities are pursuing negotiations with the OECD to be compliant with the codes of liberalization, irrespective of whether Brazil will ultimately become a member of the OECD. That is, Brazil may in due course become fully compliant with the codes without being a member. The authorities are strongly committed to this process, and negotiations between the authorities and the OECD appear to be progressing well at the technical level. Future accession to the OECD is a stated objective of the government.

34. ***Privatizations are also part of the reform agenda. We note that staff considers that, more than generating fiscal resources, this program can improve productivity as these companies would be then managed following market principles. Nonetheless, we wonder whether staff considers this to be a good case to use a balance sheet approach? Furthermore, we would ask staff whether the legal framework to implement the program is in place.***

- Balance sheet analysis can be useful in this context, especially with regard to fiscal sustainability considerations. Nevertheless, considerations about aggregate economic productivity implications go somewhat beyond the net balance sheet effect for the government. On the legal framework, privatization of core public companies requires Congress authorization and a bidding process. However, a recent supreme court decision opened the way for privatization of subsidiaries without legal approval or bidding.

35. ***We take note in the buff statement that staff is overestimating the direct short-term impact of the reform on demand, as the increase in savings will accrue over time. We invite staff to comment.***

- Staff GDP projections for 2019 imply a continuous increase in qoq growth rates consistent with a pick-up of investment and consumption in the second half of the year, assuming approval of the pension reform. Staff projections are also in line with the BCB's and MoE's revised growth estimates of 0.8 percent for 2019.

36. ***The authorities have a broad and ambitious agenda of structural reforms. They need to make social assistance more targeted and effective. Challenges in the area of education and healthcare remain formidable. We noted that staff favored reducing the footprint of the state in Brazil. Are there any estimates of the size of this footprint and of the main areas in need of close attention?***

- Total expenditure of the NFPS amounted to almost 40 percent of GDP in 2018, 70 percent of which was in interest, wages and social security benefits. Spending in health and education is also above international standards. The forthcoming WP by Flamini and Soto shows that substantial savings could be reached by increasing spending efficiency in health and education at no detriment to social outcomes.

37. ***We encourage staff and the Brazilian authorities to maintain active dialog on structural reform priorities, including through the Fund's technical assistance. We recall that, in 2017, the authorities completed and published the Fiscal Transparency Evaluation report. We would appreciate an update on the implementation of key recommendations in this report. We also welcome the recent completion and publication of the PIMA. In the report staff devoted a separate section to the anti-corruption framework. Did staff provide any technical assistance in this area?***

- The authorities have made important progress in two areas. First, the new law regulating financial transactions between the Central Bank and the Treasury will strengthen the monetary framework and its transparency. And second the 2020 PLDO (Draft Budget Guidelines Law), Annex IV has been expanded to include a discussion of the medium-term fiscal policy objectives as well as an evaluation of the targets from previous years PLDOs. In addition, the 2020 PLDO includes more detailed budget lines for 2020-2022 detailing a path of expenditure that would be consistent with the expenditure ceiling.
- With respect to the specific anti-corruption and AML-issues that are mentioned in this section, in 2016 authorities benefitted from a Fund staff-led training on how to undertake a national risk assessment in line with the international standards. Undertaking national risk assessments is a relatively new feature that was added in

2012 to the international AML standards, which is indeed challenging for many countries. It is noted that most of the IMF's AML-related technical assistance is financed by external donors through an AML/CFT Thematic Trust Fund, which would not necessarily prioritize projects in upper-middle income countries such as Brazil.

38. ***We take positive note of the recent EU-Mercosur trade agreement. Could staff elaborate what major adjustments Brazil needs to make to comply with the high standard of the agreement?***

- The agreement will extensively liberalize trade in goods (91 percent of Mercosur's imports from the EU over a transition period of up to 10 years for most products. Longer linear liberalization of up to 15 years is reserved for some sensitive products).
- The agreement is very comprehensive. It covers a broad range of issues such as: tariffs, rules of origin, technical barriers to trade, sanitary measures, services, government procurement, intellectual property, sustainable development, small- and medium-sized enterprises. Brazil will need to introduce reforms in all these areas, in addition to encompassing economic reforms (labor, tax, pension) which would also be needed to improve Brazil's competitiveness.