SUR/07/112

September 12, 2007

The Acting Chair's Summing Up
Brazil—2007 Article IV Consultation
Executive Board Meeting 07/67
July 30, 2007

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the strong performance of Brazil's economy, which—against the backdrop of a favorable global environment—has been reaping the benefits of an impressive fiscal effort, sound monetary policy, and a reduction in vulnerabilities. Particularly notable have been the significant reductions in inflation and in public debt ratios, and the buildup of official reserves to comfortable levels. Directors also praised Brazil's enhanced social policies, which have contributed to a significant decline in poverty rates.

Directors considered that Brazil's near-term economic prospects are favorable. Notwithstanding the significant appreciation of the *real* and a sustained increase in imports, the external current account is expected to register another moderate surplus in 2007, reflecting the continued strength of exports. At the same time, Directors expected that Brazil's improved fundamentals and attractive asset prices will continue to encourage strong capital inflows.

Directors considered that the main challenge facing Brazil remains the creation of conditions for higher sustainable economic growth and further poverty reduction. This will require the continued implementation of sound macroeconomic policies and a deepening of structural reforms to make the economy more flexible and competitive. Directors welcomed the authorities' recognition of these challenges, which are reflected in the recent launching of the Growth Acceleration Program (PAC), with its focus on raising investment and growth.

Directors commended the central bank on its skillful management of the inflation targeting regime, and stressed that further entrenching the gains from a low rate of inflation remains a priority. While underscoring the need for continued vigilance, Directors saw room for further interest rate cuts. In this context, several Directors noted that resource pressures are expected to be contained. With inflation and inflation expectations below the authorities' mid-range target, a number of Directors also suggested lowering somewhat the inflation target, while narrowing the tolerance band. Many other Directors preferred to retain the present target range until low inflation is further entrenched, thus allowing greater flexibility for dealing with adverse shocks. A number of Directors favored granting *de jure* autonomy to the central bank to further solidify the inflation targeting framework and reduce inflation uncertainty.

Directors considered that the flexible exchange rate regime has served Brazil well, and noted that the level of the exchange rate is broadly in line with fundamentals. They noted the authorities' commitment to use intervention to minimize volatility and to strengthen international reserves. A number of Directors suggested that—while Brazil's foreign reserves buildup has helped create a welcome, strong buffer for the economy—large-scale intervention in the recent period may have reinforced capital inflows. In their view, reducing the magnitude of intervention would help attenuate one-way bets on the currency and minimize the fiscal costs of sterilization.

In the context of the strong private demand and buoyant tax collections, a number of Directors suggested that government revenue in excess of budgeted projections be saved. Raising public sector saving would alleviate appreciation pressures on the currency, introduce a welcome element of counter-cyclicality in fiscal policy, and strengthen public debt sustainability—thus widening the room for further interest rate cuts. Some other Directors—noting the strong track record of fiscal performance and declining debt ratios—were inclined to support the authorities' view that additional revenues may be used to reduce taxes and/or increase priority infrastructure spending. Several Directors considered that limiting the growth of primary fiscal current spending, which has been very rapid in recent years, would help strengthen the basis for high growth by creating space for much-needed infrastructure investment, reductions in the still-high gross public debt, and a lower tax burden.

Directors welcomed the reform plans in the fiscal and social security areas, aimed at further improving the quality of fiscal policy. Directors supported plans to merge all indirect taxes into two VATs, as this will help simplify the tax system, reduce tax evasion, and promote investment. To ensure its success and sustainability, several Directors noted that this complex reform will require a broad consensus and the introduction of mechanisms to minimize losses for some states. Some Directors considered that a meaningful social security reform is crucial to improving Brazil's fiscal position over the medium- and long-term. Directors also welcomed the authorities' plans to continue extending the average maturity of the public debt.

Directors noted that the Brazilian financial system is healthy and that the banking sector is adapting smoothly to lower interest rates. As long-term credit markets develop, it will be critical to ensure that lending growth remains guided by sound prudential principles. In the context of declining interest rates and to help deepen financial intermediation, Directors encouraged the authorities to reduce reserve requirements gradually and to lower the statutory rate of remuneration of savings accounts, and a number of Directors encouraged the authorities to also phase out financial transaction taxes. With new financing opportunities developing rapidly for the corporate sector, Directors saw room for phasing out directed lending by commercial banks. Directors noted that the welcome deepening of the Brazilian capital market should promote growth, but underscored the need for careful supervision and prudent management.

Directors considered that improvements in infrastructure, as envisioned in the PAC, will be critical to enhancing the climate for long-term investments and competitiveness. Given the sizable resource requirements for infrastructure and the benefits of private investment and expertise, Directors saw scope for the authorities to foster sound public-private partnerships and concessions. They also encouraged the creation of conditions to accelerate needed investments in electricity generation, and welcomed the authorities' plans to reform and strengthen the role of autonomous regulatory agencies.

Directors called for further labor market reforms and improvements in the business environment to help boost productivity and investment. Some Directors also encouraged the authorities to make further progress in trade liberalization. Directors encouraged the authorities to continue to play a constructive role in the Doha round negotiations.

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