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5:31 p.m., July 11, 2008

3. Brazil—2008 Article IV Consultation

Documents: BUFF/08/101; SM/08/175 and Supplement 1; and SM/08/180

Staff: Terrier and Kaufman, WHD; Kincaid, PDR

Length: 44 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	Alternate Executive Directors
P. Gakunu (AE)	
	E. Nyambal (AF), Temporary
J. Silva-Ruete (AG)	P. Pereira (AG), Temporary
	S. Duggan (AU), Temporary
W. Kiekens (BE)	
P. Nogueira Batista, Jr. (BR)	M. Agudelo (BR)
H. Ge (CC)	
J. Rojas (CE)	
J. Fried (CO)	
	B. Claveranne (FF)
K. Stein (GR)	
	K. Dheerasinghe (IN)
	M. Xafa (IT)
D. Kotegawa (JA)	
(MD)	
A.S. Shaalan (MI)	
	V. Yotzov (NE), Temporary
	J. Bergo (NO)
A. Mozhin (RU)	
A. Alazzaz (SA)	
P. Warjiyo (ST)	
	G. Jung (SZ), Temporary
	F. Parodi (UA), Temporary
A. Gibbs (UK)	

B. Esdar, Acting Secretary
R. Mowatt, Assistant

Also Present
IBRD: R. Chaves. Fiscal Affairs Department: J. Tyson. Finance Department: S. Williams. Monetary and Capital Markets: C. Medeiros, C. Walker. Office of the Managing Director: O. Brekk, T. Kato. Policy Development and Review Department: C. Beddies, R. Kincaid. Research Department: M. Chamon, I. de Carvalho Filho. Secretary's Department: A. Blazejewski, B. Esdar, P. Gotur, R. Mowatt, S. Zucchini. Western Hemisphere Department: R. Goyal, M. Guerra-Bradford, M. Kaufman, A. Singh, G. Terrier. Advisor to Executive Director: M. Maia (BR), C. Mira (CE), A. Mohammed (MD). Senior Advisors to Executive Directors: W. Abdelati (MI), A. Guerra (CE), P. Jenkins (CO), A. Joseph (BR), H. Mori (BR), L. Palei (RU), N. Riad (Mi). Advisors to Executive Directors: C. Brinkmann (GR), A. Eng (ST), K. Florestal (BR), J. Hukka (NO), M. Jakoby (BE), M. Jakubowicz (FF), R. Lin (CC), I. Mwanawina (AE), M. Nozaki (JA), R. Perez (BR), H. Robinson (UK).

3. BRAZIL—2008 ARTICLE IV CONSULTATION

The staff representative from the Western Hemisphere Department (Mr. Terrier) submitted the following statement:

> This statement summarizes developments in Brazil since the issuance of the staff report (SM/08/175). This information does not change the thrust of the staff appraisal.
>
> Inflation has continued to pick up. In May, the 12-month increase in the CPI rose to 5.6 percent (5.0 percent in April) and core inflation to 5.0 percent (4.6 percent). Market inflation expectations now stand at 6.4 percent for end-2008 and 4.9 percent for end-2009. The unemployment rate fell to 7.9 percent in May (8.5 percent in April), its lowest level since the adoption of a new methodology in 2002.
>
> The Central Bank has raised its inflation forecast for end-2008 to 6 percent, while keeping its end-2009 forecast near the middle of the target range. In its latest Quarterly Inflation Report (June), the monetary authority also noted that that there was a moderate chance that inflation could breach the 6.5 percent ceiling of the inflation target range. Last week, the National Monetary Council announced that the end-2010 inflation target would be kept at 4.5 percent, ± 2 percentage points, unchanged since 2006.
>
> Credit growth remains strong**.** In May, bank lending to the private sector grew by 33 percent year on year, to 35.9 percent of GDP. The ratio of nonperforming loans for corporate credit remained stable at 1.8 percent in May, while that of household credit increased slightly, to 7.3 percent (7.1 percent in April).
>
> To help contain demand pressures, the authorities have announced an increase in the primary fiscal target. In May, the 12-month primary surplus reached 4.3 percent of GDP. The government announced that, for 2008 as a whole, the primary surplus target was raised by ½ percent of GDP to 4.3 percent. To reach the target, the government plans to rely on higher revenue, mainly dividends from BNDES and Petrobras, and some spending cuts. At the same time, the authorities increased the benefits under *Bolsa Familia* by 8 percent on average, starting this July, to compensate lower income families for the rising inflation.

Draft legislation has been submitted to Congress to establish the *Fundo Soberano do Brasil* (FSB). The objectives of the FSB will be to promote investments in Brazil and abroad; accumulate public savings; mitigate the effects of business cycles; and promote Brazil's strategic interests abroad. It will initially be funded with resources from the higher 2008 primary surplus. The modalities of its operations are expected to be known later this year, once the law has been approved and the implementing regulations issued.

Mr. Nogueira Batista and Mr. Mori submitted the following statement:

We would like to thank staff for the comprehensive assessment of the Brazilian economy. The report represents a good account of the productive dialogue that took place between the authorities and the mission during this year's Article IV discussions.

Recent Developments

The Brazilian economy has been characterized since the last Article IV by a further increase in economic activity and the reappearance of imbalances in the current account and inflation pressures in an external scenario of rising energy and food prices and financial turbulence in the major centers. The economy has been experiencing an acceleration of GDP growth since 2005, reaching 5.4 percent in 2007 and 5.8 percent in the accumulated 12-month rate to the first quarter of 2008. As a result, all indicators of employment have been recording positive numbers. Poverty rate has also been reduced further with strong economic performance supported by targeted transfer policies. On a quarter-to-quarter basis, indicators point to some deceleration of growth.

The strong economic performance is reflected on the supply side as well. Investment has seen annual growth rates at two-digit levels since the second quarter of 2007. The share of investment in GDP in the first quarter of 2008 reached 20 percent against 17.4 percent in the same period last year. The expansion of credit and of capital goods imports has allowed the corporate sector to renew and increase productive capacity. The government has continued to implement its plan to invest in infrastructure so as to reduce bottlenecks through the Growth Acceleration Program (Plano de

Aceleração do Crescimento - PAC), which also includes measures to foster private sector investment.

The inflation rate was 4.46 percent at end-2007—the second year below the center of the target range. In Brazil, the inflation targeting regime has a central target of 4 ½ percent with a tolerance band of ± 2 percentage points. Inflation accelerated in 2008 reaching 5.58 percent in the 12-month period to May 2008. Like in other countries, price pressures have been affected by energy and especially food, but other prices, including non-tradable goods, have also accelerated. Market expectation by early July signaled inflation rates close to the upward ceiling of the band for 2008 and somewhat above the center of the target band in 2009. Nevertheless, inflation in Brazil is lower than in most emerging market and developing countries.

A strong currency and strong domestic demand have led to a deterioration in the current account. Imports are growing at a faster rate than exports. In the 12-month period to June 2008, the trade surplus was US$ 30.8 billion, down from US$ 40 billion in 2007 and US$ 46.5 billion in 2006. In the 12-month period to May, the current account deficit was 1.1 percent of GDP, compared to surpluses of US$ 1.5 billion in 2007 and US$ 13.6 billion in 2006. The current account deficit is being financed by large flows of foreign direct investments (FDIs), currently at levels around 2.8 percent of GDP per year.

Brazil has been receiving massive external capital, especially in 2007, with improvements in fundamentals reflected in the upgrade of the country to investment grade by two rating agencies in 2008. The improvement in fundamentals, the high prices for commodities exported by Brazil and the high interest rate differential, among other factors, have led to a nominal appreciation of the real in recent years. Staff estimates the equilibrium exchange rate by applying three methodologies. They indicated an appreciation of the real effective exchange rate ranging from 4 to 13 percent. The central bank follows a floating exchange rate regime with interventions restricted to those directed at mitigating disruptive market developments and maintaining international reserves at levels sufficient to safeguard against turbulences in the external markets. International reserves stood slightly above US$ 200 billion in early July 2008.

Policy Reaction

The authorities are concerned with inflation pressures and the deterioration in the current account observed in the first half of the year. In response, they have strengthened both monetary and fiscal policies. Macroeconomic stability is essential to preserve the real income of workers, especially those of lower salaries, and to maintain the investment rate.

The central bank continues to adopt a cautious monetary policy by monitoring closely the developments in the economy. In October 2007, it decided to interrupt the monetary easing followed since 2005 in view of the rapid acceleration of the economy and the reversal in the benign behavior of prices. Since April, it has tightened monetary policy on two occasions, increasing the policy rate by 100 basis point to 12 ¼ percent.

The National Monetary Council (Conselho Monetário Nacional —CMN) decided on June 30 to maintain the inflation target of 4 ½ percent and the tolerance band of ± 2 percentage points for 2010. The target rate and the band have been appropriate to accommodate supply and external shocks as observed in the current environment.

Despite the rejection of the financial transaction tax (Contribuição Provisória sobre Movimentação ou Transmissão de Valores e de Créditos e Direitos de Natureza Financeira - CPMF), which was not renewed by Congress, the rapid growth in revenue has enabled the government to achieve fiscal targets with a margin. The merger of the tax collection and social security contribution in a single entity seems to have helped increase revenue. The primary fiscal surplus reached 3.97 percent of GDP in 2007, above the target of 3.8 percent of GDP. In 2008, the 12-month primary surplus has been kept above 4 percent of GDP—the outcome in May was 4.34 percent of GDP. The overall consolidated fiscal deficit has declined from 2.26 percent of GDP in end-2007 to 1.72 percent of GDP in the 12-month period to May. The overall deficit is, therefore, moderate despite the burden of interest payments on public debt (6.06 percent of GDP in the 12-month period to May).

The government increased its target for the primary surplus from 3.8 percent of GDP to 4.3 percent of GDP for 2008 to support the control of domestic demand. Staff is concerned about a possible fall in revenue if a weakening of GDP growth materializes. It should be recalled, however, that the government was successful in the past in achieving its fiscal targets even in very difficult situations with weaker economic activity. The government has been able to control expenditure by a periodic review of revenue and expenditure throughout the fiscal year.

The objective of gradually reducing the net debt to GDP has been achieved. The ratio declined to 40.8 percent in May from 42.7 percent by end-2007. Moreover, the government has kept its objective of lengthening debt maturities and increasing the share of fixed-rate instruments and inflation indexed debt. This policy has been more difficult to implement recently given the deterioration in market conditions, in particular the acceleration of inflation and the ongoing turbulence in the major financial centers with potential transmission to the domestic market.

Staff suggested that the government take advantage of benign conditions in the world markets to increase pre-financing of domestic debt that matures this year. One should consider, however, that external debt is not a substitute for domestic debt. It is correct that the government can access external markets to pre-finance the external debt that is maturing in the near future, for instance, to extend the average maturity of the outstanding debt. But, in the macroeconomic framework of the Brazilian economy, foreign resources cannot be used to amortize domestic debt.

Financial Sector

The rapid expansion of credit has brought back the concern of its association with large capital inflows and deterioration in the external current account, given the disruptive effects observed in some other countries—both emerging markets and advanced countries—with similar combination of flows. This is still an unresolved problem with no straightforward answer of how to better address the effects of large capital inflows into the domestic economy.

The authorities have implemented measures to reinforce the prudential framework, such as the introduction of reserve requirements on the deposits of leasing companies in banks thereby closing a loophole; a ban on loan-originating fees to discourage the initiation of payroll-backed loans by independent agents; a ban on the use of loan pre-payment penalty fees; a more conservative accounting and prudential treatment of credit securitization and sales; and the adoption of capital charges for open credit lines and other off-balance sheet exposures.

Staff encourages the authorities to revise the regulations on loan classification and provisioning, to ensure that banks appropriately internalize the risks associated with rapid credit growth. It should be noted, however, that the Brazilian accounting rules in this respect are stricter than the IAS39 or those of other countries that adopt recognized robust accounting practices. Furthermore, the new regulation regarding sales of assets when risks and rewards are substantially retained (Resolution 3,533) was approved in January, 2008 (to be effective from January 2009 on). It is important to note that improvements in the prudential framework for credit risk are being developed. They will probably include general lending criteria and a formal requirement for financial institutions to devote management resources to monitoring and mitigating credit risk.

Staff also suggests considering the liquidity requirements of investment funds jointly with those of their related banks, to reflect the reputational risks associated with their affiliated financial funds. The authorities are of the view that asset management has to be conducted separately having a "Chinese wall" between bank and investment fund. Therefore, it would be strange for the supervisor to set such a requirement. Bonds issued by banks represent on average around 12 percent of the funds' portfolio.

In the event of a systemic shock, the authorities count on some instruments to address the problem of contraction in liquidity in the domestic financial market. The relatively large reserve requirement could be used, if necessary, by the central bank to transfer liquidity to localized problems. The holdings of government bonds by financial institutions are another instrument to manage domestic liquidity. As it has done in past financial shocks, the central bank can shift through auctions the maturity and indices of the government securities held by financial institutions by swapping them with adequate instruments to avoid a disruptive process in the system caused by unexpected adverse movements in prices. It is fundamental in this case, however, to preserve credibility in government instruments with sound fiscal policy.

The management of liquidity is more complex when the turbulence is caused by external markets. Problems in the spot currency market associated with the drying out of liquidity in the short-term trade and interbank credit lines can be mitigated basically by using the international reserves. This is a reason to keep an adequate level of reserves where short-term cross border operations are built in a context of ample liquidity in international markets.

Staff suggests to further liberalize the capital account and to expedite efforts toward full convertibility of the real. The authorities' policy is to liberalize the capital account gradually and cautiously. The Brazilian market has been opened since the 1990s as reflected in the large movement of cross border capital in different modalities. The authorities' view, however, is that capital account liberalization has to be implemented following an adequate sequencing of liberalizing policy, domestic first and then the external capital account. This is consistent with the finding of the empirical exercise carried out by the IMF Research staff[1]. Also, opening of the capital account has to be preceded by steps to strengthen the prudential framework to ensure safeguards against cross border operations, especially leveraged ones.

Structural Policies

The authorities have reached an important milestone in their tax reform efforts. After a wide ranging debate with states, municipalities, workers and the business community, they were able to send a reform proposal to Congress. The reform has as its main objectives: simplification and administrative streamlining of the tax system, elimination of distortions in the tax structure and ending the fiscal war among the states.

At the federal government level, the major alteration proposed is extinction of five taxes and creation of a new value added tax (IVA-F), with a neutral impact on tax collection. At the states level, the indirect tax (ICMS) laws of 27 states will be unified into a single tax (new ICMS) law and the rates will be uniform throughout the country. The reform also involves the reduction of payroll taxes to reduce informality and to promote competitiveness, the correction of tax

[1] "Structural Reforms and Economic Performance in Advance and Developing Countries" (SM/08/166 of June 11, 2008)

system distortions and the creation of a revenue equalization fund to compensate states for possible revenue losses from the reform.

The authorities are cognizant that there is still a pending agenda that has to be considered in the future to make fiscal management more flexible and to ensure the long-term sustainability of the public sector.

Conclusion

The Brazilian economy continued to experience a significant GDP growth rate, which has allowed improvements in social indicators. This performance has been achieved, despite adverse conditions in global capital markets. Investments have increased strongly supported by the PAC and increasing imports of capital goods. The international commodity price shock and some domestic demand pressure have led to a somewhat higher inflation and a deterioration in the external current account. In response, the authorities tightened policies in both monetary and fiscal areas, and they continue to closely monitor developments in the economy and abroad to take further actions, if necessary, to preserve macroeconomic stability and growth prospects. The supervisory and regulatory authorities are also following the rapid credit expansion in order to take timely action to further reinforce the prudential framework and to contain excesses.

Mr. Shaalan and Ms. Riad submitted the following statement:

Brazil is in a much stronger position now to deal with the heightened uncertainty confronting the near-term policymaking environment for many emerging market economies. Strong macroeconomic policies and a favorable external environment have allowed the economy to expand at a robust rate in 2007 and supported a continued overperformance on the primary surplus target. Notwithstanding the notable expansion in potential growth over the past few years, large capital inflows and rapid credit growth have fueled private sector demand and lifted utilization rates close to capacity. Amid emerging signs of overheating, the rise in global food and energy prices have stoked inflationary pressures, and with uncertainty over the path of food and oil prices in the near term, anchoring inflation expectations and dynamics becomes an immediate priority. Of importance is the fact that financial markets have weathered well the global turbulence, with improved fundamentals being reflected in a rating upgrade to investment grade. We congratulate the Brazilian authorities for their commendable performance.

The outlook for Brazil remains essentially favorable, albeit requiring an appropriately calibrated policy response to carefully steer domestic demand growth in the midst of a slowdown in global growth and heightened financial market uncertainty. A modest deceleration in activity is projected for 2008 and 2009, the extent of which will likely hinge on several interrelated factors: the slowdown in major trading partners, the trajectory of commodity prices to which a sizable portion of the market is indexed, and the persistence of inflationary pressures and the associated degree of monetary tightening. These considerations would call for policy vigilance and flexibility to support domestic demand while safeguarding macroeconomic stability in the period ahead, and for a continuation of the comprehensive structural reforms in the medium term.

Despite a significant appreciation of the real, inflation through 2008 has edged above the mid-point of the central bank target, with evidence of broader second-round effects taking hold. The tightening stance since April 2008 is therefore appropriate, and we agree with the authorities that a decisive and front-loaded response is needed to guard against the entrenchment of higher inflation expectations, given the lags in monetary policy transmission and some market expectation that inflation could likely breach the upper limit of the band. In hindsight, the authorities' response not to lower their inflation target and narrow the target band as suggested by staff last year was appropriate. The current framework needs to maintain adequate flexibility to cope with unexpected external shocks common to many emerging market economies. Indeed, following the staff's advice would have harmed credibility of the inflation targeting regime if immediately followed by an uptick in inflation.

With markets pricing in further rate increases, a widening of interest rate differentials is likely to increase capital inflows and associated potential risks of sudden reversals. We take positive note that Brazil's deep and liquid derivatives market is becoming an important factor in mitigating the effects of abrupt shifts in investor sentiment, by providing efficient means of hedging against various risks. However, the buildup of large positions by foreigners in the domestic markets and the high degree of leverage built into many instruments could amplify the impact of a potential abrupt shift in foreign financing conditions. We regard the mushrooming of exotic derivatives where, in our view, neither the buyer nor the seller is fully aware of the underlying risks as a potential source of risk. Regulatory oversight therefore needs to remain vigilant to developments in the credit derivatives market. We cannot overstate this view.

The surge in productivity that has underpinned the recent growth in export volumes in the face of significant appreciation of the real appears to be fading. The contribution of net exports to growth has turned negative in 2007 and concerns about competitiveness are supported by staff's estimates of modest exchange rate overvaluation. With some appreciation pressures likely to continue in the period ahead, we have sympathy with the authorities' measures to increase the transaction costs on certain capital flows. While this may help limit carry trade operations in the short run, it may also reduce market liquidity. The key issue for the authorities would be to reconsider these measures lest they adversely affect investor sentiment more broadly.

Despite welcome improvements in the structural component of revenues, the recent surge in revenues appears to be in large part due to cyclical factors. Given the expected moderation in economic activity through 2008 and 2009, achievement of the primary surplus target by relying on revenue buoyancy alone may become more difficult, although we concede that the authorities have established a strong track record in meeting primary surplus targets. More generally, we believe that fiscal policy is potentially more effective in calibrating domestic demand in the short run, and see merit in staff's advice to contain discretionary current spending to control the fiscal impulse to the economy and support a less tightening of monetary conditions. This action would also support competitiveness by reducing upward pressure on the exchange rate, and provide room for future maneuverability should global conditions weaken. In this respect, we are encouraged by the authorities' decision to raise the target for the primary surplus for 2008 to 4.3 percent of GDP, as conveyed by Messrs. Nogueira-Batista and Mori in their insightful buff statement.

We note the authorities' intention to establish a Brazilian Sovereign Fund (FSB), in part financed by the proceeds from overcompliance with primary fiscal surplus targets, to help contain appreciation pressures and limit the procylical bias in fiscal policy.

Going forward, the FSB would assume added relevance with the coming on stream of the recent large discoveries of oil and gas.

The rapid growth of credit, especially the surge in consumer credit and the potential for weakening of lending standards, is a cause for concern. We take positive note of the authorities' steps to strengthen the prudential framework for banks expressed by Messrs. Nogueira-Batista and Mori. With the projected deepening of structured credit products connected to consumer finance, we strongly support a proactive approach to prudential oversight to align it with changing conditions.

Mr. Silva-Ruete and Mr. Pereira submitted the following statement:

Brazil has achieved strong growth with low inflation in recent years as a result of the government's commitment to sound macroeconomic and social policies. Robust investment and productivity growth, continued increase in industrial production, strong employment growth, and targeted transfer policies have contributed to a steady decline in poverty and income inequality, all centerpieces of the authorities' growth acceleration program. It is also clear that the government has taken advantage of the favorable external conditions, further strengthening its fiscal front, reducing its public debt, and building up a large stock of international reserves. All in all, as pointed out by Mr. Nogueira Batista and Mr. Mori in their buff statement, the economy seems to be in a good position to weather the worsening external environment. Thus, we agree that Brazil's outlook remains positive, although somewhat tilted to the downside by a protracted slowdown in the global economy and the unraveling of the current financial crisis.

While the current policy framework has served the Brazilian economy well in the past years, the unprecedented turmoil in global financial markets and the greater uncertainty about economic prospects in advanced countries creates new policy challenges. We are of the view that the Brazilian authorities have timely implemented policy actions fully consistent with its own policy framework. Thus, we put a word of caution on the staff's emphasis in advancing stronger policy responses, namely decisive monetary tightening coupled with fiscal restraint while expediting further capital account liberalization and full convertibility of the real. More is not necessarily better at this critical juncture. Growth effects differ significantly according to the sequencing strategy. It is conceivable that, under some circumstances, the external shocks could be amplified by domestic policy responses if they are primarily aimed at enhancing policy credibility. Overall, we support the authorities' more cautious and gradual approach in their policy stance.

We would now like to focus our attention on two issues that are critical to ascertaining the appropriate stance of monetary and fiscal policies: 1) the determination of the output gap; and 2) the effectiveness of tightening monetary conditions to curb global inflationary pressures and the long-term growth benefits of full convertibility of the real. We will also provide some brief comments regarding future policy challenges.

I. Output Gap Assessment: Be Aware of Huge Uncertainties

The staff builds its policy recommendations in assessing the Brazilian potential growth rate, concluding that the emergence of a positive output gap by the end of 2007 ensures the need of macroeconomic tightening to bring economic activity gradually in line with its potential. In a nutshell, they endorse the view that the growing underlying inflationary pressures in the economy mainly reflect buoyant demand growth.

While the staff adopted a more comprehensive methodological approach, we believe that the determination of potential growth deserves careful consideration. Indeed, we need to be cautious about taking on board the implications of the current estimates of the output gap. No matter how sophisticated the models are, it is still critical to identify measurement uncertainties, to test the validity of some key assumptions and projections and better discern the impact of cyclical factors or the existence of structural breaks going forward. Perfectly sensible alternative assumptions in each model can lead to very different estimates of potential output. Because it is so difficult to reliably estimate potential output using either univariate statistical or economic procedures, it should come as no surprise a lot of judgment is needed in constructing the estimates of potential output. Overall, we stress that at least two factors must be kept in mind in the case of Brazil.

First, methodological shortcomings prevail. All univariate statistical procedures face significant limitations that once corrected through more flexible filters and less restrictive assumptions, prove to be insufficient to accept the hypothesis of a positive output gap. The staff recognizes certain weaknesses: i) arbitrary and fixed assumptions of business cycle frequencies that may lead to misspecification of the underlying economic structure of the Brazilian economy, particularly when dealing with short and volatile time series; ii) the end of the sample problems due to missing lead information, making the estimate most uncertain for the period of greatest interest, even when including projected data.[2]

However, other drawbacks are also critical: 1) the positive relationship between the output gap and inflation implied by the notions of the Phillip curve – Okun's Law is subject to challenge, as long as a third factor can play a role in their seemingly positive correlation (e.g., exchange rate dynamics) and some studies cast doubts on the "positive" relationship between inflation and the output gap in developing countries[3]; 2) the elements of randomness inherent to the statistical relationships can be reduced but not eliminated; 3) purely statistical methods provide a measure of trend output but not of potential output; 4) an output gap is an unobserved variable, highly model-specific and data-specific; 5) there are considerable measurement errors in the output gap and even data revision can produce big swings. The staff's comments on these factors are welcomed.

Turning to economic model procedures, other challenges arise: strong restrictions are imposed in defining key macroeconomic variables; it is not trivial to derive the output gap in an unobserved components model where parameters are also to be estimated in a time-varying fashion; when the state variables (including output gap) and the parameters are to be estimated simultaneously, the models takes a non-linear characteristic and even recursive algorithm for optimally forecasting that the unobserved component (such as Kalman filter) needs to be modified. Since measures of the output gap are so

[2] The end of the sample problem may not be trivial in the case of Brazil. We note that all estimates of the output gap come from negative territory up to 2006 and suddenly pick up in 2007. We understand that the staff "averages" both past and future values to calculate the trend at the end of the sample, although fewer future values are available to include in the average. Error measurements and uncertainties are indeed large for 2007.

[3] See, for instance, Ozbek and Ozale (2004) "Employing the Extended Kalman Filter in Measuring the Output Gap", Journal of Economic Dynamics and Control.

uncertain, we must be aware that we might be providing misleading signals to sound policy stance.

Second, some country specific macroeconomic factors are telling: 1) Investment has been growing but it is still quite low in terms of GDP (18 percent according to the staff's figures), compared with other upper middle-income countries or even compared to historical levels, proving that there is scope for further expanding Brazil's productive capacity through productivity growth and investment, without creating inflationary pressures by itself[4]; 2) there is a large potential for continuous productivity growth going forward in big firms, driven by the sharp increase in imports of capital goods produced since 2003 and the competitiveness pressures derived from the continuous appreciation of the real; 3) the unemployment rate has continued to decline but it is still above the so called "natural rate", given the high levels of labor informality and the large inequalities persisting across regions; 4) income inequality, regional disparities and the still relatively high incidence of poverty must be properly borne in mind when assessing the overall impact of the rapid credit growth on consumption demand; 5) the slowdown of the global economy will itself play a critical role in gradually adjusting domestic demand growth in the short-term (the recoupling hypothesis), thus policies to manage demand can generally be futile because of lags, uncertainties, and political pressures; 6) expected inflation at the end of 2008 is anchored at the midpoint of the Central Bank target band according to the staff's figures, without clear signals of second-round effects from rising food prices during 2008. Summing up, a wider range of indicators drawn from the labor, product and financial markets and a proper assessment of global external environment may provide us with a perspective on the balance of supply and demand in the Brazilian economy going forward.

In general, uncertainties prevail in the determination of the output gap. Thus, we support the authorities' more cautious approach, aimed at consolidating macro stability and inclusive growth.

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[4] We note that the authorities have recently launched new measures to support the growth of production, export and investments, with the overall objective to raise the investment ratio to about 21 percent of GDP. We welcome Mr. Nogueira Batista's assertion that progress has already been achieved in this regard in the first quarter of 2007 (share of investment to GDP of 20 percent).

II. The Effectiveness of Monetary Tightening and the Long-Term Benefits of Full Capital Liberalization: An Open Debate

There is no doubt that inflation is now a global phenomenon. In fact, global imbalances have led to both a credit crunch in the U.S. with worldwide consequences and rising inflation across the globe driven by soaring commodity prices. These two crises are indeed interrelated and the exchange rate regimes are their link. On the one hand, the U.S. needs to expand domestic demand to offset the contractionary effects of its external deficits and the slowdown from its housing recession. On the other hand, loosening monetary policy produces a huge liquidity excess in the global financial markets, despite insolvency and credit problems, and the expansion of those economies linked to the U.S. dollar beyond domestic absorption. Overall, global imbalances have proven to be hugely destabilizing in the past, but they will prove to be more threatening now that the bubble has burst.

With these comments, we would like to stress that inflation is a global challenge that could be hardly addressed by simply adopting responses aimed at mainly enhancing policy credibility. Global imbalances are at the core of the problem, calling for coordinated responses. We wish this message were clearly conveyed by the Fund. Thus, inflation targeting schemes are constrained by global conditions and untimely actions could increase macro and financial risks when it is coupled with rapid capital account liberalization. Among them, a steady appreciation of the domestic currency may endanger export performance and the country's overall external position, hurt growth through reduced investment incentives in the manufacturing and tradable sectors, and disproportionately affect small and medium-sized firms[5] that are not prepared to deal with over-valued currencies as long as they are constrained by market failures and underdeveloped institutions that block their structural transformation. In addition, while foreign capital may not always supplement domestic savings due to limited absorptive capacity in the economy, tighter monetary conditions attract instead more short-term capital inflows and create arbitrage conditions and carry trades that induce a vicious cycle of flows, appreciation, and further monetary tightening.

[5] Notable labor-intensive industries.

Despite the fact that the Brazilian authorities have taken steep actions to bolster exports and support affected sectors through changes in trade-tax policies and financial assistance, none of those negative effects are strange in its economy. Brazil has experienced a critical surge in capital inflows, reaching record levels in 2007. The staff recognizes that the real's appreciation has indeed been the highest in the world (17 percent in effective terms in 2007 alone), exceeding that of the euro, yen, and pound sterling, among others. As a result, export volume growth has started to trend down and the current account is registering a small deficit in the first quarter of 2008. Meanwhile, the expansion of the domestic banking and financial system has followed the same hasty pace, not without risks. Overall, the economy seems to be exposed to external shocks in a less benign global environment.

We must also contrast these costs against the benefits of price stability when assessing the right sequencing strategy. The staff argues that there are lags in the transmission mechanism of monetary policy that call for decisive increases in the policy interest rate to avoid stronger adjustments in the future. Against this background, we note that: a) financial intermediation is still relatively low in Brazil, while food demand is intrinsically inelastic to the downward despite rising food prices, leaving the economy with higher interest rates; b) a sizeable part of the Brazilian public domestic debt is currently indexed to the SELIC rate, thus an increase in the country's base interest rate may promote a positive effect on the wealth of private net creditors as long as the maturity of debt is mostly short. The staff's comments on these factors are welcomed.

To conclude, not to lose sight of the development perspective is critical to sound policy advice if we are committed to serve the needs of our members. Brushing away any possible ideological bias is also vital.

III. Some Policy Challenges Going Forward

On the fiscal side, we note that the primary fiscal surplus target was exceeded in 2007 and we are reassured by Mr. Nogueira Batista and Mr. Mori that the same outcome will be comfortably achieved through close monitoring of developments this year. For the reasons exposed above, shielding the country's fiscal position against external shocks is key to allow further room for counter-cyclical actions going forward. Nonetheless, the authorities face the challenge of stimulating and protecting productive and social investment without compromising its public finance. In this regard, we welcome the authorities' initiatives to build up public investment design and implementation capacity, public-private partnership arrangements undertaken under sound regulatory frameworks and the creation of a Brazilian Sovereign Fund to strengthen fiscal funding.

Regarding financial issues, we take note of the authorities' actions to reinforce the prudential and supervisory framework of the banking system and we encourage them to continuously improve it in a pro-active manner. We highlight the importance of enhanced liquidity oversight that can stem from banks, as well as from their related financial institutions. The staff recommendation of the close monitoring of the development in the derivative markets is well placed.

Finally, we reiterate our claim to focus the Fund's policy advice on their areas of core expertise. Serious consideration must be given to the principle of comparative advantages as an effective way to serve members' needs and increase the credibility and effectiveness of the Fund's policy advice. Calling for labor flexibility or calling for wage and pension's moderation to ensure "fiscal credibility" over legitimate social goals is heading in the opposite direction.

With these comments, we thank the staff for a comprehensive set of papers and Mr. Nogueira Batista and Mr. Mori for their insightful buff statement. We wish the authorities all the best in their endeavors.

Ms. Lundsager and Mr. Parodi submitted the following statement:

We commend the authorities for good macroeconomic performance and the recent investment grade rating from two credit rating agencies. Brazil's solid macroeconomic framework has helped produce strong growth and reduce debt-related vulnerabilities. We agree with the staff that the economy is beginning to overheat, however, and that a continued tightening of the policy mix is warranted.

The well-written staff report and selected issues papers provide a thorough and balanced description of economic performance and propose useful policy recommendations. We again urge the authorities to consent to publication of the staff report.

The real has appreciated significantly over the past year. Strong external performance and attractive investment opportunities, along with Brazil's position in the business cycle, have led to a surge in inflows. Foreign exchange reserves more than doubled over the past year and now provide an ample cushion to defend against external shocks. In this respect, we are pleased to note that foreign exchange intervention has moderated over the past few months.

Going forward, concerns about possible exchange rate overvaluation could be addressed through countercyclical fiscal policy. A tighter fiscal stance would likely lead to lower inflation and reduced real exchange rate appreciation. As highlighted in Messrs. Nogueira Batista and Mori's statement, the authorities' decision to raise the primary surplus target from 3.8 to 4.3 percent of GDP demonstrates the authorities' commitment to a prudent policy response.

We welcome the measures taken to streamline foreign exchange regulations, but are disappointed with the recent introduction of the IOF tax on capital inflows. We are somewhat more skeptical than the authorities about the effectiveness of such measures, as they can be easily circumvented using the very large and well-developed derivatives market. We also look forward to further measures to liberalize the capital account.

We remain unconvinced that setting up a sovereign wealth fund is an optimal policy response to the recent revenue windfall and robust capital inflows. Gross sovereign debt, while declining, remains substantially higher than other investment-grade countries. In addition, Brazil's heavy tax burden on private investment and inefficiencies of the current tax regime are generally believed to impact growth negatively. As such, we would favor lowering the debt burden or reducing taxation before setting up a SWF.

The SWF, if established, should not interfere with central bank foreign exchange policies nor distort incentives in the financial system. In this context, the authorities should clarify concerns about possible conflict with monetary operations by granting the central bank full autonomy. We advise that any SWF adopt the Generally Accepted

Principles and Practices currently being developed by the International Working Group of SWFs.

We support the authorities' efforts to forge a consensus for a sweeping indirect tax reform and applaud the objectives highlighted by Messrs. Nogueira Batista and Mori. The large social security deficit is a long-pending area for further reform. In this regard, we recommend that the authorities provide specific proposals to reform the social security system. We also welcome the authorities' recognition of the need to increase budgetary flexibility by reducing the scope of revenue earmarks and urge them to begin the process of reform.

We are skeptical about the increase of the fiscal adjuster for the pilot public investment program to 0.5 percent of GDP. While facilitating infrastructure investment is certainly desirable, recent experience shows that increasing the infrastructure investment adjuster to the primary surplus does not necessarily translate into higher investment. Tax incentives and exemptions, and lower interest rates for certain sectors, complicate the tax system further and deepen distortions in the financial markets.

We encourage the authorities to remove structural barriers that impede market-based lending. There is scope for further reductions in directed lending, and we are disappointed that the authorities have decided to provide additional tax benefits for firms seeking BNDES credit. Although politically difficult, we suggest that the authorities consider a long-term plan to phase out credit quotas to specific sectors and to redefine the role of the state-owned development bank toward market-oriented lending. Lastly, we support the staff's recommendation for an FSAP update.

Ms. Xafa submitted the following statement:

We thank staff for the well-balanced and informative report and Mr. Nogueira Batista and Mr. Mori's comprehensive buff statement. We commend the authorities for the impressive economic performance in recent years, largely as a result of strong macroeconomic policies, an outward-oriented development strategy, and terms of trade gains. The authorities have wisely taken advantage of benign external economic and financial conditions to build reserves and to reduce vulnerabilities stemming from the level and composition of public debt. Brazil is thus well-placed to withstand the pressures from a worsening external environment. However, with the output gap still positive, current financial conditions probably are not sufficiently tight to slow demand sustainably in line with potential output. There are clear signs of overheating: above-potential growth, a shift to a current account deficit, and strong inflation pressures. The key near-term challenge is to slow demand growth so as to achieve a soft landing.

Fiscal Policy

Prudent fiscal policy, in line with the Fiscal Responsibility Law, has contributed decisively to economic stabilization. Given the need to slow demand and meet rising interest payments, we welcome the authorities' decision, mentioned in Mr. Nogueira Batista and Mr. Mori's buff, to raise the primary surplus back to the 4.3 percent of GDP target prevailing before 2006 from 3.8 percent in 2006-07. However, we wonder whether the primary surplus is the right fiscal target. While keeping the deficit low, this rule has led to a procyclical fiscal expansion as primary spending increased in line with booming revenues, reducing the scope for further decline in the tax and public debt burdens. Spending may be difficult to scale back in the event of an economic slowdown.

While the primary balance should remain a key fiscal objective, adoption of a medium-term budget framework as proposed by staff would help contain public spending and ensure continued reduction in the still-high debt burden, taking cyclical developments into account. The discovery of large off-shore oil and gas fields, expected to start production in 2013-15, will clearly require a medium term fiscal framework to safeguard the sustainability of public finances. Such a framework would require reducing budgetary rigidities (mandatory spending and earmarking) that limit the extent to which fiscal policy can respond to cyclical developments. The growing burden of pension expenditures – presumably partly reflecting the link between the rapidly rising minimum wage and minimum pensions – also represents a fiscal vulnerability. We therefore call on the authorities to maintain a tight fiscal stance and to adopt a medium-term budget framework that would restrain public spending.

Monetary Policy

Inflation appears well-contained as skillful monetary management has kept it within the 4.5 +/-2 percent target range despite soaring food and fuel prices. However, this strong performance partly reflects near-stability in administered prices, which account for nearly one-third of the CPI, and a reduction in the tax on fuels. The recent pick-up in non-tradables and core inflation should dispel any notion that inflation is purely an exogenous phenomenon. With the economy growing above potential and the capacity utilization rate at its cyclical peak, the 100bps tightening since April appears modest, leaving in place fairly accommodative conditions. Against this background, the central bank has appropriately signaled its intention to hike the policy rate further to help slow credit growth. The risk of a reversal in the real's appreciation trend as net FX inflows slow underscores the need for early action to bring inflation down toward the mid-point of the target range.

Financial Sector

The end of the easing cycle has marked a missed opportunity to reduce reserve requirements, which keep interest rates high. Similarly, directed lending raises the interest costs of firms that have no access to such lending and hinders financial market development. As a result, real interest rates in Brazil remain well above those in peer countries (Box 1). We see little justification for continued reliance on directed lending in the current environment of low inflation and macro predictability that is conducive to capital market development. A more market-based financial system with lower reserve requirements would reduce capital inflows and sterilization costs by easing interest rates; it would also improve the effectiveness of monetary policy by raising the share of interest-sensitive borrowing.

We take positive note that the prudential framework is sound and that the financial system is well capitalized. Brazil's financial markets have proved resilient to the credit crunch in developed countries and NPLs remain low despite rapid credit growth. Nevertheless, there is room to improve the prudential framework for credit risk and liquidity oversight. We agree with staff that an update to the 2002 FSAP could help evaluate evolving financial sector risks and detect any fault lines arising from balance sheet mismatches. We thus encourage the authorities to take advantage of the opportunity offered by staff to conduct an FSAP update in the second half of 2009.

Exchange Rate Issues

Following its strong appreciation since the 2002 crisis, staff finds the REER moderately overvalued. However, this estimate does not take into account Brazil's newly-discovered energy potential and productivity acceleration stemming from infrastructure investments and business-friendly reforms envisaged in the Growth Acceleration Program (PAC). Moreover, private investment is booming as the strong real has contributed to an increase in capital goods imports that helped upgrade the capital stock. External competitiveness thus does not appear to be an area of concern.

With these remarks, we wish the authorities continued success.

Mr. Fried and Mr. Jenkins submitted the following statement:

We commend Brazil's authorities for having taken major strides toward reducing vulnerabilities, creating the conditions for stronger and more sustainable growth, and taking effective measures to reduce poverty. In virtually every area of economic policy, Brazil has improved both framework and execution, creating the genuine prospect that the cycle of boom and bust, and lower average growth, may be behind it.

Macroeconomic Policies

Notwithstanding the marked overall improvement in economic policies, we agree with the staff that the key short-term policy challenge facing the authorities is to avoid a resurgence of inflation. Inflationary risks emanate from both domestic factors, notably above potential economic growth in an environment of minimal economic slack, and the impact of higher world food and fuel prices. In this context, while noting the reservations expressed by Mr. Silva-Ruete and Mr. Pereira on the wide confidence interval that surrounds particular point estimates of the output gap, we consider that the evidence provided by the staff is compelling in support of the view that the Brazilian economy is above, or at least rapidly closing in on, its potential. We thus agree with the staff that the appropriate policy response in this context is a substantial front-loaded tightening of monetary policy. By taking determined actions now, the monetary authorities will prevent inflation from becoming entrenched, and avoid the need for what might otherwise be the need for an even more pronounced tightening in the future.

Tighter monetary policy is likely to lead to additional upward pressure on the real. The additional tightening of monetary conditions stemming from a higher exchange rate would contribute to containing inflation by restraining external demand. With Brazil's international reserves, at over $200 billion, now ample from a precautionary perspective, we would join the staff in discouraging the authorities from additional reserve accumulation. Given the well-known limits to effective sterilization, systematic reserve accumulation could interfere with the needed tightening of domestic liquidity conditions, and would undermine the credibility of the inflation targeting framework by casting doubt on the primacy of the inflation objective.

We also agree with the staff on the desirability of additional fiscal consolidation, given Brazil's continued elevated levels of public debt and the overall deficits being incurred despite the government's success in modestly exceeding its target for the primary surplus. While an argument can be made that fiscal policy should be oriented toward longer-term objectives, rather than short-term demand management (a view implicitly endorsed by the staff in their call for the creation of a medium-term budgetary framework) in Brazil's current conjuncture these objectives are not in conflict. As Brazil's economy is close to its potential, one can interpret the actual (overall) fiscal deficit as being a good measure of the structural deficit. It would be our judgment that the authorities should consider aiming for a higher structural balance given Brazil's relatively high level of debt, implying a smaller overall deficit than we now observe. The contractionary fiscal impulse that would stem from such a transition to a more prudent fiscal stance would, fortuitously, also contribute to short-run anti-inflation objectives in the present environment.

We agree with the staff on the importance of making progress on a range of structural fiscal measures, most notably containing the deficit in the public pension system, and reducing the budgetary rigidities which have in the past complicated fiscal management. We welcome the authorities' plans to reform and unify Brazil's indirect tax system into a single VAT, despite the legal and political complexities of achieving the needed agreement at the federal, state and municipal levels.

We note the authorities' intention to create a Sovereign Wealth Fund, to be partially funded from the resources associated with overcompliance with the primary surplus target. We concur with the cautions presented by the staff concerning the need for transparency and avoiding conflicts between the activities of the fund and macroeconomic stabilization objectives. More fundamentally, it is not clear why a country like Brazil, with significant levels of public debt, would choose to accumulate assets rather than pay down debt. One possible explanation is that the authorities consider that the risk-adjusted return on the assets held in the fund would exceed the interest rate on public debt. We would invite the staff's views on this issue.

Financial Sector and Structural Policies

Although Brazil has weathered well the recent period of international financial market turmoil, we share the staff's concern, amplified by the international comparative analysis presented in the selected issues paper, on the implications of very rapid growth in private sector credit. While Brazil's banking sector is very well capitalized, and returns on equity are strikingly high, experience suggests that rapid credit growth is very frequently associated with deterioration in loan appraisal practices, leading to an eventual rise in non-performing loans. Indeed, the current level of non-performing loans, while exhibiting no particular trend in recent years, appears already somewhat elevated. We agree with the staff that it would be highly desirably for Brazil to request an update to the 2002 FSAP.

We note the staff's recommendations in the area of structural reforms, which particularly emphasize the need for efforts to improve infrastructure and the investment climate as well as increase the flexibility of labor markets. To the extent that the cost of doing business in Brazil is high in comparison with "other countries", as asserted by the staff, we agree with the importance of reforms aimed at streamlining the regulatory environment. However, the persuasiveness of the staff's arguments would have been buttressed if the staff report had provided some modest quantitative and other additional evidence to support these policy recommendations.

With these observations, we wish the authorities well in their endeavors.

Mr. Moser and Mr. Jung submitted the following statement:

The adherence to a strong macroeconomic policy framework, together with favorable external conditions, has resulted in reduced volatility and higher growth, and the authorities are to be commended for their achievements. Like staff, we believe that key short term actions call for a macroeconomic tightening in order to bring economic activity gradually in line with its potential. Moreover, a further reduction in the still high public debt level is warranted.

Recent inflation and inflation expectations data show a continued drift to higher levels, underlying the need for a tightening of monetary policy. We welcome the recent policy rate increase by the Central Bank and very much agree with the authorities that front-loaded monetary policy action is needed to contain the inflationary momentum and anchor inflation expectations.

Tighter monetary policy will have to be accompanied by fiscal tightening; the recently announced increase in the primary surplus target for 2008 to 4.3 percent of GDP is appropriate but probably not sufficient. Moreover, as buoyant tax revenues since 2004 are mostly due to cyclical factors, the focus should be on lowering expenditures. We also agree that there should be a change in the composition of expenditure, namely a shift from current to capital expenditures. Budgetary rigidities and earmarking are a long-standing fiscal problem in Brazil, hampering fiscal management and efficient resource allocation.

We support the tax reform aiming at improving and simplifying the indirect tax system. The authorities' plan to introduce a system of transfers between states, and the federal government and states. Can staff provide more information on current inter-state financial arrangements? Is there already a system of transfers in place, on which a new system can be built?

We note that draft legislation has been submitted to Congress to establish the Fundo

Soberano do Brasil (FSB). We would have preferred a more detailed assessment from staff on the desirability and purpose of such a Fund. In our view, it would have been preferable to use the proceeds to lower the public debt burden. We have also concerns that the FSB might pursue outmoded industrial and interventionist policies. What is the staff's view?

The staff notes that Brazil's composition of public debt has been improved in recent years. Brazil now relies more on domestically issued local currency debt, including inflation- and interest rate-indexed debt. This, however, does not necessarily mean lower vulnerability than in the past, where a larger share of government debt was issued externally and denominated in foreign currency, particularly in an environment of increasing inflation.

In the light of staff's analysis on the relationship between credit growth and non-performing loans, we encourage the authorities to review and strengthen the prudential and supervisory frameworks. Credit growth has been particularly strong in the consumer credit segment and non-performing loans for credit cards have been rising since 2004. Consumer demand contributes to a large extent to economic growth in Brazil and thus, there are downside risks to the economic outlook arising from household indebtedness.

Finally two technical comments on the selected issues papers. First, on the methodology to separate structural from cyclical factors in fiscal revenues. As recognized by staff in their analysis, the simple output gap model may attribute some temporary, non-structural factors such as higher revenues arising from higher commodity prices to the structural component and lead to an overestimation of structural revenues in the current context of high commodity prices. To assess the robustness of the results, we suggest complementing the analysis with a method that distinguishes between revenues from commodity and noncommodity sources (as in IMF Working Paper 08/137 by Vladkova-Hollar and Zettelmeyer).

Second, on Potential Growth and Output Gaps in Brazil, the wavelets filter produces a very small output gap, in particular during the crisis period of 1998. In fact, judged by this measure, there was only a small and very short output contraction in 1998, which appears to be at odds with other pieces of evidence. Does this result therefore question the ability of the wavelets filter to capture output dynamics correctly?

Mr. Alazzaz submitted the following statement:

I thank the staff for a well-written set of papers and Mr. Nogueira Batista and Mr. Mori for their informative buff statement. The Brazilian economy continues to perform well. Growth has picked up strongly since the last Article IV consultation, the unemployment rate has fallen further, poverty rates are declining, and inflation remains within the target range. Moreover, the public debt-to-GDP ratio is declining and the external reserves are rising. It is therefore not surprising to note the recent upgrade of Brazil's sovereign debt rating to investment grade. Credit for this impressive performance goes to the authorities' continued implementation of prudent macroeconomic policies and structural reforms. The challenge now is to address concerns of overheating while advancing structural reforms in order to bolster medium-term growth prospects and further reduce poverty.

In the fiscal area, I compliment the authorities for their sustained implementation of prudent policies. Indeed, it is encouraging to note that apart from a significant reduction in the public debt-to-GDP ratio, the composition of public debt has improved in recent years and its average duration has been extended. In this regard, the authorities' commitment to keep the debt ratio on a downward path and to maintain prudent limits on subnational borrowing is reassuring. I also welcome the recent raising of the primary surplus target for 2008, which would help restrain domestic demand growth and lessen the burden of adjustment on monetary policy. To reach the target, the staff rightly underscores the importance of reducing the rate of growth of current spending while protecting priority investment.

On structural fiscal issues, progress in the reform of the indirect tax system and the social security would not only enhance fiscal sustainability, but also improve economic efficiency. In this regard, I am encouraged that the authorities have sent a comprehensive reform proposal to Congress to simplify and streamline the tax system, eliminate distortions in the tax structure, and end fiscal competition among the states. It is also important to press ahead with the reform of the social security system, which has a large deficit as a share of GDP, and to take steps to reduce budgetary rigidities.

On monetary policy, the Central Bank has rightly tightened the policy stance in response to inflation developments. Here, the Central Bank deserves credit for taking early actions even though inflation in Brazil compares favorably to most emerging market economies. In the financial area, I welcome the measures taken by the authorities to reinforce the prudential framework, especially in view of the risks posed by the rapid growth of credit and the relatively higher level of nonperforming loans for consumer loans.

Turning to the external sector, the authorities have rightly taken advantage of the favorable external conditions in recent years to build international reserves buffer that has significantly strengthened the resiliency of the economy. I also join the staff in welcoming the progress made in streamlining foreign exchange regulations. On the staff's suggestion to expedite efforts toward full convertibility of the real, I agree with Mr. Nogueira Batista and Mr. Mori that it is important to proceed gradually and cautiously with an adequate sequencing of liberalizing policies.

Finally, the stress placed in the Growth Acceleration Program (PAC) on improving infrastructure to enhance long-term growth prospects is welcome. In this regard, I am encouraged by the authorities' efforts to strengthen public investment design and implementation capacity. I also welcome the recent announcement of a package of measures to support the growth of production, exports, and investment across a broad set of industries. To this end, the ongoing efforts to enhance the business environment and lower the cost of doing business should continue. In this connection, further advancing labor market reforms will be important.

With these remarks, I wish the authorities further success.

Mr. Kiekens and Mr. Jakoby submitted the following statement:

We thank staff for comprehensive and well-written set of papers and Messrs. Nogueira Batista and Mori for their useful and candid buff statement. We are in broad agreement with the thrust of the staff analysis and we will make a few comments for emphasis.

In 2007, Brazil's economic growth continued to be robust as the country benefited from a record increase in investment and improved terms of trade conditions due to higher export commodity prices. Thanks to the benign conditions and sound economic policies, Brazil has also managed to increase employment and reduce poverty through targeted social assistance programs.

However, Brazil has not been able to avoid the rising inflation and deterioration of the external account due to the food and fuel price increases and financial turbulence. The emergence of a positive output gap at the end of 2007 indicates some excess domestic demand. The moderate overvaluation of the real raises some concerns about further competitiveness. The recent inflation figures compare relatively favorably with other emerging market economies and the Latin American countries. However, with the expected 2008 inflation approaching the upper limit of the target range and the increasing probability that even this limit will be breached, addressing the emerging inflation pressures and containing second-round effects and expectations represent a short-term policy priority.

While the external current account has turned from a surplus to a moderate deficit, so far this deficit has been safely financed with robust FDI inflows. However, the external balance could suffer from a reversal of the recent favorable export commodity price surge.

The monetary policy response to the surge in inflation in the form of the recent increase in policy interest rate has been correct. The authorities also deserve credit for the prudent fiscal stance, which has resulted in a larger primary surplus and a declining overall consolidated deficit. In this regard, the recent upward revision of the 2008 primary balance target is commendable. However, reaching the new target will be demanding because of the discontinuation of the CPMF tax, the planned 15.5 percent nominal public wage increase and high level of mandatory spending.

While the improved fiscal stance in 2007 and 2008 has been supported by buoyant revenues, continued buoyancy is questionable in light of the expected slowdown of economic activity. From a medium-term point of view, we welcome the consensus reached among key players on the comprehensive tax reform.

From the information provided in the selected issues paper and the buff statement, we note that the unification of the collection of taxes and social contributions in 2007 has helped increase revenue.

Could staff quantify the impact of this step? In addition, we are of the view that a comprehensive analysis of the process of the unification and its resulting impact could provide useful information to other member countries of the Fund.

In Box 2 of their report, staff point out that in order to mitigate the impact of the rising fuel prices the authorities reduced the excise taxes for gasoline and diesel by one third and more than half, respectively. Could staff please comment on the impact of this measure on retail prices?

We support the staff's recommendation that the authorities should adopt the medium-term budgetary framework with deficit targets, expenditure limits and spending priorities as its cornerstones. The authorities' debt management strategy which focuses on lengthening the maturity of debt instruments and shifting to the fixed interest rate is commendable. However, we note that external financing conditions have tightened, as documented by the rise in Brazil's sovereign spreads since the release of the Staff Report, reaching 238 bps this week. This could create complications for future debt restructuring. Staff comments are welcome.

The liberalization of the foreign exchange regime following the abolition of the export surrender requirements and the financial operations tax on exports is commendable. However, we have some reservations about the adoption of protectionist measures, including the increased tariffs on import of selected goods.

The Brazilian financial sector has remained in good shape, as confirmed by all major indicators. However, the dynamic growth of bank credit, including mortgages and the expansion of credit to the new segments of borrowers call for ensuring prudent lending standards and sound risk management frameworks.

As in the cases of previous Article IV consultations, we encourage Brazilian authorities to consent to the publication of the staff report.

Mr. Yakusha and Mr. Yotzov submitted the following statement:

We thank staff for a well written set of papers. We also thank Mr. Nogueira Batista and Mr. Mori for their insightful buff. We agree with the conclusion that Brazil has benefited from exceptionally favorable external conditions over the last couple of years. Supported by sound macroeconomic policies, this has resulted in a commendable decline of macroeconomic vulnerabilities and a build-up of robust foreign reserves. Indeed, Brazil now is in a better position than in the past to withstand a worsening in the external environment. This notwithstanding, there are a lot of uncertainties associated with global conditions which reinforce the need to contain buoyant economic momentum and strengthen further Brazil's position.

Like staff and other Directors, we too believe that the key macroeconomic issue in the near term is to bring domestic demand growth in line with potential output growth. Staff suggests that a comprehensive policy response is needed in order to contain domestic demand growth, including further tightening of monetary policy and slowing the growth of current fiscal spending to increase the primary surplus. While we certainly agree with this general notion, it should be noted that the expected reduction in external demand has already alleviated some pressure on the production capacity. In this regard, overplaying the monetary response may be ill-advised. The monetary authorities have already increased the policy rate substantially and the real rate is by far higher compared to peers, as evidenced in Box 2. This, in turn, implies that a serious cut in public spending should be given first priority.

As rightly indicated by staff, containing current spending growth is critical, both to restrain domestic demand growth but also because over-reliance on buoyant revenues has raised some risks to the fiscal outlook. In this regard, we see merit in staff's recommendation for a continued back loaded discretionary spending to help contain domestic demand and currency appreciation pressures while protecting priority investment. We note that just recently the Minister of finance has indicated that the projected GDP growth of 5 percent in 2008 will not be realized and that it would now more likely be around 4.5 percent. This calls for caution in the preparation of the revenue and expenditure projections for the 2009 budget since the slowdown in economic growth may also spread into the next year.

We commend the authorities for their reform efforts aimed at improving and simplifying the tax system. The VAT reform is long overdue and we are really encouraged by the new developments in this area. We gladly note that the reform is expected to be revenue neutral, and that the authorities plan to manage the distributional impact across states and between the federal government and the states through a system of transfers. We share staff's view that that the law and regulations should ensure that the state and federal VAT have similar tax bases and credit systems and that there be limited differentiation of rates across products in the two VAT laws.

We note that in order to increase farm production, President Lula has recently launched a new farm credit program which is also expected to help lower food prices. Substantial increases in farm financing, together with the significant increase in agricultural subsidies which was introduced as a way to combat the rising prices of food, make in fact Brazil another country which heavily subsidizes the agricultural sector. Can staff elaborate on the issue, and especially on the authorities' long-term perspectives in farm subsidizing?

We note the authorities' intention to launch a Sovereign Fund. Even though the specifics of the fund remain unclear for the moment, it is expected that it will amount initially to about US$10-15 billion, which would make it a significant factor. While we agree that establishing such a fund can help create some buffers, this should be weighted against the gains from lower debt levels. We would appreciate more convincing arguments for the rational for this (non-resource-based) fund. At this point, the proposal to set up a Sovereign Fund seems to have not received unanimous support within the government and it appears that it has been opposed by some key economic leaders, as they reportedly feel that the fund might affect the monetary policy. Can staff shed more light on the issue, in particular on the possible interactions with monetary policy? In any case, we strongly agree with staff that the use of such resources should not bring an additional impulse to domestic demand at this juncture and that the fund should aim at playing a counter-cyclical role. If this fund does materialize, it should operate in a close coordination with the central bank, while the transparency of operations will be critical for maintaining confidence in macroeconomic policy. Like Ms. Lundsager and Mr. Parodi, we would encourage the authorities to adopt the Generally Accepted Principles and Practices currently being developed by the International Working Group of SWFs.

Mr. Rutayisire submitted the following statement:

We thank staff for a concise and well written report on Brazil and Mr. Nogueira Batista and Mr. Mori for their helpful buff statement.

We commend the Brazilian authorities for their good economic performance and resilience to the global financial turmoil. Indeed, the economy is undergoing its fastest period of economic growth in two decades with an average growth of about 4.1/2 percent a year during 2004-07, owing to the continued implementation of sound economic policies. Owing to higher revenue mobilization, the fiscal stance improved markedly. Strong employment and targeted social policies have contributed to a significant decline in poverty. In particular, the rapid expansion of employment and credit together with the positive effect of the government's Fome Zero Initiative have helped move a large segment of the population from absolute poverty. The authorities have also taken advantage of favorable external conditions to reduce macroeconomic vulnerabilities further and increase international reserves. At the same time, we note the persistence of inflationary pressures stemming from rising food and fuel prices and a significant weakening in the external current account balance due to strong domestic demand and the appreciation of the real. Looking ahead, economic prospects remain broadly favorable, in spite of a number of downside risks arising from uncertainties in the global conditions.

Fiscal policy has been a key pillar in reducing macroeconomic risks, while fostering economic growth, as higher revenues have created room for higher spending. As a result, the authorities have been able to reduce the overall consolidated fiscal deficit and to exceed the target for the primary surplus. Given the risks to the fiscal outlook stemming from deteriorating economic conditions, we encourage the authorities to shift their focus on containing public spending growth for medium-term fiscal sustainability. To this end, the authorities should adopt a medium-term framework to help improve spending efficiency, lower the tax burden, while protecting infrastructure investment. To improve spending efficiency, it is also important to reduce budgetary rigidities and earmarking. Progress in reducing the public debt burden is commendable and should be reinforced to bring Brazil to the level of other investment-grade countries. We equally urge the authorities to forge a consensus to further contain social security spending for medium-term fiscal sustainability. We particularly welcome the authorities' intention to establish a Sovereign Fund with the proceeds of the revenue windfall and robust capital inflows. We would like to stress the need to ensure that the Sovereign Fund is managed in accordance with international best practices in terms of transparency and governance, without adding to domestic pressures, complicating exchange rate policy or undermining confidence in macroeconomic policy.

As regards monetary and exchange rate policy, we welcome the recent steps taken by the central bank with early and decisive increases in the policy interest rate to anchor inflation expectations. Together with fiscal tightening, these measures could contain domestic demand and alleviate the burden of adjustment. However, with inflation through 2008 rising above the mid-point of the central bank, it appears that monetary tightening has essentially added to the appreciation and subsequent overvaluation of the real. Regarding staff proposal to further liberalize the capital account, we believe it is important to proceed gradually and cautiously by paying greater attention to strengthening the prudential and supervisory framework before implementing full liberalization. We commend the authorities for the comfortable buffer of international reserves built over time to protect against exogenous shocks and we welcome progress made in streamlining foreign exchange regulations.

In the financial sector, steps taken to address some of the risks posed by the rapid credit growth are commendable. We particularly welcome plans to strengthen supervisory frameworks for assessment of credit risk and regulations on loan classification and provisioning to ensure that banks appropriately internalize risks associated with rapid credit growth. Also, creating a comprehensive database on household indebtedness by income levels is a step in the right direction for monitoring risk. Although Brazil has weathered well the global turbulence, thanks to financial market deepening and the reduction of government exposure to exchange rate risks, it remains important to improve liquidity oversight. In this regard, we welcome the authorities' plan to consider the liquidity requirement of investment funds jointly with those of their related banks.

In the structural area, we support the authorities' strategy to accelerate and deepen the reform agenda to boost economic growth over the medium, further reduce poverty and improve competitiveness.

At a time of rising global demand for food and energy, Brazil is uniquely placed, because of consistent policies implemented in the past to boost the supply side and become a major producer. Focus on infrastructure bottlenecks is appropriate to harness the country's economic potential and we encourage the authorities to increase public-private partnership arrangements in infrastructure. We welcome the authorities' planned package of measures to support the growth of production, exports and investment across a broad range of industries, particularly high tech industries, capital good and exporters. The authorities should also reinforce their efforts to further lower the cost of doing business, increase the formalization and flexibility of the labor market and continue to play an active role in moving forward the Doha trade liberalization agenda.

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

Mr. Claveranne submitted the following statement:

At the outset, we would like to thank Staff for their excellent report and very interesting set of selected issues papers, as well as Messrs. Nogueira Batista and Mori for their informative buff statement.

The sound macroeconomic framework implemented in Brazil over the past several years has laid the basis for sustained economic growth and fostered macroeconomic stability, the last achievement being the investment grade status granted by two rating agencies this year. We are also pleased to note that the social policies, with implementation of innovative targeted transfer programs that are now replicated in other countries, are also bearing fruit, with a declining trend in poverty. These achievements have taken place against the background of a favorable external environment. Brazil has, however, to confront a gloomier outlook today, with a rebound in inflation and risks of a global slowdown that might affect commodity prices and credit conditions.

Monetary Policy

Like several countries at this juncture, Brazil is facing inflation risks, since inflationary pressures have resurged in the wake of high international food and oil prices. We agree with Messrs. Nogueira

Batista and Mori that “nevertheless, inflation in Brazil is lower than in most emerging market and developing countries” and the flexible exchange rate regime has been instrumental to alleviate inflationary pressures. However, as highlighted by Staff in their detailed analysis of the output gap, different signals also point to some overheating pressures in the economy and we agree with Staff’s conclusion that the positive output gap played a role as well in explaining the rise in core inflation. In this context, the tightening of monetary policy has been appropriate and we encourage the authorities to stand ready for further tightening if necessary, with a view to anchor inflationary expectations. The determination of the Central Bank to keep inflation on target and the credibility it has gained from its implementation of the inflation targeting regime over the past years are both greatly reassuring in this regard.

The rapid credit growth of bank credit to the private sector, and more specifically to consumers, adds to overheating pressures by nourishing domestic demand. Drawing lessons from international comparisons, Staff clearly highlights the potential consequences a rapid credit boom might have on the asset quality of bank portfolios and on the risks of a crunch later on. We thus encourage the authorities to heed the Staff’s recommendations for reviewing, and strengthening if necessary, prudential regulatory and supervisory frameworks. We also see merit in an update of the FSAP, which dates back to 2002, for a comprehensive assessment of the financial sector.

Fiscal Policy

With regard to fiscal policy, we take good note that, after a period of growth in both revenues and current expenditures, the Government recently moved to a less expansionist fiscal stance, by increasing the primary fiscal surplus target. Such a stance aligns fiscal policy with the monetary tightening cycle and will contribute to bring economic activity in line with its potential, all the more appropriate that strong demand growth was feeding inflationary pressures.

Like Staff, we encourage the authorities to take into account structural and cyclical components for budget preparations and revenue forecasts and to adopt a medium-term budgetary framework based on structural revenue, with a view to reduce the impact of the business cycle on public spending. Such a stance is all the more important, given the still very high level of public debt - and will be key if the oil discovery materializes.

Sovereign Wealth Fund

Thanks to the accumulation of international reserves, the authorities have announced their intention to create a sovereign wealth fund. While the process is at an early stage, we would be grateful if the authorities could clarify the objectives of this fund. In any case, we strongly encourage aligning the management of such a Fund with the best practices.

Publication of the Reports

Finally, we hope that the authorities will consent to the publication of the reports. As we have stated on earlier occasions, this publication would contribute to sending positive signals to both domestic and external economic actors, especially in light of the authorities' recognized strong ownership of their economic policies. In our view, promoting greater transparency as regards its relations with the Fund would be a highly rewarding strategy for Brazil.

Mr. Ge and Ms. Lin submitted the following statement:

We thank staff for the comprehensive papers and Messrs Nogueira Batista and Mori for their informative buff.

Prudent macroeconomic policies and buoyant commodity prices have brought substantial rewards for Brazil's economy in recent years, as seen in the fast economic expansion, subdued inflation, and strong external current account balance. However, as robust domestic demand growth outpaces potential growth, the industrial capacity utilization rate has recorded a high of 83 percent, stretching available resources and overheating the economy. The signs of overheating are manifested in the pick-up of inflation, a historically low unemployment rate, and a significant weakening of the current account balance. In the context of soaring food and oil prices, inflationary pressures are likely to remain elevated in the near term, reinforced by the second-round impact of the initial price hikes. Even though the global economic slowdown and unfolding events in the international financial market will undoubtedly cloud Brazil's growth prospects, there is great uncertainty about the extent to which these global conditions will affect commodity prices and Brazil's export strength and future capital inflows. Nevertheless, Brazil has taken advantage of large capital inflows to shore up its foreign reserves buffer within a flexible exchange rate regime. This, combined with improved fundamentals, has convinced us that the economy is now in a better position to weather adverse external shocks than before.

We share staff's view that a key macroeconomic challenge facing the authorities is how to realign domestic demand growth with potential output growth. More importantly, it is better to act sooner rather than later on the grounds that containing domestic demand growth early on increases the degree of flexibility to respond to a deteriorating external environment. On the supply side, the extremely high capacity utilization rate in the industrial sector has clearly revealed bottleneck problems in certain sectors, imposing a straightjacket on potential output growth. In this regard, we applaud the authorities' implementation of the Growth Acceleration Program to strengthen investment in infrastructure. More generally, in sharp contrast with other emerging economies, investment as a percentage of GDP remains low in Brazil despite recent steady increases, leaving room to enhance Brazil's productive capacity through investment and productivity growth.

We commend the authorities' cautious monetary policy, keeping a close eye on economic developments. Judging from the rapid acceleration of the economy and a reversal in the benign price movement, the Central Bank sensibly decided to end its monetary easing cycle in late 2007. The front-loaded characteristic of the April 2008 tightening measure deserves particular credit, although Brazil's heightened inflation still compares favorably with that in most other emerging market economies. It is also encouraging that the National Monetary Council has decided to maintain the inflation target of 4.5 percent and the tolerance band of +-2 percentage points for 2010. This move will inevitably enhance the credibility of the current inflation-targeting framework and help re-anchor inflation expectation in the face of huge upward pressure on domestic prices.

On fiscal policy, given the strong growth in government revenue in recent years and the authorities' proven capacity to keep its budget implementation on track through periodic reviews, we believe that the pre-set fiscal target for the year can be achieved even though a weakening of GDP growth might materialize. Moreover, consistent with tightening monetary policy, the increase in the targeted primary surplus by 0.5 percent GDP is realistic and commendable, withdrawing further incentive from domestic demand growth. The tentative establishment of a SWF would help in de-linking the fiscal surplus from the economic boom and bust cycle while pursuing a higher rate of return on financial investment. However, we concur with staff that SWF resources should not be invested domestically at a time of overheating so as to avoid providing additional impetus to domestic demand and complicating the implementation of macroeconomic policies. Turning to public debt management, owing to the authorities' strenuous efforts, the debt ratio has been put on a declining trajectory. The main vulnerability now lies in the short average maturity of the public debt and the share of bonds linked to short-term interest rates. In light of the accelerated inflation and unfolding events in global financial markets, we sympathize with the authorities on the difficulties involved in lengthening debt maturities and increasing the share of fixed-rate instruments and inflation indexed debt.

On the external front, reflecting demand pressures and a strong currency, the external current account balance has weakened significantly, turning negative for the first time since 2002. The deterioration in the current account was more than offset by massive capital inflows, which are now subject to high uncertainty, necessitating close monitoring from the authorities. On one hand, the recent promotion to investment grade, underpinned by improved fundamentals, could attract resurgent capital inflows, adding to already high pressures on currency appreciation and further boosting domestic demand. On the other hand, liquidity drain and rising risk aversion in the international financial market might spill over to Brazil by reducing capital inflows, of which a sudden stop could give rise to a balance of payments financing need. Against this backdrop, it does not appear to be the right time to consider further liberalizing the capital account and expediting progress toward full convertibility of the real without all sound domestic institutions well in place. International experience indicates the sequencing and pace of capital account liberalization has substantial consequences for its success. Moreover, management of the capital account depends on the overall incentive structure for such flows, with the configuration of interest and exchange rates as well as the stage of development of the domestic financial system being of critical importance. As such, we favor the authorities' policy to proceed with capital account liberalization in a more gradual and cautious manner.

Brazil's financial sector remains well capitalized and profitable overall. However, the 30 percent growth rate of credit has raised concerns over a relaxation in lending standards, which in turn could undermine the quality of banks' portfolios and lead to rising NPLs. Specific attention should be paid to consumer credit and mortgage lending, sectors experiencing fast expansion, albeit with their NPL ratios currently at a low level. We are reassured by the authorities' awareness of these risks and that they have already taken steps to strengthen the supervisory framework, including moving towards Basel II and developing a prudential framework for credit risk. Drawing lessons from recent financial turbulence in advanced economies, the authorities attach great importance to enhancing liquidity oversight, requiring banks to hold relatively large reserve requirements and government bonds to counter liquidity problems.

With these remarks, we wish the authorities all the best in their future endeavors.

Mr. Gakunu and Mr. Mwanawina submitted the following statement:

We thank staff for their comprehensive set of papers and Mr. Nogueira Batista and Mr. Mori for their informative buff statement. We are in general agreement with the staff assessment and make the following comments for emphasis.

We commend the Brazilian authorities for sustained strong economic growth, which is reflective of the authorities' continued implementation of sound macroeconomic policies, supported by favorable external conditions. It is encouraging to note that there has been good progress in reducing poverty, and that social indicators have improved markedly. The level of investment is high and productivity growth has increased significantly, underpinned by fiscal and monetary stimulus, rapid credit expansion and strong labor income growth. Although inflation is low, high domestic demand in comparison to potential output and rising energy and food prices are exerting inflationary pressure. The external current account balance has weakened. Notwithstanding the overall good economic performance, we see the key challenges faced by the authorities as the need to expand the fiscal space, further reduce poverty, improve financial sector oversight, and enhance the export competitiveness.

We commend the authorities' efforts towards poverty reduction by adopting appropriate social policies and creating employment opportunities. While agreeing with staff on using a combination of tighter fiscal and monetary policies as a means of containing the inflationary pressure, we would also encourage the authorities to do it in such a way as not to constrain priority productive investment, which is important to ensure high growth and thereby provide a much firmer basis for efforts to reduce poverty.

We note the moderate improvement in revenue generation which has been matched by increased spending in 2007. Also, the primary budget surplus envisaged for 2008, as a consequence of ad hoc tax increases and some expenditure restraints, is to be offset by reductions in fuel taxes, sectoral tax alleviation measures and pickup in expenditures for the remainder of the year. Nonetheless, we support and encourage efforts aimed at enhancing the fiscal space by reducing the distortions and simplifying the tax system as well as the adoption of measures in support of investment, exports and growth in output.

We welcome the establishment of the Brazilian Sovereign Fund and concur that the surplus revenue should be made to play a counter-cyclical role in a transparent and accountable manner. It may also be desirable to consider using the surplus revenue to finance high priority projects in support of poverty reduction in a manner that does not threaten macroeconomic stability or the debt dynamics. In this regard, we applaud the authorities' commitment and efforts to lower the high debt ratios and continued adherence and enforcement of the fiscal responsibility law as a means of ensuring debt sustainability.

We note that the financial sector is sound. Nonetheless, given the expansion in credit, we agree with staff analysis that this may reflect deepening of credit as well as deteriorating credit conditions in certain segments of the market, as reflected by the elevation of nonperforming consumer loans. We support efforts aimed at strengthening the financial sector, including intensified prudential oversight by enhancing the regulatory and supervisory framework aimed at improving the efficiency and effectiveness of the sector.

While we welcome the authorities' efforts to build foreign reserves, there is need to exercise caution in order to avoid overvaluation of the exchange rate, which could have detrimental impact on export competitiveness and encourage the authorities to put priority on smoothening excessive volatility. Further, we support trade liberalization efforts and the policy to gradually and cautiously liberalize the capital account, which is also in line with the recommendations of the staff research paper on “Structural Reforms and Economic Performance in Advanced and Developing Countries” as observed by Mr. Nogueira Batista and Mr. Mori in their buff statement.

We welcome and support efforts aimed at deepening the structural reform agenda, such as reforms aimed at expanding fiscal space and improving the competitiveness of the private sector--reforming the indirect and direct tax system and pressing ahead with investment in infrastructure. We, therefore, support the continued implementation of the Growth Acceleration Program. We further encourage the authorities to target support for small scale enterprises as a direct mechanism of reducing poverty.

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

Mr. Stein and Mr. Brinkmann submitted the following statement:

We thank the staff for a set of high-quality papers and Mr. Nogueira Batista and Mr. Mori for their insightful buff statement. We broadly concur with the staff’s assessment and recommendations. Prudent macroeconomic policies, including a skillful debt management and a favorable external environment have resulted in a robust economic expansion, higher investment, strong employment growth, a decline in poverty, and much improved resilience to external shocks. Against this background, the recent upgrade of Brazil’s sovereign debt rating to investment grade is not surprising and acknowledges the strengthened debt repayment capacity. More recently, however, signs of overheating have emerged, including very high capacity utilization, rising inflation, rapid credit expansion and a weakening current account position. Hence, going forward, it will be key to safeguard macroeconomic and financial stability through tightened monetary and fiscal policies and, if need be, through adjustments in the financial supervision framework. Moreover, advancing the structural reform agenda, further raising labor productivity through skill improvements, and enhancing public infrastructure will be crucial for further boosting private investment, increasing the country’s growth potential and making continuous progress in poverty reduction.

We fully support the staff's view that early and decisive hikes in the policy interest rate are warranted to contain domestic demand and inflationary pressures. In this respect, the Central Bank's recent monetary tightening and its firm commitment to price stability are commendable. Given that the inflation rate is above the midpoint of the target range, core inflation as well as inflation expectations are also rising, and additional price pressures from the adjustment of administered prices can be expected in 2009, further interest hikes will most likely be required in the future.

A tight fiscal stance will be necessary to support monetary policy in generating the required adjustment in domestic demand. Thus, we are pleased to note that the authorities have raised the primary surplus target to 4.3 percent of GDP. Given the need to safeguard much-needed public investment, as foreseen in the Growth Acceleration Program (PAC), current spending, in particular fast growing wages and pension, should be the focal point of the efforts to restrain public expenditure growth. In this context, there seems to be an urgent need to reform the social security and pension systems. Also, given cyclical and "one-off" factors in past years' revenue growth, as indicated in the selected issues paper, a prudent fiscal stance appears warranted. At the same time, the authorities' comprehensive tax reform package is welcome as it promises to yield significant gains in tax efficiency.

The planned creation of the Brazilian Sovereign Fund (FSB) will require careful consideration and preparatory work. Clarity and transparency about objectives and institutional design are key to ensuring its efficient operation. Like the staff, we caution against procyclical demand impulses stemming from the FSB's operations. Moreover, we wonder whether reducing the still large stock of public debt would not be preferable from an economic point of view. Staff's comments would be welcome.

The authorities have taken advantage of buoyant capital inflows and accumulated a comfortable stock of international reserves. At the same time, the ongoing appreciation of the Brazilian real has been helpful in mitigating inflationary pressures, thus supporting monetary policy. Hence, despite its slight overvaluation, the benefits of the strong real, including the underlying favorable terms of trade development in recent years, seem to outweigh its cost. At the same time, we note that export volume growth has diminished recently and we would very much welcome additional information about the competitiveness of the Brazilian export sector. While competitiveness can certainly be strengthened by addressing infrastructure bottlenecks and further enhancing the business environment, we caution against granting tax benefits to some sectors of the economy as this might have distortionary effects on investment and production.

The rapid expansion of domestic credit associated with strong capital inflows requires close supervision in order to safeguard financial sector stability. As identified by the staff, strengthening the monitoring of banks' risk management, liquidity position, and credit policies appears particularly crucial. Against this backdrop, we encourage the authorities to agree to a timely update of the 2002 FSAP.

We encourage the authorities to consent to the publication of the staff report.

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

The staff report testifies to the remarkable progress made by Brazil in recent years. A well-articulated and consistently executed macroeconomic policy framework and a very favorable external environment have helped deliver strong economic growth combined with low inflation, while reducing the economy's vulnerabilities and strengthening its ability to withstand external shocks, including the ongoing turbulence of global financial markets. The framework has relied on a strong fiscal posture, as reflected in the maintenance of large primary surpluses, and a monetary policy anchored to an inflation targeting regime with a flexible exchange rate. Social policies, including a well-targeted safety net for low-income families, and strong employment growth have helped achieve a marked decline in poverty. Under the circumstances, the recent upgrade of Brazil's sovereign debt rating to investment grade does not come as a surprise.

How this combination of optimal outcomes can be sustained in a context of signs of overheating and less favorable external environment is the main challenge that the authorities should now confront. In the domestic sphere, the basic issue is to bring domestic demand growth in line with potential output growth in order to prevent overheating and unhinging inflation expectations in the wake of the sharp rise in food and fuel prices. On the external side, the challenge is to manage massive capital inflows in ways that do not impair the competitiveness of the economy, such as through an unwarranted appreciation of the real, or otherwise weaken the credibility of the external policy objectives (in terms of current account balance or the net debt-to-GDP ratio) that the authorities have steadily pursued in the aftermath of the payments crisis at the turn of the century. In both spheres, the authorities have undertaken measures that are generally aligned with positions advocated by the staff, albeit there remain some areas of divergence mentioned in the insightful statement of Messrs Nogueira Batista and Mori.

A tightening of the fiscal stance is reflected in the decision to increase the target for the primary surplus from 3.8 percent to 4.3 percent of GDP for 2008 and to allow the overall consolidated fiscal deficit to decline from 2.3 percent at end-2007 to 1.7 percent in the 12 months ending May 2008. Whether this declining trend could be maintained during the rest of the year and beyond depends on the revenue outturn in the face of likely weakening of economic activity and the non-renewal of the bank debit tax by Congress. We are reassured, however, by the high tax buoyancy, supported by ad hoc tax increases and expenditure restraint and the intention to keep expenditure under control by a periodic review of revenue and expenditure throughout the fiscal year. The authorities' ongoing work on elements of a medium-term budgetary framework, as indicated by Messrs Nogueira Batista and Mori, is encouraging. A slight difference of views emerges on the funding of the overall deficit. The staff "encourage the authorities to take advantage of relatively benign conditions in world markets to pre-finance domestic debt" that matures during the year; we are inclined to support the view expressed by Messrs Batista and Mori that "external debt is not a substitute for domestic debt," if only for the additional foreign exchange risk associated with the former.

The fiscal policy instrument is being supported by a reversal of the monetary easing pursued from 2005 onwards; the policy rate has been raised by 100 basis points to 12 ¼ percent. While the inflation forecast by the Central Bank for end-2008 has been projected at 6 percent and with a moderate chance that the rate could breach the 6.5 ceiling of the inflation target range, the National Monetary Council has announced that the end-2010 inflation target would be kept unchanged at the level set in 2006, reflecting the authorities' determination to keep inflation within well-established bounds.

However, for this target to be reached, the global intensification in inflationary pressures may force a further raising of the policy rate, thereby renewing the dilemma posed by large-scale capital inflows in Brazil and other emerging market economies. Estimates of the real effective exchange rate point to an appreciation ranging from 4 to 13 percent. By aggravating the already high interest rate differential, an increase in the policy interest rate may result in additional upward pressure on the real; this might not be burdensome in a period of high prices for commodities exported by Brazil, but may begin to impair competitiveness if global cyclical conditions turn adverse.

Alternatively, the authorities may have to intervene in exchange markets to brake the appreciation tendency, requiring a build-up of foreign exchange reserves and either creating additional monetary expansion or calling for sterilization operations that push domestic rates still higher. Messrs Batista and Mori are cognizant of the rapid expansion of credit to domestic borrowers that is already underway and its disruptive effects when associated with large capital inflows. The staff report notes that the authorities consider that raising transaction costs, such as through higher rates for the IOF tax, would be desirable to help limit upward pressure on the real in the near term, although the staff indicate that investors may have been able to circumvent the IOF tax through the derivatives market. The staff propose a partial solution through a further liberalization of the capital account and moving towards full convertibility of the real, but this is not acceptable to the authorities who would prefer to move "gradually and cautiously" and would like the process to be "implemented following an adequate sequencing of liberalizing policy, domestic first and then the external capital account." We support the authorities' argument, which is in line with the conclusions of the recent informal Board discussion on structural reforms and economic performance. Since the authorities also implicitly reject the alternative of capital controls advocated by some affected domestic sectors, Messrs Batista and Mori rightly call this "an unresolved problem with no straightforward answer of how to better address the effects of large capital inflows into the domestic economy."

Mr. Warjiyo and Mr. Eng submitted the following statement:

We thank the staff for the well-written reports and Messrs. Nogueira Batista and Mori for their insightful buff statement.

Brazil's macroeconomic performance continues to impress, thanks in large part to the authorities' strong fiscal discipline and commitment to the inflation-targeting regime. Despite a less favorable global environment in 2007, the sustained and robust economic growth and employment creation in recent years have led to improvement in the social indicators and a strengthening of the overall external position. Inflation, while creeping upwards, is below most other emerging markets. We commend the authorities for these achievements.

Monetary and Exchange Rate Policy

Against a backdrop of high and rising energy and food prices and strong domestic demand, inflation has remained relatively well-behaved thus far. This reflects to a large degree the credibility of the inflation-targeting regime built over the years. We share Mr. Shaalan and Ms. Riad's point that the credibility of the regime could have been seriously impaired if the authorities had followed the staff's advice last year to lower their inflation target and narrow the target band. While it was not possible to have anticipated ex ante the extent of the exogenous shocks, this nevertheless underscores the need for staff to be more judicious when providing policy advice to the authorities.

Given that the lags of monetary policy, we support the authorities' decisive move to be pre-emptive in their monetary policy response to anchor inflation expectations before it becomes entrenched. However, given that this would put further upward pressure on the real – which has already appreciated significantly in recent quarters and is in staff's assessment overvalued by some 10 percent – allowing fiscal policy to play a greater role would seem desirable. In particular, there appears to be scope to rein in current expenditures which have posted double-digit growth over the last few years. Moderating the pace of real appreciation would be helpful to prevent a further erosion of export competitiveness. Foreign exchange intervention could be used judiciously to avoid disorderly adjustments in the exchange rate.

We strongly support the authorities' policy to liberalize the capital account gradually and cautiously. As Messrs. Silva-Ruete and Pereira aptly put it, "more is not necessarily better", especially against the backdrop of volatile financial market conditions. Further liberalization of the capital account and full convertibility of the real should be properly sequenced and preceded by a strengthening of prudential controls.

We note the authorities' view that Brazil's exchange rate regime is both de jure and de facto an independent float given recent developments. We were somewhat surprised that staff would only revisit the classification "in the context of the upcoming revision of the Fund's exchange rate classification system" since we just had exchange rate regimes for a number of countries being reclassified in recent Board meetings. We are not a great fan of the existing classification system, or the new proposed one for that matter. In fact, we have serious doubts on the usefulness of frequent reclassification of exchange rate regime. We prefer to discuss the appropriateness of the exchange rate policies, given the de jure classification adopted by a country, in the overall setting of macroeconomic policies for securing both domestic and external stability. In this regard, we view that the flexibility of exchange rate has played an appropriate role in supporting the front-loading of the monetary policy response and strong fiscal discipline for maintaining macroeconomic stability in Brazil.

Fiscal Policy

We note that the authorities have increased its target for 2008 to 4.3 percent of GDP from 3.8 percent. While this appears somewhat ambitions given the scheduled increase in expenditures in the second half of 2008 and possibly less buoyant revenues as the economy slows, we are nonetheless cautiously optimistic that the authorities would be able to achieve their target, if their past record is anything to go by.

Financial Sector

The financial sector has shown admirable resilience to the global financial turmoil. This can be attributed to the increased depth and breadth of the financial markets and a sound prudential framework. With its substantial buffers, the banking sector appears well placed to absorb potential losses in the event of a significant deterioration in market conditions. Nevertheless, rapid credit growth calls for added vigilance and proactive policies to head off emerging vulnerabilities. In this regard, we welcome the measures introduced by the authorities to reinforce the prudential framework. More generally, we would encourage the authorities to capitalize on their position of strength to accelerate the necessary reforms to further fortify the financial system. An FSAP update would be helpful to that end.

Finally, on staff's recommendation of jointly considering the liquidity requirements of investment funds and their related banks, could staff elaborate on the basis for this recommendation and whether this is usual international practice? We are surprised with the staff reported that the authorities had agreed, when Messrs. Nogueira Batista and Mori in their buff statement, said the authorities considered it strange to set such a requirement. We would appreciate further insights into the staff's thinking on this issue and why the authorities' views were not represented accurately.

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

Mr. Rojas and Ms. Mira submitted the following statement:

We thank staff for a very useful set of papers and Mr. Nogueira Batista and Mr. Mori for their insightful buff statement. We commend the Brazilian authorities for their skilful management of macroeconomic policies, which, together with a favorable external environment, have resulted in an improved and strengthened position for the country. Growth has been high, fiscal policy prudent, and inflation thus far contained (though it is now rising). Indeed, Brazil has reduced its vulnerabilities and is currently in a much stronger position. Furthermore, social policies have been effective and, together with a decline in unemployment, have contributed to a decline in poverty.

Nonetheless, the deterioration in the international environment, with high energy and food prices and the financial turmoil still unwinding, is bringing new challenges for Brazil. Looking forward, we concur with staff that the potential further worsening of the external environment is the key risk to the positive outlook.

We acknowledge the overheating concerns highlighted by staff. Given the swift growth of domestic demand above potential output growth, we agree that it is key to moderate domestic demand to contain inflation and reduce upwards pressures on the real. The policy mix recommended to achieve this aim—both fiscal and monetary tightening—is adequate. Nonetheless, we would like to make the following comments regarding staff's advice about their implementation:

- On the fiscal front, the primary fiscal surplus achieved, which has even exceeded the target, is welcomed. Both staff and authorities agree that it is desirable to increase the primary fiscal surplus target. The authorities have shown a strong commitment in this direction, with the recent announcement by the Government of a target increase of 0.5 p.p. of GDP, to 4.3 percent, as stated by Mr. Nogueira Batista and Mr. Mori. Additionally, one of the missions that will be granted to the envisaged Brazilian Sovereign Fund would be to improve fiscal discipline. We share staff's suggestion to contain current spending growth, while preserving priority investment.

Nonetheless, in a context of an expected growth slowdown, there is a significant degree of uncertainty about which should be the appropriate surplus target, and to what extent such surplus would contribute to cooling the economy. Therefore, we believe that it might have been useful to discuss and provide some guidance about which primary surplus target would be appropriate and consistent with the need to restrain demand and thus reduce inflationary pressures.

On monetary policy, the tightening already under way is appropriate, and will contribute to anchoring expectations. It is suggested to implement the contraction exclusively through the tightening of the short-term policy rate (Selic). Nonetheless, we have some concerns about the effectiveness of this single instrument:

- On the one hand, Brazil is experiencing a process of significant deepening of its financial sector, with a very considerable increase in credit to the private sector, growing at an annual rate of about 30 percent. Such structural change may hamper the transmission of monetary policy, increasing the transmission lags from the policy to the market rate. At the same time, the increase in the policy rates may lead to further upwards pressures on the exchange rate. In such a context, we wonder whether a combination of different monetary policy instruments could be considered, including increases in the reserve requirements or other regulatory measures. We understand that the increase in reserve requirements, already high, may also have drawbacks; we would welcome an appraisal of the advantages and disadvantages of these alternatives.

- Furthermore, directed lending (which amounts to around 30 percent of total lending) is not related to the short-term interest rate. A significant part of this lending is linked to the long-term policy rate, quarterly determined by the National Monetary Council (at 6.25 percent, with no changes in the last five quarters). Under the current circumstances, maybe the authorities could consider whether movements in the long-term policy rate should accompany and support movements in the short-term rate.

On the exchange rate policy, we tend to concur with the authorities that short-term capital inflows can be destabilizing at this stage and that temporary measures to increase transaction costs—if effective and not circumvented—might be appropriate.

We welcome the progress achieved on public debt management, which has been prudent and has significantly reduced Brazil's net debt to GDP ratio. We also commend authorities for their intention to further lengthen maturities and issue more fixed-rate and inflation-indexed debt. Staff recommends the authorities to consider the refinancing of the R$400 billion domestic debt that matures this year, taking advantage of the still positive market conditions. Nonetheless, we learn from Mr. Nogueira Batista and Mr. Mori that this is not an option, since "foreign resources cannot be used to amortize domestic debt." Has staff explored with the authorities the possibility of making use of the strong revenue growth and sound fiscal position to repurchase such debt, and the consequences of such operation in the medium term?

On the financial sector, we find reassuring that the prudential framework is sound, and share staff's suggestions to be proactive and further enhance the resilience of the system, improving liquidity oversight and credit risk policies. We are also reassured by Mr. Nogueira Batista and Mr. Mori's statement that the supervisory and regulatory authorities are carefully monitoring the rapid credit expansion and are ready to take action to contain excesses. Staff claims that investment funds may pose risks for banks, and thus recommends them to consider jointly their liquidity requirements. We would like staff to further elaborate on the risks they believe that these funds entail for banks.

Finally, we welcome the authorities' commitment to improve infrastructure and remove bottlenecks through their Growth Acceleration Program (PAC). We are reassured and support the increase in investment, both private and public, and the measures to improve the business environment, to ensure medium and long-term growth prospects are enhanced.

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

We thank staff for a set of interesting papers on Brazil. We were particularly pleased by the choice of topics for the selected issues paper with analytical chapters supporting key policy recommendations. Reevaluation of potential growth was important to highlight the risks of overheating in Brazil. Given the importance of fiscal policy under the current circumstances, it was important to try to distinguish between permanent and temporary improvements in revenue collection. We also commend staff for their continuing close attention to the financial sector in two additional chapters. Pick up in credit growth certainly calls for the authorities' heightened attention to the strength of the banking sector. Also, continuing capital inflows, currency appreciation, and current account moving into the deficit territory, as well as Brazil's previous episodes of financial turmoil, made the last SIP chapter particularly relevant to vulnerability analysis. We hope that staff working on other emerging market economies will also benefit from the high quality of surveillance documents on Brazil.

We congratulate the authorities on better than expected real GDP growth of 5.4 percent. Continuing growth in private investment with the public sector's contribution remaining essentially stable bodes well for the sustainability of economic growth. While favorable developments in terms of trade did contribute to this good performance, the Brazilian authorities deserve credit for prudent macroeconomic policies and their efforts to advance structural reforms.

On the inflation front Brazil looks better than many of its emerging market peers. Inflation expectations still seem to be within the inflation target range. We agree with Mr. Shaalan and Ms. Riad that the authorities' prior decision to maintain a broader target range for inflation given the likelihood of a pick-up in price volatility was a wise step. The BCB's clear communications about current price developments and risks to inflation combined with preemptive monetary tightening are likely to further strengthen its credibility. We note, however, that low inflation in Brazil benefited from the ongoing currency appreciation, and is also a result of slow pace of adjustments in administered prices (Box 2). Hence, we agree with staff that the cyclical position of the economy and the developments in the external sector are likely to complicate the conduct of monetary policy going forward. In this situation we welcome the authorities' focus on an appropriate policy mix.

The authorities' decision to increase fiscal primary surplus to 4.3 percent of GDP, as noted by Mr. Nogueira Batista and Mr. Mori, was in line with staff's recommendations. In the structural area, the tax reform, if successful, will be a significant step forward. The need for such a reform had been articulated by staff a long time ago, but it was an extremely complex political undertaking for the authorities. We also hope that the success of the tax reform will pave the way for other improvements in the fiscal area, including tackling the rigidities in the budget and the social security reform.

Macroeconomic tightening may well attract additional capital inflows, and we agree with Mr. Nogueira Batista and Mr. Mori on the associated policy challenges. The authorities have already introduced additional measures to strengthen prudential framework and supervision of the financial sector, and are proactive in this area. However, we also agree with staff that it would be useful at this juncture to review key institutional arrangements in the financial sector, and the FSAP update could be a way to stimulate this work.

With these remarks, we wish the Brazilian authorities success.

Mr. Kishore and Mr. Dheerasinghe submitted the following statement:

We thank staff for the very comprehensive and well focused set of papers and Mr. Nogueira Batista and Mr. Mori for their elaborate buff statement.

We commend Brazilian authorities for increasingly improved performance of the economy in recent years, attributable to prudent macro-economic policies and management, supported by favorable external conditions. The strong external sector performance in particular has enabled the resilience of Brazilian economy to the prevailing adverse global financial environment. A noteworthy development is also evident in the management of public debt since recent times as indicated by public debt to GDP ratio, extended duration of public debt maturity structure and a significant reduction of foreign currency denominated debt, which, inter alia has lowered the foreign currency exposure of the financial sector balance sheet to a significant extent.

In addressing the issue relating to mismatch of domestic demand growth and potential output growth, a delicate balance needs to be maintained in containing the domestic demand growth whilst ensuring that the desired output growth is not hindered. The mix of policy response in terms of tightening monetary policy and curtailing public spending needs to be carefully designed, in view of both global and domestic developments. The initiative of the authorities for raising the primary surplus to the level that prevailed prior to 2006 is encouraging though we are doubtful whether or not this instrument alone would be sufficient. Fiscal tightening will also help in reducing the extent of adjustment required in policy interest rate to reduce the inflationary momentum as the two instruments are complimentary to each other. We, however, recognize the fact that the current inflation in Brazil is lower than that in many emerging market countries.

We note the recent positive trends in the Brazilian capital markets, particularly the developments in the debt securities market. In view of the multifaceted risks associated with instruments such as those in derivatives markets, we wish to emphasize the need for capacity building in risk management, and surveillance in order to meet emerging challenges of supervision and regularization.

We are encouraged by the macro financial soundness indicators of the banking system in Brazil. We note that Brazil is moving towards Basel II and simplified standard approach will be adopted by all banks in July 2008. The new format may result in changes to recognition, valuation and reporting of data and perhaps some indicators such as capital adequacy ratios are subject to change resulting in a situation of increased capitalization of at least some banks. We also note from the buff Statement of Mr. Batista and Mr. More that Brazilian accounting rules are stricter than IAS 39. In this context we wish to know whether staff has made an assessment between applicable Brazilian accounting rules and IFRS relating to financial instruments.

With these comments we wish Brazilian authorities all success in their endeavors.

Mr. Bergo and Mr. Hukka submitted the following statement:

We thank staff for their set of reports and Messrs. Nogueira Batista and Mori for their insightful buff. With the strong economic performance in recent years, Brazil has started to gather reputation as being a regional example of the benefits of maintaining a framework of sound macroeconomic policies. With the economy simultaneously facing the dangers of overheating and a global economic slowdown, it has become even more important to extend this good track record. At the same time, the economy's growth potential needs to be developed further as various capacity constraints have recently started to show.

The risk of overheating warrants close coordination of monetary and fiscal policies. We note Brazil's impressive track record in policy management and take their decision to raise the fiscal target to 4.3 percent as a strong sign of their continued commitment to keep the course. Nonetheless, in light of expenditure pressures toward the end of the year and the cyclical component in the recent strong revenue performance, we stress caution in regard to the 2009 revenue and expenditure projections and the need to avoid slippages that would excessively push the burden of containing inflation on monetary policy. A medium-term budget framework would have merits in this respect. Expenditure moderation is especially important to retain room for flexibility against the risks of a more protracted global slowdown or a downturn in commodity prices.

In the longer term, Brazil's prospects hinge on its ability to continue extending its growth capacity. Investment, while having risen in recent years, remains quite low. The authorities' efforts to scale up public investment in the context of the Growth Acceleration Program are encouraging. On the other hand, we also take note of staff's remark that some of the current spending could have been used to increase infrastructure investment. We wonder, however, to what extent such efforts might have been limited by the public investment capacity constraints that, according to the report, the authorities are actively trying to address? Like staff, we also see merit in encouraging greater private sector participation through concessions and public-private partnership arrangements.

In other areas, the authorities' reform record is commendable. The success of the Bolsa Familia cash transfer program in reducing poverty rates and the progress with the comprehensive VAT tax reforms both at federal and state levels deserve recognition. We further note that the authorities are also cognizant of the pending agenda of further reforms in regard to reducing budgetary rigidities and improving the long-term sustainability of public finances.

We agree with the merits of further liberalizing the capital account while deepening structural reforms. However, we have sympathies to the authorities' position, as explained by Messrs. Nogueira Batista and Mori in their buff, that the liberalization needs to be carefully sequenced and preceded by a strengthening of the prudential framework.

We wonder the prudence of using a primary fiscal surplus to fund the planned FSP sovereign wealth fund in light of Brazil's relatively high public debt and notable infrastructure development needs. It is also unclear to us what purpose the fund would have. We would strongly advice the authorities to clearly define the objectives of the fund before proceeding to define its modalities – a multitude of objectives is often a recipe for achieving none. We would also warn against establishing a fund disconnected from the ordinary budget and its priorities.

Were the FSP established, there should be clear and publicly disclosed rules with regard to its funding, withdrawal and spending. We take heart of the authorities' assurance that the governance of the Fund would be underpinned by a clear set of rules.

The Brazilian financial sector has withstood the global market turmoil rather well and the regulatory and supervisory frameworks appear generally sound. Like staff, we encourage the authorities to maintain their proactive approach and address the remaining potential vulnerabilities while times are good. An update to the 2002 FSAP could be helpful in this regard. Especially the rapid private sector credit growth continues to warrant close attention. We are pleased to note the authorities' intentions to keep reinforcing the prudential framework for credit risk as noted by Messrs. Nogueira Batista and Mori.

We commend the Brazilian authorities for the leadership they have shown in the Doha Round negotiations. We encourage them to continue to show flexibility that is required from all parties to bring the negotiation round to a successful conclusion.

Finally, we encourage the authorities to consent to the publication of the staff report and wish them luck with their future endeavors.

Mr. Yamaoka and Mr. Nozaki submitted the following statement:

We thank the staff for a well-written set of papers and Mr. Nogueira Batista and Mr. Mori for their helpful and pointed statement. We praise the authorities for their prudent macroeconomic policies and structural reform efforts.

Overheating Economy and Inflationary Risks

We share the authorities' concern over the overheating economy and mounting inflation risks. Thus, we agree with the authorities that front-loaded monetary tightening would be needed to contain the inflationary momentum and anchor inflation expectations—a task which central banks around the world are struggling with. We also welcome the authorities' intention to exceed the primary surplus target if necessary, and join the staff in recommending a slowdown of current spending growth.

Exchange Rate Issues

The sharp appreciation of the real in recent years, the CGER assessment that the real is overvalued, and the recent deterioration in external current account balance all raise issues regarding export competitiveness. Nevertheless, the appreciation of the real, in the short run, could contribute toward reducing inflationary pressures. Given that the CGER's analysis not only has limitations but also aims at finding an equilibrium level over the medium-term, it would be better to avoid drawing too much on the CGER's analysis when considering short-run policy issues. Against this background, we agree with the staff that recent moderation in the size of foreign exchange interventions is appropriate.

Financial Sector Issues

Although we understand the importance of preventing liquidity shortages in the financial markets, we would like to receive more information on the possible liquidity requirements of investment funds jointly with those of their related banks. Particularly, we would welcome the staff's clarification of the following points:

Since heavier liquidity requirements would inevitably reduce their expected return, the introduction of a joint-based liquidity requirement might encourage investment funds to circumvent this requirement by limiting their relationships with the bank. Such activities might reduce the efficiency of the financial markets and increase risks as a whole. How could the authorities avoid these problems?

In principle, investment funds constitute a scheme in which their assets are insulated from other assets through the utilization of special investment vehicles (SIVs) or other legal frameworks. Investors participate in investment funds as equity holders, evaluating their risks and returns based on insulated assets. Since introducing a joint-based liquidity requirement may, in fact, treat investment funds as quasi-bank deposits, we would like to examine whether this might distort market participant incentives.

In our view, the source of the problem lies in the difference between the high expected rate-of-return in Brazil and the relatively low deposit rates, which would lead investors to prefer investment funds rather than deposits. Under such circumstances, banks have to rely on investment funds for fundraising in order to satisfy buoyant loan demand. In this regard, proceeding to further develop private bond markets would enable borrowers to directly reach investors without accumulating liquidity risks in the banking sector, which would present a more productive option than that of introducing regulations that are difficult to manage. The enhancement of competition in deposit markets, in which deposit rates more vividly reflect market interest rates, is also a policy measure that, over the long run, would benefit the nation's economy and the stability of the financial system.

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

Mr. Murray and Mr. Duggan submitted the following statement:

We thank staff for their very comprehensive papers and Mr. Nogueira Batista and Mr. Mori for their informative buff statement.

Brazil is currently reaping the benefits of previous policy reforms and a supportive external environment. Economic activity has accelerated, supported by a rising terms of trade, growing public and private sector investment and strong capital inflows. Robust income growth has in turn supported the fiscal position. With prices for Brazil's major export commodities expected to remain high for some time, the key short-term risk is the danger of overheating. Mr. Nogueira Batista and Mr. Mori's statement suggests that the authorities are both cognizant of this risk and well-positioned to deal with emerging pressures. The emphasis, therefore, is on ensuring timely and decisive policy responses. We are in broad agreement with the staff appraisal and offer the following comments for emphasis.

To be a credible anchor for inflation expectations, inflation targets must be robust throughout the economic cycle. Therefore, we strongly support the decision by the National Monetary Council to maintain the inflation target of 4½ per cent and the tolerance band of ± 2 per cent. Like staff, we believe that the macroeconomic policy framework would be further strengthened through the introduction of an explicit medium-term fiscal strategy. Designed well, this would provide an anchor for fiscal policy over the course of the economic cycle and compliment the monetary policy target.

Rising domestic inflationary pressures indicate the need for a tight monetary policy stance. The 100 basis point increase in the policy interest rate since April represents decisive action by the central bank, with appreciation of the nominal exchange rate also contributing to a tightening of monetary conditions. Nonetheless, with inflation risks firmly on the upside and real interest rates still relatively low, it would seem that there is both the need and the capacity to raise the policy interest rate further in this cycle. We agree with the authorities on the virtues of front-loading the monetary policy response and note that this accords with financial market expectations.

Tight fiscal policy also has a role to play in reducing aggregate demand pressures. We are encouraged by the increase in the primary fiscal target to 4.3 percent of GDP for 2008, underpinned by buoyant revenue. Relative to the 2007 preliminary outcome, this equates to a modest fiscal tightening - equivalent to about 0.3 per cent of GDP. While this is a move in the right direction, we agree with staff that there is scope for further fiscal tightening at this part of the cycle by restricting growth in current expenditures, including public sector wages.

The strong cyclical position also provides an opportunity to strengthen the structural budget position and undertake broader fiscal reforms. With a public sector interest burden equivalent to 6 per cent of GDP, the first priority should be applying fiscal surpluses to reducing public sector net debt while conditions are favorable. As noted by staff, priority fiscal reforms are discontinuing the practice of revenue ear-marking, reducing mandatory spending, reform of the social security system and addressing inefficiencies in the tax system. In relation to the latter, we strongly support efforts underway to simplify the VAT and encourage the authorities to hold firm against pressures to introduce differentiated tax rates.

With high public sector debt and an elevated tax to GDP ratio, the creation of a sovereign wealth fund strikes us as premature. Based on the information provided in the staff report, we share Mr. Moser and Mr. Jung's concerns regarding the pursuit of outmoded industrial and interventionist policies and staff's view that the FSB should aim at playing a counter-cyclical role. We also support Ms. Lundsager and Mr. Parodi's general point on the design of the FSB being informed by the Generally Accepted Principles and Practices currently being developed by the International Working Group of SWFs.

We are encouraged by staff's finding that the financial sector has weathered the turbulence in global financial markets well. We also note the recent steps taken to strengthen prudential regulation outlined by Mr. Nogueira Batista and Mr. Mori and the positive stress test results referred to in the staff report. Nonetheless, strong credit growth and additional challenges presented by burgeoning capital inflows highlight the need for continued close monitoring of risks. It also strikes us that, in the context of a dynamic economy and rapidly growing financial sector, much has changed since the 2002 FSAP and therefore we strongly encourage the authorities to move forward with an FSAP update. We agree in principle that further capital account liberalization would be beneficial in the long-run; however we also support Mr. Nogueira Batista and Mr. Mori's point on the need for careful sequencing. Again, an FSAP update may assist in identifying the next steps in this regard.

Finally, we wish the authorities every success in their future endeavors.

Mr. Gibbs and Ms. Robinson submitted the following statement:

We thank staff for their report and for a topical set of selected issues papers. We agree with the overall assessment that Brazil has benefited from its adherence to sound fiscal and monetary policy. We also share the view that, on the back of favourable movements in its terms of trade, Brazil has taken welcome steps to reduce its exposure to external shocks. We largely agree with the central recommendation of the staff report, in particular the importance it places on implementing structural reforms and addressing the widening gap between domestic demand growth and potential output growth.

The report identifies the key issues of relevance to external stability. However, we would be grateful if staff could provide more explanation of various conclusions, some of which raise issues of consistency. For example, the report asserts that the real is 'moderately overvalued', but it also raises the need for the real to appreciate in real terms to counter rising inflationary pressures and favourable changes in the terms of trade. Similarly, advice on reconciling the desire to increase fiscal surpluses with the proposed additional expenditure needed for the Growth Acceleration Program, which is behind schedule, was absent from the final appraisal.

We note the authorities' plans to create a Brazilian Sovereign Fund (FSB). Staff's advice in connection with the establishment, and potential benefits, of this Fund appear sensible. But we would emphasize that the foundation of a Sovereign Fund should not be a policy goal in itself, but rather should become a tool for macroeconomic management to control exposure to commodity price cycles.

The report discusses reforms to enhance growth and stability, and acknowledges the criticality of improving infrastructure to support export and production growth. We support this conclusion. The report also highlights plans to develop a new fiscal regime in which a greater shame of oil revenues would go to the federal government. If achieved, this could imply significant revenue benefits, but we would be interested in the extent to which the proposed change in legislation could lead to a reduction in private sector investment in the energy sector.

On exchange rate issues, we broadly agree with the staff's analysis. However, CGER calculations are likely to be highly uncertain for Brazil at present given the uncertainty over the magnitude and persistence of the relative price shock to commodity prices and, therefore, to the equilibrium terms of trade.

Box 2, which deals with the multilateral issue of rising global inflationary pressures, is useful. However, we feel that this analysis could have gone further in relating the risk to Brazil. For instance, it would be useful to have more information on how a global inflation shock might affect world export prices and thus Brazil's terms of trade; and further analysis of how sensitive Brazil's external sector might be to a slowdown in advanced vis-à-vis developing countries' output growth would be pertinent at this juncture.

Extending his remarks, Mr. Nogueira Batista made the following additional statement:

At the time of last year's Article IV for Brazil in mid–2007, the external environment was still favorable. Domestically, GDP growth was gaining momentum and the inflation outlook was benign, with staff seeing some space for reducing interest rates.

As some Directors reminded us in the grays prepared for today's meeting, staff suggested at that time reducing the mid–range inflation target and narrowing the confidence band. Given the large external price shocks we have suffered, I must say I am glad we did not accept that recommendation.

How rapidly the environment has changed, with the increase in food prices, the oil shock, and the turbulence in financial markets on both sides of the Atlantic. Brazil's GDP growth accelerated, but with higher inflation and a deterioration in the current account. Although we have not yet been hit by the financial turbulence, not significantly at least, we have been truly affected by the price shock. As mentioned by Mr. Silva–Ruete and Mr. Pereira, we are still in the middle of this uncertain environment; policy–making therefore is difficult, and we have to follow a prudent approach.

The liberalization of the capital account is a case in point. In this respect, the authorities prefer to be cautious in a world of large cross–border flows and highly leveraged operations. The ongoing events in global markets indicate that such operations can be very disruptive, with adverse consequences for the financial sector and for the economy as a whole, so the suggestion made by staff for full convertibility of the real is another suggestion we will not be accepting, at least for the time being. As we are in unknown territory, we prefer to continue to strengthen the prudential framework and to adopt selective controls or taxes on short–term inflows if necessary.

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

We have already provided bilateral answers to a number of Executive Directors on some of the questions that were raised, and were of a technical nature. Therefore, I would like to focus here just on a few broad issues.

First I would like to present a brief update on growth and domestic demand pressures. With respect to real GDP growth, we continue to work with the projection of 4.9 percent for 2008, which does take into account the moderation that happened in the first quarter of this year. This projection is in line with the central bank projection of 4.8 percent for this year. We see that capacity utilization in the industrial sector remains high, but now seems to be leveling off somewhat. The most recent export data that we have also show a small decline in export volumes, particularly in intermediate goods. It is still too early to know whether this indicates a trend or not. It is also difficult to assess at this stage whether this is associated with the strong domestic demand, whether it reflects the current level of the exchange rate, or if it is associated with the state of the global economy, but this is certainly an area that we are monitoring closely.

Pressures on domestic resources do remain strong. The CPI data for June was released yesterday, after we issued the update statement to the Board. The CPI data shows that the 12 month inflation has now moved up to 6.1 percent on a 12–month basis, with core inflation at 5.4 percent. There are also indications that inflation has been spreading. We use in the staff report a measure of inflation diffusion, which tries to identify within the CPI those items that are above the mid–range of the target band, which is 4.5 percent. We find that 55 percent of the items are now above this level of 4.5 percent, compared with 44 percent of the items at the beginning of this year, which implies that inflation is spreading to more products. As noted in the report, the pressure on resources is also shown in the current account balance, which has moved from equilibrium last year to a deficit of around 1.8 percent in the first half of this year, on current estimates.

One chair raised the question of the sensitivity of the Brazilian economy to a slowdown in global growth. Quantifying this impact is obviously difficult, and would depend in part on the impact that such a slowdown would have on the price of commodities. However, we do mention in the staff report that a 20 percent drop in the terms of trade would temporarily reduce growth in Brazil by about 2 percentage points and initially widen the current account deficit by about 2 percent of GDP.

A related question had to do with the impact of global inflation shocks on Brazil's terms of trade, which is also a complex issue. Brazil's nonoil terms of trade have improved by over 5 percent over the 12–month period that ended in May, and since 2002 the nonoil terms of trade have improved by around 30 percent. Therefore, it is difficult to think that they could improve significantly more.

Turning now to macroeconomic policies, one chair commented that the computation of the output gap is fraught with methodological shortcomings and that its results should be used with caution for policy purposes. We agree with both statements, and we mentioned some of these shortcomings in our assessment. However, several alternative methods of assessing pressure on resources point to the general view that the Brazilian economy is at a level which is very close to potential. Indicators such as inflation or the external current account balance provide a very similar picture. In that context, monetary and fiscal policies are the main tools for the policy response and, as noted by several Directors, the stronger the fiscal stance, the less the need to rely on monetary policy.

There was a related question on the effectiveness of monetary policy in Brazil. On that point, the Brazilian Central Bank has often pointed out, including in its quarterly inflation reports, the various channels through which monetary policy is effective, including credit and expectations. The central bank also estimates lags in monetary policy at around one to three quarters.

With respect to the credit channels, bank intermediation has deepened and increased in recent years. The ratio of bank credit to the private sector is currently equivalent to 36 percent of GDP. This is higher than the average for Latin America, which is around 27 percent. The share of financial sector assets to GDP is 64 percent, which is a relatively high level. At a time when credit to the private sector is running at a 12-month rate of growth of around 33 percent, raising the policy rate, as the central bank has been doing in recent months, is bound to have an impact on domestic demand, with a lag. The reaction of the central bank has been to act early on, by raising interest rates to help anchor expectations and to avoid higher inflation becoming entrenched.

The experience of 2004-2005 remains in the memory of the central bank. During this time, inflation picked up quickly. The central bank reacted effectively and was able to bring inflation under control by tightening monetary policy. Obviously, the central bank is best positioned for the conduct of monetary policy, and future interest rate increases will be largely data dependent, depending on what happens to commodity prices, the state of the global economy, and domestic factors.

A question was raised as to whether the authorities should rely to a greater extent on prudential measures and on reserve requirements. With respect to the prudential framework, the authorities have already adopted several measures, and, as was stated in Mr. Nogueira Batista's buff, they are developing further improvements to the framework, which is welcome.

With respect to reserve requirements, we should recognize that these are generally distortionary, particularly in Brazil where they are already at a very high level. On average, the requirements are equivalent to 30 percent of total deposits. They are also very complex—for instance, for demand deposits the requirements are 53 percent; for savings deposits, 30 percent; for time deposits, 23 percent. The central bank has also been focusing on closing some loopholes that existed on the reserve requirements.

A separate question had to do with the investment funds and their relationships with commercial banks. In recent years, investment funds have grown rapidly, and they now manage assets equivalent to close to 50 percent of GDP. An important number of these funds operate alongside banks and are part of the same financial groups. About one–fifth of their assets, or the equivalent of around 10 percent of GDP, is funding to banks. Therefore, potentially there could be important transmission channels in case of liquidity pressures. At the same time, the liquidity of banks is very high. Given the existence of these linkages between banks and investment funds, we suggested in the staff report that consideration be given to assessing the liquidity of banks jointly with that of their associated investment funds. This would give a more accurate picture of the groups individually and, at the same time, would still show that for the system as a whole, the liquidity position is comfortable. Our proposal was therefore to assess the liquidity of the banks jointly with that of their associated funds. We discussed this point with the central bank, and they agreed that consideration could be given to such an approach.

There was also a related discussion on the issue of banks' reputational risks associated with their affiliated fund. It happens that customers come to a bank to make a deposit, and they can be directed to make the deposit in the investment fund associated with the bank. We have discussed the of reputational risk for the banks with prominent members of the banking community. We found that they were receptive to the idea that such risks should be gradually recognized in the balance sheet of banks, perhaps in the form of higher capital requirements. We also understand from our colleagues in MCM that there is an expectation under pillar 2 of Basel II that national supervisors may at some stage require banks to assess reputational risks and hold capital against these risks. The determination of how this should be done would be left to national supervisors. This is clearly an area in which country practices vary, and the methods to assess and manage the risks are still evolving.

There were also several questions on the sovereign wealth fund that the authorities are planning to create. At this stage, a draft law has just been introduced to Congress, and therefore it is difficult for staff to fully assess this sovereign wealth fund. Presumably, some of its aspects will be changed in Congress. Presumably also we will learn much more about the fund and its workings once the implementing regulations have been issued, which may take a few months. However, we would like to highlight a few points. The first one is that the authorities have reaffirmed to the staff their commitment to maintain public debt on a declining path. The second point is that it is important for the fund to operate in a transparent manner, and the authorities have indicated that this will be the case. They have also told us that they plan to report to Congress every six months on the activity of the fund. The third point is that, although the authorities have assigned several objectives to the fund, they have publicly stated that the main one at this juncture will be to accumulate fiscal savings to help contain inflationary pressures. We believe that this is positive and would be consistent with debt reduction. At this stage, however, we do not have indications as to how the authorities would use the fund to support industrial policies, and we will need to look at the fine print once regulations have been issued.

With respect to the return on the investments of the fund, the objective is to generate a higher return to the Treasury than that generated by foreign reserves. There may also be benefits in terms of currency and country risk diversification of the assets. Finally, with respect to monetary policy, the fund would be positive to the extent that it increases public savings. Staff has also recommended that foreign exchange intervention be closely coordinated with the central bank.

Finally, I would like to turn to fiscal questions that have been raised. The first one was whether the primary surplus is the right fiscal target, since it has led to procyclical fiscal expansion. This is a difficult question. In terms of fiscal objectives, clearly the authorities do report on both the primary surplus and the overall objective, which is to ensure that the public debt ratio is on a declining path. In Brazil, the interest bill of the public sector is large, equivalent to around 6 percent of GDP. It is also volatile, because it depends in part on what happens to domestic interest rates. Therefore, there is a rationale for the government to continue targeting the primary surplus as the principal policy objective, although the discussions the authorities increasingly also focus on the overall balance.

However, it is true that both the primary and the overall balance tend to be procyclical. The difficulty in designing indicators that are adjusted for the cycle is that in some countries it is difficult to clearly identify the cycle. We have a selected issues paper on the cyclicality of revenue, and the components of the cyclicality are not easy to identify. We found, for instance, that the sensitivity of revenue to commodities prices is not easily identifiable. We also found that part of the increase in tax revenue in recent years has been linked to the activity in the financial markets and the capital gains tax.

With respect to the medium and long term, the staff has advised the authorities to develop a framework as a basis for countercyclical policies and as a guide to the level of the fiscal policy anchor. Such a framework would include a series of fiscal and debt indicators and identify the policy objectives of the government over the medium–term.

There was also a question about the authorities' plan for a new fiscal regime in the oil and gas sector and the extent to which this could lead to a reduction in private sector investment in the energy sector. This process is still at a very early stage. Oil fields have been identified offshore, and there is a high probability that the fields that are surrounding those that have already been identified will also have large oil reserves. This is the reason why the government in a first stage decided to suspend the granting of concessions and to use this time to design a new policy with respect to taxation. This appears to be a reasonable approach, given that the probability of finding oil in these areas is high. The authorities want to ensure not only that the design of the taxation for the new fields is done correctly for the government, but also that a significant part of the revenue benefits the entire country, rather than only the state where the fields are located. Thus, developing the design of this fiscal regime will take some time. The Fund is ready to assist the authorities, if needed. The impact on private sector investment will, of course, depend on the specifics of this new regime, but if it is done well, we can expect that both the private sector and the public sector will find it beneficial and that this will help secure the financing for the needed investments, which presumably will be very large.

Finally, there was a question on how tighter financing conditions might affect the authorities' debt management strategy. The tightening in financing conditions has made it more difficult for the authorities to lengthen debt maturity and increase the share of fixed debt more difficult. In recent months, there has been a slight decline in the share of fixed rate debt to total debt, although the stock of inflation–indexed debt has continued to grow. Thus, the impact has been marginal so far. The second point is that, although over the past year spreads have risen on the foreign borrowing, the cost to the large Brazilian companies and to the sovereign has actually declined slightly. Average spreads on Brazilian sovereign debt have increased from around 150 basis points to around 250 basis points over that period. However, at the same time, the U.S. Treasury yields against which the spreads are computed have declined by about 200 basis points. Overall for the government, there has been a decline of about 100 basis points, and for the large private corporations the decline it is around half of that amount, at around 50 basis points. Thus, barring a major worsening in global financial conditions, we believe that there should be no major problem with the financing of the 2008 public sector needs. Also, there are key elements of resilience. I would perhaps note the availability of a good spectrum of debt instruments, the strong fiscal position which has helped Brazil achieve investment grade status this year, and also the good track record in terms of past experience with debt rollover in times of financial turbulence.

Mr. Jung requested the staff's view on whether setting up a sovereign wealth fund would be preferable to using the resources to lower public debt or decrease the tax burden.

Extending his remarks, Mr. Pereira made the following statement:

I would like to thank the staff for the clarifications that have been made regarding one of the main concerns that we expressed in our statement. Given that there is uncertainty about the assessment of the output gaps, what implications should that have for policy recommendations? The Fund's policy recommendation in this case is to tighten monetary policy and to move the economy toward fuller convertibility of the reál. Indeed, the staff recognized some shortcomings. We are glad to hear that in the future a more cautious

> approach could be taken, in terms of recognizing that there are some drawbacks to the methodologies, both the statistical approach and the assessment of economic indicators. We reiterate that we are glad to hear that those constraints are recognized, and that a more cautious approach will be taken in future. We are of the view that the authorities have moved expeditiously in tightening monetary policy, even in meeting the fiscal? target beyond the initial levels, so we did not see the case for a policy recommendation of further tightening.
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> We also would like to point out that to it is important to take into account the less benign external environment, because we have seen that, in Latin America in particular, even with the small economies such as the Dominican Republic, the staff tends to overemphasize specific indicators, such as inflation or the growth in credit. However, strong consideration is not given to assessing the impact of the slowdown of the world economy in these economies, which are susceptible to external shocks. I am not saying that is the case in Brazil, but in general we see that there is an overemphasis on the output gap in all the staff policy recommendations.
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> Secondly, even if a tightening of monetary policy were justified, it is important to be cautious when we couple that policy response with recommendations such as full currency convertibility or full liberalization of the capital account. This is because of the impact of capital inflows on macro stability in our economies. In providing policy advice, it is important to take a more developmental perspective, by looking at the impact on growth. Some policy decisions that may be aimed at enhancing the credibility of the policy framework, may at the same time play a role in amplifying the external shock. We would therefore like to thank the staff for their clarifications, and say that we believe that further work and sharper analysis on the output gap in the economy are required.

The staff representative from the Western Hemisphere Department (Mr. Terrier) clarified that, in the staff's view, the establishment of a sovereign wealth fund was not necessarily inconsistent with reducing the tax burden or the overall objective of reducing public debt. It depended on which assets the fund was permitted to invest in and whether those would influence the net debt concept that Brazil was using. Furthermore, the staff was not calling for a move to full convertibility at this stage. They were instead encouraging the continuation of the gradual process already underway in Brazil.

Mr. Parodi noted that the tax burden in Brazil was quite high. He wondered about the trade-off between the sovereign wealth fund and reducing taxes.

The staff representative from the Western Hemisphere Department (Mr. Terrier) said that the sovereign wealth fund was not necessarily inconsistent with a reduction in taxes because the government was saving resources, which would have a positive impact on net debt. Another option would be to reduce taxation. He also noted that, at the beginning of 2008, the CPMF had been eliminated, which had had a fairly large net impact on tax collection, amounting to over 1 percent of GDP on a net basis and that the sovereign wealth fund was being established concomitantly with a tax cut.

Mr. Nogueira Batista made the following concluding statement:

> We would like to thank staff for their very good reports and papers as well as for the clarifications and updates they supplied today. We are also thankful to Directors for their grays. They will be of course conveyed to Brasilia.
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> First let me answer a question by one chair on the Brazilian sovereign wealth fund, complementing what Mr. Terrier has just explained. Staff has mentioned the main objectives of the sovereign wealth fund in the update, and staff also pointed out that the exact configuration of the fund will only be known later this year when the law is approved by Congress and the regulations issued. For now I would just mention that the fund will be small and, to some extent, is only a preparation for the future. As you know, large offshore and gas fields have recently been discovered in Brazil, and the country may well become a major oil exporter after 2015.
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> Turning to the macroeconomic issues, the Brazilian economy withstood very well the turbulence in financial markets. The last few months have been more difficult. Inflation accelerated, led by food price increases, and the balance of payments on the current account has deteriorated quite rapidly. In fact, as for many other developing countries, the food and fuel price shocks pose a greater challenge than the subprime crisis, so far at least. In our case, this is not because of the balance of payments. Brazil is basically self-sufficient in terms of energy and is a net exporter of food and other commodities. Inflation is the more immediate concern, especially because the external price shocks came at a time when internal demand was increasing rapidly. You have seen the figures for inflation: the consumer price index, as

just mentioned by Mr. Terrier, rose to 6 percent on a 12–month basis in the period ending in June. But I would like to add that a price index based on the consumption of low–income families increased by as much as 9 percent in this same period. In this index, food weighs as much as 40 percent, and that is the background against which the government decided to increase income transfers under the Bolsa Familia by 8 percent on average, as reported by staff in its update.

I must say that Brazil is still performing well in terms of inflation when compared to most other developing countries. In a group of 19 inflation targeting countries that includes both developed and emerging economies, only two are meeting their targets -- Canada and Brazil. Of course, this is due partly to the fact that Brazil has been less ambitious and perhaps more realistic in defining its inflation targeting model than some other countries. Brazil has decided to keep its inflation target for 2009 and 2010 at 4.5 percent, plus or minus 2 percentage points. The central bank now acknowledges that there is a modest chance that inflation could breach the ceiling of the target in 2008, as reported by staff. However, inflation expectations, as captured in surveys of market projections, seem to be reasonably well anchored. Median expected headline inflation is at 4.9 percent for calendar year 2009. This probably reflects the fact that the government reacted promptly to the acceleration of inflation in 2008. The primary surplus target was raised from 3.8 to 4.3 percent of GDP. Basic interest rates have been increased to 12.25 percent. In real terms, deducting expected inflation for the next 12 months, the policy rate is almost 7 percent, probably the highest in the world, as one of the slides shown in this morning's WEO update seems to corroborate. The Brazilian government is monitoring domestic and foreign developments carefully and stands ready to further adjust its policy stance, if necessary, while doing its utmost to preserve economic growth. This is especially important in the case of Brazil, given that recent growth in the range of about 5 percent per year comes after a very long, almost 25–year period of very low growth.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They praised the Brazilian authorities for their strong policy track record which, together with highly supportive external conditions in recent years, has boosted Brazil's economic performance and improved its resilience to adverse external shocks. Brazil is now in a significantly stronger position than in the past to withstand a deterioration in the external environment, as demonstrated by the limited impact that the global financial turmoil has had on Brazil. This has been recognized by the recent upgrade of Brazil's sovereign debt to investment grade status. Directors also praised Brazil's social policies, which have contributed to a significant decline in poverty rates in recent years.

Directors considered that Brazil should contain domestic demand growth, as inflationary pressures have mounted beyond the effects of the global commodity price shocks, and the external current account has shifted rapidly from a surplus to a deficit. Directors welcomed the authorities' strengthening of monetary and fiscal policies, and noted that containing domestic demand early on would enhance policy credibility and increase the degree of flexibility to respond to a possible further deterioration in the global environment.

Directors noted that inflationary developments reflect both the recent commodity price shocks and the strong domestic demand. They stressed that further entrenching the gains of low inflation remains a priority and commended the recent steps taken to raise the policy interest rate, as early and decisive action is critical to help reduce the inflationary momentum and avoid a stronger and more protracted tightening later on. Directors welcomed the authorities' intention to monitor domestic and external developments closely and stand ready to tighten monetary policy further as needed for preserving macroeconomic stability.

Directors noted that fiscal tightening would help alleviate the burden of adjustment on monetary policy. They, therefore, commended the authorities for targeting a higher primary surplus in 2008. Directors considered that containing public spending growth while protecting priority areas would be key to rebalancing the macroeconomic policy mix. In the context of heightened uncertainty about revenue buoyancy, a cautious approach to revenue and expenditure projections for 2009 would also minimize risks to the fiscal outlook.

Directors considered that Brazil's flexible exchange rate regime has served the country well. They observed that the significant appreciation of the *real* has also contributed to containing inflation.

Directors commended the Central Bank for building a comfortable buffer of foreign reserves.

Directors urged the authorities to consider carefully the design and purpose of the Brazilian Sovereign Fund (FSB). They recommended that FSB resources not be used to add directly or indirectly to domestic demand pressures. Directors also considered that the transparency of the operations of the fund would be critical to maintaining confidence in macroeconomic policy, including in the area of foreign exchange operations that need to be closely coordinated with the Central Bank. A number of Directors considered that the surplus resources available would be more appropriately utilized for reducing Brazil's still high level of debt.

With regard to the financial sector, Directors noted that the prudential framework is generally sound. They recognized, however, that it is important to review the framework, and strengthen it where necessary, to limit risk-taking practices usually associated with rapid credit growth, particularly consumer credit. Directors welcomed the measures being taken, as well as those under development by the authorities, to reinforce the prudential framework. In the context of adopting the International Financial Reporting Standards, Directors considered that the existing prudential framework for credit risks should be maintained. Directors noted the staff's finding that the current global financial turmoil has highlighted the need to improve liquidity oversight and lender-of-last-resort facilities, and that work is under way to strengthen the legal foundations of the Central Bank's lender of last resort facilities. In this general context, Directors recommended an FSAP update.

Directors welcomed the authorities' tax reform plan and called for an acceleration and deepening of the structural reform agenda, which would enhance competitiveness and further boost private investment. Some Directors highlighted the importance of measures aimed at reforming the social security system to enhance the long-term fiscal position; improving the business environment; and raising the quality and efficiency of fiscal policy, while a few Directors stressed measures to further liberalize trade and increase the flexibility of labor markets. In this context, they welcomed the authorities' commitment to improve infrastructure and remove bottlenecks in their Growth Acceleration Program. Directors also recommended developing a comprehensive medium-term budgetary framework to guide fiscal policy, limit its current pro-cyclical bias, and protect priority spending during economic downturns.

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

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SHAILENDRA J. ANJARIA
Secretary