IMF Executive Board Concludes 2013 Article IV Consultation with Brazil

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On July 26, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Brazil.[1]

During the last decade, Brazil's strong macroeconomic frameworks have contributed to preserve macroeconomic stability, support robust growth, and underpin sustained poverty reduction. The key pillars of Brazil's macroeconomic frameworks have been the fiscal responsibility law, the inflation targeting regime, and the flexible exchange rate. In addition, a strong prudential framework has underpinned a sound financial sector that withstood well the global financial crisis of 2008–09. The prolonged macroeconomic stability has facilitated the adoption of far-reaching social programs that have produced a remarkable social transformation—in particular, a substantial reduction in poverty and the increase in living standards of large segments of the population.

Brazil's economy is recovering gradually from the slowdown that began in mid-2011. Consumption remained resilient last year underpinned by low unemployment and broad gains in real wages, although it has slowed somewhat more recently. After a protracted period of weakness, investment has begun to recover in recent quarters while business confidence has firmed. With the economy estimated to be operating close to potential, supply-side constraints have restrained near-term growth and exacerbated inflationary pressures. Low unemployment has also contributed to demand-pull and cost-push inflation pressures. End-of-period inflation, the reference measure for inflation-targeting in Brazil, has been below the upper limit of the 4½ ± 2 percent target range for several years; it has been running however in the upper range of the target band, while medium-term inflation expectations have risen above the mid-point target. The authorities have started to focus on alleviating supply-side constraints (including infrastructure bottlenecks) and containing inflationary pressures by tightening monetary policy.

The external current account deficit has widened, reflecting weaker external demand, buoyant consumption and, more recently, a pickup in investment and temporary disruptions in oil production. The real exchange rate depreciated over the last year, most recently as part of a broader realignment across emerging markets. At the same time, unit labor costs in U.S. dollars have remained broadly unchanged, limiting the impact on competitiveness, as the effect of the weaker currency has been offset by rapid growth in real wages and stagnant labor productivity gains. Capital inflows, particularly portfolio flows, subsided in 2012 linked to a weaker growth outlook and lower interest rates in Brazil, and the use of capital flow measures. More recently, global financial volatility and higher global risk aversion have further dampened portfolio inflows to Brazil. Equity prices have declined and corporate debt and equity issuances have slowed, in line with other major emerging markets. Foreign direct investment inflows, however, have remained robust. International reserves have remained broadly stable at a high level following a halt in reserves accumulation since mid-2012.

Financial conditions have tightened but credit growth has remained strong, driven by public banks′ lending. Mortgage lending has continued to grow strongly, but remains a relatively small share of total credit. Real estate prices, though moderating, have continued to increase. The authorities have made progress in implementing key recommendations of the 2012 Financial Sector Assessment Program (FSAP) Update.

Executive Board Assessment

Executive Directors commended the Brazilian authorities for their long-standing commitment to sound policy frameworks, notably the fiscal responsibility law, inflation targeting, the flexible exchange rate, and a strong prudential regime. They noted that these frameworks, together with the implementation of social programs, have underpinned macroeconomic stability and remarkable growth over the past decade, lifting living standards and reducing poverty.

Directors observed that, in addition to headwinds from external conditions, domestic supply-side constraints and policy uncertainties may be holding back near-term growth. A tighter policy stance would help address persistent price pressures, safeguard confidence in policy frameworks, and set the stage for a medium-term rebalancing of demand away from consumption. In this context, Directors welcomed the initiation of a monetary tightening cycle, and agreed that monetary policy should remain geared at containing inflationary pressures and anchoring inflation expectations. They underscored the need for a steady, measured pace of fiscal consolidation, anchored on Brazil′s long-standing primary surplus target. Some Directors saw a continued role for fiscal stimulus as a counter-cyclical tool. More generally, Directors considered that monetary policy should play the main role in aggregate demand management, with fiscal policy focused on rebuilding buffers.

Directors highlighted the importance of adhering to a primary surplus target that places public debt firmly on a downward path. They encouraged efforts to maintain fiscal discipline at the sub-national level, ease budget rigidities to increase public savings, and recognize more fully potential fiscal risks associated with public bank assets and infrastructure concession agreements. Directors also recommended a gradual reduction of policy lending to public banks to improve debt dynamics. A number of Directors considered that a more detailed assessment of Brazil's public debt encompassing net and gross concepts would permit an enhanced interpretation of fiscal developments and prospects.

Directors welcomed the substantial progress in strengthening financial regulation and supervision. They observed that Brazil's banking system is sound and well placed to implement Basel III ahead of schedule. Directors noted nevertheless that some risks, notably those associated with household credit and mortgage loans, warrant ongoing vigilance. They welcomed the progress in implementing most of the recommendations of the recent Financial Sector Assessment Program Update.

Directors concurred that the flexible exchange rate remains the main shock absorber in periods of financial turbulence, and welcomed the authorities' intention to limit interventions in the foreign exchange market to moderating excessive volatility. They agreed that Brazil has an adequate toolkit to deal with capital inflow pressures, by allowing the exchange rate to appreciate somewhat, supported by other policies, including some further temporary reserve accumulation and carefully-considered capital flow management measures.

Directors supported the focus of reforms to ease supply-side constraints, noting that the government's market-based concessions program would boost investment and alleviate infrastructure bottlenecks. They emphasized that comprehensive efforts to boost productivity, competitiveness, and investment are critical for raising potential growth. To this end, it will be important to increase domestic saving, improve the minimum wage indexation mechanism, and continue to reform the pension system. Other efforts to foster private investment should include streamlining taxation and improving business conditions.

Brazil: Basic Data, 2006-2012

	2006	2007	2008	2009	2010	2011	2012
	(Annual percentage changes, unless otherwise indicated)						
National accounts							
GDP at current prices	10.4	12.3	13.9	6.8	16.4	9.9	6.3
GDP at constant prices	4.0	6.1	5.2	-0.3	7.5	2.7	0.9
Private consumption	5.2	6.1	5.7	4.4	6.9	4.1	3.1

Public consumption	2.6	5.1	3.2	3.1	4.2	1.9	3.2
Gross Investment	8.0	15.6	15.6	-17.7	31.1	3.1	-9.0
Exports	5.0	6.2	0.5	-9.1	11.5	4.5	0.5
Imports	18.4	19.9	15.4	-7.6	35.8	9.7	0.2
Prices							
Consumer price index (IPCA, period average)	4.2	3.6	5.7	4.9	5.0	6.6	5.4
Consumer price index (IPCA, end of period)	3.1	4.5	5.9	4.3	5.9	6.5	5.8
GDP deflator	6.1	5.9	8.4	7.1	8.3	7.0	5.4
Terms of trade	5.3	2.1	3.5	-3.2	17.0	7.8	-5.8
	(In percent of GDP)						
Public finances							
Federal government 1/							
Nonfinancial revenue 2/	23.0	23.3	23.6	22.8	24.4	23.9	24.1
Primary expenditure	20.9	21.1	20.6	21.0	22.6	21.6	22.5
Primary balance	2.2	2.2	2.8	1.3	1.8	2.2	1.7
Nonfinancial public sector							
Primary balance	3.3	3.5	4.1	2.2	2.5	3.2	2.1
Net interest payments	6.8	6.1	5.5	5.3	5.2	5.7	4.9
Overall balance	-3.5	-2.7	-1.4	-3.1	-2.7	-2.5	-2.8
Policy lending 3/	-2.3	-2.7	-2.1	3.2	2.7	1.0	1.5
Nonfinancial public sector gross debt 4/	67.0	65.2	63.5	66.8	65.0	64.7	68.0
Public sector net debt 5/	47.3	45.1	38.0	41.5	39.1	36.4	35.2
	(12-month percentage changes, unless otherwise indicated)						
Money and credit							
Base money 6/	12.6	21.8	-17.4	11.3	131.8	10.8	-13.6
Broad money (M2) 7/	18.0	18.7	17.8	16.3	15.8	18.5	16.6

Credit to the private sector	21.7	30.1	28.1	13.7	23.0	20.2	15.8
	(In billions of U.S. dollars, unless otherwise indicated)						
Balance of payments							
Current account	13.6	1.6	-28.2	-24.3	-47.3	-52.5	-54.2
Merchandise trade balance	46.5	40.0	24.8	25.3	20.1	29.8	19.4
Exports	137.8	160.6	197.9	153.0	201.9	256.0	242.6
Imports	-91.4	-120.6	-173.1	-127.7	-181.8	-226.2	-223.2
Services, income, and current transfers (net)	-32.8	-38.5	-53.0	-49.6	-67.4	-82.3	-73.6
Capital and financial account	16.3	89.1	29.3	71.3	99.6	109.4	76.7
Foreign direct investment (net)	-9.4	27.5	24.6	36.0	36.9	76.0	68.1
Portfolio investment (net)	4.3	37.9	3.5	50.5	56.4	31.2	8.2
Other capital (net)	21.3	23.7	1.3	-15.2	6.3	2.2	0.4
Errors and omissions	0.6	-3.2	1.8	-0.3	-3.5	-1.3	3.0
Change in net international reserves	32.0	94.5	13.4	44.7	50.1	63.4	21.1
Current account (in percent of GDP)	1.3	0.1	-1.7	-1.5	-2.2	-2.1	-2.4
Outstanding external debt (in percent of GDP)	15.8	14.1	12.0	12.2	12.0	12.1	14.1
Debt service ratio (in percent of exports of goods and services)	45.4	44.8	24.8	34.2	25.9	23.0	23.6
Gross reserves/short-term external debt (residual maturity, in percent)	100.0	231.3	235.5	314.6	269.8	394.6	474.3

Sources: Central Bank of Brazil; Ministry of Finance; and IMF staff estimates.

1/ Includes the central government, central bank, and social security system.

2/ Excludes proceeds from privatization.

3/ Policy lending to BNDES and other public financial institutions.

4/ Gross non financial public sector debt consolidates debt of public enterprises with that of general government. Unlike the authorities' definition, gross general government debt comprises treasury bills on the central bank balance sheet not used under repurchase agreements.

5/ Includes assets, which mainly comprise international reserves, outstanding liabilities of public financial institutions to the Treasury, financial assets of public enterprises, and assets of the federal labor fund (FAT).

6/ End of period. Currency issued plus required and free reserves on demand deposits held at the central bank.

7/ End of period. Base money plus demand, time and saving deposits

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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