EXECUTIVE BOARD MEETING

SM/20/104
Correction 2

July 23, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **2020 External Sector Report—Chapter 3**

Board Action:	The attached corrections to SM/20/104 (7/8/20) have been provided by the staff:
Evident Ambiguity	**Page 10 (row 2, line 14, and row 8)**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Page 10 (row 2, lines 12 and 13)**
Questions:	Mr. Leigh, RES (ext. 34747) Mr. Adler, RES (ext. 35648) Mr. Rabanal, RES (ext. 36784)

Table 3.4. Brazil: Economy Assessment

Overall Assessment: *The external position in 2019 was moderately weaker than the level implied by medium-term fundamentals and desirable policies.* In the wake of the COVID-19 shock, the CA deficit is projected to narrow in 2020 on account of the currency depreciation and weaker domestic demand.

Potential Policy Responses: If imbalances that existed prior to the COVID-19 outbreak persist in the medium term, efforts to raise national saving remain essential to provide room for a sustainable expansion in investment. Fiscal consolidation, anchored by the federal spending cap, will be needed to boost net public saving. Structural reforms to improve efficiency and reduce the cost of doing business would also help strengthen competitiveness. Foreign exchange intervention, including using derivatives, can be appropriate to alleviate disorderly market conditions in the foreign exchange market.

Foreign Asset and Liability Position and Trajectory	**Background.** Brazil's NIIP was –39.8 percent of GDP at end-2019, weaker than the 2013–18 average (about –29 percent of GDP). At end-2019 external debt accounted for about 37 percent of GDP and 264 percent of exports. At the end of the first quarter of 2020, the negative NIIP had shrunk substantially compared with end-2019 due to a combination of exchange rate valuation effects (assets tend to be in FX, while liabilities are concentrated in local currency) and a fall in domestic equity prices~~volume contraction in portfolio investments~~. **Assessment.** Brazil's NIIP has remained negative since ~~2011~~ the series was first published in 2001. Short-term gross external financing needs are significant, at about 13 percent of projected 2020 GDP, with capital flows and the exchange rate particularly sensitive to global financing conditions.				
2019 (% GDP)	NIIP: –39.8	Gross Assets: 48.6	Res. Assets: 19.4	Gross Liab.: 88.4	Debt Liab.: 23.1
Current Account	**Background.** The CA deficit widened from –2.2 percent of GDP in 2018 to –2.7 in 2019 due to a modest pickup in domestic demand, a slowdown in external demand (exports to key trading partners China and Argentina declined by 2 and 34 percent, respectively), and fairly sizable statistical revisions. Relative to last year's ESR assessment, the CA has been revised to show larger deficits for 2018 and 2019 because of statistical revisions to improve data quality.[1] During January–April 2020, the trade balance declined slightly compared with the same period in 2019 on the back of lower manufacturing exports. Over the year, the IMF staff projects a narrowing in the CA deficit to about –1.7 percent of GDP as the sharp currency depreciation boosts the trade surplus and lower service imports and distribution of profits and dividends reduce the service and income deficits. **Assessment.** In 2019, the cyclically adjusted CA deficit was –3.7 percent of GDP, reflecting a still large negative output gap. EBA estimates suggest a CA norm in 2019 of –2.5 percent of GDP. The IMF staff assesses a CA norm between –2 and –3 percent of GDP. Thus, the CA is assessed to have been moderately weaker than the level implied by fundamentals and desirable policies. The medium-term outlook for the CA is difficult to assess given the unfolding COVID-19 crisis and related policy response.				
2019 (% GDP)	Actual CA: –2.7	Cycl. Adj. CA: –3.7	EBA CA Norm: –2.5	EBA CA Gap: –1.2	Staff Adj.: 0	Staff CA Gap: –1.2
Real Exchange Rate	**Background.** After depreciating by about 8 percent in 2018, the REER (Information Notice System) was broadly stable in 2019, depreciating by 1.9 percent relative to 2018. In 2020 the REER has depreciated sharply. As of May 2020, the REER had depreciated by about 26.8 percent relative to 2019 average. Depreciation pressures have subsided since mid-May, but uncertainty remains high. **Assessment.** Based on the results of the EBA CA balance and the REER index and level methodologies, the IMF staff assesses the REER gap at end-2019 to be in the range of –4 to 11 percent, with a midpoint of 3.5 percent.[2]				
Capital and Financial Accounts: Flows	**Background.** Net FDI has fully financed CA deficits since 2015 (averaging 3.2 percent of GDP during 2015–19, while CA deficits averaged 2 percent), despite net portfolio outflows of (0.6 percent of GDP on average during 2015–19). In early 2020, however, net portfolio outflows accelerated sharply (1.6 percent of GDP in 2020:Q1) before beginning to ease in late April. FDI inflows have been stronger than in the same period in 2019, supported by high intercompany lending, but portfolio equity investment has declined sharply as foreign investors sold off their shares. Sizable external buffers and a new swap line with the US Federal Reserve for US$60 billion provide a comfortable cushion against external shocks. **Assessment.** The high degree of uncertainty about the scarring effects of COVID-19 on the global economy makes it challenging to assess the medium-term prospects for capital flows. A renewed spike in international risk aversion, potentially linked to a second wave of COVID-19, could trigger a new bout of capital market volatility.				
FX Intervention and Reserves Level	**Background.** Brazil has a floating exchange rate. Between August and December 2019, the central bank unwound part of its FX swap position while selling dollars in the spot market in nearly equivalent amounts in response to an increasing demand for spot dollars and decreasing demand for FX hedging in Brazil. Consequently, gross reserves fell by about $19 billion in 2019 and ended the year at US$357 billion—about 19 percent of GDP or 154 percent of the IMF's composite reserve adequacy metric. Gross reserves net of FX swaps stood at US$322 billion at end-2019. To dampen excess exchange rate volatility during the COVID-19 shock, the central bank sold FX in the spot, repo, and FX swap markets in the year through June 10. Nevertheless, reserves remain adequate ~~high~~ at US$348 billion, while gross reserves net of FX swaps declined to US$289 billion. **Assessment.** The flexible exchange rate has been an important shock absorber. Reserves are adequate relative to various criteria, including the IMF's reserve adequacy metric, and serve as insurance against external shocks. The authorities should retain strong external buffers, with intervention limited to addressing disorderly market conditions.				