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Statement by Mr. Bevilaqua on Brazil
Executive Board Meeting
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On behalf of my Brazilian authorities, I would like to thank Ms. Lim and her team for a timely and fruitful Article IV consultation mission. The discussions were candid, and we appreciate staff's flexibility to delve deeper into the country-specific circumstances to form a well-grounded assessment. Overall, after the intense policy dialogue, there is a great deal of convergence between the views of the authorities and staff. The remaining differences, albeit relevant, are mostly of nuance and limited to a couple of specific issues.

The country was starting to reap the benefits of bold reforms when the COVID-19 pandemic struck

Brazil was clearly on track for an economic revival earlier this year. Important steps were taken in 2017-19 to help restore confidence in the sustainability of the fiscal accounts, as well as remove obstacles to the well-functioning of the financial system and transmission of monetary policy. The adoption of a strict expenditure ceiling, the retreat in subsidized public lending, the flexibilization of labor markets and a comprehensive pension reform are among some of the main structural transformations that fundamentally changed the economic landscape. In addition, the push for an ample reform agenda to open the economy further and reduce the presence of the state in many economic sectors bolstered investors' confidence. As a result, policy and market interest rates declined consistently while inflation and inflation expectations remained in check. Capital markets flourished including by filling in the gap left by the retreating subsidized credit for long-term investments on a more robust and sustainable manner. Hence, at the beginning of 2020, the early signals of a strong rebound in investment and growth were visible. The Brazilian economy was converging to a new growth trend.

Effective policy reaction to cope with the unprecedented shock

Brazil was hit hard by the pandemic, but the economic policy reaction was swift and commensurate to the challenge, on par with those of advanced economies. In mid-March, Congress approved a decree recognizing the occurrence of a "state of public calamity" in the country, which triggered the escape clause for the constitutional expenditure ceiling. On those grounds, comprehensive and effective fiscal measures were adopted, among them the Emergency Aid (EA) benefit, which covered 67 million beneficiaries at its peak with a 5-month monthly stipend of R$600 (double in the case of single mothers). In early September, the EA benefit was extended until the end of the year at half the original value. The impact of the EA was substantial, with 15 million people being lifted above the poverty line, while another 10 million people who would have fallen below the poverty line due to the pandemic were kept above it. With an estimated cost for the whole year of R$322 billion (4.5 percent of GDP), the EA amounts to more than 9 years of the successful and highly regarded *Bolsa Família* social assistance program.

The Income and Employment Support Emergency Program was another success. Of the 12 million formal jobs most vulnerable to the pandemic, about 10 million benefited from the program, with workers preserving their jobs and most of their income. In addition to sustaining aggregate demand, the program retained employment links, which are likely to be crucial to avoid scarring and support the post-pandemic recovery. With a direct fiscal cost estimated at R$52 billion (0.7 percent of GDP), this program was highly efficient, managing to absorb a good part of the shock on the formal labor market. In contrast to previous recessions in Brazil, this time job losses in the formal sector were significantly contained.

Additional emergency measures were adopted to address other needs stemming from the pandemic. Complementary measures amounting to R$97 billion (1.3 percent of GDP) were taken to support states and municipalities, and R$113 billion (1.6 percent of GDP) were spent to support the health sector, as well as micro-businesses, small enterprises, and other credit-constrained businesses which were hit hard by the containment measures. Several other measures, with no direct impact on the primary fiscal deficit, were also implemented to support states and municipalities, aggregate demand and credit for an additional 5.3 percent of GDP.

Monetary policy has been highly expansionary while inflation and inflation expectations remain well-anchored. Since March 2020, the policy rate—then at a record low—was slashed by 225 bps to 2 percent. In addition, since August the Monetary Policy Committee (Copom) has been providing forward guidance on the future path of policy interest rates. This guidance states that the policy rate will not be raised as long as inflation expectations and Copom projections for the relevant policy horizon are below target, long-term inflation expectations are firmly anchored, and the fiscal regime is maintained. While portfolio outflows between February and April were sizable, net flows later stabilized, and the exchange rate has continued to work very well as a shock absorber, floating freely and sliding by almost 20 percent since March, with interventions confined to high-volatility episodes.

Early on, the Central Bank of Brazil (BCB) took several regulatory measures to address liquidity needs in the financial system, enhancing resilience and supporting the flow of credit. The Brazilian financial sector was in a sound position when the pandemic hit, with banks well capitalized, well provisioned and showing robust profitability. Liquidity was provided to address bottlenecks and support financial stability—mostly by releasing private resources through a reduction in reserve requirements. Overall, these measures have allowed financial institutions to have the funding necessary to meet liquidity needs, providing market participants with confidence to maintain or expand credit plans. In addition, regulation was adjusted to facilitate the refinancing of corporate and household loans, while monitoring credit quality to prevent possible spillovers. All the measures were taken without moving the focus of the regulatory framework from its goal of ensuring the resilience and soundness of the financial system.

The economy performed better than expected

After plummeting in the second quarter by less than initially projected, the economy rebounded in the third quarter. Output contracted by unprecedented 9.7 percent in 2020Q2 (q-o-q, seasonally adjusted), against market expectations in the beginning of June pointing to a plunge of 14 percent. The forceful policy response was very effective in counteracting the freefall of economic activity and in averting a financial crisis. Brazil's fiscal stimulus, most notably the EA benefit, supported household income, allowing for a quicker recovery than in most peers. In the June WEO update, staff projected a contraction of 9.1 percent in 2020—much worse than what the authorities and market analysts were projecting. Developments since then have vindicated the authorities' more sanguine view, which was predicated on the strength of the policy response and the rollback of lockdown measures. Since then, staff has revised its 2020 growth forecast to -5.8 percent—still more pessimistic than the median market expectation of -4.7 percent and the government projection of -4.5 percent.

While the outlook continues to be characterized by considerable uncertainty, the economic recovery has proceeded with encouraging signals. A sound financial system and lower interest rates have continuously propelled credit even during the crisis. The total credit by the domestic financial system to businesses and households increased by 13 percent in the twelve months to September. From May through September, increased consumer and business confidence have supported the recovery in economic activity and bode well for the near-term outlook. Accordingly, retail sales have followed a V-shaped recovery, growing by 24 percent in 2020Q3 (using the broad concept, including vehicles and construction materials). Industrial production has also rebounded steeply and is already above pre-pandemic levels. The recovery of the services sector—as has been the pattern everywhere—is lagging but already shows early signs that a pickup will take place in 2020Q4 and 2021Q1.

Fiscal, monetary and credit measures will continue to provide support going forward. As services gather steam, the positive traction on the informal job market, which is flexible and reacts swiftly, is expected to be very substantial. Furthermore, the remaining stimulus that will be disbursed in the last six weeks of the year (R$45 billion), plus the R$15 billion that can still be withdrawn from the workers' severance fund (FGTS) and an estimated R$50 billion of EA that has been precautionarily saved will bolster demand in 2021Q1. Programs that support credit to micro-businesses and small enterprises (e.g., Pronampe and PEAC-Maquininhas) are also an effective lifeline for the economic recovery. Positive activity and confidence indicators, gradual job creation, credit expansion and the overall improvement in expectations point to a robust growth recovery—which the authorities believe will be in the range of 3 percent to 4 percent in 2021. This recovery is underpinned by the strong macroeconomic framework and government's firm commitment to an ambitious agenda of structural reforms.

Recalibrating the policy stance and continuing the push for reforms

A determined resumption of fiscal consolidation in 2021 will sustain economic growth prospects and dispel doubts about sustainability. Navigating away from this crisis will be challenging for most, if not all, countries. Limited policy space constrains options and thus requires a delicate balance, to be pursued in every country, between stimulus and sustainability. With public debt approaching 100 percent of GDP, Brazil must protect the integrity of its main fiscal anchor—the constitutional expenditure ceiling—to preserve debt sustainability. Any move that undermines confidence in the existing fiscal framework would push the yield curve higher and steeper, eventually destabilizing the economy, resulting in higher inflation and forcing a reversal of the monetary policy stance.

Further flexibility in budgetary allocation would enhance the efficiency of public spending and have lasting positive consequences for the economy. The authorities have introduced in Congress several proposals for constitutional amendments to reduce revenue earmarking, trim and redistribute mandatory spending, remove the endogenous pressure stemming from the public payroll, and improve the allocation of idle resources currently parked in public funds. The government's goal with these proposals is to regain margin to maneuver within the expenditure ceiling, improving the quality of fiscal policy while retaining the effectiveness of the fiscal anchor.

Monetary policy will continue to be supportive provided that inflation and inflation expectations remain below target and the fiscal anchor is maintained. In October the Copom kept the policy rate unchanged at 2 percent for the second consecutive meeting and clarified its forward guidance, in an environment of higher-than-usual variance in the balance of risks. The Committee made it clear that any change in fiscal policy that undermines the public debt path or compromises the fiscal anchor would lead to a re-evaluation of the forward guidance. Although inflation has remained subdued, recent price pressures led market expectations for 2020 inflation to increase from 2.65 percent to 3.25 percent in the past four weeks, with a smaller (20 bps) increase to 3.22 percent for 2021. While those pressures are mostly localized and temporary, the BCB will continue to closely monitor all relevant indicators.

Overall, the assessment of the Copom members is that the remaining space for additional monetary policy stimulus, if any, would be small. Moreover, given Brazil's history, the well-functioning of some markets or economic sectors could be impaired by the unprecedentedly low levels of the interest rate. Indeed, a majority of the Copom members consider that the current interest rate might be close to the level that could unleash asset price instability. On a brighter note, the BC# agenda is making important progress in all pillars, namely, inclusion, competitiveness, transparency, education, and the recently launched pillar of sustainability. For instance, the agenda to enhance competition in the Brazilian financial system is making meaningful strides with the newly adopted instant payment system, Pix, which became fully operational this week, and the progress in the implementation of the open banking framework.

The authorities would consider fiscal support beyond what is currently envisaged only if there is a second wave of the pandemic that significantly derails the ongoing economic recovery. Outside this tail risk scenario, the instruments to support the recovery will continue to rely on the existing framework—which subjects them to the clear limits imposed by the constitutional expenditure ceiling—furthered by the implementation of the government's reform agenda.

Resolute implementation of the reform agenda is an intrinsic part of the overall support to the private sector-led recovery. In addition to the measures to preserve fiscal sustainability and ensure the required flexibility in the allocation of expenditures, the reform agenda includes: (i) a big push in privatizations and concessions; (ii) opening further the Brazilian economy to international trade; (iii) reducing and rationalizing subsidies; (iv) a revenue-neutral tax reform to simplify taxation and improve efficiency; (v) new regulatory frameworks for the sectors of oil and gas, railways, cabotage, energy and sanitation; (vi) a new and modern insolvency legal framework; and (vii) *de jure* central bank independence. The government has submitted the needed draft legislation in Congress, and several of them are making good progress. Notably, the Central Bank Independence bill was approved by the Senate in October. With the conclusion of the municipal election season (second round voting will take place on November 29), the reform agenda is expected to move more expeditiously in the Congress. The authorities very much welcome the staff's views and inputs, including in the form of technical assistance, in support of the reform agenda. The Fund continues to be a partner of preference for the authorities in several of those key areas of reform.