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Statement by Mr. Trabinski and Mr. Gindrat on Brazil
(Preliminary)
Executive Board Meeting
November 25, 2020

We thank Mr. Bevilaqua for his informative Buff statement. The pandemic has added to Brazil's growth challenge. Brazil is being hit hard by the COVID-19 pandemic, and the economy is expected to contract significantly in 2020, followed by only a partial recovery in 2021. We encourage the authorities to move forward with a dynamic reform agenda to address the structural rigidities and vulnerabilities in the economy and create the conditions for a strong post-pandemic recovery.

While Brazil's immediate policy response to the pandemic has been strong, it has also increased long-term vulnerabilities. The decisive and concerted easing of fiscal, monetary and financial policies, including fiscal and quasi-fiscal measures of around 18 percent of GDP, have prevented a deep economic downturn and helped mitigate the immediate impact on society. Still, the pandemic is taking a heavy toll on Brazil in terms of lives, whilst income inequality is growing. Moreover, the legacy of the high emergency spending will remain a burden on Brazil's public finances and will necessitate a large consolidation from 2021 onward.

Preserving the credibility of the fiscal anchor is key. While more gradual fiscal withdrawal in 2021 may be needed if economic conditions deteriorate significantly, maintaining the expenditure ceiling in 2021 will be crucial to support market confidence. We side with the authorities in their commitment to fiscal restraint and in their caution towards staff's proposal for possible additional fiscal support of 2 percent of GDP in 2021. This proposal sits uneasily with the need to reduce the primary deficit (currently at almost 12 percent of GDP) to around zero in order to stabilize gross debt to GDP beyond the projection horizon of 2025. *Further comments by staff in this regard would be welcome.*

Despite mitigating factors, risks are to the downside, in particular regarding debt sustainability. We agree with staff that high international reserves, a resilient banking system and a low share of public foreign currency debt have been important mitigating factors and that the flexible exchange rate has absorbed a sizable part of the macroeconomic shock. On the downside, as the economy is likely to recover only partially next year, there is the risk of wiping out years of poverty and inequality reduction. As outlined in the Risk Assessment Matrix, the real possibility of social discontent and political instability might undermine debt sustainability. Staff's macro-fiscal shock scenario, which would lead to an unsustainable debt situation for several years, thus cannot be ruled out. Brazil's gross public debt and financing needs will reach record levels this year and are projected to remain at levels above the DSA-based risk thresholds over the medium term.

The crisis has highlighted the key importance of implementing structural reforms to lock in consolidation over the medium term and regain fiscal space. Structural reforms are critical to address Brazil's long-standing impediments to productivity growth and living standards. Reforms in the fiscal sector and in growth-related areas that promote competition, investment, business and trade as well as education could serve these objectives while also making the economy more resilient. In addition, *de jure* central bank independence would help strengthen the credibility of the monetary framework. We take note that the authorities are well aware that not addressing these long-standing deficiencies will endanger medium-term fiscal consolidation, and we welcome that certain reforms are already in the pipeline. Nevertheless, Congress just recently extended tax exemptions for 2021. *Could staff comment on this development?*

We encourage the authorities to closely monitor the liquidity and capitalization of banks and support staff's call for continued strong efforts to fight corruption and money laundering. Staff underlines in the report that the Brazilian banking system will remain resilient to the COVID shock. However, given the expected growth contraction and increased borrowing from banks, there is an increased risk of a rise in NPLs, putting pressure on bank capitalization. *In this context, we would appreciate staff's elaboration on the risks stemming from increased NPL levels*. Moreover, the legal and institutional setup to combat corruption and financial crimes has proved its effectiveness over the past years and should be further strengthened. We also encourage the authorities to enhance their AML/CFT framework with a view to achieving comprehensive FATF compliance.