November 23, 2020

Statement by Mr. Rosen, Ms. Shortino, and Ms. Robitaille on Brazil
(Preliminary)
Executive Board Meeting
November 25, 2020

The COVID-19 pandemic could not have come at a worse time for the Brazilian people. For the past few years, Brazil has been struggling to recover from its steepest recession in history. **Amid already very challenging circumstances, we applaud the Brazilian authorities' decision to undertake aggressive fiscal and monetary policy responses to address the health and economic consequences of the pandemic.** Key fiscal reforms in recent years created the space for a large discretionary fiscal response to the pandemic (over twice the average for the G20), despite the high level of public debt. Monetary policy has been more accommodative, without de-anchoring long-term inflation expectations. Thus far, the banking system appears to have coped with the severe adverse shock fairly well, although private sector banks have constrained lending of late, raising questions about the strength of the recovery process, as we note below.

We agree with staff's concern that withdrawing fiscal support abruptly could inflict considerable pain on the vulnerable and be disruptive on economic activity. The authorities will need to strike a delicate balance between using one-off spending to raise near-term growth without compromising medium-term fiscal discipline or debt sustainability. Market commentary reinforces staff's assertion that implementing additional one-off transfers while backloading fiscal consolidation could cause a loss of market confidence, which could lead to severe implications for financing conditions. Like staff, we stress that a full economic recovery cannot take hold until the authorities address longer-term fiscal imbalances. The root problem is an overly large size of the government, and in particular, a government wage bill that is very high by international standards. Furthermore, Brazil lacks a well-structured social safety net. A much-hailed pension reform in 2019 that limits pension spending time was a step in the right direction towards stabilizing public debt, but the authorities need to do more. We urge the authorities to redouble efforts to reduce the government wage bill, rationalize the complex system of transfer payments at the federal and state levels, and accelerate its tax reform agenda.

The authorities have responded to the higher cost of long-term borrowing by reducing the maturities of new debt issues to an average of 2 years. *To what extent does a shortening in the maturity profile of public debt raise the government's near-term financing needs and increase the risk of a debt crisis? What are the implications for the banking system, given that banks are major holders of government debt?*

The Central Bank has appropriately loosened monetary policy, with the policy rate at its lowest level ever. One disagreement between staff and the authorities is whether there is room for further monetary policy accommodation, with staff suggesting that the policy rate could be cut further. However, the very steep yield curve may signal that investors are skeptical about the Central Bank's ability to keep inflation low over the longer term. Relative to other countries in the region, Brazil has intervened relatively heavily in the foreign exchange market at times to stave off disorderly conditions, including broadening its toolkit beyond forward market instruments that it has been using for some time in past episodes of stress. Despite the Central Bank's active foreign exchange intervention, staff assess that the sharp depreciation has left the currency undervalued. *Would staff comment on the effectiveness of the Central Bank's foreign exchange intervention and the market drivers of the currency's underperformance?*

On the banking system's ability to weather the severe shock, while we take comfort from the aggregate indicators showing that banks are well capitalized and have ample liquidity, Brazil's banking system has many small and mid-sized banks that have come under stress in past episodes of financial stress, including in 2008. *Should smaller banks come under stress, what risks would the troubled banks pose to the overall economy?*

The reform agenda also needs to tackle challenges to longer-term growth, with a focus on increasing Brazil's attractiveness as an investment destination. These steps include making the labor market more flexible, and reducing obstacles to business creation and exit, along with a credible commitment to reduce the size of government. Staff also note that reforms needed to reduce the extremely high cost of credit are underway, and we welcome the authorities' commitment to reduce the cost of credit. High cost of credit and high loan-deposit spreads are a mark of an underdeveloped financial system, a fact which is masked by the high participation of government-owned banks in credit intermediation.