

easyBrasil

BRAZIL'S MACROECONOMIC SUSTAINABILITY

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A series of reports covering the Brazilian business environment, **easyBrasil** provides official, transparent, reliable information for those oriented toward investment and trade, and for those simply looking to learn more about the country and its economy. Each report addresses specific topics and opportunities in Brazil's diverse economic spheres, providing macro- and micro-economic information, information on regulation and policy, and forecasts, all affirmed and acknowledged by the Brazilian federal government. The series' individual reports are published as booklets in both digital and print editions.

BRAZIL'S MACROECONOMIC SUSTAINABILITY

2017 was a pivotal year for Brazilian business prospects, seeing a conjunction of positive shifts in three fundamentals: a significant drop in the rate of inflation, reduction of interest rates, and resurgent economic activity. Disciplined guidance of monetary policy, reinforced by changes to economic policy overall, played a crucial role in curbing inflation, actual and projected, and in enabling the easing of interest rates. These achievements, along with adjustments and reforms implemented in a low-inflation environment, stimulated the economy's recovery.

In this positive domestic scenario, the external accounts are more favorable: current Foreign Direct Investment more than offsets the external deficit and foreign reserves have in recent years held to a liquidity buffer of USD 380 billion, approximately 20% of GDP. This anchor provided by national policy for reserves management plays a crucial role in the federal government's strategy of providing a foreign exchange hedge to insure against extremes in volatility.

With the financial system capitalized, well provisioned and amply liquid, Brazil's central bank is pursuing comprehensive reforms. Its Agenda BC+, covered in this report, is modernizing exchange regulation through enhanced security and implementation of best practices. These measures are recognized in international forums as bringing unprecedented flexibility to the country's foreign exchange system. Additionally, the federal government is committed to the country's full adherence to standards of the OECD, including codes of services and liberalization of capital flows.

With inflation reined in, a rebalancing of external accounts, a solid financial system and a comprehensive agenda of reforms, Brazil's economy is primed for a return to sustainable growth.

7. Final considerations

Current efforts to enhance monetary flexibility have brought about a decrease in real exchange rates, today at historic lows, as conformed by several metrics: the real ex-ante rate, based on the fixed 12-month interest rate (in the Pre-DI swap market) minus the inflation expected in 12 months, approximately 9% p.a. as of September 2015. This rate, which remained relatively stable throughout 2016, at around 7%, has been falling, reaching 2.8% p.a. by late 2017.

Disciplined monetary policies, in conjunction with a reorientation of national economic policy, was decisive in mitigating defensive pricing typical of high inflation environments, shifting inflation expectations into a downward trend.

Efforts by the government in the infrastructure and privatization sectors promise a crucial foundation to make the country's growth sustainable

Notwithstanding the gains already made in consumer purchasing power, a key next step is renewed investment to generate sustainable growth in the medium and long term. Q3 2017 saw a 1.6% upswing in investments over the previous quarter. ■

CONTENTS

1. MONETARY POLICY AND INFLATION IN BRAZIL	4
2. EXCHANGE RATE POLICY	6
3. ROBUSTNESS OF EXTERNAL ACCOUNTS	6
4. POLICY ON THE LIBERALIZATION OF THE FOREIGN EXCHANGE MARKET AND CAPITAL FLOWS	8
5. ADHERENCE TO THE OECD CODES OF CAPITAL FLOW LIBERALIZATION AND SERVICES	9
6. NATIONAL FINANCIAL SYSTEM AND THE BC+ AGENDA OF REFORMS	10
7. FINAL CONSIDERATIONS	11

6. The National Financial System and the BC+ Agenda

Brazil enjoys a solid and developed financial system. The resilience of the National Financial System (NFS) is rooted in work carried out by the BCB over the years, in a robust set of steadily improved regulations and oversight procedures incorporating standards set forth by international regulators. The country also relies on financial institutions with adequate risk management engaged in prudent conduct of their activities.

Demonstrating the NFS’s resilience was the real-world stress test imposed by the recent domestic crisis, whose impacts on the economy were indeed well controlled. The system proved to be appropriately equipped to deal with these stresses, remaining capitalized, provisioned, and liquid. Troubled assets and delinquency did not threaten stability. Brazilian financial institutions meet Basel Indexes regarding capitalization and leveraging above minimum requirements.

The BCB’s focus is to maintain the system’s stability and resilience. The bank has recently completed the extensive agenda of reforms targeted at NFS structural issues, Agenda BC+. This agenda was structured on four pillars:

- Better Financial Citizenship: actions focused on increasing the population’s education and financial inclusion; greater consumer protection for financial products and services; greater transparency between financial institutions and their clients; and improved metrics for the impact of BCB actions, from the perspective of financial citizenship.
- Updated/Modern Legislation to: enhance the legal framework governing BCB activity and its alignment with best international

practices, providing greater legal security to its legal prerogatives; establish BCB technical and operational autonomy; strengthen the institutional environment to maintain financial stability; standardize laws and norms governing BCB activity; improve the relationship between BCB and the National Treasury.

- A More Efficient NFS: actions focused on increasing efficiency and fostering NFS sustainability; simplifying BCB rules and procedures, adapting them to the size and profile of institutions; adapting to, aligning with, and converging on international standards; analyzing new payment methods; monitoring the impact of technological innovations; reducing compliance costs; improving the relationship between financial institutions and their clients and users.
- Cheaper credit: focus on reducing credit costs for the final borrowers; reducing delinquency levels; increasing competitiveness and ease in credit granting; encouraging a more efficient credit allocation; reviewing reserve requirements.

Various actions under this agenda were complete in 2017, and the others are ongoing.

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1. Monetary Policy and Inflation in Brazil

In pursuing its mission to ensure price stability, Brazilian Central Bank (BCB) uses an inflation-targeting regime, per benchmarks defined by the National Monetary Council (CMN). As domestic and international experience affirm, price stability, with low and steady inflation in keeping with stated targets, bolsters confidence, investment, entrepreneurialism, and employment. In addition to enabling longer-term strategic planning on the parts of businesses and households, the real and sustainable growth enabled by a low-inflation environment provides the foundation for sustainable policies of social inclusion.

The BCB's inflation-targeting regime, in place since 1999, puts special emphasis on projected inflation rates in relation to broader monetary policy, and bases projections in analysis of divergent scenarios for the evolution of primary variables influencing price dynamics. While other components of macroeconomic policy do influence price evolution, monetary policy assumes primary responsibility for preventing localized and temporary pressures from propagating widely or in the longer term.

Since 2016, with changes in macroeconomic policy and government implementation of necessary economic reforms, the BCB has been effective in holding down current inflation rates and anchoring projections. Amid a recession, cumulative inflation in 2016 dropped slightly, from 10.7% (December 2015) to 9.0% (August 2016). Monetary policy adopted in the second half of that year, specifically aimed to

anchor projected inflation prior to a cycle of easing, helped to shift a cycle of increasing inflation and recession toward disinflation and recovery.

An extended inflation-target horizon — now set forward to the middle of the third calendar year — contributes to sustained price expectations. Current targets follow a descending trajectory: 4.50% for 2018, 4.25% for 2019, and 4.00% for 2020.

These changes in course, albeit challenging, have shown themselves to be credible and practicable. Disciplined monetary policy, in conjunction with redirection of national economic policy, has played a decisive role by mitigating defensive pricing, a characteristic of high-inflation environments, and stabilizing market expectations for inflation — 4.0% for 2018, 4.25% for 2019, and 4.0% for 2020, floating around BCB's targets.

National Extended Consumer Price Index
IPCA: annual variation



FIGURE 1
Source: BCB/IBGE

5. Adherence to OECD Codes of Capital Flow Liberalization and Services

Over the past 3 years, the federal government has been taking the necessary steps for Brazil's adherence to the standards of the Organization for Economic Cooperation and Development (OECD). A milestone in this process was submission, in May 2017, of a formal request for the country's inclusion as a full member.

The majority of OECD member states regard Brazil as the most qualified applicant among those currently requesting inclusion as full members, due to the magnitude and complexity of the country's economy, its traditionally consistent technical position, and its increased alignment with the standards and values of the West. Brazil is also considered a country whose adherence would contribute greatly to the significant gains made by the OECD in recent decades, and serve as a bridge to the BRICS.

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seeking to adopt global best practices. Adherence to best international practices and standards, as established by the OECD, is an initiative already taken by the Brazilian government, and well in effect. This adherence is not conditioned on acceptance as a full member.

Convergence on OECD benchmarks is especially pertinent in relation to the organization's rules for international investments, transfers, and payments. The BCB sent two letters to the OECD in mid-2017 stating its commitment to adhere to

International recognition of Brazil's participation in the OECD increases the country's ability to attract business, reflecting positively not only in growth, but on the macroeconomic environment, especially on the cost of financing sovereign debt, all of which benefit the country's economy.

OECD basic instruments: the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Intangible Operations.

Full membership would protect Brazil against discriminatory treatment given to Brazilian investors established in member states, also benefiting Brazilian companies seeking financing abroad. OECD membership is an excellent paradigm to pursue when

Existing Brazilian practices facilitate adherence to the codes. With the exchange rate liberalization adopted in recent years the financial system is subject to few reservations. Foreign investment in Brazil benefits from a high level of liberalization, with restrictions not substantially different from those imposed by many OECD member states.

4. Policy for Liberalization of Foreign Exchange and Capital Flows

Brazil's economic history includes episodes of controls on foreign exchange flows, arising from the need to manage the scarcity of foreign currency. This was particularly aggravated in the early 1980s by persistent deficits in the balance of payments. These controls especially impacted international trade transactions, justified by the importance of earnings from exports, which at the time were virtually the only source of foreign funds available for stabilizing the country's external balance.

The BCB entered into a direct relationship with companies and financial institutions operating in foreign markets, guiding and monitoring their operations to ensure their adherence to standards in effect.

Progressive improvement in the country's economic scenario over the past decades, plus the strengthening of external accounts and the accumulation of international reserves, enabled the country to overcome a historical scarcity of hard currency. Macroeconomic balance, in addition to the country's financial and institutional development, paved the way for gradual elimination of currency-exchange restrictions.

An important milestone in the process for easing foreign exchange flows occurred in 2005, when the country formally adopted the principle of comprehensive freedom for buying and selling foreign currency in the exchange market, with no quantitative limits or a need for specific authorizations from the BCB.

Subsequent years saw further advances. For example, easing of the requirement for foreign exchange hedging for exports resulted in reducing both the bureaucracy and costs incurred in foreign exchange transactions.

In order to guarantee a safe and efficient financial system, foreign exchange transactions are required to be conducted by institutions having BCB authorization, required to abide by rules in place

for accurate identification of clients. Relevant data on transactions must be submitted to the BCB, and authorized agents must perform their activities in compliance with the rules and procedures set forth by the regulations in effect, including those aimed at impeding money laundering, formulated in keeping with best international practices in this arena.

Brazilian foreign exchange regulation is today at an unprecedented level of flexibility, recognized in international forums such as the OECD's Foreign Direct Investment Regulatory Restrictiveness Index (FDI Index), and the G20's surveys on remittance costs.

The modernization of foreign exchange regulation is ongoing, incorporating innovation, eliminating outmoded devices and instruments, and adopting standards for increased security and better practices. All this aims to increase efficiency for all participants in the foreign exchange market.

In November 2017, the BCB signed the Notice of Adherence to the Global Foreign Exchange Code¹, which consists of a set of global principles of best practices for the foreign exchange market, to reinforce its commitment to integrity and this market's smooth operation. The BCB therefore adopted the principles covered in the following sections for its internal routines and procedures associated with the foreign exchange market.

In view of decreasing inflation, with market expectations and central bank targets in alignment, and continuing overcapacity, the BCB's overnight rate ("Selic") retreated in 2017 by 725 basis points.

December saw this rate move down to 7.0% p.a., the lowest on record. Market analysts estimate further reductions to the Selic rate through the course of 2018.



FIGURE 2
Source: BCB

The course of monetary easing has delivered in reduced real interest rates—now at levels under 3% p.a., approaching a record low.

Coming out of a two-year recession, economic indicators signal the onset of gradual recovery, driven by:

- positive results in industrial activity;
- expanded activity in commerce and transportation;
- recovering consumption supported

by rising real incomes and sustained purchasing power in an environment of reduced inflation;

- the consumer credit sector's positive response to reduced central bank and commercial interest rates and rebound in the advanced stage of individual and household deleveraging;
- recovering consumer confidence;
- a strengthening job market and lower unemployment rates.

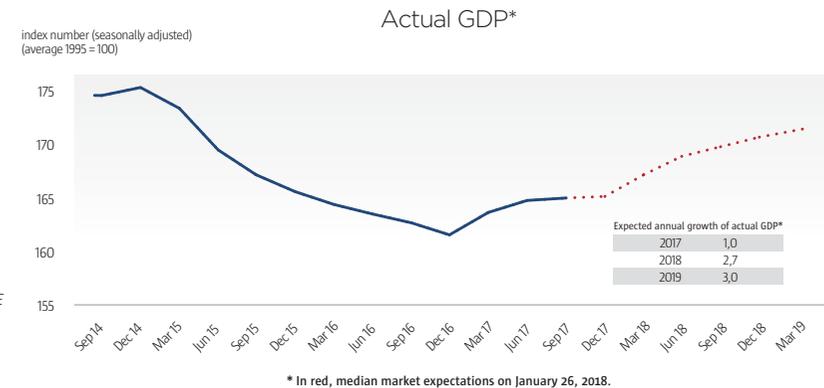


FIGURE 3
Source: BCB/IBGE

1 - FX Global Code (accessed 12/27/2017): https://www.globalfx.org/fx_global_code.htm

2. Exchange Rate Policy

Given that the Brazilian real is a floating currency, the BCB's primary line of defense against external shocks inheres in a central bank's hold on interest rates. The float-rate regime notwithstanding, the BCB retains at its disposal other tools to be employed in a judicious and predictable manner in mitigating any destabilizing movements in the currency market.

In fulfilling the essential mandates of a central bank, the BCB not only monitors exchange flows, following the dynamics that set currency rates to keep the country's foreign-exchange markets working well, but intervenes in situations in which excessive volatility and low liquidity threaten to distort the market. The tools of intervention, used appropriately in both the interbank and derivatives markets, do not undermine the premises of the established floating-currency regime.

An instance of such use of these tools was the inauguration in 2013 of a foreign-exchange swap

exchange program, with a view to maintaining internal financial stability by providing a hedge in moments of stress, and enable companies and investors to ride out periods of exchange rate volatility and steep depreciations of the real. By late 2014, the swap inventory reached USD 108 billion. Since then, the BCB has gradually reduced its position, mitigating exchange rate volatility without affecting trends in the market. The present swap inventory of USD 24 billion provides sufficient security and freedom of movement at moments potentially calling for action by the monetary authority.

Exchange rate - BRL/USD

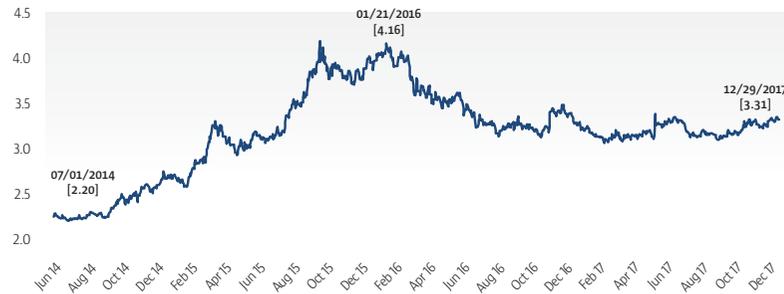


FIGURE 4
Source: BCB

3. Robustness of External Balances

The Brazilian economy is well positioned with respect to both balance of payments and vulnerability to external shocks. In recent years, the country's external transactions have been evolving positively, with results evident in a reduction in the current transactions deficit, running at 4.2% of GDP in 2014 and at 0.5% in 2017; 2017's trade surplus ran at USD 64 billion, an increase of 42% over the previous year.

In the same period, the inflow of direct investment remained high, and is more than sufficient to finance the deficit in current-account deficits. In 2017, FDI reached 3.4% of GDP, amounting to USD 70.3 billion—seven times

greater than the current-account deficit at the time. These trends provide clear and durable benefits for economic activity, allowing for a renewal of growth without danger to external balances.

External sector: deficit in current transactions and FDI (accrued in 12 months)

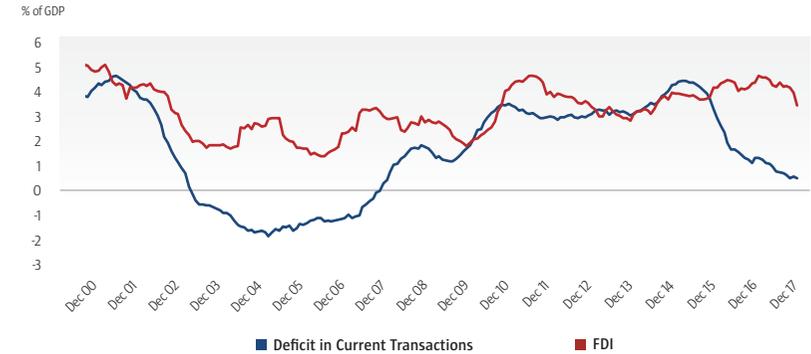


FIGURE 5
Source: BCB

Brazil's foreign reserves, currently near USD 380 billion (roughly 20% of GDP), constitute adequate insurance, per international liquidity standards, for foreseeable upheavals in the market. Brazil's economy stands better equipped to withstand

reversals in the international scenario. A healthy balance of payments and a low-inflation scenario, anchoring expectations of economic recovery, among other variables, reflect in reduction of the country's perceived sovereign risk.

Sovereign CDS (5-year)



FIGURE 6
Source: Bloomberg