BRAZIL: Boom, Bust, and the Road to Recovery

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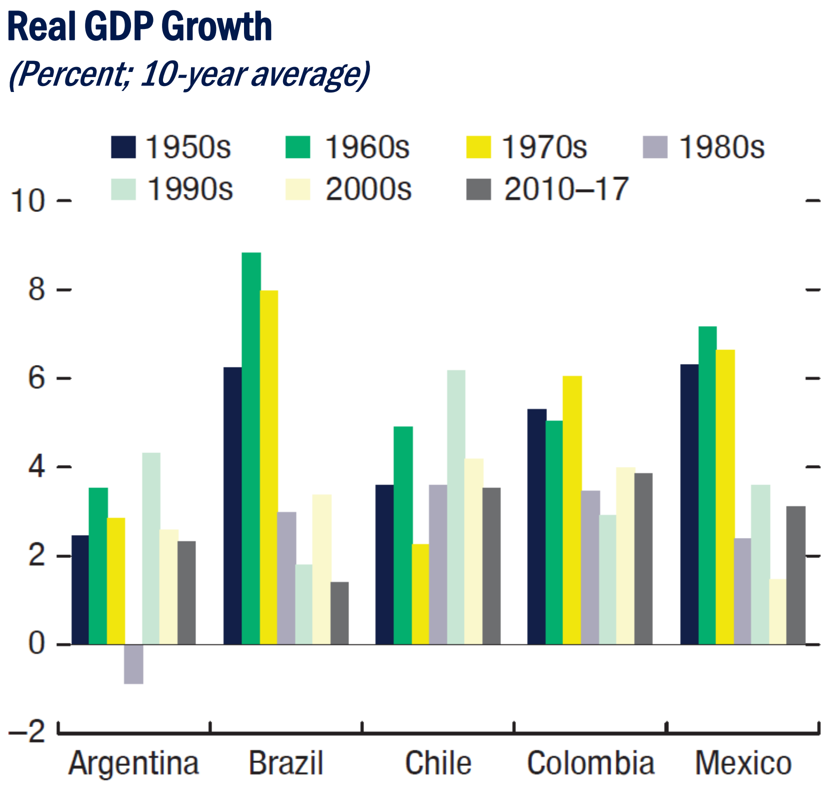
Economic History: Brazil Went from BOOM to BUST

- Growth averaged 8 percent until the 70s, ahead of most EMs, but fell to 2.6 percent since the 80s, trailing other EMs and AEs



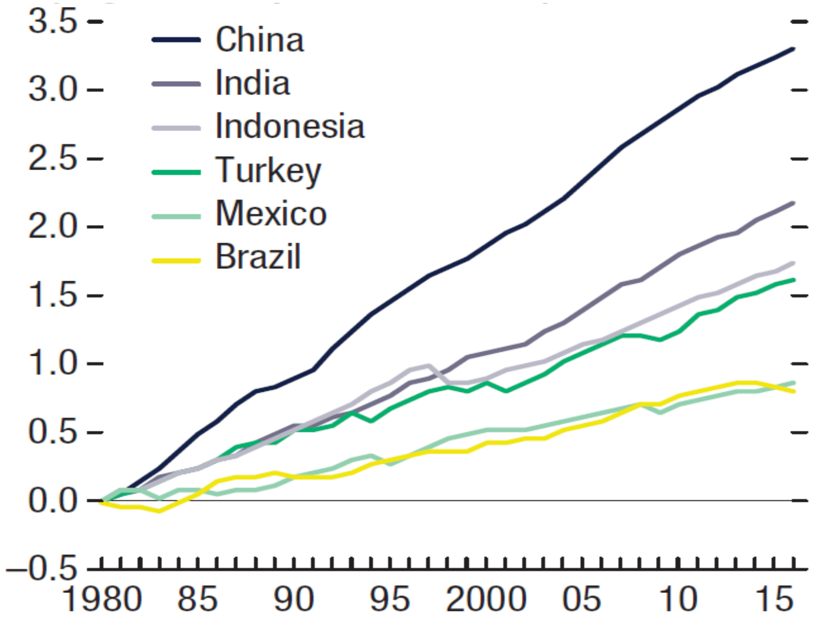
Pathbreaking Reforms Ensued

- The Plano Real in 1994 addressed large macroeconomic imbalances and ended hyperinflation
  - New currency and floating exchange rate regime
  - Inflation targeting
  - Fiscal responsibility
- Financial reforms improved the resilience of the financial system and aligned financial regulation with international standards
- Privatization of state-owned national and subnational banks addressed structural distortions
- Trade liberalization increased aggregate productivity both directly (greater availability of imported goods) and indirectly (lower cost of imports)

But Economic Performance Remains Uninspiring, Although Impressive Social Progress

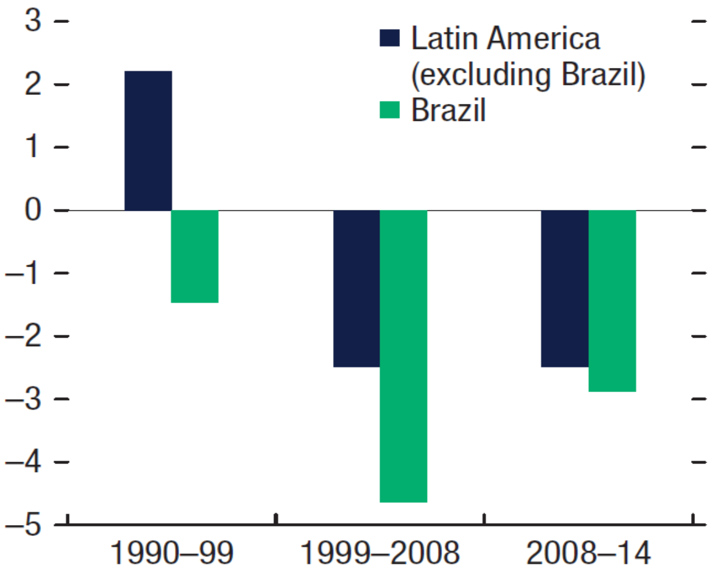
- No convergence towards the income levels of AEs over the last 40 years, differently from other EMs
- The 2015-16 recession shaved almost 10 pp of real GDP

Real GDP
(Log scale, equal to 0 in 1980)



- But remarkable declines in poverty and inequality resulted from progressive social policies

Decline in Gini Coefficient
(1990-2014)



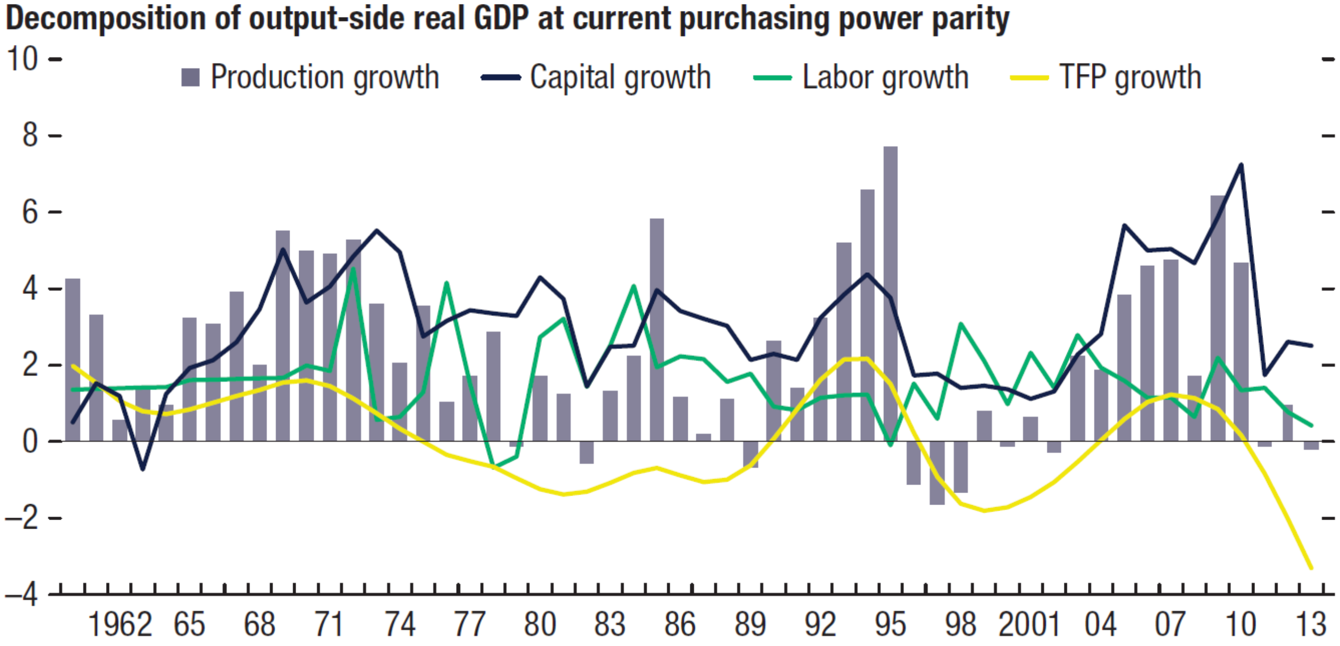
Note: The Gini Coefficient measures income distribution on a scale between 0 (most equal) to 1 (most unequal). Hence, a reduction in the Gini coefficient implies a reduction in income inequality.

What Explains the Growth Slowdown?
A Key Culprit: Productivity Growth is Stuck in Low Gear

Labor productivity growth averaged less than 1 percent per year over the last decade, significantly below levels in other EMs

With underwhelming productivity, GDP growth has been almost entirely driven by growth in labor and capital

Brazil's Economic Performance (1960-2014)
(Percent)



1. Unsustainable fiscal position
2. Large infrastructure gaps
3. Inefficient credit allocation
4. Closed economy
5. Inefficient state

LOW
PRODUCTIVITY
GROWTH

The Road to Recovery

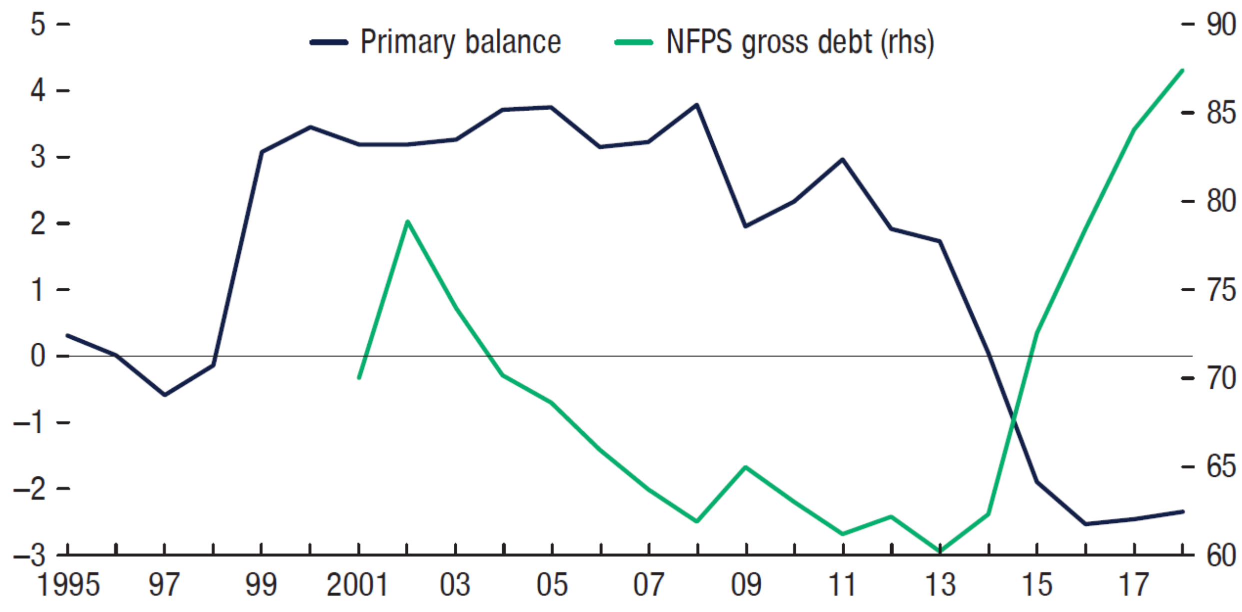
1. Restoring Fiscal Sustainability
2. Closing the Infrastructure Gap
3. Enhancing the Efficiency of the Financial System
4. Opening the Economy
5. Making the State More Effective

1. Restoring Fiscal Sustainability

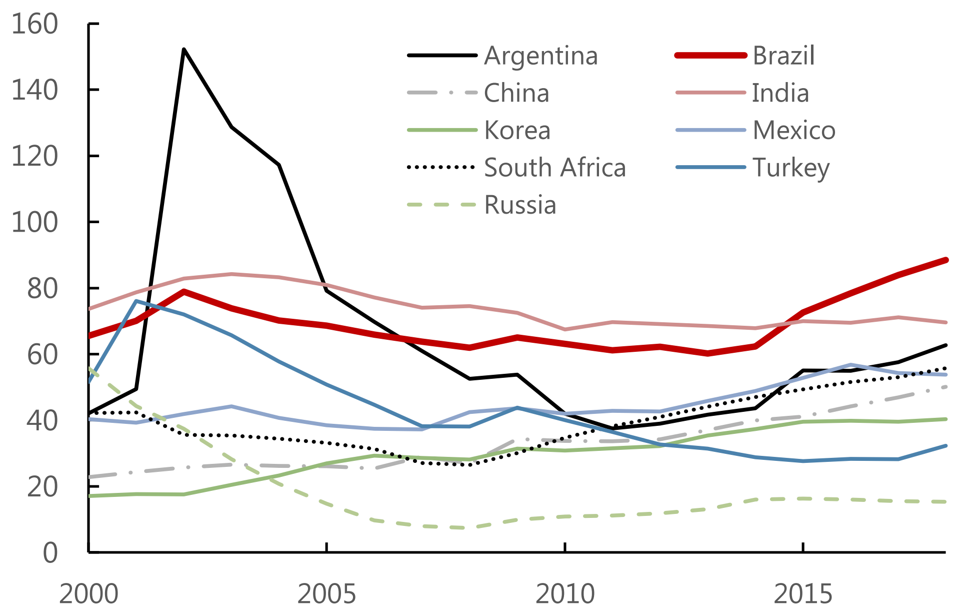
Economy Stuck in a Low-Growth, High-Debt Cycle

- The 2015-16 recession resulted in a marked deterioration of fiscal balances
- The Non Financial Public Sector debt is the highest amongst large EMs

Brazil: Primary Balance and Gross Debt
(Percent of GDP)

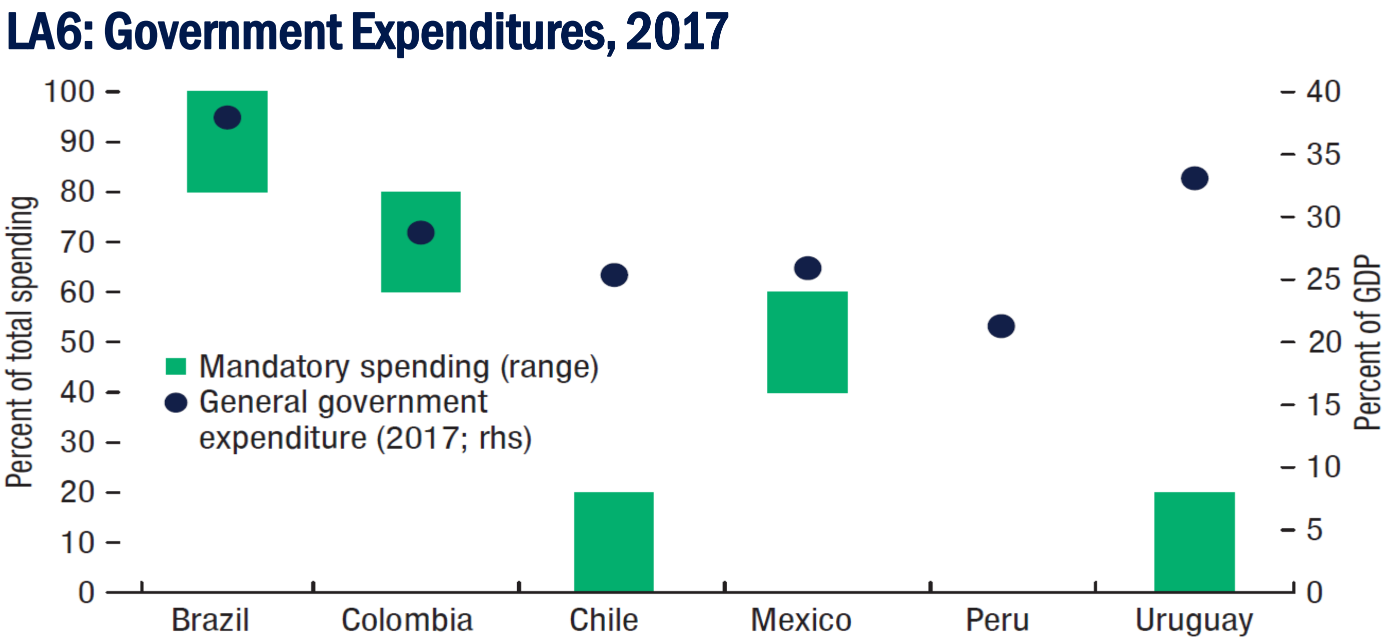


Real GDP Growth
(Percent; 10-year average)



Need to Rein in Mandatory Public Spending

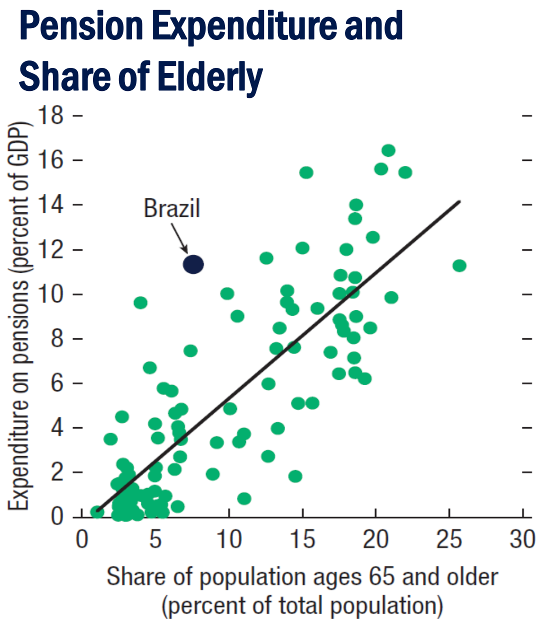
- The deterioration of fiscal balances is the results of high levels of government spending compared to regional peers, on the back of declining tax revenues during the recession
- High public spending is largely a result of the comparatively high share of mandatory spending

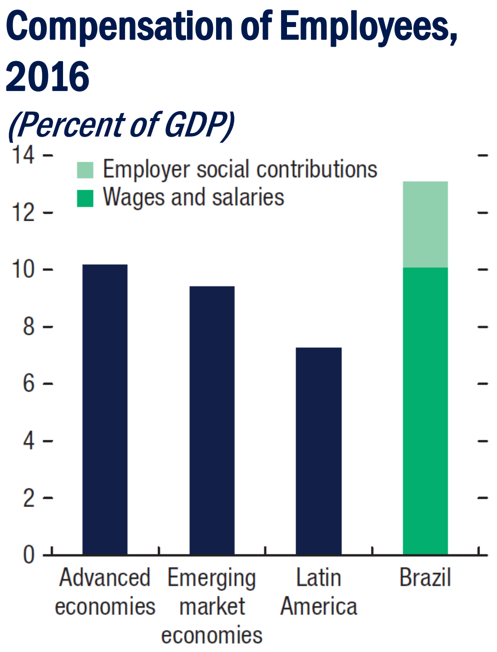


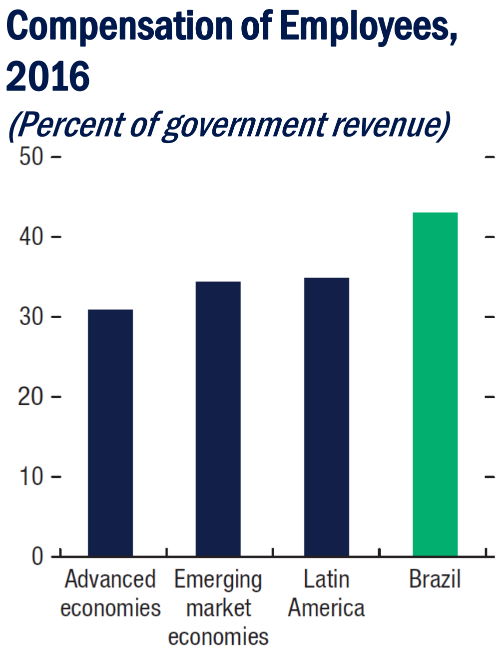
Note: Mandatory spending is expressed as a share of total spending. Ranges reflect requirements in different sectors.
Source: OECD, and IADB, 2014, Government at A Glance: Latin America and the Caribbean 2014, Towards Innovative Public Financial Management.

By Addressing Structural Fiscal Pressures

- Structurally high and increasing pension and wage bills are behind the high levels of mandatory spending, including in federal states







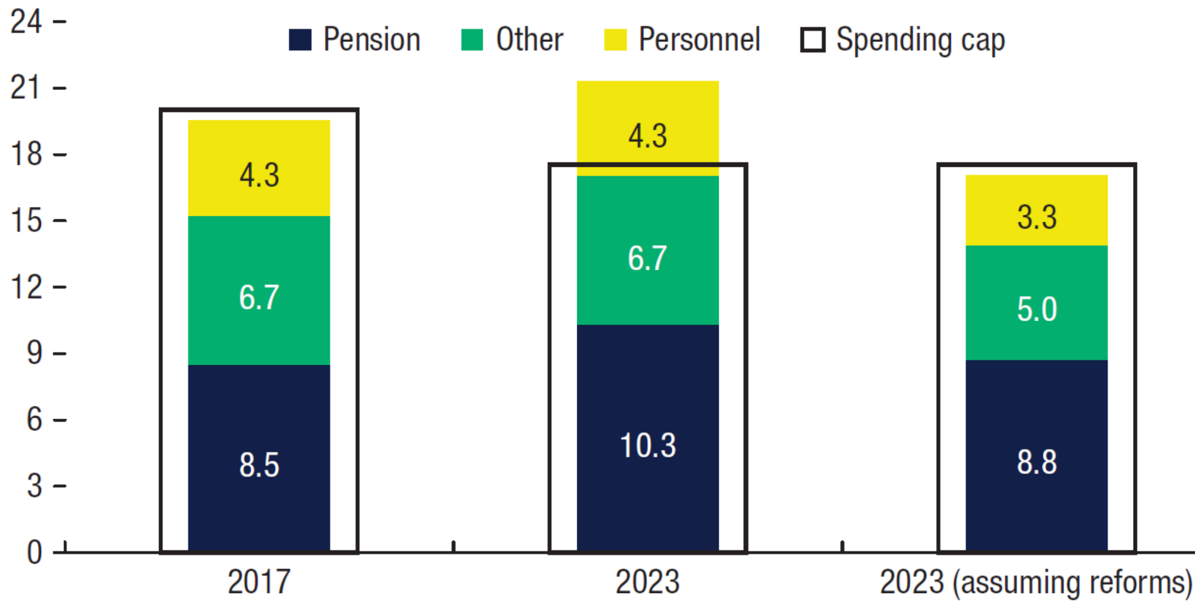
- In the absence of reforms, the deficit of the social security system will worsen due to adverse demographic trends

The Constitutional Spending Cap was an Important First Step

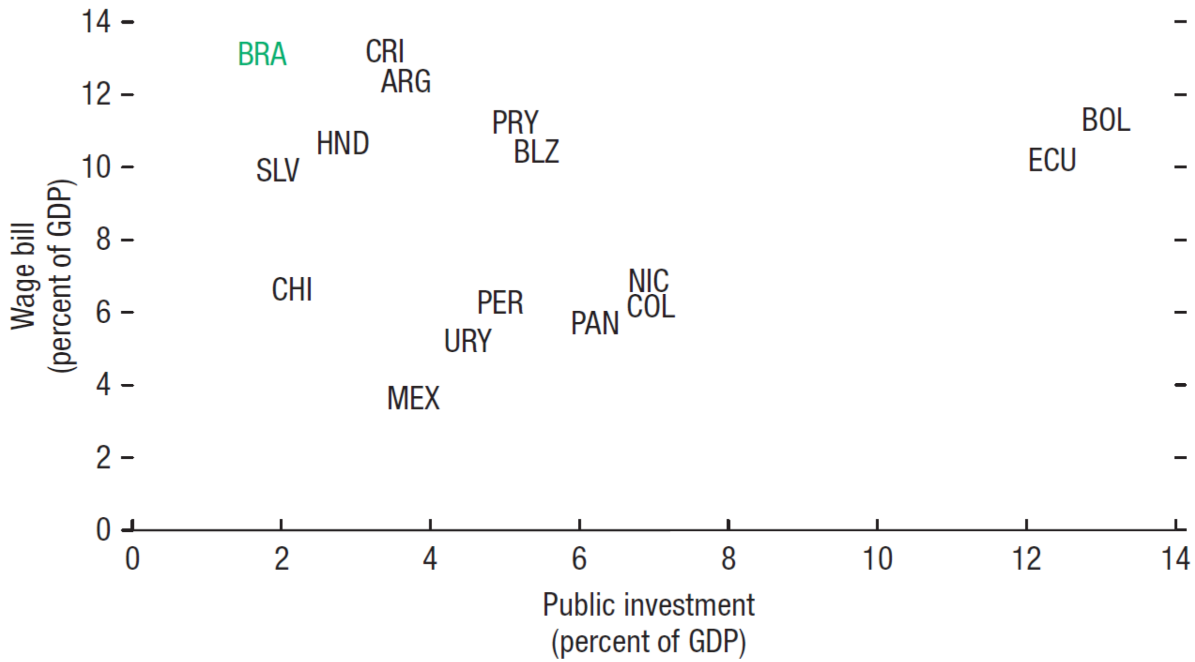
- The constitutional spending cap introduced in 2016 sets an useful fiscal adjustment path
- But going forward, complying with the cap will require ambitious fiscal reforms

- The adjustment so far has largely been borne by cuts in discretionary expenditure, in particular public investment

Federal Government Expenditure, 2017-23
(Percent of GDP)



Public Investment and Wage Bill in Latin America



But Additional Reforms are Needed to Restore Fiscal Sustainability

- A sustainable medium term fiscal consolidation will require:
  - Enacting an ambitious social security reform
    - ✓ The reform proposed by the government on February 20 is strong
  - Containing public wages (limit remuneration and employment growth, rethink the compensation structure)
  - Changing the indexation of minimum wage
  - Delinking pension and other benefits from the minimum wage
  - Enhancing the targeting of social benefits
  - Reducing tax expenditures and simplify the tax code
  - Limiting revenue earmarking and improving budget flexibility
  - Reforming the tax system

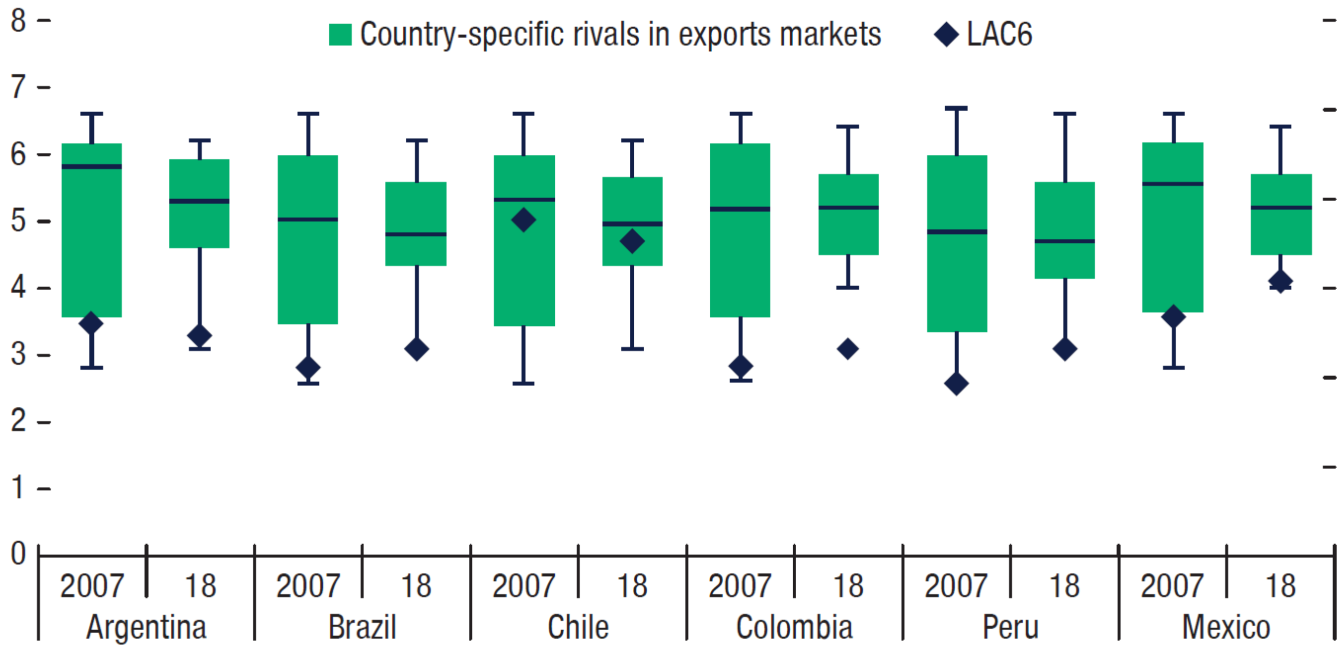
2. Closing the Infrastructure Gap

Infrastructure Quality in Brazil is Dismal

- Brazil's infrastructure gap is large relative to other emerging economies and trade competitors

LAC6 and Trade Competitors: Quality of Infrastructure, 2007-18

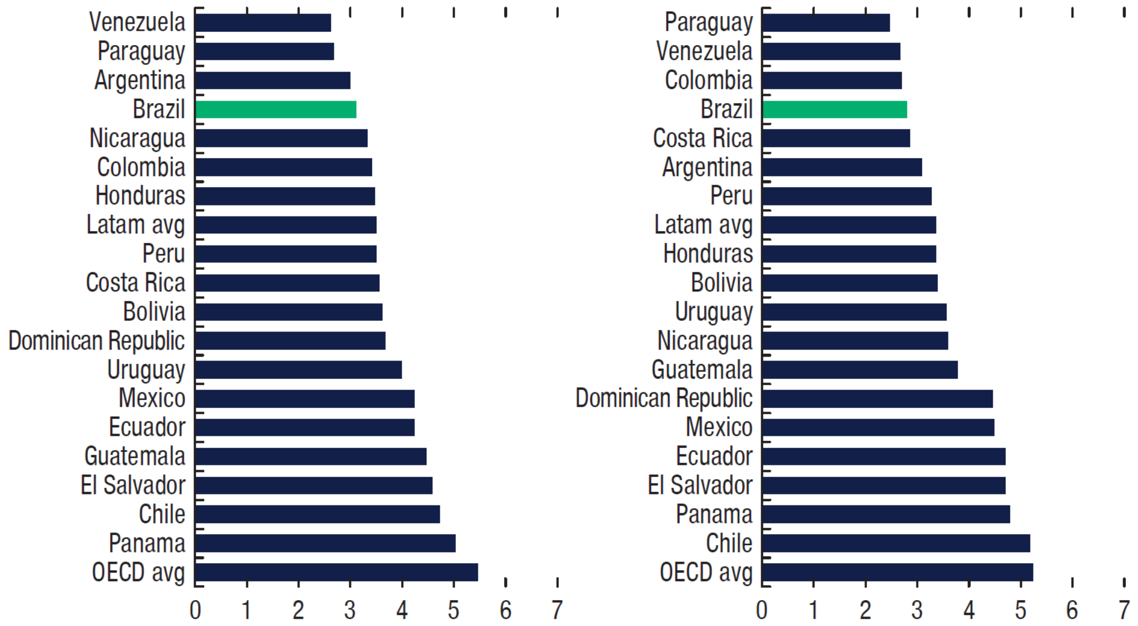
(Index, 7=best)



Note: The diamonds measure each individual LA6 country's quality of infrastructure. The upper and bottom ends of the boxes represent the 75th and 25th percentiles respectively of trade competitors' infrastructure quality. The middle line is the median. The ends of the whiskers represent the highest and lowest quality of infrastructure among trade competitors.

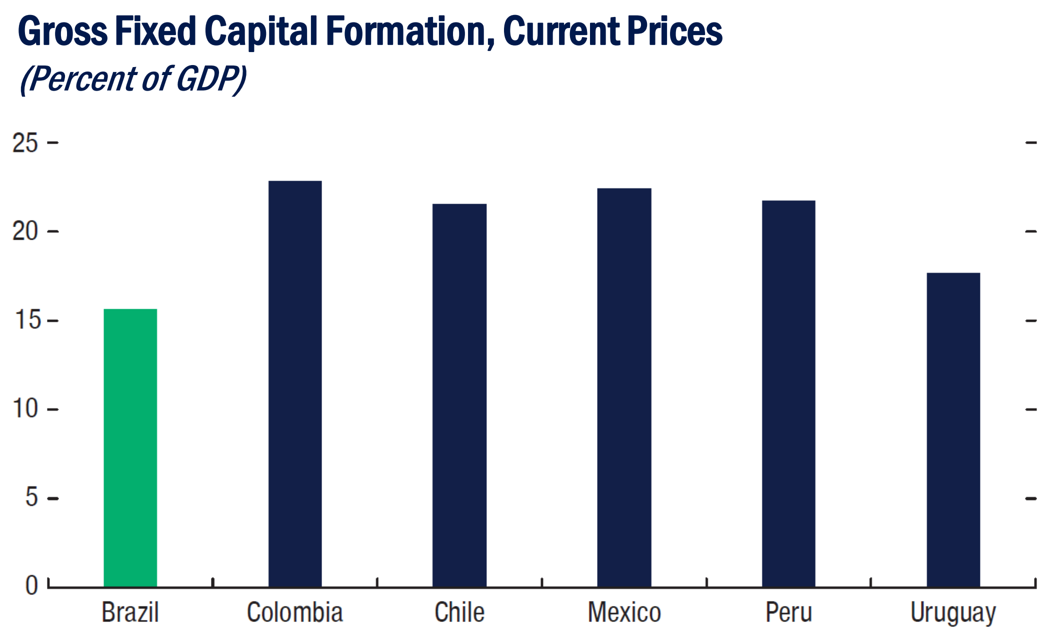
- Both quantitative and qualitative indicators lag behind regional peers

Latin America: Quality of Infrastructure and Roads



To Close the Infrastructure Gap Investment Needs to Pick Up

- Brazil's infrastructure gap is due to a prolonged period of underinvestment



- Infrastructure bottlenecks affect productivity and market efficiency and hinder market integration and export performance

- Fiscal constraints means that Brazil will have to 'do more with less' by optimizing costs, eliminating inefficiencies in service provisions, and facilitating private sector involvement in infrastructure.

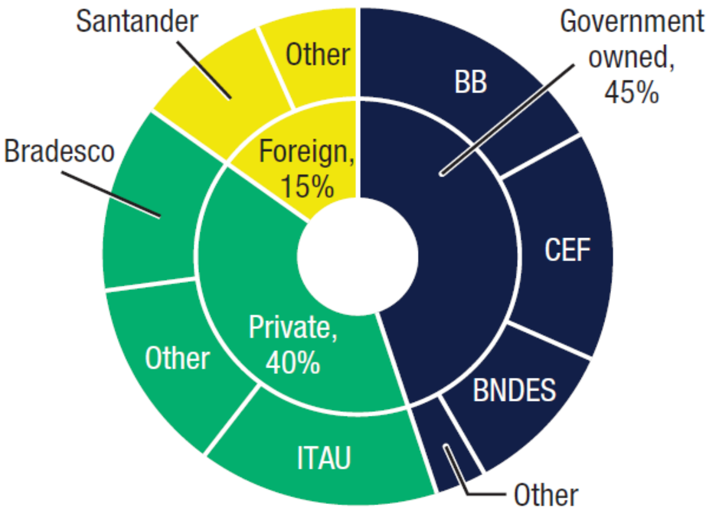
3. Enhancing the Efficiency of the Financial System

The Financial System is Inefficient

Concentration in the banking sector

- At the product level, for both public and private banks

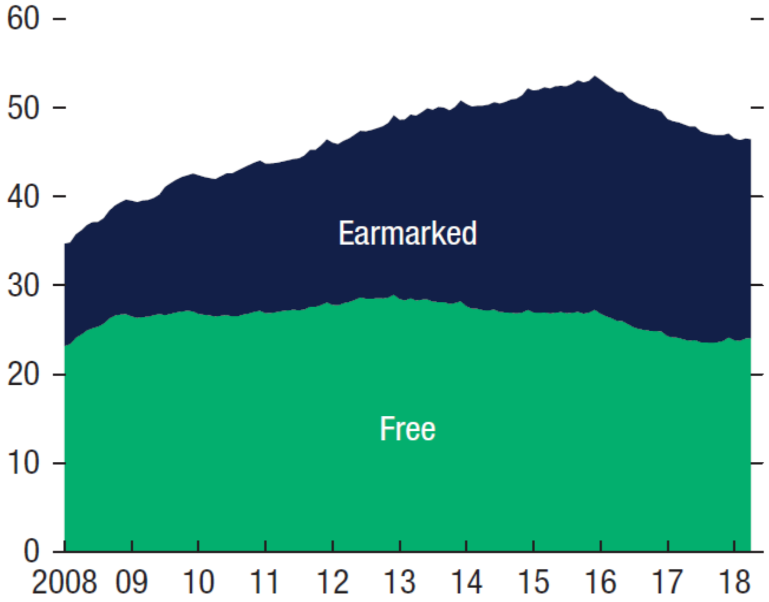
Banking Assets by Controlling Shareholder, 2018:Q1 *(Percent of Total Market Share)*



Earmarked credit

- Distortions
- Crowding out effects
- Fiscal cost

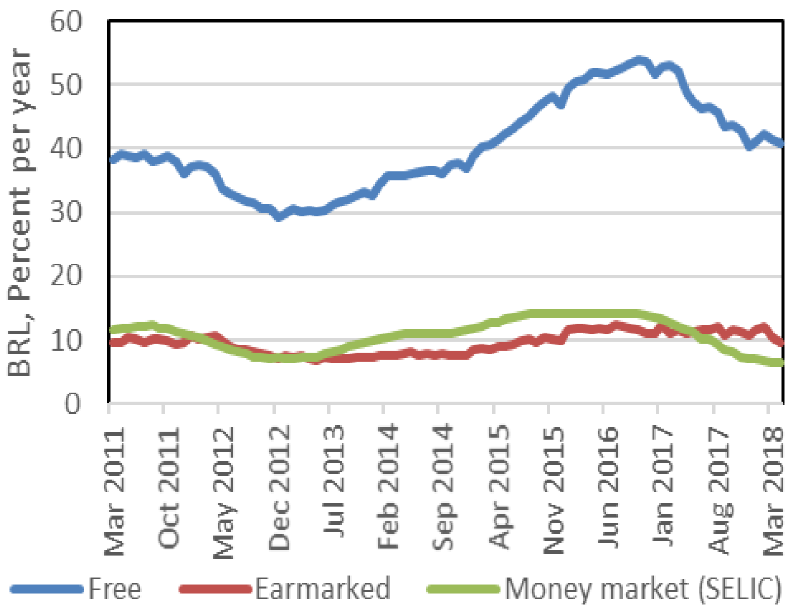
Earmarked and Free Credit *(Percent of GDP)*



Free market credit

- High spreads point to inefficient intermediation

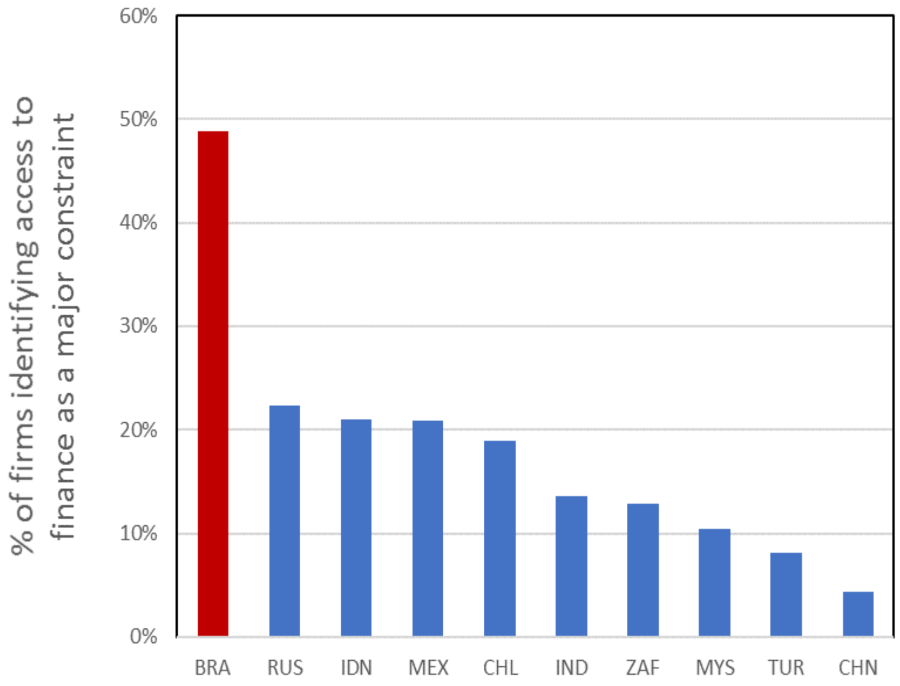
Earmarked vs Free Market Credit Spreads (*Percent per Year*)



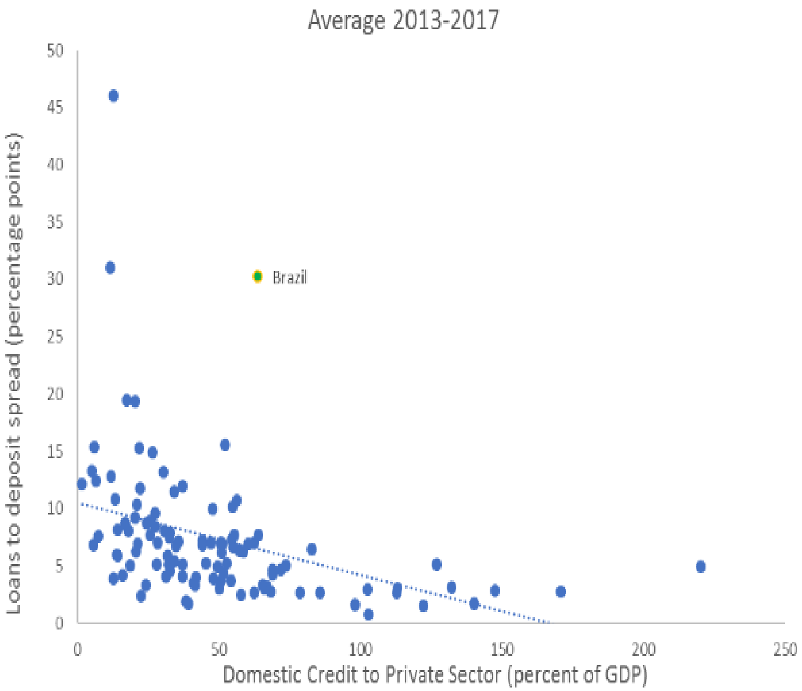
Hence Credit is Constrained and Spreads are Elevated

- There are symptoms of credit rationing
- High spreads in the free market holds back financial deepening

Constrained Access to Credit



Free Credit Spreads and Financial Depth



Recent Reforms are Important but More is Needed

- Recent reform efforts should help improve financial intermediation efficiency (TLP, insolvency framework, *Cadastro Positivo*—positive credit registry, etc.)
- But more remains to be done:
  - Reform earmarked loans programs and refocus public banks
  - Improve governance, invite strategic investors
  - Reduce high operating costs
  - Strengthen credit enforcement, enhance credit information
  - Improve competitive conduct in banking sector

4. Opening the Economy

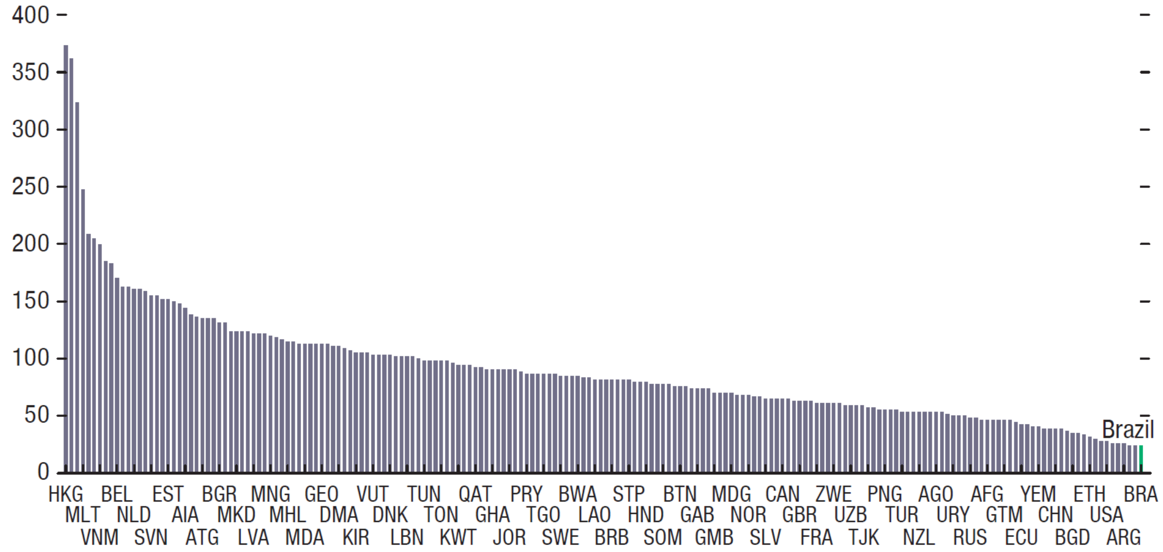
Brazil is One of the Least Open Economies in the World

- Trade flows are only about 25 percent of GDP

- High average tariffs (highest among LA5 and BRICs) and rampant use of non-tariff barriers (antidumping duties and local content requirements)

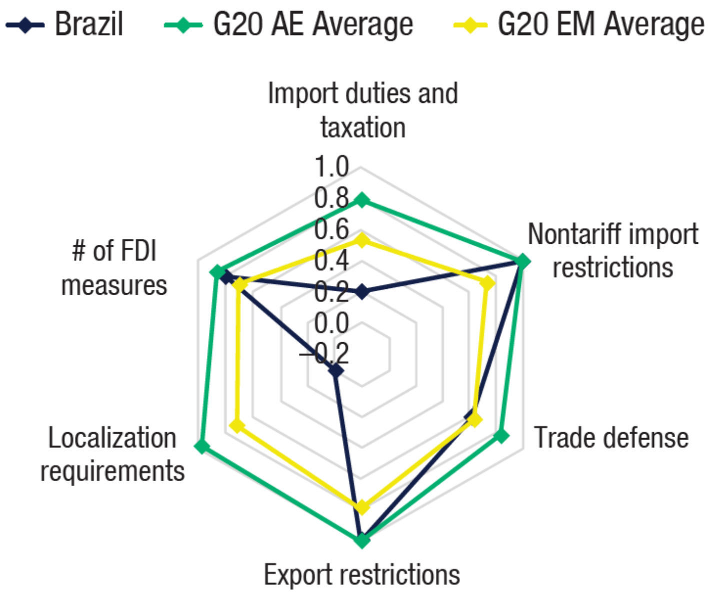
Trade Openness, 2017

(Sum of Imports and Exports of Goods and Services, Percent of GDP)



Trade Restrictive Measures as of end-January 2018

(0=Least open country in G20; 1 = Most open country in G20)

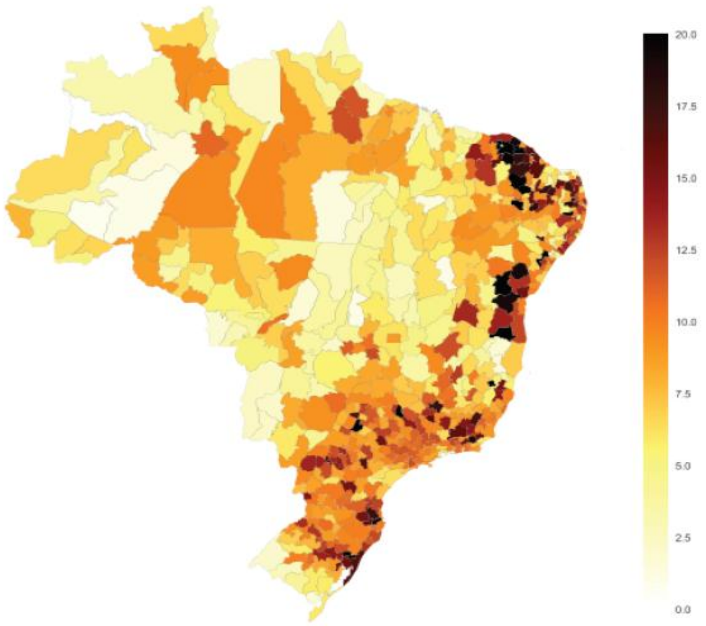


Brazil participates little in global value chain and has not benefited from booming global trade

Trade Liberalization Will Boost Potential but Adverse Effects Need to be Managed

- Reducing tariffs barriers, especially on capital goods, and eliminating non-tariffs barriers would enhance efficiency and boost potential growth
- Pursuing free-trade negotiations, including beyond Mercosur, would increase competition and foster productivity gains

Brazil: Regional Tariffs by Microregion
(Effective average tariff, ad valorem percent;
Average weighted by sectoral distribution of the labor force)



But: Trade liberalization will affect regional labor markets, with regions that now enjoy higher trade protection more likely to suffer

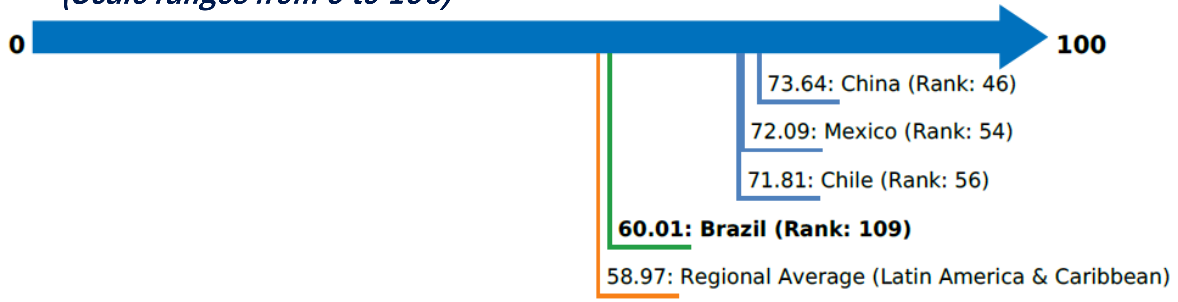
➡ Given limited labor mobility, active labor market policies should be used to mitigate impact on most affected regions and facilitate interregional and intersectoral reallocation of workers

5. Making the State More Effective

The State is a Constraint—Not Easy to Do Business in Brazil

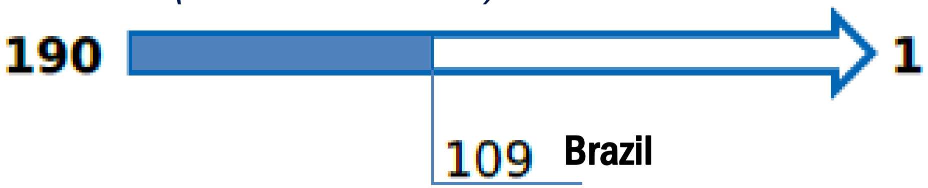
Ease of Doing Business Score, 2019

(Scale ranges from 0 to 100)



Ease of Doing Business Rank, 2019

(Out of 190 economies)



Brazil: Ease of Doing Business Score on Individual Topics, 2019

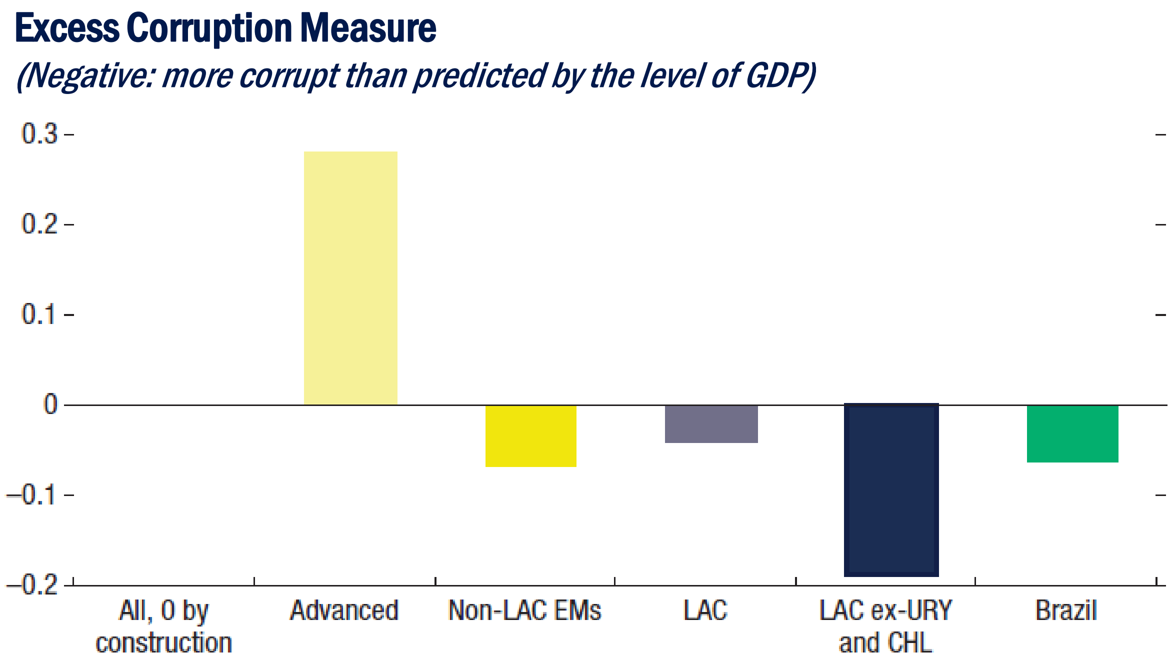
(Scale ranges from 0 to 100)

Serious Reforms are Needed

- Promoting policies and institutional frameworks that improve the business environment will be key to boosting productivity and growth:
  - Simplify and improve transparency of the tax system
  - Enhance the judicial system to enforce contracts and provide legal security for business transactions
  - Ease labor market regulations
  - Promote entrepreneurship, competition and innovation
  - Strengthen the legal framework for insolvency and reduce related costs
  - Fight corruption and improve governance

Corruption has been a Serious Drag on the Economy

- Corruption is an impediment to socioeconomic progress
- Brazil's corruption perception is higher than its level of development would imply



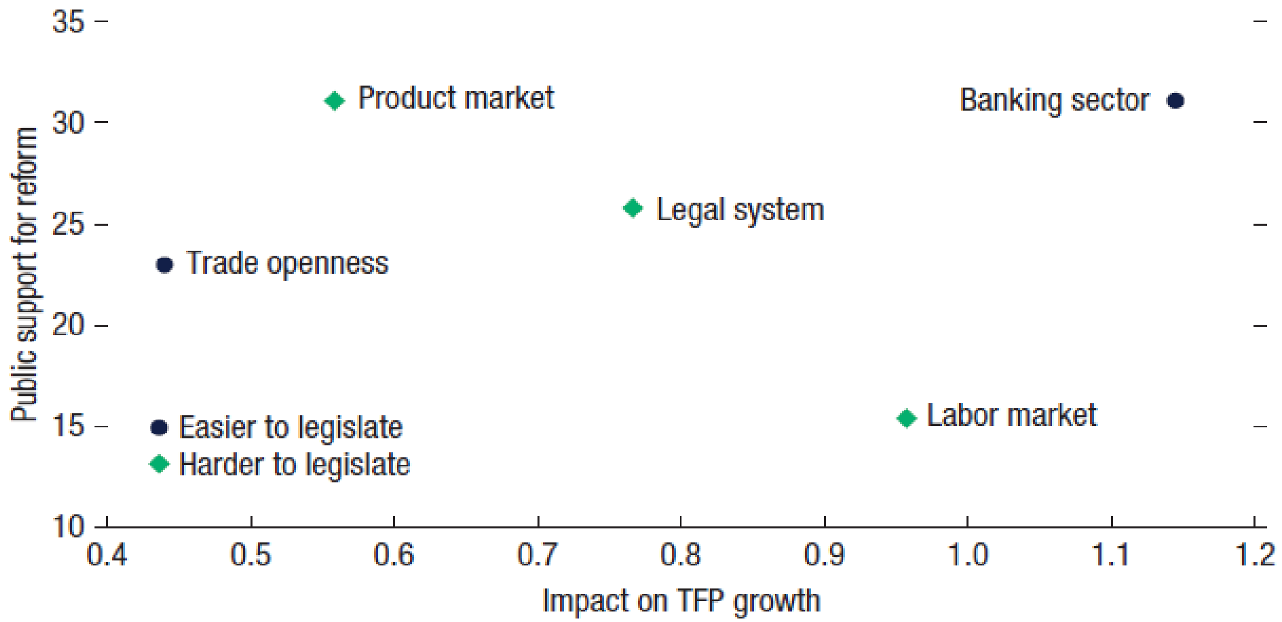
Note: The bars show the residual from a regression of Control of Corruption (World Bank) on GDP levels.

- Reducing corruption and improving governance would unleash growth and boost social progress

Leadership and Resolve Needed to Carry Over Much Needed Structural Reforms

- Structural reforms are politically unpalatable
- Concentrate reform efforts in critical areas with *high growth payouts* and *low political cost*

Economic Impact and Public Support for Reforms



Note: The *Impact on TFP growth* measures the estimated effect on the 1-year ahead TFP growth from closing Brazil's structural reform gaps with AEs. The *Public support for reform* shows the share of surveyed people (2016 Latin Barometer) supporting each structural reform.

Back to High Gear

- Brazil achieved impressive economic and social progress in the past
- It can unleash growth again by pursuing much needed reforms
- This will require:
  - Clear policy priorities
  - Strong political leadership
  - Partnership across all stakeholders
- Time is of the essence to change gears and return to PROGRESS.

THANK YOU