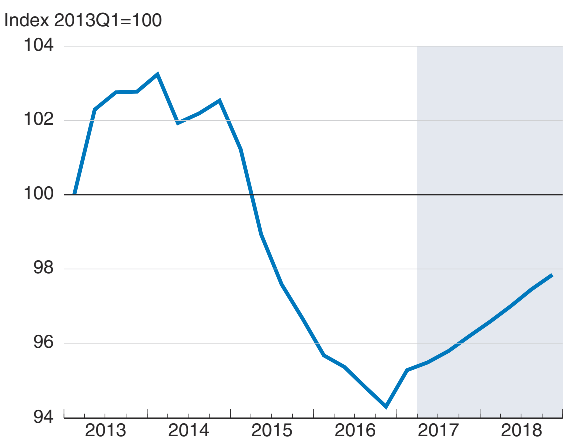
BRAZIL

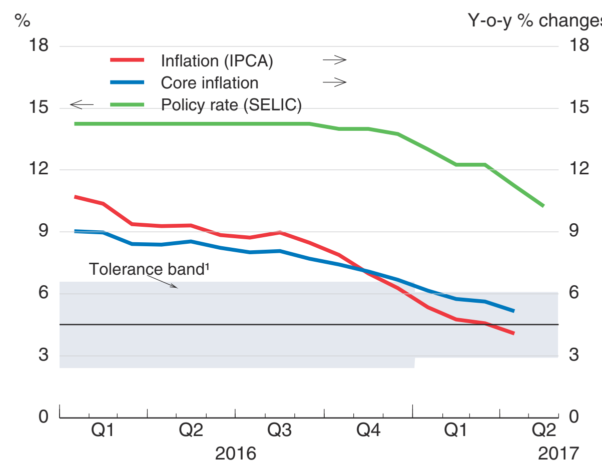
The economy is finally emerging from a severe and protracted recession. Still, the recovery is projected to be weak and slow. Consumer and business confidence is rising and agricultural exports started the year on a strong footing. However, unemployment is projected to decline only towards the end of this year, and then to fall only gradually. Inflation has decreased significantly, partly due to lower demand, and is projected to close the year below the 4.5% inflation target. Inequality remains high.

Lower inflation will allow for a more frontloaded monetary easing than anticipated earlier, which should support a stronger recovery of investment. Fiscal policy will need to be broadly neutral, balancing the need to ensure medium-term fiscal sustainability against the need to support a still fragile recovery. Implementing the planned pension reform is crucial to ensure the sustainability of the public finances and compliance with the recently passed expenditure rule. A sustainable pension system is part of a package to make growth more inclusive, along with a reorientation of social spending towards more effective instruments such as conditional cash transfers. Labour market rigidities and legal uncertainty would be reduced by a labour reform currently being discussed in Congress. In light of recent corruption revelations, more effective measures to fight corruption and improve governance are needed.

The economy remains fairly closed, which hampers competition and limits access to imported intermediate inputs. The recent easing of local content rules is welcome, but trade barriers remain high. Domestic policy reforms to raise competitiveness, including a major tax reform, lower administrative burdens and stronger infrastructure investment, will boost growth and ease the adjustment towards a more open economy. Strengthening vocational training would help displaced workers to find new jobs.

Brazil





1. The inflation target is met whenever the accumulated inflation during the period January-December of each year falls within the tolerance band.

Source: Central Bank of Brazil; and OECD Economic Outlook 101 database.

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Brazil: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices BRL billion	Percentage changes, volume (2000 prices)				
GDP at market prices	5 329.8	0.5	-3.8	-3.6	0.7	1.6
Private consumption	3 289.1	2.3	-3.9	-4.3	-0.6	1.5
Government consumption	1 004.3	0.8	-1.1	-0.5	-0.8	0.7
Gross fixed capital formation	1 115.0	-4.2	-13.9	-10.3	-3.7	1.7
Final domestic demand	5 408.4	0.7	-5.3	-4.6	-1.1	1.3
Stockbuilding[1]	45.0	-0.3	-1.0	-0.6	1.9	0.0
Total domestic demand	5 453.5	0.3	-6.3	-5.2	0.8	1.3
Exports of goods and services	618.0	-1.0	6.2	1.8	4.7	4.6
Imports of goods and services	741.7	-1.9	-13.9	-10.3	5.2	2.7
Net exports[1]	- 123.7	0.2	2.6	1.7	0.0	0.3
Memorandum items						
GDP deflator	_	7.9	7.9	8.3	5.8	5.4
Consumer price index	_	6.3	9.0	8.7	4.2	4.5
Private consumption deflator	_	8.1	9.6	9.4	4.6	5.8
General government financial balance[2]	_	-6.0	-10.2	-9.0	-8.2	-8.0
Current account balance[2]	_	-4.2	-3.1	-1.3	-0.2	-0.1

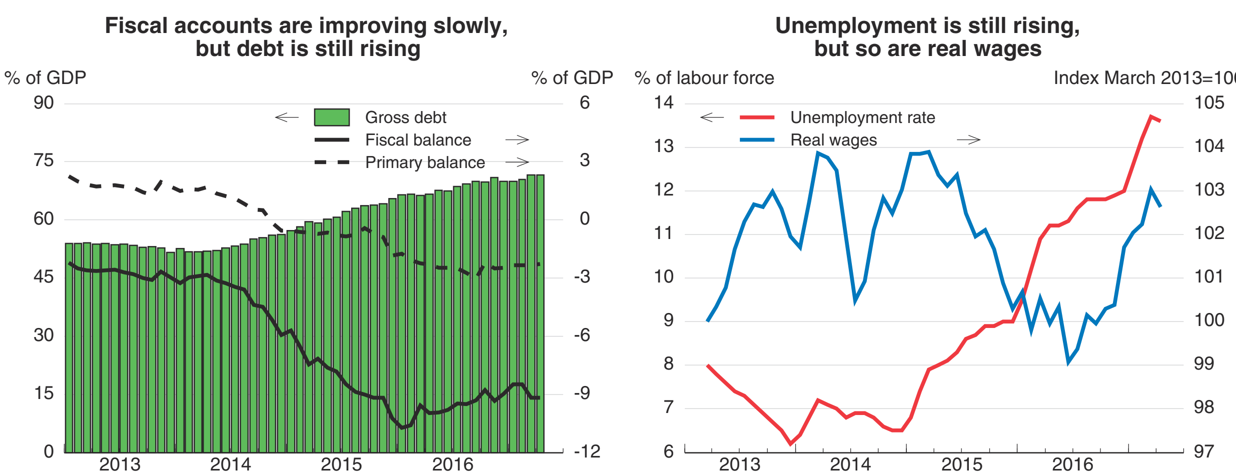
1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933506208

The economy is emerging from a severe and protracted recession

After eight quarters of falling output, the signs of an ongoing recovery are now becoming firmer. Confidence indicators are rising, even if their level is still low, and retail sales have been strong. Signals of industrial production have been mixed so far. Inflation

Brazil



Source: Central Bank of Brazil; and IBGE.

StatLink http://dx.doi.org/10.1787/888933502807

has declined substantially, partly driven by falling demand. Exports had a strong start this year, supported by an exceptionally good harvest, rising commodity prices and stronger external demand.

Unemployment has risen to above 13%, but formal employment has recently picked up somewhat and real wages have increased as inflation has declined.

Policies are supporting the recovery

After two years significantly above the 4.5% target, year-on-year inflation has now returned to the target and inflation expectations for the year-end are even lower. This opens space for further policy rate cuts, in addition to the 300-basis point reduction since October 2016. Lower financing costs will support investment and provide relief to indebted corporations. Going forward, the recent decision to link directed lending rates to market rates should make monetary policy more effective.

In light of rising public debt, currently at 72% of GDP, fiscal policy has to ensure a medium-term adjustment without derailing the still fragile recovery. The fiscal deficit remains above 9% of GDP. Part of the recent weakness of revenues is cyclical, but further permanent adjustments will be required to ensure a firmly declining path for public debt. An appropriate balance has been struck so far, combining a mild adjustment in the near term with measures to rein in spending over the next years. A new expenditure rule limits real increases in spending and reduces the rigidity of the budgeting process, improving long-term fiscal sustainability. Nevertheless, flexibility is still limited regarding pensions and social benefits, which amount to almost half of central government spending, and interest payments on public debt account for 19% of public spending, due to an average interest rate of over 9% on public debt.

Implementing the currently discussed pension reform is crucial to comply with the new expenditure rule and to turn the fiscal adjustment into a success. The population aged 65 and above will more than triple in the next four decades and, without a comprehensive reform, pension spending would increase by almost 3% of GDP by 2030, from 8.2% of GDP now. Seizing the occasion to better target benefits and better balance social protection across age groups could accelerate Brazil's social progress and lead to larger declines in inequality and poverty. Scope for raising spending efficiency exists across many areas.

Additional structural reforms have a significant potential to boost growth. Reducing the compliance costs and distortions imposed by Brazil's fragmented system of indirect taxes would provide an almost immediate cost reduction for firms, and could be achieved by consolidating all indirect taxes into one broad-based value-added tax. In addition, reducing barriers to international trade would cut the costs of imported inputs and strengthen incentives to enhance productivity. The recent decision to ease local content rules is one step towards reducing trade barriers, which will however remain high in international comparison. Stronger trade integration would benefit low-income earners in particular, as an expansion of the export sector would have a larger impact on the demand for low-skilled labour and greater competition would lower prices. Improvements in infrastructure could also reduce transport costs, particularly for exporters. Further improvements in educational attainment would not only raise productivity, but allow more low-income households to join Brazil's growing middle class.

More effective measures to prevent corruption, particularly in public procurement, are needed to improve governance and prevent future diversions of public funds. This should include a thorough assessment of public procurement laws, including the rules pertaining to conflicts of interests. Planned reductions in directed lending are likely to reduce the scope for kickbacks from implicit subsidies and should be pursued as planned.

Growth is projected to strengthen gradually

Growth is projected to rise gradually in 2017. Improvements in confidence and further monetary easing will support a recovery of investment. Private consumption is projected to improve on the back of rising real incomes due to lower inflation. A recent decision to widen the scope for withdrawals from individual accounts in the unemployment insurance scheme will also raise household disposable incomes and support private consumption. Private sector investment will be limited by high corporate debt. Unemployment will continue to rise until end-2017, before starting to decline as growth strengthens further in 2018.

Political uncertainty related to recent corruption allegations could pose significant risks for growth. Political events could lead to a resurgence of uncertainty, reverse the recent recovery of confidence and cast doubts on the implementation of structural reforms, which are supporting the projected recovery. In particular, a successful implementation of the pension reform, without amendments that would jeopardise the expected improvements in sustainability, will be seen as a litmus test for the ability of the authorities to implement structural reforms. Downside risks could also come from the corporate sector, where the protracted recession is reflected in rising corporate defaults in the face of high debt levels, which could in turn weaken some parts of the financial sector.