Santander

ECONOMICS

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Brazil—Economic Activity

The Unstoppable Force of Consumption

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- **Regardless of the results of the elections and the (likely lack of) evolution of Social Security reform, we see room for consumption to grow faster than 5% in 2018, in real terms.**
- **Apart from the impulse coming from employment and wages, we believe the reduction of interest rates will decisively contribute to the boost in household disposable income (net of payments of interests and amortizations) beyond the usual measures of aggregate wages.**
- **Our indicator of income net of financial burden is already growing closer to 4% p.a., faster than the Central Bank's estimation for disposable income (3% p.a.). Even under very conservative assumptions, this modified version of income could easily expand faster than 5% in 2018, in our opinion.**
- **For the same reasons consumption was repressed during the crisis, leading to a more intense reduction than income (increasing savings rate), it may grow faster than income (decreasing savings rate) during the recovery**
- **Therefore, one should not rule out consumption growing faster than our 5% forecast in 2018, well above consensus estimates.**

Chart 1: Household Disposable Income, Total and Net of Interest and Amortizations (% in 12 Months, Above Inflation)

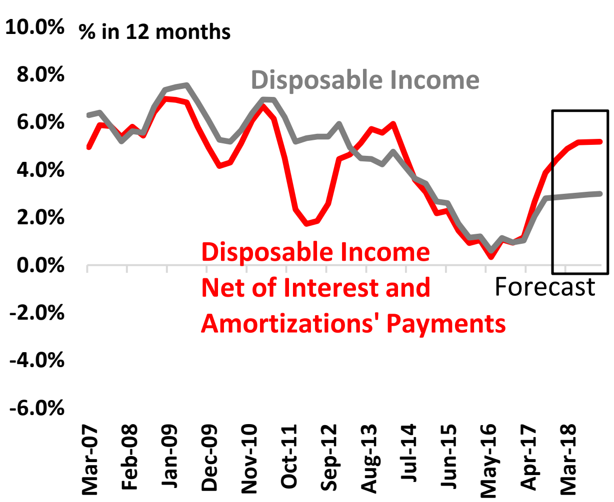
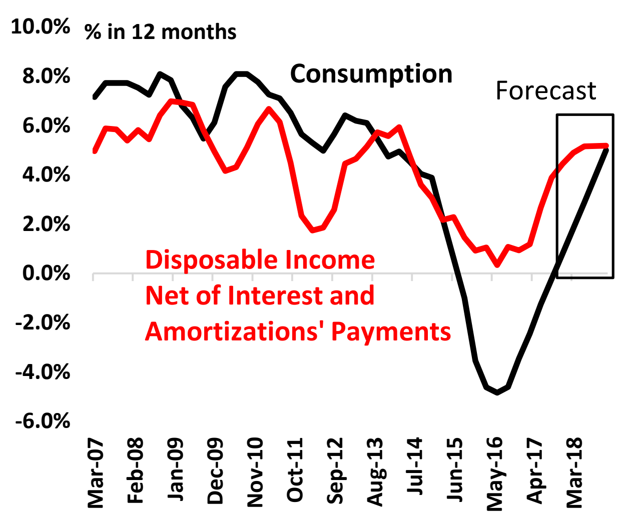


Chart 2: Household Disposable Income Net of Interest and Amortizations and Consumption (% in 12 Months, Above Inflation)



Sources: Brazilian Central Bank and Santander estimates.

Consumption Expected to Grow Faster Than Income in 2018

Favorable prospects for economic activity in 2018 have been systematically reinforced by the recent performance of employment and wages, as shown by data released by the IBGE, as well as by disposable income figures estimated by the Brazilian Central Bank. The 12 months accumulated aggregate wages up to October is already expanding at a pace of 2.8%

compared with the same period one year before, according to the monthly employment survey, as a consequence of both job creation and increase of salaries in real terms. This impulse can be already perceived by the advance of retail sales and demand for services.

Common sense tends to assign great deal of responsibility for labor markets to the performance of consumption dynamics**.** *We suggest that household demand for goods and services in 2018 may be affected by two additional important factors beyond aggregate wages: (1) the impact of lower borrowing costs on disposable income (net of interest payments and amortizations) and (2) the reduction of the savings rate, meaning household consumption may grow faster than income.*

Disposable Income Net of Interest and Amortizations Payments

We look at *disposable income net of interest and amortizations payments* in order to evaluate what is going on in terms of the amount of income available to families to purchase goods and services. Apart from usual monetary policy transmission mechanisms to domestic demand (wealth, credit, confidence, etc.), the impact of lower borrowing costs on households' monthly debt burden tends to be considerable in Brazil due to the unusually short average tenor of debt and the high share of income allocated to pay for financial services. While short debt maturities mean that changes in the base rate are passed thorough borrowing costs reasonably quickly, the elevated financial burden assigns substantial importance to this component on the final availability of resources households are left with in order to allocate towards consumption. Brazilian Central Bank data show that after peaking at 22.4% of monthly disposable income, the debt burden (share allocated to pay interest and amortizations) has already fallen by more than 2 p.p., toward 20.4% at the end of September.

According to our calculations, while disposable income seems to be currently expanding at a pace of 3% per year (12 months to September, the latest data available by the BCB), the concept of income net of payments of interests and amortizations is already growing 4% per year. *Even assuming a very conservative hypothesis for the performance of labor markets in 2018 (i.e., extrapolating current 2% expansion of employment and 1.5% of real income) and considering an additional reduction of debt burden toward 18.5%; our measure of net disposable income would show a 5% expansion in 2018.*

Those figures mean that aggregate wages in 2018 would add BRL 87 billion (1.2% of GDP) to household income available for consumption, while the reduced debt burden contribute with another BRL37 billion (0.5% of GDP). The chart on the left hand side of previous page depicts both concepts of household disposable income, including our forecasts for next year.

Household Savings Rate

Apart from the favorable impact from increased income, one should consider what may happen with the savings rate. Chart 1 provides some insights into the behavior of consumers during the recent economic crisis. While disposable income has slowed substantially, consumption collapsed well beyond the adjustment of income, suggesting households repressed consumption in the period, possibly due to pessimism regarding the economic prospects. Similarly, by the same token as individuals increased their saving rate and engage in a process of deleveraging during the recession, it is likely that improved optimism will unleash repressed consumption and reduce the savings rate, meaning consumption could increase at pace faster than income.

Therefore, we may see consumption growing more than our forecast for income, which is currently 4-5% next year. An expansion of consumption around 5% would mean a contribution of 3 p.p. to Brazilian GDP in 2018.

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