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## Brazil — Economic Activity

# Can FGTS Funds Boost the Economy in 2017?

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- **In the coming days, the government will release a calendar for the withdrawal of funds from inactive FGTS accounts – resources which workers did not expect to receive – totaling BRL 41.4 billion. Some 10 million people will benefit from this measure.**
- **In this piece, we address whether these resources can help leverage domestic consumption in 2017. According to our preliminary estimates, impacts tend to be modest: even under optimistic assumptions, household consumption could see a lift of 0.4% this year and 0.3% the next, leading to an additional GDP growth of up to 0.25% in 2017 and 0.15% in 2018. Potential impacts on household debt dynamics and delinquency levels also tend to be very limited.**
- **Nevertheless, we welcome the measure, less for its short-term effects and more for its positive (if incremental) contribution to increasing efficiency in resource allocation.**

### FGTS: what it is and how it works

Within the so-called microeconomic package announced last December, perhaps the most pragmatic and immediate measure was the permission for private sector workers to withdraw funds from inactive FGTS accounts – the type of news which, in an income-constrained economy, tends to be read as positive for consumption. But what is the potential impact of this measure – and what exactly is the FGTS, to begin with?

FGTS (Fundo de Garantia por Tempo de Serviço) is a system created in 1966 aimed at establishing a severance fund for workers. Every month, the employer deposits 8% of the employee's salary in an individual account on her behalf, so that at the end of contract with a firm the employee will have deposits equivalent to one month of salary for each year worked at that firm, plus interest. The balance in the FGTS account also serves as a base for calculating the fine paid by the firm in cases of undue dismissal, making that fine also proportional to both the time worked for this employer and the worker's average salary during this period. In that sense, FGTS accounts represent a "guarantee" that the dismissed worker will receive a severance payment: i.e., even if a firm lays off workers due to financial distress, past deposits will guarantee part of the severance payment due to workers, and the firm would only need to make sure to have new funds to pay the fine[1]. Each employer opens an individual account for each of its employees, which means that an employee may have several different FGTS accounts during her career. The accounts from previous employments, which are no longer receiving deposits, are called *inactive accounts*.

Although the funds are deposited on behalf of the worker (and therefore should be considered part of her compensation), access to those funds can only happen under specific circumstances, the most important[2] being: 1) in cases of undue dismissal (in which case the worker receives the balance of deposits by the dismissing firm, but not from inactive accounts), 2) in cases of terminal disease, 3) for housing acquisition, under very strict and limited conditions. If the worker does not meet any of these

[1] Note that financial distress of the firm does not constitute a due cause for dismissal, under FGTS rules. In cases of undue dismissal, the worker receives the balance of funds deposited by this firm in her FGTS account, plus a fine corresponding to 40% of total deposits made by this employee. Since 2001, the firm bears an additional cost related to a fine of 10% of total deposits which is paid to the government (not to the dismissed employee); also in December, the government announced this additional fine will be phased out within the next 10 years, at a pace of 1 percentage point per year.
[2] In 2015, withdrawals from FGTS totaled BRL 99 billion, with undue dismissal leading the reasons for withdrawal (66%), followed by housing (13%) and retirement (12%).

criteria – for instance, if she voluntarily quit her job – previous rules dictated that she could only access funds in inactive FGTS accounts at the time of retirement or if she remains out of the formal job market (i.e., not receiving deposits in any FGTS account) for at least 3 years. **The measure announced last December allows for workers to withdraw all funds from accounts that were inactive as of end-2015**. According to the government, the measure unfreezes some BRL 41.4 billion in 18.6 million inactive accounts, benefiting around 10 million workers. In order to avoid a concentration of withdrawals on a given date, a timetable is expected be released in February, likely based on workers' birthdates[3].

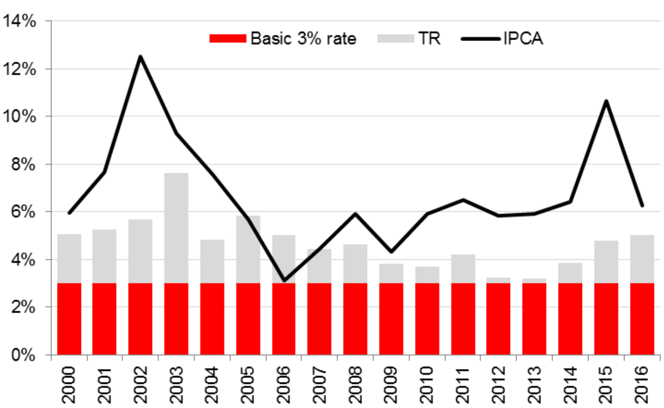
**Will these funds make a difference for the growth outlook this year? The answer requires a view on two questions: 1) how likely are workers to withdraw those funds from their inactive FGTS accounts?, and 2) what is the most likely use they will make of those resources?** In the following sections, we examine these issues and make some assumptions that allow us to outline potential impacts on consumption, delinquency and household debt burden.

### How likely are workers to withdraw from liberated inactive FGTS accounts?

We do not have much information about how the process will work, but it seems reasonable to assume that workers will have to proactively contact a branch from Caixa Econômica Federal (where all FGTS funds are deposited) in order to claim their funds, following a timetable yet to be announced. While it might be reasonable to suppose that this could prevent some of the workers from withdrawing their funds, we feel compelled to assume that the vast majority of funds will be withdrawn, for three reasons: (i) the coming opportunity for workers has been widely advertised and discussed by media; (ii) many of the eligible workers are facing financial difficulties, so the unexpected access to this resource is rather welcome; and (iii) for those who are not in financial distress, the extremely low yields on FGTS accounts should be more than sufficient to stimulate the decision to withdraw.

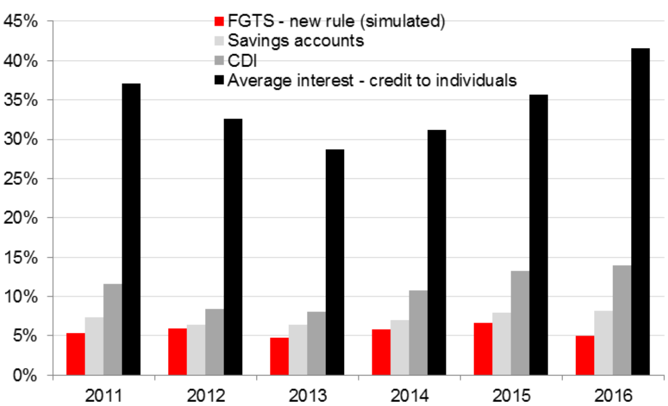
On the latter point, FGTS yield has, for many years, been set by law at an annual 3% plus TR[4]. As a result, interest on FGTS accounts has been underperforming not only conservative investments widely available to the public, but even inflation itself: in fact, FGTS has been yielding negative interest in real terms for most of the last 17 years (Figure 1). Another measure announced as part of the December microeconomic package changes this, by committing the fund to distributing half of its annual profits to workers. According to some estimates, this could bring the total yield to the range of 5% to 6% plus TR – close to the most conservative investment instrument available to small investors (savings accounts), which currently pays 6.17% plus TR. This additional yield depends on the fund's actual performance (and therefore is not guaranteed), and will be distributed annually with a 4 to 6-month lag, based on the existing balance of individuals' accounts at the close of the preceding year. In theory, this additional yield could stimulate workers to postpone the withdrawal until after year-end. However, we do not anticipate postponed withdrawals, as we believe alternative options such as paying down consumer credit debt, avoiding additional consumer credit borrowing, or investing the money elsewhere will seem more attractive options for most workers. **Therefore, we assume the full BRL 41.4 billion in withdrawals, starting in March and evenly distributed over one year (i.e., assuming birthdates as access criteria and no postponements due to the promised additional yield).** This estimate contrasts with government's more conservative assumption that only 70% of the funds will be withdrawn (BRL 30 billion), as per historic experience.

**Figure 1 – FGTS remuneration versus inflation**




FGTS remuneration = 3% + TR per year. TR = max{0, 100 x [(1 + TBF/100)/R – 1]}, where TBF corresponds to an average remuneration of time deposits (usually 90% tp 95% of Selic) and R is a reduction factor which depends on the Selic level (the higher the Selic, the higer the R and hence the lower the transmission of the Selic to the TR).
Sources: BCB and Santander.

**Figure 2 – New FGTS versus alternative uses of funds**




**FGTS – new rule**: simulations based on the distribution of half of each year's profit to the existing accounts (according to our estimates, average of 4.8% + TR per year in the 2011-2015 span); **savings accounts**: set by law at 6% + TR (since 2012, 6% + TR or 80% of the Selic, whichever is lower); **CDi (interbank depositary certificate)**: 99% of Selic on average – most depositors are paid something between 90% and 100% of CDI; **interest paid by individuals in credit operations:** weighted average of all modalities. Sources: BCB and Santander.

[3] Alternative criteria under review include enrollment numbers (PIS) and balances in the inactive accounts, but birthdates seem the most simple and therefore plausible choice.
[4] TR stands for Taxa Referencial (reference rate) and is set automatically according to a complex formula, which in practice makes the TR underreact to changes in the target overnight rate (Selic).

## How will workers use these funds, and how will this impact the economy?

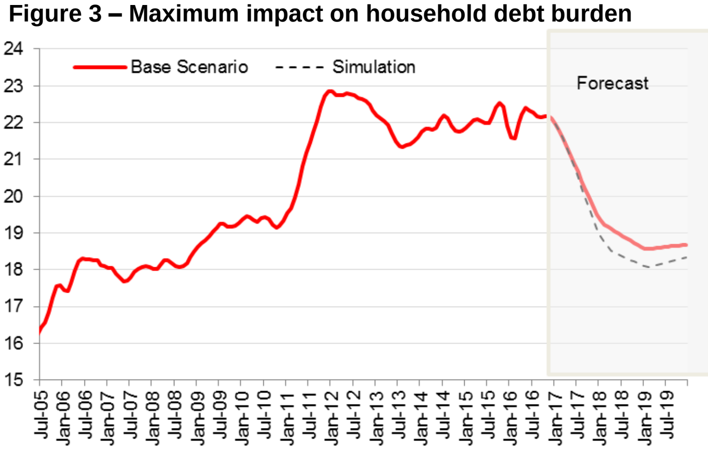
Once we assume that eligible accounts will be withdrawn, the next question is what workers will do with the resources. The three main potential uses are: (i) increasing consumption, (ii) paying down existing debt or (iii) simply reallocating the resources to more interesting investment alternatives.

Although it is practically impossible to answer this question with precision, we ran an exercise in order to obtain at least an approximated impact on consumption. We assume, for simplicity, that the BRL 41.4 billion will be treated by workers as if it were a temporary increase in income. Hence, we assume a corresponding increase in the variable "income" in our consumption forecast model[5]. Note that, as with any econometric model, our analysis is based on historical patterns, and in that sense, it assumes that the pattern seen in the historical series – which implies that not all income gains become consumption – will be replicated in this exercise. Another advantage is that the methodology we use already takes into account eventual multiplying effects of this positive shock on income.

**According to our estimates, the BRL 41.4 billion would correspond to an increase of about 1.4% over the sum of income available from labor, social security and social transfers**. **Our model suggests that this increase would translate into a 0.4% additional advance in household consumption, potentially adding some 0.25% to headline GDP this year**. As we assume that some of the disbursals will happen in early 2018, and also considering the lagged effects predicted by the model, there could be an additional lift of 0.3% for household consumption and 0.15% for headline GDP next year. Regarding the latter point, it is possible that the effect is more frontloaded than the model suggests, given the nature of the additional income.

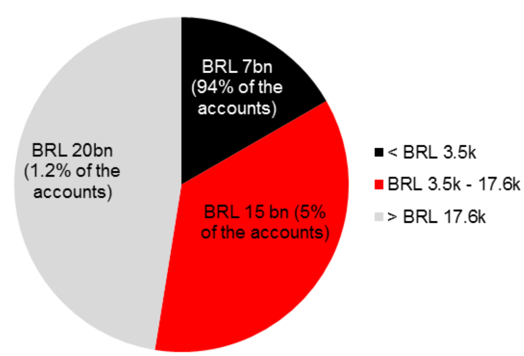
While the model assumes that the FGTS resources will not be entirely devoted to consumption, it does not specify the share that will be put to that use as opposed to paying down consumers' debt. **Nevertheless, even without this information, it is possible to hazard a guess that there will be a negligible effect on household debt burden and delinquency.** The rationale supporting this claim is that, even under the rather extreme assumption that all BRL 41.4 billion would be used exclusively for paying down debt, the total (maximum) effect would be far from meaningful. **We calculate that an eventual reduction of BRL 41.4 billion in outstanding consumer debt would reduce household debt burden by some 60 basis points, which in turn would reduce delinquency by 15 basis points** (currently, household debt burden stands at 22.2% and delinquency of individuals' credit is 4.1%). Given that the maximum effect is so limited, the actual impact would be rather small and definitely not a game-changer.

**Figure 3 – Maximum impact on household debt burden**




The dotted line represents the expected household debt burden if the entire BRL 41.4 billion is used for individuals' debt reduction, all else equal. It assumes that withdrawals are distributed evenly across 12 months. Sources: BCB and Santander estimates.

**Figure 4 – Inactive FGTS account: estimated distribution**




Based on information available at the 2015 FGTS Managerial Report (2015 MR), and figures mentioned by the press. From the report, we obtain the number of inactive accounts with zero balance (10.7 million) and distribution of active accounts by balance (which we apply to the number of inactive accounts with a balance). The combination of these assumptions yield 86% of the accounts with up to 880 reais (one minimum wage) in balance, matching the statistics mentioned by officials. Sources: FGTS, press and Santander estimates.

**We caution our readers to take these estimates with a grain of salt, as there are some caveats to these exercises.** Economic theory assumes that, in their decision-making process, consumers tend to treat typical income flows differently from unanticipated and extraordinary inflows of funds (such as these FGTS disbursals). Assuming that consumers prefer to smooth consumption over their life span, they tend to consume little of inflows that are perceived as windfall (i.e. extraordinary), opting to save them instead. An exception to this behavior, however, seems to exist when consumers face credit constraints. Our

[5] Our model, estimated by VEC (vector error correction), considers household consumption, income, real interest rate, and consumer confidence as endogenous variables.

exercise leaves aside this question, as it assumes that the windfall resources will be treated as ordinary income regardless of whether or not workers receiving these resources are credit-constrained. In this sense, **our exercise potentially overestimates the impact on consumption and on GDP growth**.

This potential bias becomes more evident as we bear in mind that the BRL 41.4 billion is not evenly distributed among the 18.6 million eligible inactive FGTS accounts. Quite the contrary: according to information released by the press, the vast majority (86%) of these accounts have less than one minimum wage (BRL 880 at the time the information was released), whereas a small number of accounts (2%) are said to hold a large chunk of overall funds. However, according to press reports, distribution of inactive accounts by size is roughly similar to that of active accounts. We combined the available bits of information to produce a rough estimate of this distribution (Figure 4). We estimate that about half of the resources (some BRL 20 billion) will go to around 1% of the accounts, or a little more than 100,000 people. As a means of comparison, this distribution is even more heterogeneous than that observed in total real wages – in 2015, the top 1% income earners represented roughly 10% of total income available from labor, social security and social transfers. This particular group of workers seems less likely to use the money either for consumption or debt reduction; rather, they seem more likely to simply direct the majority of these resources towards more advantageous investment options. This is yet another factor suggesting that the actual impact on consumption and debt reduction tends to be smaller than that pointed out in our exercises.

One final comment regarding whether the reduction in FGTS resources will be detrimental to the investments and activities conducted by the fund: Because the legislation dictates such a low yield and imposes so many constraints on workers' access to these assets, the FGTS – which is structured as a fund, making investment decisions and engaging in specific projects and programs – can benefit from cheap funding, with no major concerns regarding short-term shifts in liquidity. These resources are used for a variety of programs, including subsidized housing financing and investment in infrastructure. According to our equity analysts that cover these sectors, neither unfreezing inactive accounts nor distributing half of the annual profit back to workers will affect FGTS's ability to continue supporting such programs. These decisions may, however, limit the extent to which these activities could be expanded in the future.

## Conclusion: a small step for consumption, but a large step for efficiency

**Our estimates suggest that the aggregate effect of the injection of resources from inactive FGTS accounts could hardly be considered a game-changer either for growth or for credit conditions, and in this sense, we do not see any reason to adjust our GDP forecast, which is already more positive than consensus (+0.7% for 2017 and +3% in 2018, versus consensus of +0.5% and +2.2%, respectively). Nevertheless, we warmly welcome the measure, as it represents a step in the right direction: unfreezing these funds should help reduce, even if only marginally, the inefficiency in resource allocation that plagues the country by virtue of a series of rigidities and artificial prices, of which the FGTS stands out as an egregious case. Finally, it is worth noting that, although the aggregate impact may be rather modest, the windfall resources eventually used for consumption might mean a welcome stimulus for some specific segments.**

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