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Brazil: Macro Scenario

Is Monetary Policy Stimulative for Consumption?

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- **In this piece we show that debt burden and confidence — two variables related to important monetary policy transmission channels — are already at levels consistent with expansion of household consumption, at a pace not very far from 2% per year.**
- **Moreover, we believe this impulse could probably become even stronger, considering that consumer confidence has already recovered from 3Q18 lows and that financial conditions are no longer in contractionary territory.**
- **We conclude (at least from the point of view of consumption) that the current Selic rate does not appear to be at or above the neutral level, and that monetary policy is expansionary.**
- **We emphasize, however, that this does not mean that monetary policy could be even more stimulative, particularly in a context of an unusually wide output gap.**
- **In our view, a decent pension reform (generating savings of approximately BRL800 billion in the next 10 years) will be approved by the end of the year.**
- **As events advance towards this outcome, we believe the resulting additional positive influence on household and business confidence will make additional monetary policy stimuli unnecessary.**
- **Hence, we expect the Selic rate to remain unchanged, at 6.5%, at least until the end of the year.**

Figure 1. Consumer Confidence and Consumption Growth (% YoY)

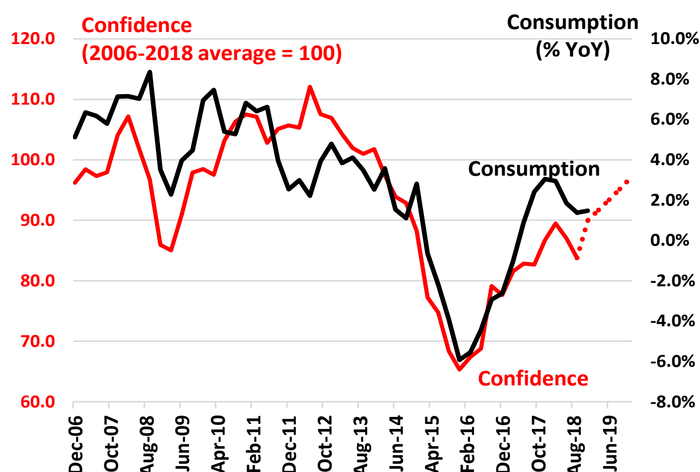
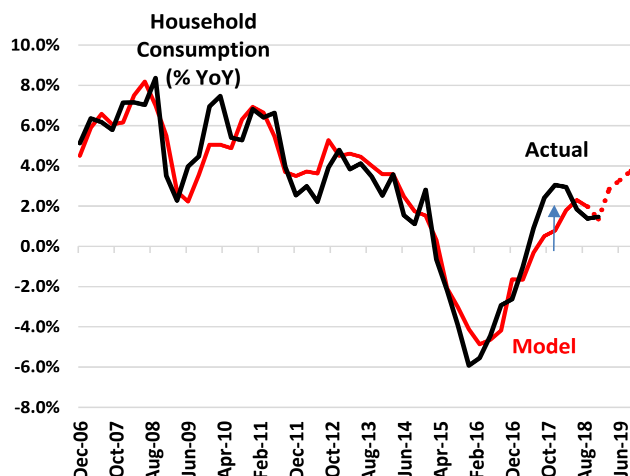


Figure 2. Consumption Growth (% YoY). Actual and Model Outcome based on debt burden and consumer confidence



Sources: IBGE, Brazilian Central Bank, Bloomberg and Santander estimates.

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Introduction

As economic activity in Brazil fails to strengthen as expected after the substantial interest rate reduction of the last two years, the financial community has begun to question more intensively whether the current monetary policy stance is stimulative enough.

In fact, recently released GDP figures show that the economy has remained virtually flat in recent months, which has also raised concerns that monetary policy might not be expansionary at all, suggesting that the current interest rate may not be very different from its neutral level. According to this view, structural changes in Brazil's economy have managed to reduce the Selic rate to a level compatible with stable inflation. If this thesis proves valid, not only should we expect another cycle of rate reductions but also that the economy is destined to remain weak, running with an unusually wide output gap.

Among structural changes that could be constraining economic recovery and compressing the neutral interest rate, we highlight: (i) a tighter fiscal policy; (ii) a reduced credit supply from public-owned banks; and (iii) a lower risk premium and anchored inflation expectations (which changes the trade-off between savings and consumption decisions for households).

In taking a deeper look at this issue from the point of view of household consumption, we focus on two variables (debt burden and confidence) associated with household consumption's most important monetary policy transmission channels (credit and expectations).

What's Wrong with Consumption?

In our view, there is nothing strange going on with consumption. We see the frustration in terms of its performance as fully attributable to the usual exogenous variables, meaning that there is no clear indication of a structural change or the emergence of a new variable that models should incorporate. We illustrate this point by depicting a very simple relationship among household consumption, consumer confidence and debt burden.

With respect to debt burden, the interruption of the downward trend as of mid-2018 seems to have been associated with deteriorated **financial conditions**, owing to higher global risk aversion and exacerbated political uncertainties related to presidential elections (Figures 3 and 4). Those factors have played an important role in preventing banks from narrowing spreads in tandem with the base rate.

Figure 3. Household Debt Burden (Monthly Amortizations and Interest Payments as a Percentage of Income) and Consumption Growth

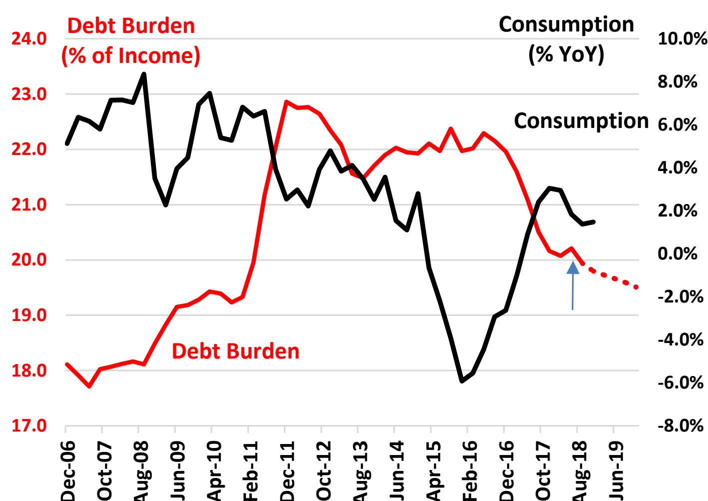
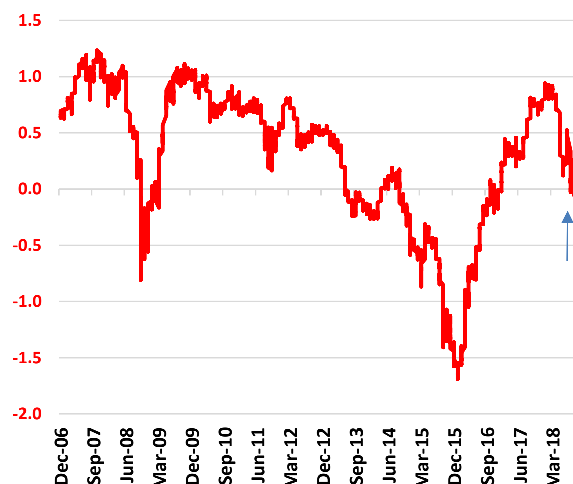


Figure 4. Financial Conditions Index (SAN-ICF)



Sources: IBGE, Brazilian Central Bank, Bloomberg and Santander estimates.

SAN-ICF is constructed using financial markets variables in a way such that positive values indicate stimulative financial conditions, whereas negative values suggest contractionary conditions.

As for confidence, not only elections, but also the truckers strike that broke out in May, drastically affected expectations and contributed to individuals taking a more cautious approach in their spending plans. Figure 5 illustrates the relationship between confidence and household spending, while Figure 6 depicts the outcome of a simple model relating consumption growth and consumer confidence. The charts do not suggest that there has been a structural change that could have led to an underperformance of consumption vis-à-vis its main explanatory variables. **Actually, consumption has outperformed our model**, probably as a result of exogenous factors, such the injection of funds from FGTS accounts and the PIS/PASEP (see our January, 26, 2017 report, *Can FGTS Funds Boost the Economy?*).

Figure 5. Consumer Confidence and Consumption Growth (% YoY)

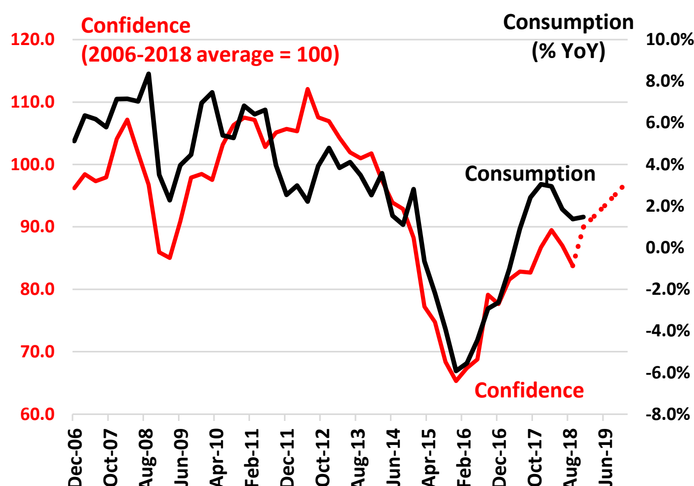
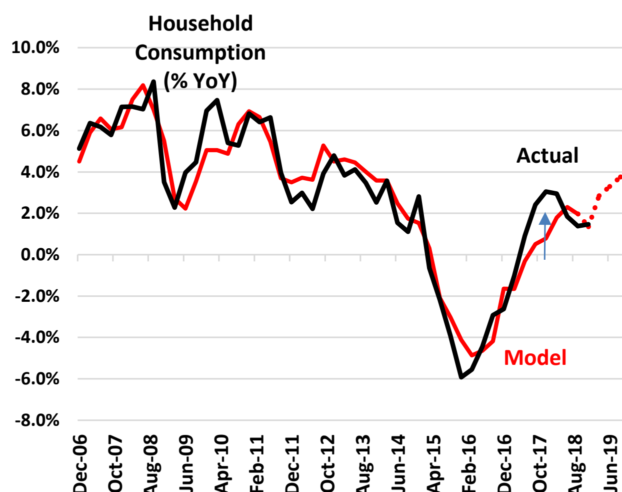


Figure 6. Consumption Growth (% YoY). Acutal and Model Outcome Based on Debt Burden and Consumer Confidence



Sources: IBGE, Brazilian Central Bank, Bloomberg and Santander estimates.

The Monetary Policy Is Doing its Job

According to our models, the slowdown of consumption during 2H18 was related to an adverse shock on consumer confidence and the impact of deteriorated financial conditions on debt burden. Both shocks have already reversed, and, in our view, those variables are trending toward levels compatible with stronger expansion of household demand, thereby suggesting that current monetary policy stance is not an impediment to consumption gaining strength in the upcoming quarters, in the absence of another negative shock on expectations and financial conditions. We conclude (at least from the point of view of consumption) that the current Selic rate does not appear to be at or above the neutral level.

In our view, an improvement in the overall mood expected with the evolution of the social security reform should maintain household debt burden and confidence in a benign trend, consistent with an acceleration of consumption from current levels, even in the absence of additional monetary policy stimulus.

We emphasize, however, that this does not mean that monetary policy should be even more stimulative than it currently is, particularly in a context of an unusually wide output gap. In fact, there are important indications that both debt burden and consumer confidence would probably be in much better shape if fiscal policy were not as contained and public-owned banks were not as cautious as they have been, on average, during the last 15 years.

According to our scenario, a decent pension reform (generating savings of approximately BRL800 billion in the next 10 years) will be approved by the end of the year. If events advance toward this outcome, we believe the resulting additional positive influence on household and business confidence will make additional monetary policy stimuli unnecessary. For this reason, we maintain our YE2019 Selic forecast at 6.5%.

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