

Brazil—GDP and Consumption

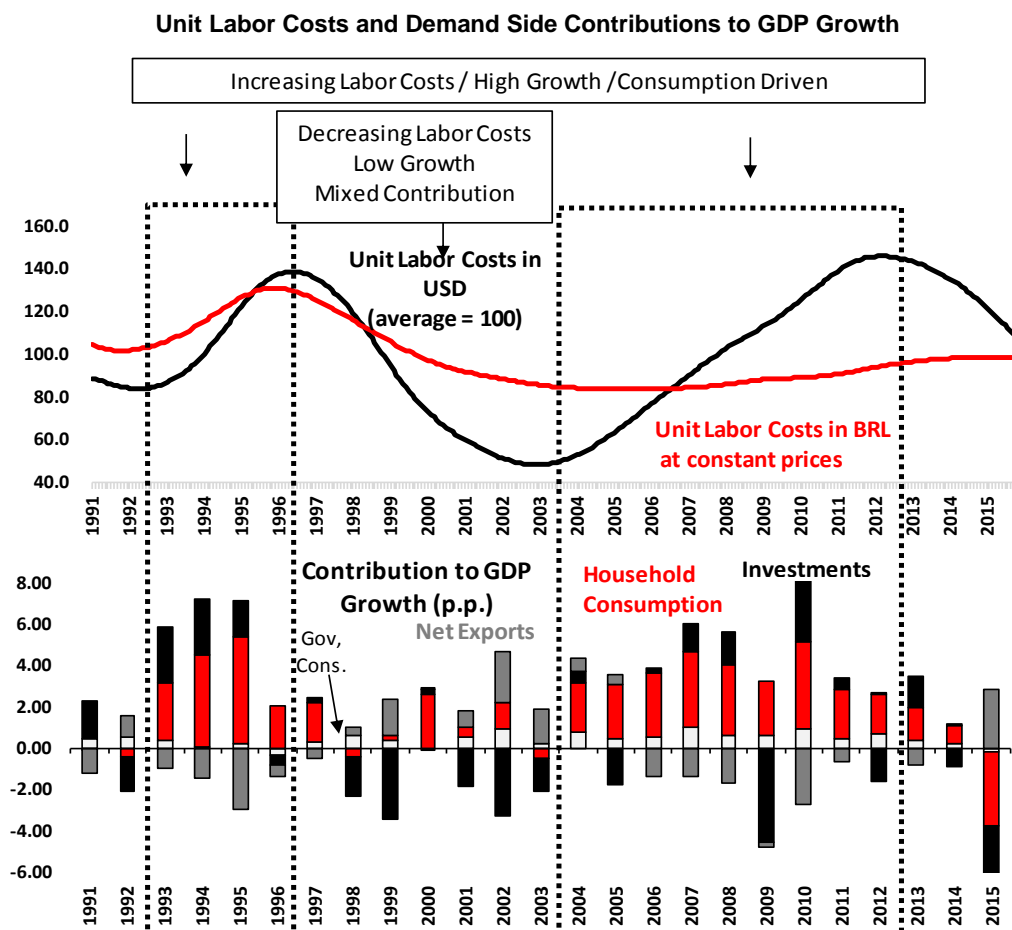
Optimistic about GDP, Not So Much about Consumption

Maurício Molan*

mmolan@santander.com.br

5511-3012-5724

- Although improved confidence may lead to a reduction in savings temporarily, employment will likely remain a drag in coming months, in our view. Moreover, we think credit dynamics are not likely to be of any help before and during the early stages of a monetary policy easing process.
- On the structural side, we highlight the role of competitiveness and corporate sector margins. We believe that during the recovery process, in contrast to what happened between 2004 and 2012, wages will be limited by productivity, meaning labor costs will likely decrease, as will the share of household income in GDP.
- The outcome, in our view, will be GDP expanding at a slower pace than in the previous growth cycle and consumption mostly underperforming.



Sources: IBGE and Brazilian Central Bank.

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Introduction—The Mechanics of Consumption

Not only expectations, but also recently released economic activity data, have reinforced the view among market observers that Brazilian GDP is bottoming out in 3Q16 but will likely resume an upward trend thereafter. (See our report *Climbing Out of the Hole: The End of the Recessionary Cycle*, September 13, 2016; [click here](#).)

The favorable contribution of net exports and improved business confidence suggests, in our view, that domestic demand expansion in the near term will likely be driven (at least in the early stages) mostly by investments in spite of still-low utilization of production factors. (See our report *It's Happening: The Ongoing Investment-Led Recovery*, August 4, 2016; [click here](#).)

In this note, we delve into the expected dynamics of household consumption during the recovery. We argue that, unlike the expansion cycles of 2004-2012 and 1993-96, consumption will probably not be the major contributor to GDP growth in the near future.

From a cyclical perspective, we see the most important consumption drivers lagging GDP. Although improved confidence may lead to a reduction in savings temporarily, we think employment will likely remain a drag in coming months. Moreover, in our view, credit dynamics will not be of any help before and during the early stages of a monetary policy easing process.

On the structural side, we highlight the role of competitiveness and corporate sector margins. The recent rising unit labor costs and decreasing share of companies' income as a percentage of GDP have substantially contributed to the recent collapse of investments, which has been one of the major causes of the 10% loss of per capita income since 2014.

Consumption Drivers—Not So Fast

Household consumption has been in freefall since 2014. In a period of no more than 18 months, it has decreased 8.7% in real terms, returning to levels last seen only at the end of 2010. This steep and rapid contraction was, to a great extent, caused by a serious fiscal crisis, which seriously damaged consumer and business confidence. Fortunately, since the beginning of 2016, we have witnessed some improvement in overall economic sentiment. However, a deeper analysis of the main drivers of consumption suggests that the pace and intensity of the recovery will not be anywhere near the rapidity of the decline.

1) Credit supply and demand will probably remain subdued until mid-2017.

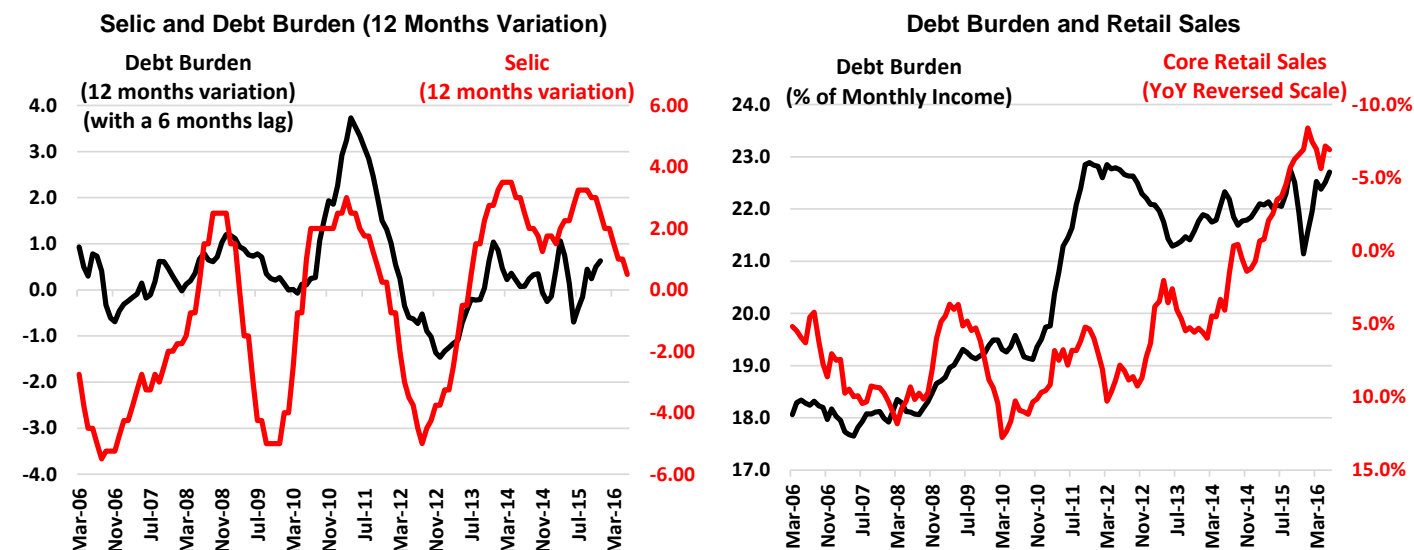
In our view, the resilience of the financial sector in Brazil should be considered one of the most important strengths and reasons to be optimistic that the economy will pick up in 4Q16. Contrary to what has been suggested by the most pessimistic analysts at the end of last year, excessive leverage among households and corporations in a context of deep recession has not led to adverse surprises in the behavior of nonperforming loans. Delinquency remains below provisions, and liquidity is not a problem for the banking system, in our view.

Nevertheless, high levels of debt are reason for caution. Before changing behavior in terms of credit supply and demand, we think consumers will probably wait for stronger indications that the labor market is poised to improve as well as that the debt burden is decreasing owing to lower interest rates.

The charts on the following page illustrate the point. On the left, we expect Selic reductions to favor the debt burden, considering the close relationship between variations of the base rate and final borrowing costs for consumers. This importance should not be underestimated. Due to unusually high lending rates and short maturities of loans in Brazil, the importance of the cost of debt for the dynamics of the debt burden is also disproportional compared with other countries.

On the right, the chart shows that a reduction of the debt burden should affect consumption (retail sales are a proxy here).

Therefore, we expect the credit channel to favor consumption by mid-2017. (See our report *What Can Credit Do for Brazilian Growth?* July 18, 2016; [click here](#).)



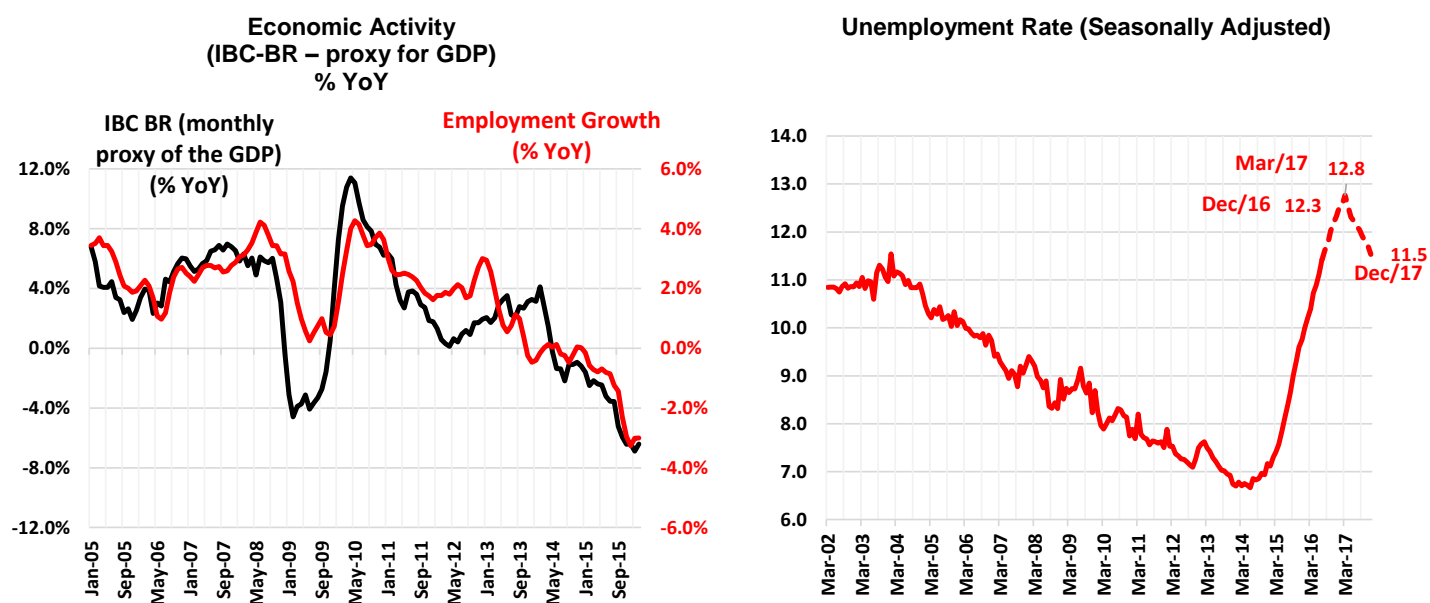
Sources: IBGE and Brazilian Central Bank.

2) Labor market also tends to react with a lag to GDP.

According to our estimates, this time the difference on average should be around three to six months, meaning an inflection of the GDP in 4Q16 will likely lead to an inflection in labor market conditions around 2Q17. The two charts below illustrate this point. On the left-hand side, the IBC-BR, a proxy for GDP estimated by the Brazilian Central Bank, shows that economic activity collapsed in 2014, but that labor markets deteriorated markedly only in 2015.

The existence of this lag makes sense from a theoretical point of view, particularly in economies with more rigidity in the labor market. As firing and hiring are expensive processes, companies tend to wait until the last moment to make these decisions. The chart on the right-hand side shows the expected dynamics of unemployment, according to our estimates. Although the unemployment rate may end 2017 at almost the same level as in 2016, next year's average should still be higher than this year's.

This is another reason why we believe a recovery in consumption is likely to be delayed vis-à-vis GDP.



Sources: IBGE and Brazilian Central Bank.

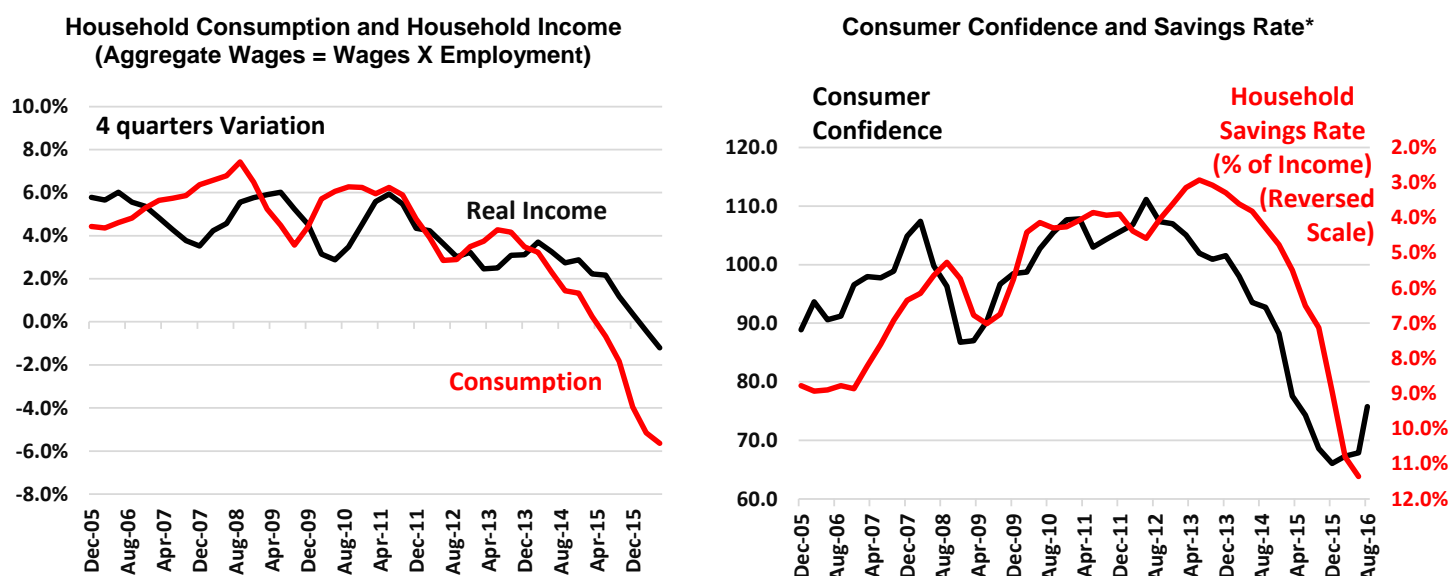


3) Confidence (propensity to spend).

Although confidence alone may not be enough to sustain growing consumption, it can make a difference in the short term, particularly by preventing consumption from falling further between 4Q16 and 2Q17, while credit and income are not playing a favorable role.

Even considering that household income will likely continue to contract for one or two quarters after GDP starts to react (as employment and real wages remain in negative territory), we believe better prospects for the economy will likely reduce savings in the short term and prevent consumption from falling further.

As shown in the charts, the current crisis is characterized by consumption falling much more steeply than income, meaning household savings are probably increasing, according to our analysis. (See the left-hand chart below.) In our view, this makes sense, as even those individuals who have not lost their jobs or had their wages reduced have increased precautionary savings in order to face difficult times ahead. **As confidence recovers (right-hand chart), there may be room to unleash repressed consumption, according to our projections.**



*Estimated by Santander based on IBGE data.
Sources: IBGE and Brazilian Central Bank.

A Different Growth Structure: Improving Competitiveness

Apart from the impact of collapsing confidence on consumption and investments, the current recession, the deepest ever, was also a consequence of a decade of mounting imbalances for businesses.

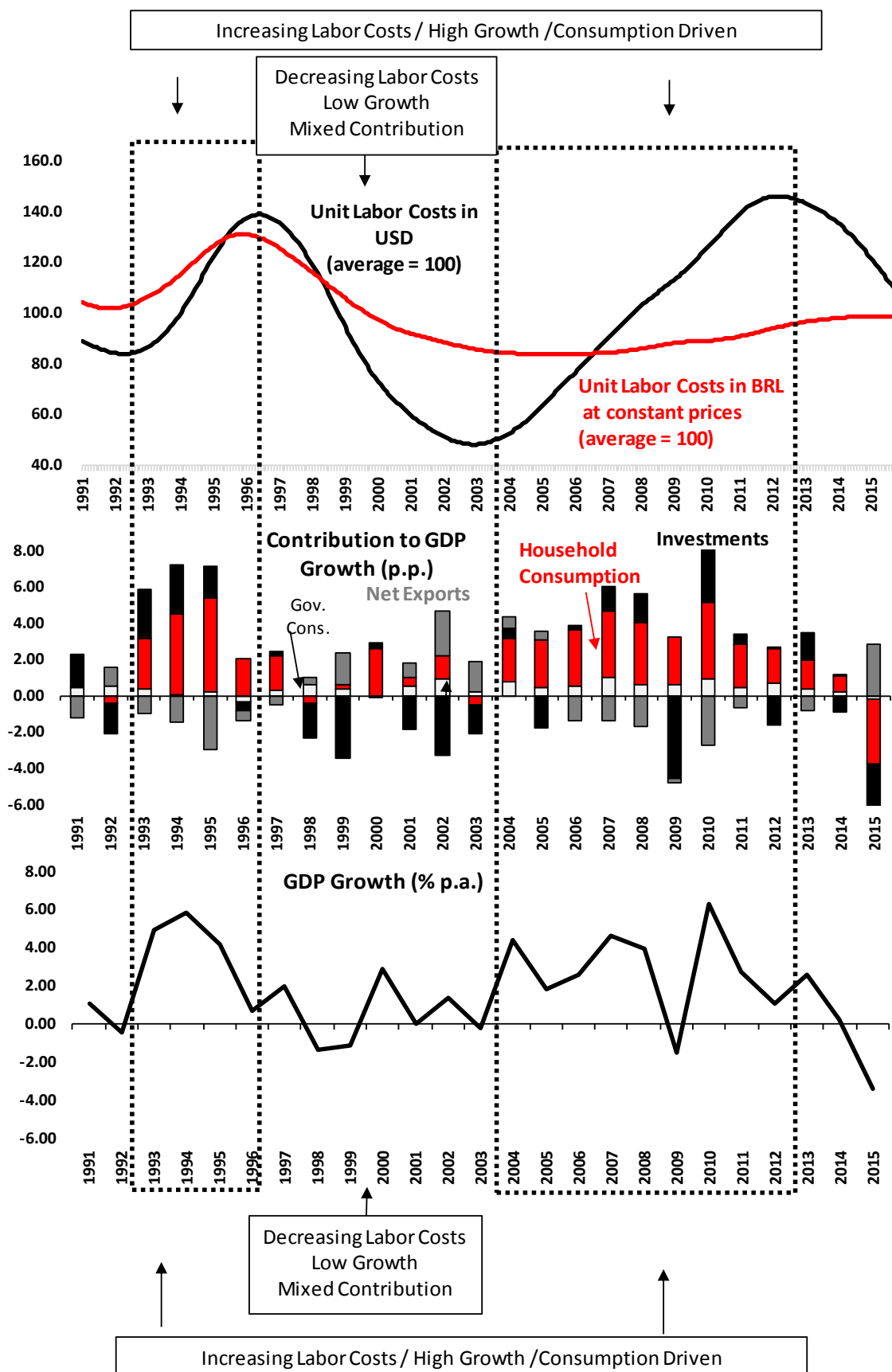
On one side, wages increased systematically above productivity in the period due to expansionary economic policies, particularly in periods of tight labor markets. This has certainly favored households, as their income accounted for an increased share of GDP, sustaining strong consumption.

The other side of the coin was a reduction of corporate sector margins and corporations' share of income as a consequence of increased labor costs, particularly when measured in foreign currency (due to the appreciation of the BRL). We believe **this erosion of competitiveness played an important role in discouraging investments, which helped trigger the current recession.**

This mechanism is illustrated by the figure on the following page.



Unit Labor Costs and Demand Side Contributions to GDP Growth



Sources: IBGE, Brazilian Central Bank, and Santander estimates based on IBGE data.



The previous schematic shows that Brazil has enjoyed two periods of consumption-related expansion in the last 30 years: 1993-96 and 2004-2012. These episodes were characterized not only by the supremacy of households but also by deteriorating competitiveness conditions, a strong BRL, and high current account deficits.

What's Next?

We do not believe there is room for the consumption-based model to be replicated in the near future. Although global liquidity conditions remain benign and could, at least theoretically, finance Brazilian twin deficits (current account and fiscal), we believe that in practice, the current fiscal crisis will tend to prevent long-lasting complacency.

In our view, conditions for growth for the next few years will likely more closely resemble those of 1997-2003: austere fiscal and monetary policies, compressed wages to restore competitiveness, weaker currency than the historical average, and economic growth that is not higher than the historical average. In terms of drivers, we expect to see a mixed picture. At moments of optimism regarding the evolution of economic reforms, we could see room for a better performance of consumption, while in times of uncertainty (global conditions and a paralyzed economic agenda), weaker currency may sustain growth based on the external sector.

In any case, the need to restore competitiveness and the risks related to the current weak fiscal position suggest, in our view, that consumption will not be the major driver of GDP in coming years as it was at the end of the previous decade.



CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537

Fixed Income Research

Brendan Hurley	Macro, Rates & FX Strategy - LatAm	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santanderibm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978

Equity Research

Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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