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ECONOMICS

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Brazil - A Contrarian View

Understated Consumption Drivers

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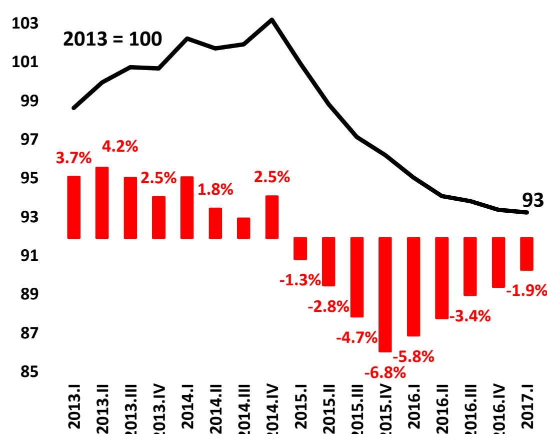
- **The recently deteriorated political environment brought volatility to asset prices and increased uncertainties on the timing and pace of GDP recovery.**
- **In this piece, we analyze what we consider important drivers for consumption which, in our view, have not been receiving adequate attention from market analysts:**
  1) **The inertial component of household income (from 1Q17's favorable agriculture and inflation);**
  2) **The impact of the FGTS (release of mandatory savings funds to individuals);**
  3) **Lower debt service due to the monetary policy easing cycle; and**
  4) **The likelihood of the savings rate declining from already exaggerated levels.**
- **We run an exercise translating those factors into conservative assumptions for income and the savings rate, and conclude that consumption could increase as much as 0.9% in 2017 according to our set of hypotheses.**
- **Therefore, we see room for our projection of +0.3% for consumption growth this year to absorb a negative shock from a deterioration of consumer confidence – as long as it does not collapse towards the historical lows seen in mid-2016.**

Introduction: The Game is not Over Yet

The recent wave of political uncertainty in Brazil threw cold water on the incipient and unsteady recovery of domestic demand. Consensus expectations for GDP growth this year stand at a meek 0.5%, and even that estimate seems to be under a downward bias – the underlying assumption behind that seems to be that the negative impact of the crisis on business and consumer confidence will be strong enough to, at the very least, postpone and tone down the recovery. However, we believe **this is a good time to take a step back and look at the bigger picture: we look at the demand drivers and conclude that they do not warrant such pessimism**.

Consumption index (2013 = 100) and (YoY)



Household Income, Savings Rate and Consumption Hypothesis and Simulation

	YoY to Mar17	YoY to Dec17(S)
Employment	-1.9%	-1.0%
Real Wages	2.4%	-0.5%
Household Income	**0.5%**	**-1.5%**
FGTS		0.9%
Lower Interest Rates		0.4%
"New" Income		**-0.2%**
Savings / Income	15.0%	14.0%
Consumption	**-1.9%**	**0.9%**

Sources: IBGE and Santander. *(S) Hypothesis and Simulation.*

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Those are: (1) the inertial benefit of the recent expansion in real income (due to agriculture, lower inflation, etc.), (2) the impact of the FGTS measure announced last December (permission for private sector workers to withdraw funds from mandatory savings accounts), (3) lower interest rate payments, and (4) the likelihood that household savings rates may not increase further beyond already high levels, unless confidence collapses back to mid-2016 historical lows (which does not seem likely).

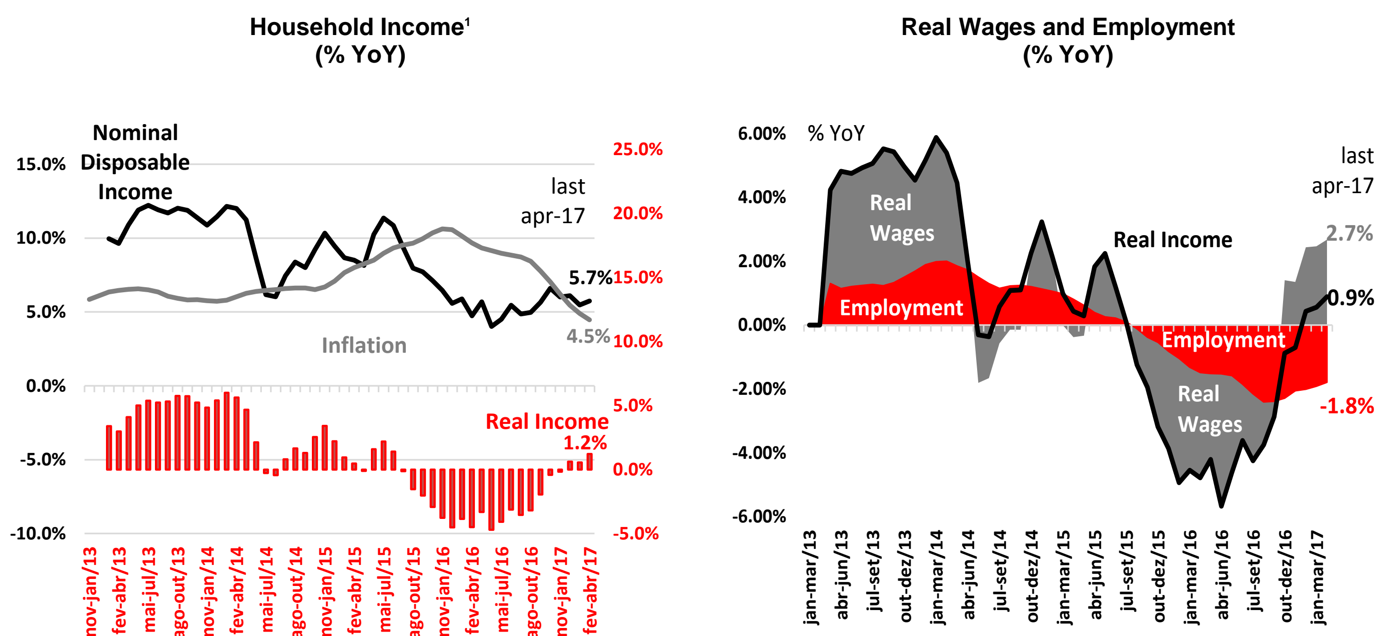
Therefore, we believe those drivers – whose magnitude is depicted in the table above and further detailed in the upcoming sections – warrant a faster pace of consumption recovery than that implicit in our GDP forecast for this year. Given the current uncertainties, we opt for a cautious stance while we wait to see what their effect will be on confidence levels – nevertheless, we see no reason to expect a plunge in confidence large enough to offset these drivers, and hence we believe our 0.3% forecast for household consumption growth is sufficient to absorb that shock.

1) Inertia and Inflation on Real Income

The first quarter brought two very positive developments in terms of economic activity. First, it marked the resumption of economic growth, with a 1% q/q advance in GDP, largely driven by one-off factors, mostly associated with the performance of agriculture and the external sector, but also pointing to a slower pace of contraction in services and domestic demand. The second, and perhaps less debated development, is the reversal in the trend for real income, which has migrated to positive territory and, **for the first time in two years, will have an inertial effect playing in favor of the performance of GDP growth in the coming quarters.**

Going forward, **falling inflation favors the dynamic of real compensation**, as it reduces the pace of erosion of purchasing power of salaries. This has already been confirmed by recent official statistics, which currently show real wages expanding in real terms in spite of still abnormally weak labor market conditions. Although this dynamic will not persist for long, as nominal salary readjustments moderate due to lower inflation, it certainly improves the "feel-good factor" in the short term.

The following charts illustrate recent dynamics of household aggregate wages (salaries + employment) and real wages (as estimated by IBGE).



Sources: IBGE.

2) FGTS on Real Income

We believe that the government's decision to unfreeze a portion of mandatory savings accounts could represent a non-negligible stimulus for household income in 2Q17 ("*Can FGTS Funds Boost the Economy in 2017?*", January 25, 2017, click here). In fact, state-owned bank Caixa Economica Federal has recently estimated[2] total withdrawals of BRL 40 billion, favoring roughly

[1] We use here, as a proxy for household income, the IBGE measure of aggregate wages (employment*real wages). We acknowledge this measure is mostly representative of wage-related sources of income and government transfers (around 70% of household income), not including rents, profits and other sources of income.
[2] http://epocanegocios.globo.com/Empresa/noticia/2017/06/caixa-eleva-para-cerca-de-r-40-bilhoes-estimativa-de-saques-de-contas-inativas-do-fgts.html

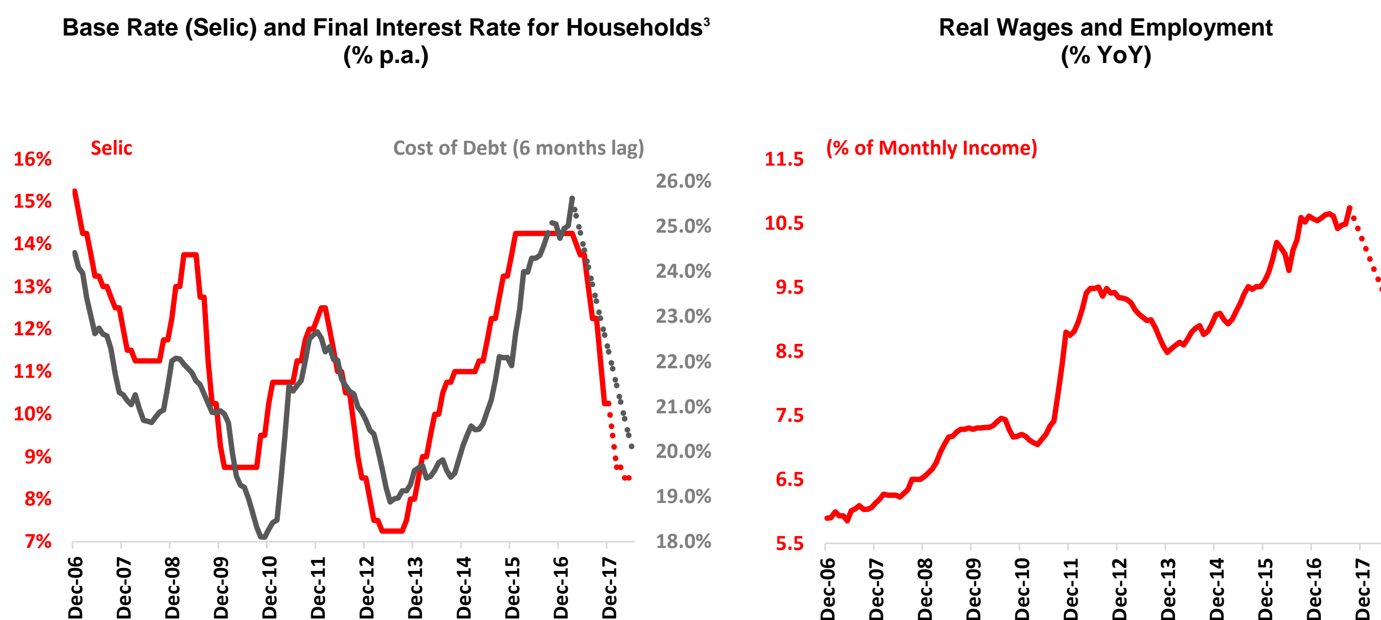
10 million families. This means an estimated additional **0.9% of household income**, which could be used either to reduce debt or to increase consumption.

3) Interest Rate Burden on Real Income

Apart from the economic cycle, lower inflation, and the unfreezing of mandatory household savings, we see household disposable income also likely to benefit in 2017 (and particularly in 2018) from lower financial burdens resulting from the BCB's aggressive monetary policy easing.

We have been arguing that, contrary to what many analysts claim, Brazilian households are not excessively indebted. Indebtedness (measured as debt to annual income) stands currently at 41% and cannot be considered excessive by any international comparison. The problem for consumers has historically been the excessive financial cost of outstanding debt, currently at 10.7% of monthly income (not including amortizations).

Furthermore, if this high interest rate is a heavy burden for households, this could also mean an opportunity for the country if it manages to permanently reduce it towards a level closer to the global average. Although it is too early to assume that real interest rates are coming down for the long term, it is almost certain that household financial costs as a percentage of monthly income will fall substantially in 2017 and 2018.



Sources: Brazilian Central Bank and Santander estimates.

We estimate that the 400-bps Selic reduction since the end of 2016 will likely be enough to reduce the final implied rate for consumers by roughly 450 bps this year (chart on the left hand side), reducing the financial burden of household debt by almost 1.1pp of household income in the next 12 months (0.4pp so far in 2017). This implies, according to our calculations, a R$52 billion reduction in interest payments from mid-2017 to mid-2018, slightly more than the net injection of resources from FGTS.

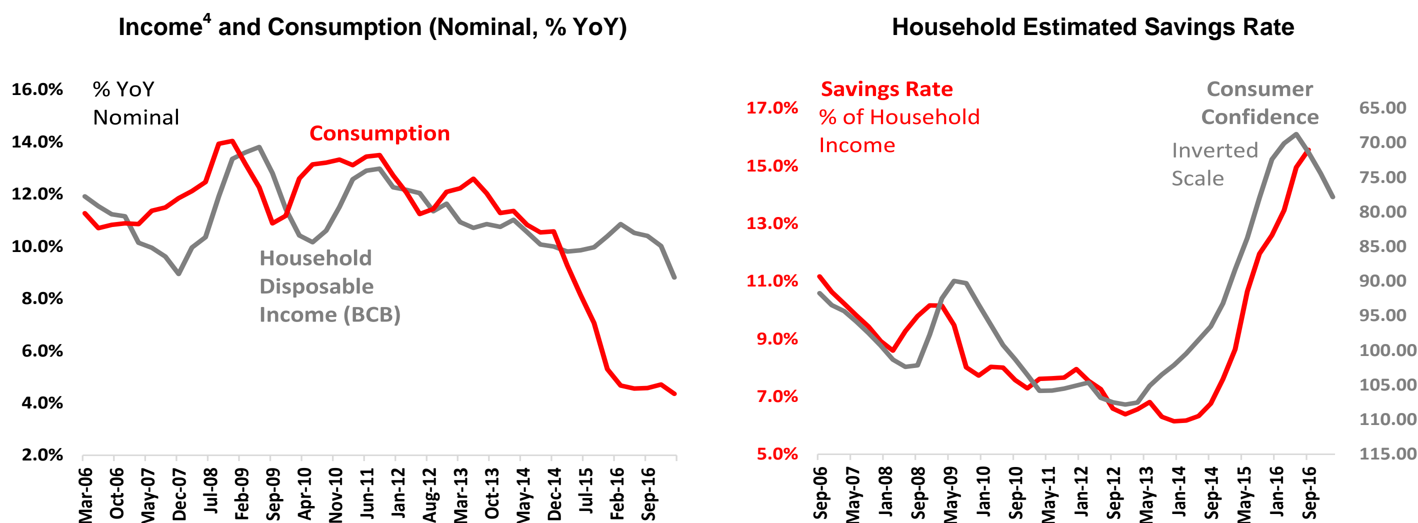
4) Consumer Confidence and Household Savings Rate

The most important and straightforward transmission channel of a political crisis to the economy is through its likely impact on business and consumer confidence, and their resulting drag on investment and consumption decisions. We believe this channel has a more important and immediate effect than the potential effects from lower financial asset prices, even though these could eventually also play a role in GDP dynamics.

The conventional reasoning is that a more uncertain political and economic environment will drive households to increase savings, therefore reducing the share of income allocated to consumption. **The following charts illustrate both income[4] and consumption growth in nominal terms since 2005.**

[3] Implied rate = Interest Rate to Income divided by Debt to Income, according to BCB data.

These two data series provide useful information regarding savings dynamics. When incomes increase faster than consumption, household savings rise, and vice versa. We used historical data to build a proxy for savings as a percentage of income, so as to illustrate this dynamic on a more up-to-date dataset[5]. We find that consumption and income data are consistent with a surge in the savings rate from 2015 onward, bringing this variable to its highest level in recent years. **The chart on the right suggests an inverse relationship between savings and consumer confidence, with savings reacting with a lag of around 2 to 3 quarters to changes in consumer confidence. Due to this lag, the significant improvement in consumer confidence in recent months has not yet, according to our estimates, translated into the expected decline in savings. Although the political uncertainty may hinder consumer sentiment, it would require a deep plunge in consumer confidence (to mid-2016 levels) to prevent the savings rate from declining from its very high levels in the coming quarters.** Since we do not anticipate such a dramatic decline in confidence, in this exercise we work with the assumption that the savings rate will fall by 1 p.p. in 2017 vis-a-vis the current level, in spite of the political crisis.



Sources: Brazilian Central Bank, IBGE and Santander estimates.

Conclusion: All Together Now

1) There has **recently** been an important **increase in household real income**, mostly associated with falling inflation and the exceptional performance of agriculture. This factor seems to have been enough to break the negative inertia that has prevailed in the previous two years. Household income is currently expanding at a pace of 0.5% in YoY terms, using aggregate wages as a proxy (a more conservative assumption than if we had used the BCB's measure of disposable income).

Let's assume "core" household income declines to -1.5% (-1% employment and -0.5% real income).

2) We add 0.9 p.p. of additional resources from the FGTS.

3) Consider another 0.4 p.p. as disposable income, which will not be allocated to paying interest.

4) (1)+(2)+(3) = Total expansion of household available income, in real terms: -0.2%

5) Assuming the savings rate falls by 1 p.p.

6) Change in consumption (combining (4) and (5)): +0.9%

Our exercises seem to reinforce the expectation for a positive performance of consumption in 2017 even considering some deterioration of confidence due to the political environment. Our forecast of +0.3% for consumption growth in 2017 should not, therefore, be viewed as excessively optimistic.

[4] We use here, as a proxy for household income, the Central Bank measure of disposable income. We acknowledge this measure is mostly representative of wage-related sources of income and government transfers (around 70% of Household income), not including rents, profits and other sources of income.

[5] Our proxy for savings/real income is built using the 2005-2010 average of 10% (as measured by IBGE in its national accounts statistics), and applying more up-to-date information for consumption and income dynamics from 2011 on.

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