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BRAZIL: THE MODERATION OF CONSUMPTION

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Resilient consumption is gradually slowing

- After maintaining its resilience despite below-potential GDP growth since 2011, private consumption—the main growth driver of the economy—is displaying gradual moderation.
- Accounting for two-thirds of GDP, private consumption grew by an annual average of 4.9% in real terms in 2004-12 upon firm fundamentals, favorable labor and credit market dynamics, and expansion of the middle class. Nowadays, however, the combination of elevated inflation, lower wage gains, slowed credit, and drop in consumer confidence is subduing consumption growth.
- Growth of real private consumption slowed to 0.1% qoq/sa and 2.1% yoy in 1Q13 (from 1% qoq/sa and 3.9% yoy in 4Q12). Meanwhile, retail sales averaged growth of 3.3% yoy in January-May 2013, versus 9% yoy in the same period in 2012.
- In the absence of factors to sustain a noteworthy acceleration, real consumption growth is expected to slow to 2.5% this year from 3.1% in 2012 and 4.1% in 2011. While weaker demand should provide welcome relief to inflation, it means that the government has an obvious incentive to improve economic policies and balance consumption-led growth with higher fixed investment.

Several factors are placing downward pressures on consumption

High inflation

- Amid a third year of below-potential growth, persistently high inflation is compromising real wage increases and confidence levels. The 12-m consumer price inflation reading was 6.27% in July, down from 6.7% in June upon lower food and transportation prices but still in the upper range of the Central Bank's target. Core inflation remains high at 6%. (Figure 1.)
- The challenge is that high inflation is coinciding with changes in the external environment that are supportive of BRL weakness, with pass-through placing upward pressure on prices. First, the Chinese economy is slowing and weighing on commodity prices. Moreover, the US Fed may taper QE, underpinning a stronger USD and tighter global liquidity conditions. Combined with weaker fundamentals, the outlook is for a weaker BRL than we have seen in recent years.
- The Central Bank has signaled that the tightening cycle continues to be underway, and we expect at least one more 50bp hike on August 28th. Yet, inflation is likely stay to high in the upper target range through 2014 unless the Central Bank gets assistance from tighter fiscal policy.

Lower wage gains

- While high inflation is eroding real wage growth, nominal wage growth is decelerating amid low GDP growth and a labor market that is finally showing signs of softening. (Figure 2.)
- In Brazil, the formula for adjusting the minimum wage is calculated as the inflation rate of the previous year plus the GDP growth rate from two years prior. Owed to weak GDP growth, the nominal wage adjustment was 9% in 2013 versus a higher 14% in 2012. The increase looks to be around 6.6% for 2014. This would equate to a real minimum wage adjustment of slightly less than 1% compared to 3% in 2013 and 8% in 2012.
- Additionally, net job creation is finally showing signs of slowing in a low growth environment. This may prompt a gradual upward trend in unemployment, which remains near record lows, in 2H13.

Decelerated credit market

- The less dynamic credit market has been testing the resiliency of consumption since last year (See *Divergence in Credit Growth Cycles*, May 2013 and *Opposing Forces for Consumption*, November 2012). Indeed, real credit to individuals grew 9.7% yoy in June, decelerating from average growth of 12.4% in 2012 and 14.9% in 2011. (Figure 3.)
- Indebted consumers still need to deleverage. Household debt as a share of annual disposable income reached 44.5% in May, the highest on record. Moreover, one-fifth of households' disposable income is still directed to pay principal and interest obligations. (Figure 3.) Credit is being issued at lower rates and credit quality is slowly improving but, with the Central Bank raising the SELIC to contain inflation, the debt service burden is unlikely to decline soon.

Drop in consumer confidence

- Consumers are now less optimistic. (Figure 4.) Following the protests, confidence about current conditions fell 9.7% in July from June, while expectations for the next six months fell less (1.6%).
- Optimism has not entirely faded, but its trajectory and impact on activity will be largely influenced by how the government adjusts its policy responses to high inflation, low growth, and protests.

Figure 1: SELIC and consumer price inflation

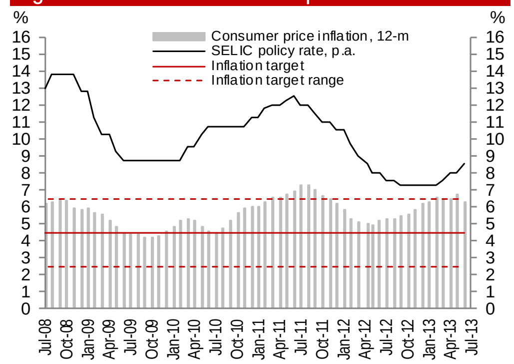


Figure 2: Labor market

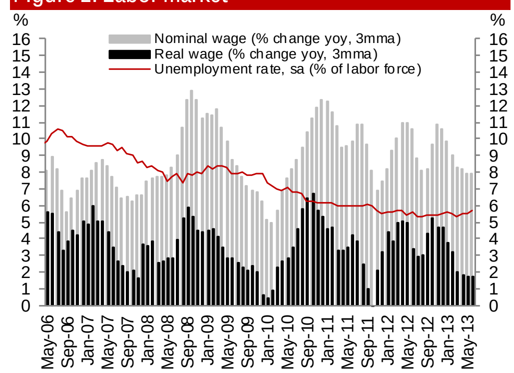


Figure 3: Consumer credit growth and debt service

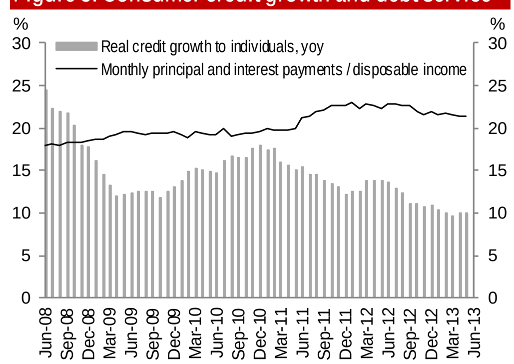
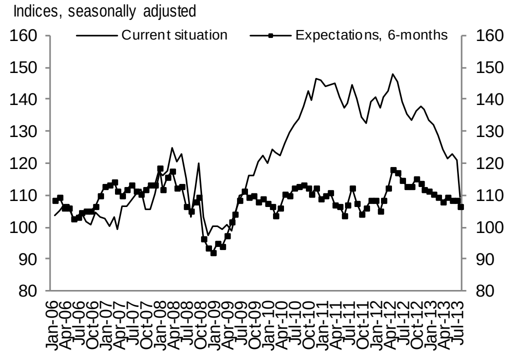


Figure 4: Consumer confidence

Indices, seasonally adjusted



Source: Central Bank; IBGE; FGV; BTMU Economic Research.

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