Looking Beyond Consumption-Led Growth in Brazil

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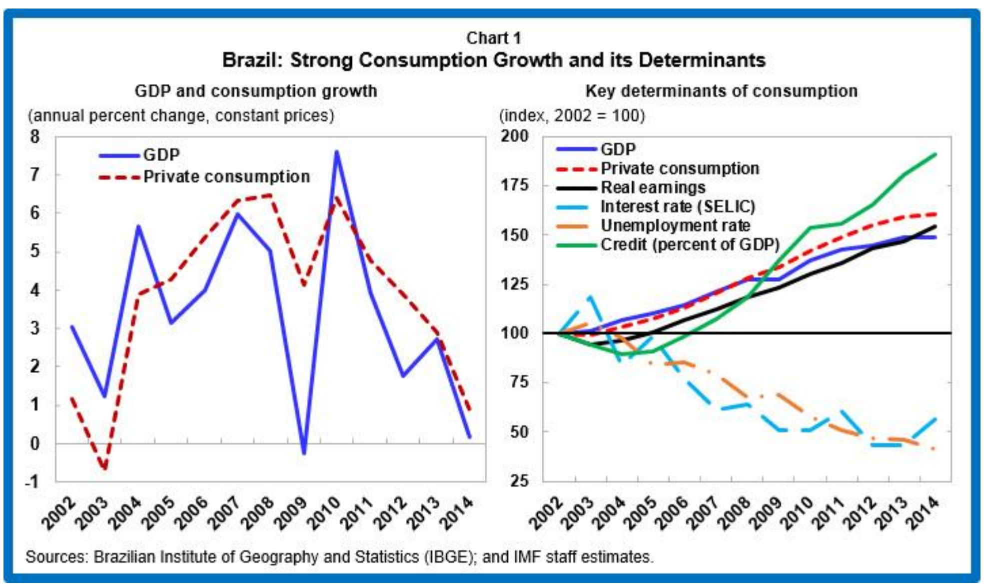
Prior to Brazil's current recession, private consumption was the largest contributor to growth for more than a decade. During this period, Brazilian consumers benefited from sound policies, a phase of relatively rapid economic development, and a supportive external environment (mainly low global interest rates). But as the favorable factors that boosted consumption wane, it's time for the country to rethink its consumption-led growth model and look for alternative sources of growth.

Why was consumer spending so strong?

Strong consumption growth in the lead up to Brazil's current recession was supported by a range of favorable factors, including economic and social policies.

Higher levels of schooling and literacy in the 1990s began to pay dividends in the early 2000s as graduates entered the labor market, increasing productivity and income levels. At the same time, social programs—most notably Bolsa Família—and significant increases in the minimum wage provided a boost to incomes and increased financial inclusion for millions of Brazilians at the lowest income levels, increasing their spending power and access to financial services. Widespread indexation to the minimum wage, including in the social safety net, helped to support income levels and consumption. Between 2002 and 2014, both nominal and real interest rates also fell dramatically, fueling a sharp increase in household credit, almost doubling as a share of GDP (see Chart 1).



More recently, policies adopted in response to the global financial crisis focused on stimulating household income and spending through various measures, including formal adoption of a minimum wage rule that ensured minimum wage increases that outstripped productivity gains, income tax relief, subsidized lending for automobiles and other durable goods, and a rapid expansion of credit by public banks. These efforts ultimately proved to be counterproductive and contributed to one of Brazil's deepest recession in decades.

The decline in consumer spending

There are a number of reasons why private consumption has fallen sharply in the ongoing recession and is likely to slow in the near term, including:

- ***Income and the labor market:*** The recession has caused employment to fall and average wage growth to slow dramatically. Brazil's strong social safety net has also been under stress as public finances have deteriorated, most dramatically in some state governments which have struggled to pay retirement pensions on time. If they continue to be guided by their current formula, minimum wage increases may also hamper wage adjustment and employment growth.
- ***Real interest rates:*** Real interest rates are very high in Brazil now, likely reflecting large risks that may be slow to decline. Pressures on funding markets from high government borrowing needs will remain significant for a considerable time. Nearer term, unanticipated price and/or exchange rate shocks, or price inertia, could have adverse impacts on the behavior of inflation and expectations, affecting the path of policy rates going forward (markets currently price a significant easing). Central banks in advanced economies are also expected to increase rates, contributing to higher global interest rates.
- ***Credit and debt:*** Credit growth has been slowing as the labor market has weakened and high levels of debt and debt service have reduced consumers' demand for credit. Weak domestic demand and rising nonperforming loans have also led to a tightening of credit conditions on the supply side. A prolonged period of labor market weakness and high interest rates could prompt a sustained period of household deleveraging and contribute to weaker consumption growth.
- ***Confidence and uncertainty:*** Consumer confidence is expected to remain at low levels for some time as the result of the weak labor market. At the same time, political uncertainty and uncertainty related to the Petrobras corruption probe looks set to continue in the near term, making households more cautious about their spending decisions and increasing saving.

Time to change the growth model

In a recent paper we have shown that consumption-led growth in Brazil has coincided with widening infrastructure gaps and low investment. Low levels of investment are typically associated with lower levels of capital per worker and lower levels of income per capita (see Chart 2; right panel). There is also some evidence that higher levels of consumption are associated with lower levels of income per capita (see Chart 2, left panel). This suggests that Brazil could achieve higher income levels in the future by consuming less and investing more.

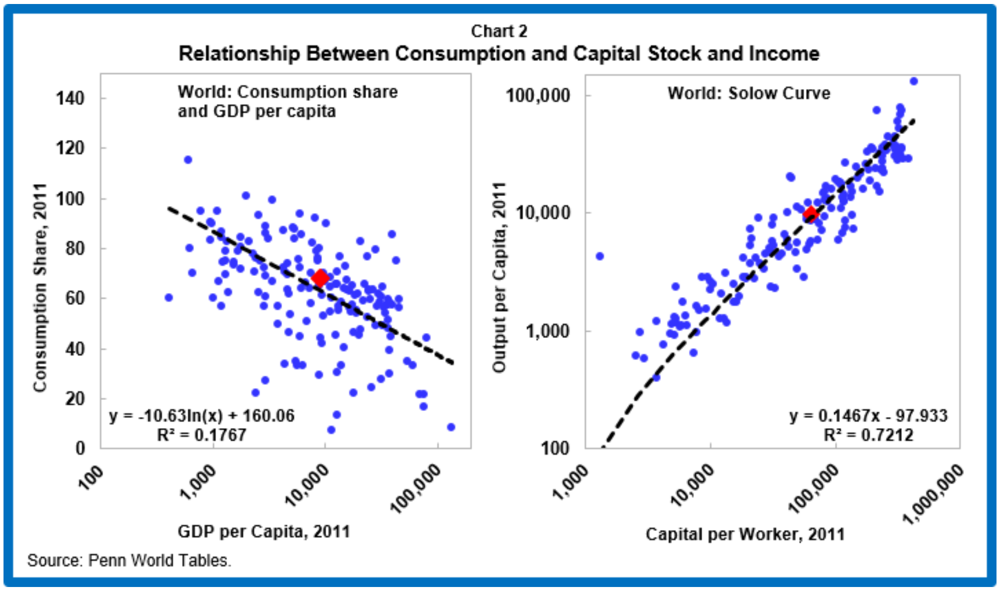


Chart 2
Relationship Between Consumption and Capital Stock and Income

Source: Penn World Tables.

Alternative sources of growth

Private consumption growth should turn positive again as the economy recovers, which is both normal and desirable. But consumption is unlikely to be again a leading driver of growth. To make sure growth is vigorous and better balanced going forward, other forces will have to lead the way.

Key areas to address include:

- ***Infrastructure bottlenecks:*** Expanding the scope and size of the infrastructure concessions program would not only boost investment growth in the near term, but also support it over the medium term.
- ***Minimum wage and pension system:*** The minimum wage formula should better reflect productivity gains to promote employment over the long term. Reforming the pension system by reducing its financial imbalances and extending retirement ages should also create incentives for large segments of the population to boost their savings, providing funding for higher levels of investment.
- ***Tax reform:*** Brazil's tax system is notoriously complex, and represents a large cost of doing business in Brazil. Simplification of the tax code would help to improve the overall business environment and foster investment. Distortions in the system that promote consumption and discourage investment (and exports) should be evaluated and addressed to improve efficiency and more balanced growth in the medium term.

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