Fundamentals Point to Lower Retail Sales Growth in the Medium Term

In 2013, retail sales have been growing at a moderate pace in comparison to the previous nine years. We see a downward trend in retail sales growth that is associated with permanent factors. The fundamentals behind retail sales dynamics are likely to remain less favorable in the coming years. Most of the factors behind the strong growth observed between 2004 and 2012 – when the average annual increase reached 7.9% in real terms – are no longer present. The real wage bill is growing more slowly, there is less room for a drop in real interest rates and the capacity for increasing fiscal transfers is narrowing. We expect core retail sales to rise by around 3.0% per year in real terms (and by close to 9% in nominal terms) in the next few years.

Evolution of retail sales over the last decade

Between 2004 and 2012, core retail sales (excluding vehicles and building materials) climbed sharply, by an average of 7.9% a year in real terms. Even during the most acute phase of the 2008 crisis (and its period of influence on economic activity over the following year), the retail sales growth accumulated in 12 months remained above 5% in real terms.

Several factors were crucial to the strong retail sales performance we have seen in recent years. Among the most important of these were a growing real wage bill (due to a sharp decline in unemployment and gains in the real average wage), lower neutral real interest rates, increasing credit-GDP ratio and higher government transfers. Additionally, consumer confidence strengthened in the period.

Our models confirm that these variables significantly affect the dynamics of retail sales in the medium and long run. Regarding elasticity, changes in the real wage bill tend to prompt the biggest changes in the growth pace of core retail sales.

But in the current economic environment, many of these conditions for growth in retail spending are no longer as favorable: i) there is no slack in the labor market; ii) after reaching a historical low, the real interest rate has been increasing; and iii) the stock of consumer credit (excluding mortgages and vehicles) is already close to international levels. Hence, we believe that retail sales growth in the coming years is likely to be slower. A brief study of the fundamental variables that affect retail sales in the long term will help to explain this outlook.

1 We used five models considering the variables in level and in difference.
The real wage bill is likely to expand more slowly

Robust growth in the real wage bill in recent years was a key determinant of the high growth rates in retail sales. Between 2004 and 2012, the real wage bill grew at an average rate of 5.2% per year. There were two reasons for this good performance.

First, Brazil’s unemployment rate was high at the beginning of this period, close to 10%, meaning that there was slack in the labor market. With the economy expanding and oversupply in the labor market, employment increased faster than the supply of workers. Idle workers were absorbed quickly. While the economically active population and the working-age population rose by an average of 1.5% per year between 2004 and 2012, employment climbed by 2.5% per year.

Another factor behind the good performance of the real wage bill between 2004 and 2012 was fast growth in the real average wage. The average income of workers advanced by 2.7% per year in real terms. In the first years of the recovery, real wages climbed sharply, even though there was slack in the labor market.

Part of this increase was a reflection of a relative decline in wages compared with the cost of capital at the beginning of the last decade. The pick-up in inflation following two exchange-rate shocks (in 1999 and 2002) in an environment of weak economic growth caused a substantial retreat in real wages. In other words, there was an advantage to hiring workers, as real wages were low at the start of the expansion cycle. In the following years, the brisk pace of hiring along with hikes in the minimum monthly wage (by above 5%, on average, in real terms) contributed to a sharp growth in wages. Importantly, the minimum wage is a benchmark for wage negotiations in Brazil.

Currently, there is not much room left for either fast growth in employment or wage gains of the levels seen in the last nine years. The unemployment rate is now below 6%, which is less than our estimated neutral rate (around 6.5%). So, in the next few years, employment is likely to expand in line with the growth of the workforce. In the short term, it may grow even more slowly than that, given that the adjustment in the labor market tends to move the unemployment rate toward its equilibrium levels. With a cool-down in hiring and higher wage levels, the average income of workers is likely to increase more slowly, at rates that are closer to the rate of productivity growth.

With employment rising in line with the size of the workforce (by an estimated 1.2% a year) and the real average wage rising in line with productivity growth (by an average of 1.4% per year in recent years), the real wage bill should increase by about 2.5% per year, or at nearly...
half of the average rate seen over the last nine years. Given our expectation of low economic growth in 2013 and 2014, gains in the real wage bill may be even weaker during the period.

**Interest rates are likely to follow a different path from the one seen in the recent past**

Another phenomenon which buoyed retail sales in recent years was the downward trend in real interest rates. For instance, the real ex ante interest rate (the gap between the 1-year swap pre-DI contract and expected inflation for the next 12 months, according to the central bank’s Focus survey) tumbled to less than 2% per year in the second half of 2012 from over 10% in 2004-05. Hence, there was a material adjustment in real interest rates, which was an important factor in the development of the credit market – itself another source of growth in retail sales.

The room for further drops in real interest rates is now more limited. In fact, the recent evolution of inflation suggests that equilibrium interest rates are higher than the figures observed recently. In our scenario, we project that interest rates will climb further and will remain closer to 3.0% in real terms over the next few years.

Higher real interest rates also have an indirect impact on retail sales through the credit channel, by lifting borrowing rates. In this scenario, the expansion in credit excluding mortgages and auto loans is likely to be less intense than in the previous years of steadily declining real interest rates.

**Little help from government transfers**

Government transfers have been another source of incentives for consumer spending (we gauge transfers through pension disbursements, welfare funds under the LOAS program and unemployment benefits). The change in the six-month moving average from one year earlier (monthly figures are quite volatile) shows that transfers have been growing by around 5% in real terms, close to the previous years. This increase was also influenced by the minimum monthly wage growth.

We do not see much more room for substantial increases in government transfers or for strong adjustments in the minimum wage due to the necessity of preventing a further decline in the primary surplus.

**Simulation**

Using models which estimate the future behavior of retail sales, we added some hypotheses for explanatory variables, aiming to estimate the future evolution of core retail sales. The assumptions in this exercise are based on prior analyses of each explanatory variable and seek to predict sales growth in 2014 in particular.
Our simulation used the following assumptions:

i) the real wage bill growing by 2.0% yoy; ii) the real interest rate remaining stable at 3.6%; iii) new loans growing by 4.0% in real terms; iv) government transfers to households increasing by 4.0% in real terms; and v) confidence remaining stable at its August 2013 level.

In this exercise, the models predict that core retail sales will increase by 2.0%-4.0% yoy on average, down from 7.9% annual growth in the 2004-2012 period.

Conclusion

Following a long stretch of fast growth, household spending on goods is likely to grow at a slower pace in the next few years. The main reason for this slowdown would be the labor market. Employment and income are already rising more slowly, causing a cool-down in real wage bill growth.

Our simulations indicate slower growth in core retail sales in the medium term. An exercise with selected assumptions for income, interest rates, credit, transfers and confidence indicates that the annual expansion in core retail sales will range from 2.0% to 4.0% in real terms in the next few years.

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