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Analysis: Brazil's middle-class economic miracle at risk

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By Raymond Colitt

BRASILIA (Reuters) - They were the big winners in Brazil's economic boom: nearly 40 million people who joined the middle class since 2003 and went on a shopping spree, many of them buying televisions, cars or air conditioners for the first time.

Yet there are signs that some of these Brazilians -- known here as the "new C Class" -- are in danger of sliding back into poverty.

The consequences are potentially dire for President Dilma Rousseff, some of Brazil's major companies, and an economy that has in recent years been one of the world's few powerful engines of growth.

There are several causes behind the incipient reversal of fortune, including an economy slowing in tandem with the rest of the world, rising inflation and high household debt.

While it inherited the problems, Rousseff's government has struggled to limit the fallout -- and has arguably made some of them worse.

"If we don't watch out, a worsening of the international scenario can cause a setback," said Strategic Affairs Minister Wellington Moreira Franco, who is charged with coordinating long-term planning. "What we want is a type of brake to prevent these Brazilians from falling back into poverty."

That "brake" could take several forms, and Rousseff and senior economic officials have repeatedly said they have policy tools available to protect the gains of recent years.

During the last crisis in 2009, Brazil responded to a fall in consumer demand with a massive fiscal stimulus program.

Yet its options are much more limited this time, since it is still suffering side effects from that budget splurge -- including inflation that now sits at about 7.3 percent on an annual basis, well above-target.

Any erosion of the gains in Brazil's fight against poverty would weaken Rousseff's political base, and her response may determine her chances for re-election in 2014.

It would also hit Brazilian and multinational companies. For example, car manufacturers such as Hyundai (005380.KS: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and Fiat (FIA.MI: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) came to depend on Brazil -- now the world's No. 5 auto market -- in recent years to help fuel sales growth. At the first signs of a weakening market in Brazil, Fiat shares slumped in August [ID:nLDE77H09N].

Economic growth is expected to slow to at least half last year's 7.5 percent rate amid a menacing global scenario.

MAKING ENDS MEET

Consumer debt defaults jumped 3 percent in August and are now up 29.2 percent from a year ago [ID:nS1E78B0KR]. Credit demand is slowing from last year, in part because the central bank hiked interest rates 175 basis points through August.

At the lower end of the "C" income category, which ranges from 1,200 to 5,174 reais (\$656-\$2,827) per month, credit growth is half the national average.

Experts say most at risk are those who for the first time have disposable income to consume beyond basic needs.

"People have been dazzled by the consumption craze; they need financial education," says Alessandra Ninis, who runs the "new middle class" project at the strategic affairs ministry.

So far, neither tighter monetary nor fiscal policy have been able to tame above-target inflation of 7.3 percent per year, which hits particularly lower-income households. The lack of structural reforms to tackle price-indexed salaries and utility prices have compounded the problem.

"There are signs the emerging middle class is stagnating - that's bad news for Brazil. If it contracts, it would be a disaster," says Professor Marcelo Neri, an expert on social mobility at the FGV business school's Center for Social Policies in Rio de Janeiro.

People say they are feeling the effects.



"The budget is getting tight. Food and clothing is going up and I've got those car payments," said Edinaldo dos Santos, who works at a catering company in Brasilia. "Many of my neighbors are struggling with debt."

If, as some economists forecast, economic growth slows more sharply in the short term and unemployment begins to rise, the government may have to take aggressive measures to protect the lower middle class.

"Right now they're looking more at trampolines into the middle class but soon they may have to look at parachutes for those falling out," said Neri.

Rousseff has already launched a micro-credit program designed to lower capital costs for small entrepreneurs and a job training program designed to form future professionals who will continue to fuel consumer demand.

Another measure the government is eyeing is a monthly stipend for employees receiving on-the-job training and earning up to 1,100 reais, the strategic affairs ministry said.

Rousseff also moved to liberalize the cable TV market, expand low-cost Internet coverage, and improve private health care -- all concerns to Brazil's new upwardly mobile.

ELECTION INTERESTS

Roughly 55 percent of Brazil's population now belongs to the middle class, nearly the same amount that was classified as poor when former President Luiz Inacio Lula da Silva took office in 2003.

Rousseff was Lula's hand-picked successor and it was his government's achievements in attacking poverty that carried her to power in last year's election.

But Lula's high spending has forced Rousseff into austerity measures and they have hit her popularity. Her disapproval ratings doubled in August, partly because of frustration over slow progress in improving public services [ID:nN1E7791S8].

"Demands on policy-makers have shifted; people care about more than just jobs and income," said Christopher Garman, Latin America analyst with Eurasia Group consultancy in New York.

"The new public agenda is the quality of public services and that's what's going to drive the next elections."

Rousseff has recently shifted from poverty-eradication talk to a focus on middle-class issues. "When people surge into the middle class, they demand quality public services: education, health, security," she said at a recent ceremony.

But with economic and political constraints, such as a tight budget and volatile support for her policies in Congress, it will be difficult in the short term for Rousseff to significantly improve long-neglected public services or boost the living standards of the new middle class.

"It's hard to see Rousseff's approval ratings not falling more in coming months," said Garman.

(Editing by Brian Winter and [Kieran Murray](#))

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