Brazil's Growing Labor Pains

Brazilis facing a paradox. Rapid rises in wages and record low unemployment are boosting the country's middle class and stimulating a consumer boom. But these same wage rises are a major factor in the damage being wrought to manufacturing. A shrinking industrial base has some analysts wondering if Brazil could face so-called "Dutch disease," where an economy becomes lopsided with commodities exports driving up the currency and reducing overall competitiveness. According to Felipe Monteiro, a Wharton management professor, it's much too early to draw that conclusion, but it is a possible outcome.

Industry chiefs have been complaining vociferously. Benjamin Steinbruch, head of Brazilian steel group CSN, and former head of the powerful Federation of Industries of the State of São Paulo (FIESP), recently noted that it's cheaper to make steel in high-cost Germany than in Brazil.

Industry's contribution to GDP has wilted. It has fallen to 14.6% of the economy, the lowest level since 1956, from a high of close to 30% in the mid 1980s, according to the Brazilian Institute of Geography and Statistics (IBGE), part of the Ministry of Planning, Budget and Management. That means Brazilian industry is failing to cash in on a consumer boom that is seeing spending rise across the board.

There are a number of issues hurting industry, but wages is the one area over which industrialists have most control. FIESP also points to the high real, hefty interest rates, weak logistics and especially elevated taxes, particularly those imposed on labor, as bugbears.

Its lobbying has paid off in the first two areas, and the government is trying to improve logistics, although this will take time. The Central Bank has slashed interest rates by 4% to 8.5% since August of last year and indicated more cuts are possible. Real rates are now coming down towards a reasonable 3%. Those interest rate cuts and a series of capital controls have helped dampen the Brazilian currency by discouraging investments in fixed-income markets. The real has fallen close to 30% against the US dollar in the last 12 months to 2.06 on June 22 from 1.60 one year before. President Dilma Rousseff is also increasingly using protectionist measures, such as renegotiating a deal with Mexico for free trade in cars and parts.

Minimum Wage and Market Forces

While these areas are being addressed, wages and the related costs continue to soar. Labor costs themselves are being driven by two factors: market forces and government policies.

Brazilhas urgently needed higher minimum wages to correct wealth distribution in what is one of the world's most unequal societies. The minimum wage has been raised some eightfold over the 16 years from 1994 to 2010, says José Márcio Camargo, professor at the Pontifical Catholic University in Rio de Janeiro. Increases are now mandated in a move introduced by former President Luiz Inácio Lula da Silva. The mechanism indexes the minimum wage at inflation, plus Brazilian GDP growth recorded two years previously, he notes. This locks in gains permanently and is irreversible, leaving little on the table for owners of capital, analysts note. The wage was raised again by a hefty 13% to R$622 at the start of this year, thanks to GDP growth of 7.5% in 2010.

The minimum wage mechanism has a disproportionate effect on the economy, because it is widely used as a benchmark for a host of other payments. According to Marcelo Neri, professor atFundação Getúlio Vargas (FGV), the minimum wage greatly affects municipalities, where pay levels are low, and is used to calculate about 60% of social security and insurance and non-contributory pensions, including for the disabled and elderly poor.

Rises in the minimum wage also have a cultural effect, as middle class Brazilians tend to measure their salary as a multiple of it and are trying to keep up with these rises. This year, average nominal salaries are expected to increase in Brazil 7.4%, 2.2% above the IMF's predicted inflation rate of 5.2%, according to a survey undertaken by consultant ECA International. Higher wages are responsible for expanding Brazil's C class, those earning between R$1,064 and R$4,561 per month, which now accounts for 105.5 million Brazilians, according to FGV, which compiles statistics on spending and produces the distinctions between spending 'classes'. The average wage in Brazil was R$1,202 last year, according to the IBGE.

In a couple of years, a further 13 million Brazilians are likely to join the C class, an increase of 12%. These are the very consumers that industry needs tosell to. Workers in this group are also increasingly seeking extra benefits such as health plans and payment towards education, say businessmen, creating further pressures.

Meanwhile at the executive level, Brazil has become one of the most attractive places to be employed in the world. In Mercer's widely used global remuneration comparison survey, which analyses salaries of 807 executives in 40 countries working for leading companies with sales of at least $1 billion, Brazil has the highest paid executives. Brazilian company heads working for top international firms earn an average of R$5.16 million, compared to the overall survey average of R$2.17 million. Heads of leading domestic Brazilian companies earn R$6.81 million against an average of R$5.18 million overall. The survey also found that Brazil has some of the most aggressive bonus practices in the world, which represent 68% of total remuneration compared to 55% for the world average.

Talent Trouble

There are few signs that this era of higher wages is coming to an end, with continued wage pressure at both the top and bottom end.

At middle and higher levels, a significant shortage of talent helps explain wage increases. According to the Organisation for Economic Co-operation and Development (OECD), Brazil has one of the lowest levels of higher education in the industrialized world: Just 11% of adults can boast tertiary-level qualifications. Not surprisingly, they find jobs easily, and in this group 85.6% are employed, a substantially higher figure than the OECD average.

At the bottom, the mechanism to raise the minimum wage will not be altered through 2015, says Alessandra Ribeiro, head of economic analysis at consulting firm Tendências Consultoria in São Paulo. The Ministry of Planning is predicting further large wage increases: Its latest Budgetary Directive Law, which outlines estimated spending, predicts that the minimum wage will be up at R$803.93 by 2015, a rise of 29.4% from today.

Meddling with the increases in minimum wage is political poison, and there is almost no political opposition to the increase mechanism, which has very positive effects, such as reducing inequality and stimulating consumption, says Camargo. Instead, there is pressure for flexibility to allow occasional top-ups, he notes.

The labor market is tight, as evidenced by very low unemployment and very high levels of turnover, says Ribeiro. Over the longer-term, unemployment has been falling steadily and was at 5.6% in February of this year compared to 12.6% at the end of 2002, although it has ticked up slightly since the end of the year when it reached a record low of 4.7%. "Unemployment is close to its natural level. This is putting pressure on wages with companies having to pay to hire and pay to retain," she notes. Another feature of this super-heated jobs market is high turnover.

In construction, one of the most heated sectors in the economy, for example, there are stories of chaotic poaching, says Monteiro. Trucks from one company are going to rival's sites to hire workers, offering an immediate raise and securing workers, he notes.

High wages are compounded by excessive social costs and high taxes. Direct and indirect taxation, including social contributions as well as industrial taxes that can be levied all along the productive chain, make Brazil a complex market for business to negotiate. Depending on the industry and size of the company, benefits can nearly double the cost of each worker, says Luiz Claudio, a partner in the project finance area of Ernst & Young Terco in Rio de Janeiro.

Monteiro, who meets many Brazilian CEOs and senior managers, says the issue of wages and shortage of talent has risen to the top of the agenda for these businessmen. "In the past, the questions used to be about the macroeconomic situation or inflation. Today, it's all about wages and finding talent."

The cost of labor is a significant factor in the low levels of competitiveness of Brazilian manufacturing, adds Ribeiro. The large increase in salaries has not been accompanied by productivity gains, and industry can't pass on cost increases to consumers, thanks to foreign competition. This exposure to competition from overseas products is peculiar to manufactured goods. The non-tradable service sector continues to grow fast, says Ribeiro.

A Service Boom

Indeed, the growing middle class is increasingly setting up business in service, which is growing rapidly as a proportion of the economy. Brazilians are starting up businesses in areas such as beauty (the country is the world's third biggest spender on beauty products after the U.S. and Japan), fast food outlets and car maintenance to serve Brazil's massively growing fleet. *Brazilian auto sales* rose 2.9% to a record 3.4 million units in *2011*, *according to* Automotive Vehicles Distribution National Federation (Fenabrave).

Equally, Brazil's booming agrobusiness has ridden higher wages well. While wage costs have increased substantially, the industry has been able to compensate by increasing production rapidly, for example through mechanization of harvesting. That is enabling agribusiness to outpace the rise in wages, says Ribeiro.

Manufacturing, however, is bearing the full weight of higher wages and a higher currency and is at the mercy of globalization. According to the Brazilian Institute of Applied Economic Research (IPEA), part of the Secretariat of Strategic Affairs of the

President, Brazil's manufacturing industry has substantially lost productivity, calculated by dividing the number of hours worked by the number of workers. Over the last 30 years, productivity in Brazil has fallen 15%. That compares to a gain of 808% in China over the same period.

Already, close to 20% of industrial goods consumed in Brazil are produced outside the country, according to a study undertaken by the National Confederation of Industry (CNI). That is a record, as is the 21.7% of foreign inputs that went into Brazilian manufactured goods in 2010.

Wages are going up even faster in U.S. dollar terms, thanks to the long-term appreciation of the real, which may be down over one year but is up over five- and 10-year periods, while Brazil also has higher inflation than most of the developed world. *The Economist's*Big Mac index shows that a burger in Brazil costs $5.68 today -- 32% higher than the U.S. average of $4.20.

Foreign direct investment (FDI) remains strong and hit a record of $66.7 billion dollars in 2011, according to data from the Central Bank of Brazil, up from $48.5 billion the previous year. But some see it slowing. Ribeiro believes some overseas companies, particularly in manufacturing, are starting to think twice before jumping into Brazil. "A strong currency, high taxes, weak infrastructure and high wages and related labor costs are making it very expensive to produce in Brazil. This is leading foreigners to consider other countries in the region," she says.

Look Overseas

In the absence of deep structural reform on taxation, labor practices and logistics, what can Brazil do to try and boost productivity?

One way might be to alleviate the labor shortage by allowing in skilled migrant workers. Recruiters report that they are inundated with resumes from Spanish and Portuguese nationals, but rarely hire them thanks to visa restrictions. The government has contemplated issuing more temporary work visas for foreign nationals, but this is another political hot potato, and analysts are divided over whether it might really come to pass.

"You could increase the supply of labor by allowing in more overseas workers from Europe and the U.S.; this would help the work shortage situation. But there is no political will for this," says Ribeiro. Monteiro agrees that in the short term, it is hard to envisage flexibility from the government on this, but sees changes as inevitable in the longer term because the education system will take years to produce the needed engineers, IT professionals and administrative professionals.

It's not only the government that is to blame for the sorry state of industry. Brazilian companies have failed to look at and adopt best practices from overseas, and many are very behind on benchmarking, says Monteiro. Their Korean, Japanese and Chinese counterparts are very aware of international trends and strive to adopt them, whereas companies in São Paulotend to be very inward looking, he points out.

Given the inflexibilities in Brazil and this tendency to naval gaze, Brazilian industry has reacted to its own demise by seeking protection and selected tax breaks, and has found a receptive ear. The further use of directed tax breaks for various sectors will continue, but the moves are likely to be piecemeal, predicts Ribeiro. "In our evaluation, there is no political will to carry out a more profound tax reform – this agenda does not exist. The policies are very specific," she says. And there is only so much that can be done on interest rates without rekindling inflation.

It’s too early to write off Brazilian industry, and the country remains one of the most feted investment destinations in emerging markets, analysts agree. But there are gnawing fears that a continued retreat of industry could lead to a lopsided economy -- one that is dominated by minerals, oil and gas, and that imports consumer goods. “We’re not coming to Brazil to make losses,” said BMW’s manager for production in March, hinting that the company may not proceed with a new plant planned for Brazil. Thatreticence may be a sign of things to come.

Volver al Artículo