TIME IN PARTNERSHIP WITH CNN

Monday, Jul. 18, 2011

Brazil, the Un-China

By Ruchir Sharma

When Brazilians contemplate the beauty of their country or the ability of their soccer team, they like to joke, "God is Brazilian." It seems foreign investors have taken the joke seriously.

No emerging nation has attracted portfolio flows the way Brazil has in recent years. Charts tracking the money pouring into the country this year have shown a near vertical line to surpass the totals for 2010, which itself was a record year. This has made the Brazilian real one of the most expensive currencies in the world, and it sure feels that way on a visit to the country.

Hotel rooms in Rio de Janeiro cost more than in the south of France. Restaurants in São Paulo are pricier than in Paris. Bellinis are cheaper in Venice. Apartments in the chic Leblon area of Rio sell for more than Fifth Avenue co-ops with views of Central Park. But often there is something amiss when a middle-income country has such a rich currency. The real's gross overvaluation is a symptom of a seriously imbalanced economy. (See pictures of São Paulo.)

Brazil has sucked in record amounts of capital in part because it is a big beneficiary of booming commodity prices and the global mania for commodity-related investments. To cool the looming threat of inflation, the central bank has been raising interest rates for several quarters, and Brazil now has the highest interest rate of any major economy. That attracts foreign capital in an otherwise low-interest-rate world. And even though growth is showing signs of slowing from over 7% last year to 4% this year, inflation is still rising, so the central bank figures it has to keep raising rates. That is translating into a bubble of hot money.

Little of that wealth is being spent on much-needed infrastructure. Brazil collects more in taxes as a share of its economy than any other developing country, yet the government spends barely 3% of its revenue on infrastructure. Little wonder there are inordinate delays at the ports and on the roads. It is now common for top Brazilian executives to travel across São Paulo by helicopter in order to beat the city's legendary traffic snarls. (See "Obama Goes to Rio: A Nod to Brazil's Growing Power.")

Until recently, the Brazilian economy was one of the most amazing comeback stories of the past decade. After the country suffered through a period of hyperinflation and economic stagnation in the 1980s and '90s, its growth rate doubled in the past few years. But now Brazil is bogged down by the burden of Big Government.

Government spending is not only too high, at 35% of the economy — compared with an average of 25% in other emerging markets — but also too soft. Most of it goes to generous pension and welfare schemes rather than to building roads or improving schools. Brazil ranks poorly on measures of educational achievement like average years of schooling, coming in lower than most other middle-income countries.

Foreign investors gloss over these shortcomings and focus on the stability Brazil has achieved since the turmoil of the '80s and '90s, as well as on the commodity windfall. From iron ore to coffee, Brazil is already one of the largest exporters of commodities, and following major deepwater oil discoveries in recent years, some experts have called it the next Saudi Arabia. (See "Brazil's Start-Up Generation.")

But any strength taken too far becomes a weakness. The commodity hype is drawing in too much foreign money, driving up the value of the real to a level that hurts other industries. Brazilians are spending a record amount on imports, so the current-account balance, which measures income from trade and services, is deep in the red. If commodity prices decline, then that hole becomes unmanageable.

All this makes Brazil the antithesis of China. A cheap currency, high savings and low-cost capital are the hallmarks of China's success. Brazil is the opposite in all respects, including what it ought to do to keep growing. China needs to cut back its investment binge, create a better social-safety net and let its undervalued currency appreciate further. Brazil needs less of a welfare state, more investment and a cheaper currency. To be sure, it is unrealistic to expect Brazil, with a much higher per capita income of $11,000, to grow anywhere near as fast as China. But if Brazil does not carry out the much needed reforms, it will be hard-pressed to grow at even 4% — less than half China's rate. If it manages much more, then perhaps God really is Brazilian.

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