Dark Side of Brazil's Rise

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Abstract (summary)

Brazil is booming amid a tectonic shift in global investing toward the developing world that has lifted its stock market, strengthened its currency and provided financing for new ports and World Cup soccer stadiums. Concern about the strong real is a key reason why Brazil's central bank late last month cut its benchmark interest rate by half a percentage point to 12%, reversing course after a year of rate hikes.

Full text

SAO PAULO -- Brazil is booming amid a tectonic shift in global investing toward the developing world that has lifted its stock market, strengthened its currency and provided financing for new ports and World Cup soccer stadiums.

But while foreign investment is mostly a good thing, there are downsides. The abundance of cash has helped fund riskier bank loans and fueled a potential real-estate bubble. By some measures, the Brazilian real is now the world's most overvalued currency, and many local factories aren't competitive in global markets.

Daily life has become so expensive that movies, taxis and even a can of Coke cost more in Sao Paulo than in New York. Rio de Janeiro apartment prices have doubled since 2008, and office space in Sao Paulo is suddenly more expensive than Manhattan. In many cases, investment banks must pay their Brazilian bankers and analysts more than they would get doing the same job in New York.

Concern about the strong real is a key reason why Brazil's central bank late last month cut its benchmark interest rate by half a percentage point to 12%, reversing course after a year of rate hikes. The move risks spurring inflation and spawned a debate in Brazil on whether the central bank had succumbed to political pressure. But Brazilian officials say the country's high rates have lured speculative foreign investments that pump up the real and hurt the economy. Indeed, there are early indications that the Brazilian economy is beginning to slow.

Brazil's real has weakened 6% against the dollar since the central bank cut rates, but even so it is still up some 36% since Jan. 1, 2009. With the U.S. and Europe awash in economic gloom, global investors are on pace to pour more than $1 trillion into emerging economies such as China, Brazil and India this year -- nearly a five-fold increase from a decade ago. The money is coming because emerging market economies have been the main drivers of global growth since 2009.

Some executives in Brazil fret that the cost of doing business has risen so fast that their country may be unable to become the manufacturing power it has aspired to be for generations. "Ever since I was a little girl I always heard Brazil was the country of the future. Now that the future is here, I am starting to fear it will be brief," said Cynthia Benedetto, the chief financial officer of Brazil's flagship manufacturing firm, Embraer SA, the world's No. 3 jet maker. Embraer, a major exporter, says it is investing in equipment to lower its labor costs at home and opening more plants abroad.

Brazilian industrial production actually fell 1.6% in June from May for the first time since the 2008 global financial crisis. Factories are losing their overseas markets and getting beat by cheap imports because Brazilian labor, parts and transport have first-world price tags -- even though Brazil still has all its third-world drawbacks, like bad roads, poorly educated workers and high crime rates.

Brazil isn't the only developing country encountering problems of plenty. In China, heightened investment flows have contributed to food inflation in cities that some economists say may provoke social unrest. In Turkey, the government has tried a similar approach to the one just adopted by Brazil's central bank -- slashing interest rates to prevent inflows from strengthening the currency too much. But the lower rates have helped spark a big rise in bank credit and fears of a credit bubble.

Learning to manage abundance is an unusual situation for Brazil, which historically struggled to attract investment flows as it wobbled between currency crashes and economic crises. But efforts to stabilize the currency, tame inflation and lower the debt load starting in the 1990s have resulted in $350 billion in foreign reserves and investment-grade credit ratings.

Money flows easily into Brazil because it has a free-floating currency and sophisticated stock, bond and derivative markets, unlike China. Indeed, many investors seeking exposure to China get it by investing in Brazil instead because it's a major seller of raw materials to the Chinese. Brazil is the world's biggest seller of iron ore, beef, chicken, sugar and coffee. And it just made new oil discoveries off its coast that could make it into a leading global producer of that as well.

Of course, capital that floods into a country can flood out of it. Leaders in emerging economies are concerned that a financial catastrophe in the developed world -- such as sovereign defaults in Europe -- could cause a sudden reversal of investment flows. That would prompt jarring falls in currency, real estate and other prices that have soared in places like Brazil during the boom.

For now, however, emerging economies face too much cash pouring in. In May, the International Monetary Fund gathered officials from South Africa, India, Chile and other nations in Rio de Janeiro to discuss policy prescriptions for dealing with capital flows. Central bankers discussed papers with titles like "Managing Abundance to Avoid a Bust in Latin America."

"Capital flows have significantly exacerbated domestic problems like bubbles and inflation that could potentially throw emerging economies off their growth paths and produce social instability," says Cornell University economist Eswar Prasad, who formerly ran the China division at the International Monetary Fund.

Brazil President Dilma Rousseff's eight-month-old administration has fought a difficult battle to keep the real from rising. Brazilian officials blame near-zero interest rates in the U.S. and Europe for making it possible for hedge funds to borrow cheaply in the rich world to place bets in Brazil.

"We have to defend ourselves from this immense, fantastic, extraordinary sea of liquidity that finds its way to our economies in search of returns that it can't find in its own," Ms. Rousseff told Latin American leaders on July 28 in Lima.

But stopping a sea of liquidity isn't easy. Some economists believe the Rousseff administration pressured the central bank to cut rates prematurely -- something the president denies. The result could be higher inflation, the economists say. Central bank officials say global growth is slowing fast enough that inflation is becoming less of a concern.

Brazil has been announcing new measures almost monthly to stifle the flow, such as a tax on bond purchases, or to offset its impacts, such as a multibillion dollar package of subsidies for manufacturers hit by the soaring real. Manufacturers say the currency is still too strong and the subsidies aren't enough.

One reason the policies may fail: Even after cutting its interest rates to 12%, Brazil has among the highest real interest rates, or rates in excess of inflation, of any major economy. That makes Brazil a prime target for "carry trade" speculators who borrow money cheaply where interest rates are near zero, deposit it in Brazil and pocket the difference. Brazil hasn't cut rates faster because it needs to attract money to fund a growing welfare system and infrastructure projects.

It turns out that international capital flows a lot like water. Close one hatch and it pours in another. Brazilian officials suspect that when the country moves to restrict speculative investments, the money is being disguised as direct investments in companies. The evidence is a 260% spike in foreign direct investment to $38.5 billion in the first six months of the year.

On the heels of the investment flows, one of the hottest debates in Brazil these days is whether high prices of everything from cars to condos are a bubble that will pop.

"I don't see a bubble. Capital flows are a natural outcome of all the good news in Brazil ," said Fabio Barbosa, the chief executive of the Brazilian publishing giant Abril SA and a board member of Brazilian oil company Petroleo Brasileiro SA. "The issue is how can we remain competitive within a scenario of a stronger currency, which in my opinion is here to stay."

Others see froth in rising asset prices. "I call it the caipirinha effect," says Bob Fryklund, the Rio de Janeiro-based head of the oil-market research firm IHS-CERA, referring to Brazil ' s national cocktail.

Armed with a strong currency and cheap financing, a new class of Brazilian jet setters are getting on planes and shopping like mad in countries where goods are cheaper. Brazilians spent $8.5 billion on overseas shopping sprees this year -- 60% more than last year. Malls near Miami are hiring Portuguese-speaking salespeople and opening Brazilian restaurants to serve them.

Brazil ' s auto makers' association predicts that a quarter of cars sold in Brazil this year will be imported, up from 5% in 2005, as a strong currency makes imports cheaper. In July, thousands of angry auto workers from the Brazilian unit of Volkswagen and other companies with local factories clogged Sao Paulo' s streets to protest surging imports they fear will cost jobs.

The cash inflows have heated up the Brazilian real-estate market as well. A slew of Brazilian home builders such as Gafisa SA and Cyrela SA raised hundreds of millions of dollars in share sales in recent years, mainly to U. S . investors. The money helps them build homes for Brazil ' s emerging middle class -- a good thing.

But cash-rich home builders have bid up the prices of available land in big cities, causing a spike in home prices, according to Sergio Freire, chief executive of real-estate brokerage Brasil Brokers.

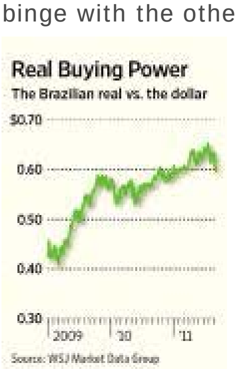
Credit bubbles are another concern. Credit is rising rapidly in the big emerging-market countries -- Brazil , Russia, India and China. Lately, loan-default rates have ticked up in Brazil .

The collapse of Maura Guarnieri' s personal credit bubble in Sao Paulo illustrates the case. A working mother of two, Ms. Guarnieri started loading up on debt last year after her husband' s kidneys failed and he stopped working. Soon, she had taken out four credit lines at interest rates over 40% -- far more than she could pay each month. Recently, she defaulted on some of the loans, adding to a 20% rise in consumer-loan defaults in Brazil so far this year.

Foreign capital flows helped Ms. Guarnieri borrow. Her three biggest creditors -- Banco Cruzeiro do Sul SA, Banco Daycoval SA and Banco Panamericano SA -- are medium-size Brazilian banks that have expanded loan books in part by borrowing cheaply overseas. Two of the banks, Daycoval and Banco Cruzeiro, have claims on Ms. Guarnieri' s paycheck and are still getting paid.

The strong real is an even bigger problem for manufacturers. Humberto Barbato owns a company that makes parts for high-power transmission lines. Decades ago, he benefited from government policies that helped manufacturers set up export businesses. Now the currency is pricing him out of hard-won overseas markets. At home, he' s losing clients to cheap Chinese imports.

He does get some comfort. While visiting his son in Florida recently, he went on a strong-real shopping binge with the other Brazilians at the local mall. "That' s my revenge," Mr. Barbato said.



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