



Stanford

Center for International
Development

Working Paper No. 445

Economic Policy Reform in Brazil and Turkey

by

Anne O. Krueger

May 2011



Stanford University
John A. and Cynthia Fry Gunn Building, 366 Galvez Street
Stanford, CA 94305-6015

Economic Policy Reform in Brazil and Turkey[♦]

Anne O. Krueger^{*}

May 2011

Abstract

At the turn of the century, the economies of both Brazil and Turkey encountered very serious difficulties; both countries resorted to IMF adjustment programs. The problems that were encountered, and the policy measures taken to address them, are analyzed.

Thereafter, the lessons from the two crises are set forth. First, tighter fiscal and monetary policy may in fact be followed by more rapid economic growth. Second, even when the situation is dire, appropriate economic policy reforms can fundamentally alter the economic prospects of an economy. But, third, economic policy reforms are crucial to alter significantly the trajectory of an economy caught in a downward spiral of rising inflation, slowing growth, increasing pressure on the exchange rate, and rising spreads on outstanding government debt.

Keywords: Brazil, Turkey, policy analysis, policy reform, financial crisis.

JEL Classification No.: F20, F30, F40.

[♦] This paper is also included in my book *The World Economy; Challenges for the Twenty First Century*.

^{*} Anne Krueger is Professor of International Economics at the School for Advanced International Studies, Johns Hopkins University. She is also a Senior Fellow of the Stanford Center for International Development (of which she was the founding Director) and the Herald L. and Caroline Ritch Emeritus Professor of Sciences and Humanities in the Economics Department at Stanford University. Email : annekrueger@jhu.edu

5/11/11

Chapter 8. Economic Policy Reforms in Brazil and Turkey

At the turn of the century, Brazil and Turkey both had economies in very serious difficulties. Both had entered into IMF programs, Brazil late in 1999 and Turkey early in 2000. High rates of inflation and other difficulties had led to attacks on the currencies. Each country was unable to borrow sufficiently to finance government borrowing requirements for fiscal deficits and needed rollovers of debt at reasonable interest rates. In each country, pressures eased after the start of each program, but rapidly began mounting again. Both countries' governments had committed to reductions in their fiscal deficits and some tightening of the money supply as part of their programs, but in both cases the authorities were unable fully to carry out their commitments.

Brazil had adopted a "nominal anchor" exchange rate regime in the early 1990s in order to try to bring down the rate of inflation from triple digits. By 1999 the country was forced to float the real. The inflation rate had fallen markedly, but the currency had appreciated in real terms. Turkey had experienced inflation rates above 50 percent in all years in the early 1990s, and adopted a nominal anchor exchange rate as part of the 1999 IMF program. For Turkey, too, adjustments in the exchange rate were far below the realized inflation rates and hence the Turkish lira also had become increasingly overvalued.

By 2001 in the case of Turkey and 2002 in the case of Brazil the situation was again becoming critical. In Turkey, there was a full-blown crisis as banks became insolvent (for reasons discussed below) and the inflation rate increasingly outstripped the preannounced changes in the exchange rate. In Brazil, a crisis was building rapidly in the

middle of 2002 as elections loomed late in the year. Observers expected Lula to win and thought him unlikely to adhere even to existing fiscal and monetary disciplines.¹ In each country, sovereign indebtedness rose sharply, and spreads on the public debt rose dramatically.

In both countries, the programs adopted in 2001 and 2002 were more far-reaching than their predecessors, addressing some of the underlying problems that had led to such severe difficulties. In the Turkish case, the domestic banks were insolvent, as extension of credits (many mandated at low interest rates by the government) had mushroomed and bank equity was largely wiped out. In Brazil's case, the inflation rate was rising but, above all, there was concern for the likely course of monetary and fiscal policy after the elections and anticipated change of government at the end of that year.

In each program, cutbacks in fiscal deficits and tighter monetary policies were adopted. And in each case, there were many doubters questioning whether the programs were realistic and whether they could succeed. But there the similarity ended. In Brazil, the major challenge was convincing the markets that fiscal and monetary policies would be maintained in a new government so that Brazilian debt and debt service would be sustainable, while simultaneously bringing the rate of inflation down and enabling sustainable growth. In Turkey, a major challenge was to bring the banking system back to health, but that, too, entailed reduced fiscal deficits and tighter monetary policy to bring down inflation and to reduce the burden of the debt to a sustainable level. These changes were necessary to enable the resumption of growth.

From the start of their respective programs in 2001 and 2002, both the Brazilian and the Turkish economies performed well, as will be documented below. Even during

¹ See Lapper (2002).

the global recession of 2007-2009, the two economies were less adversely affected than they had earlier been in international recessions, and their recovery was appreciably quicker. Turkey by 2010 had the highest rate of growth of any European economy, while Brazilian economic growth was strong and a main concern was overheating. Other key indicators were also greatly improved: debt ratios had fallen markedly, fiscal deficits were reduced, and inflation lower

The Turkish economy has in many ways been transformed, as inflation reached single digits while growth accelerated. In Brazil's case, a looming crisis in 2002 was nipped in the bud: commentators and analysts discussing the evolution of the global economy after 2000 seldom even list Brazil as having had a crisis in the 21st century.

There are several key lessons. First, tighter fiscal and monetary policy may in fact be followed by more rapid economic growth.² Second, even when the situation is dire, appropriate economic policy reforms can fundamentally alter the economic prospects of an economy. But, third, economic policy reforms are crucial to alter significantly the trajectory of an economy caught in a downward spiral of rising inflation, slowing growth, and a trajectory of increasing pressure on the exchange rate and of rising spreads on outstanding government debt.³ These lessons are spelled out in more detail in the final section of this chapter.

In the next section, the evolution of the Turkish economy from the 1999 crisis to 2010 is analyzed, while section 3 covers the behavior of the Brazilian economy from

² There are many other cases, including rich countries such as Canada and Australia, in which fiscal consolidation has been followed by accelerated growth.

³ A fourth lesson that emerges from the study of crises more generally is that the costs of delay can be quite substantial. These include a longer period of slow growth or even decline in real GDP and higher interest rates on government debt (both because the authorities were incurring new debt and because higher spreads were necessary for debt rollovers). In many cases, fiscal deficits are also widening as policy makers attempt to offset sluggish growth through increased government spending while tax receipts are falling.

1999 to 2010. Section 4 summarizes the state of the two economies at the time of writing, focusing largely on their successes and the role of the IMF in these two situations.

Turkey: Crises and Resolution ⁴

From the end of the Second World War until the 1990s, the Turkish economy had experienced an above average rate of economic growth, but with high macroeconomic volatility. The growth rate had also trended downward, with more frequent periods of macroeconomic slowdown and crisis, and shorter periods of resumption of (slower) growth. Periods of rapid growth had been followed by slowdown and usually crisis, with IMF programs to support stabilization in 1960, 1970, 1976, 1980, and 1994. Inflation in the CPI had averaged well over 50 percent annually during the 1980s and 1990s, and had dipped below 35 percent only in a few years after the macroeconomic crisis in 1979-80.⁵ The inflation rate had not fallen below 50 percent after 1988. In 1994 inflation (producer prices) reached an annual rate of 119 percent; an IMF-supported program was started, but quickly went off track, although the annual rate of inflation slowed somewhat to a range of 70-90 percent. After falling 5.5 percent in 1994, the real GDP growth rate was over 7 percent for the next 3 years, but then dropped to 3.1 percent in 1998. By 1999, the country was in crisis, with real GDP dropping 4.5 percent and inflation nonetheless remained over 50 percent in 1998 and 1999.⁶

⁴ The following account provides a very brief overview of the Turkish economy and the events leading up to the 2001 IMF program. For particulars of the 1999 program and the chronology of events in the lead-up to the 2001 crisis, see Van Rijkeghem and Ucer (2005).

⁵ Many of the 1980 reforms were undertaken early in the year before the government approached the IMF for support. The 1980 crisis resolution framework was noteworthy because earlier policies of import-substitution were dismantled, and the exchange rate regime was altered to allow maintenance of the real exchange rate. Despite the failure of the program to bring about lasting macroeconomic stability, it did enable a period of rapid expansion of exports and a resulting structural shift in the economy. That shift, in turn, contributed significantly to the Turkish growth potential that was unleashed when macroeconomic stability was attained after 2001.

⁶ All data in this paragraph are from International Monetary Fund, 2004.

With high inflation, most depositors in banks sought and received dollar-denominated accounts. The Turkish banks, however, did not cover their dollar liabilities and kept open positions. This was a significant factor undermining the banking system when adjustments had to be made (see the numbers below).

If one examined the Turkish budget, the fiscal deficit seemed small. However, since the early 1980s, the Turkish government had mandated that the state banks lend to a number of government-sponsored activities (such as a fund for financing of residential construction and funds to lend to state economic enterprises incurring losses). While the central government budget showed a primary surplus of 3.5 percent of GDP, funding by banks for government-sponsored enterprises was about 13 percent of GDP.⁷ The state banks in turn were entering the market to borrow to roll over their borrowings and had to pay higher interest rates than those offered by private banks. They also relied heavily on the Central Bank's money market facilities.⁸ After a devastating earthquake in August 1999, interest rates rose to 115 percent on rolled over debt (with inflation around 60 percent), and the authorities approached the government for an IMF-supported program of reforms.

As of the end of 2000, the open foreign exchange position of the Turkish banks was 3,300 percent of capital, the accumulated duty losses of the state banks were 3,400

⁷ Van Rijckeghem and Ucer (2005, P. 15). The banks were in effect printing money for the government, while the government books superficially appeared to be relatively sound.

⁸ "Duty losses" had been incurred and were financed since the early 1980s. In 1980, there had been a major financial crisis, and reforms had been undertaken including the adoption of a more realistic exchange rate (adjusted periodically for the inflation differential with the rest of the world), and a sharp reduction in the fiscal deficit incurred by the government. This spurred several years of high growth rates but the government began resorting to duty loss financing to enable desired expenditures on infrastructure and other items. See Krueger and Aktan (1992) for a description.

percent of their capital, and the short-term liabilities of the state banks represented 4,100 percent of capital.⁹

The 1999 IMF program's central objective was to reduce inflation and restore growth. This was to be achieved by adoption of a nominal anchor exchange rate which was to guide expectations as to future inflation rates and by a simultaneous tightening of the fiscal accounts.¹⁰ That, in turn, was to be supported by a number of structural reforms, and a gradual restructuring of the banks and their supervision.¹¹

The nominal anchor exchange rate, which set forth planned adjustments to the exchange rate to accommodate anticipated (falling) inflation, was chosen as the basic policy tool to bring down both inflationary expectations and nominal and real interest rates. This latter was seen as essential to avoid a rapid build-up of debt as rollovers were undertaken and new financing needed even with the stipulated reductions in fiscal targets.

For several months, the program appeared to be working. Interest rates fell from over 70 percent to around 40 percent, the government passed a budget entailing a significant reduction in the fiscal deficit, and the inflation rate fell from its peak of over 100 percent. However, while the inflation rate fell, it fell by significantly less than was envisaged in the program.

This built in a fundamental weakness. Not only was the real exchange rate appreciating (by the differential between the actual Turkish inflation rate and the planned rate relative to the world's) but the prospect of real appreciation led to a high rate of

⁹ Moghadam (2005, P. 54).

¹⁰ See IMF Letter of Intent, 1999 for a full description of the program.

¹¹ Banking supervision had been the responsibility of the Treasury, which resulted in a serious conflict of interest as Treasury officials were to roll over debt and supervise the banks. The situation was further complicated by connected lending both to politicians and to others. The 1999 program envisaged the formation of an independent banking supervisory authority, which did happen but which took time to be legislated and implemented.

return to foreigners investing in Turkish lira. As long as the nominal anchor exchange rate policy was maintained and the inflation differential led to high real interest rates denominated in foreign exchange, foreign investors could expect a handsome return on their investments in Turkey.

Thus, for a short while after the IMF program had been launched in December 1999, things appeared superficially to be proceeding reasonably smoothly. But rapid expansion of credit, a widening current account deficit both because of the increasing overvaluation of the exchange rate and because of the rapidly rising price of oil, and loosening fiscal policy all set in. The global recession made things worse. Moreover, some of the program's targets (such as closing some of the extra budgetary funds and increases in some taxes) were missed, even when exogenous events had not contributed to their delay. The third review under the IMF program was not completed. Bank purchases of government paper continued, with one large bank (Demirbank) financing its purchases on the overnight market.

Until November 2000, the economy limped along. The inflation rate fell (and was 32.7 percent for the year as a whole for the wholesale price index), real GDP was at least growing slowly after a drop of 4.7 percent in 1999, and the average treasury bill rate had fallen from 95 percent in 1999 to 39 percent in 2000 (although it was rising toward the end of the year). However, the current account balance as a percentage of GDP went from a negative 0.7 percent in 1999 to minus 4.9 percent in 2000, and concerns about the position of the banks intensified.

Starting in November 2000, the situation deteriorated rapidly.¹² Privatization revenues had fallen well below program targets. First steps toward better supervision of banks led to closures, jailing of bankers, and greatly increased uncertainty as to the future of the system. In September 2000, a revised banking law strengthened aspects of supervision and regulation, including elements such as limiting connected lending, setting foreign currency exposure rules, and new accounting standards. In addition the independent Banking Regulation and Supervision Agency (BRSA) was established (although it was obviously going to take time for these provisions to make a significant difference).

Despite the completion of the second and third reviews under the IMF program, the net domestic asset targets had to be breached to supply liquidity to the domestic banking system, and foreign exchange reserves fell by \$8 billion in the last two months of 2000. An effort to restore credibility was made in December, with additional reform measures and new targets announced by Prime Minister Ecevit, and the approval by the IMF of an additional \$10 billion loan through its Supplemental Reserve Facility (SRF). Among the reforms, which were enacted but did not have time to take effect, was a new banking law, which guaranteed deposits, made a number of loan provisions tax deductible, and contained other provisions designed to tide over the banks until reforms were effected.

Markets were calmed, whether because of the strengthened reforms or IMF support, and the large foreign exchange outflows that had taken place were almost entirely reversed by early January. Interest rates fell to the low 50 percent range, and the

¹² For a blow-by-blow account of events in the November-February period, see Van Rijckeghem and Ucer, Chapters V and VI.

IMF came for its fifth review in mid-January, with approval by the Executive Board early in February. Even so, the banks were fragile: as already seen, foreign currency open positions of the banking system as of December 2000 were 3,300 percent of capital, accumulated duty losses in the state banks were 3,400 percent of capital, and short term liabilities of the state banks were 4,100 percent of capital.

In February, a political eruption against the background of confusion as to the direction of economic policy resulted in a full-fledged crisis. During a long meeting of the critically-important National Security Council, an argument erupted between President Sezer and Prime Minister Ecevit in which it was reported that the President had thrown a book at the Prime Minister. Political uncertainty intensified, and with it, increased difficulty in rolling over debt, increasing dollarization and shifts of funds out of Turkish banks with associated foreign exchange reserve losses, and rising interest rates.¹³ In late February, a two-day banking holiday was decreed, but the interest rate fell only to 700 percent and capital outflows continued. Finally, it was announced that the nominal anchor policy was being abandoned and the TL was allowed to float. The next morning the TL depreciated from TL687,000 per U.S. dollar to TL960,000 per U.S. dollar. The IMF publicly supported the float. However, Turkish foreign debt was downgraded by the rating agencies and outflows continued. The Central Bank was caught between needing to fund the state banks and simultaneously to avoiding bank runs. Overnight borrowing by the state banks had risen to TL6.4 quadrillion in mid-March from TL2.4 quadrillion late in 2000.¹⁴

¹³ The overnight interest rate reached 4500 percent simple. Van Rijckegham and Ucer, P. 84.

¹⁴ Van Rijckegham and Ucer, P.85

For purposes of this analysis, the causes of failure of the 1999-2000 IMF program are not at issue. Some would argue that the nominal anchor exchange rate policy was at fault (although an exit strategy was built in). Others would focus on the lack of credibility of Turkish policies in light of political issues and Turkey's past record. Still others would point to the weakness of the banking system, and rising Turkish debt. Certainly the long history of volatile macroeconomic policy and high inflation reinforced doubts as to the credibility of the government's commitments.

All of these factors, and others, contributed. Regardless of the relative contributions of each, as of early 2001, the Turkish economy was clearly in deep crisis, and the outlook was poor. The fact that inflation and fiscal deficits had been high for a long time did not provide confidence that the government could adhere to a sufficiently rigorous program. But even if the government was initially willing to adhere to such a program, political fragility (not only between the President and the Prime Minister but also between the parties in a coalition government) made the likelihood of serious changes even more unlikely.

The situation was indeed dire by February 2001. Inflation had accelerated and reached more than 100 percent. Turkish debt was rising alarmingly, as reflected among other things, in the downgrading by the rating agencies and the refusal of creditors to roll over debt. The fiscal deficit had fallen beginning with the 1999 program, and the primary surplus actually reached 3.0 percent of GDP in 2000, but net debt was rising and the government's net debt to GDP ratio reached 93.9 percent in 2001. With high interest rates

(the average Treasury bill rate in 2001 was 96 percent), and GDP falling in 2001,¹⁵ it was clear that debt was not sustainable without significant changes.

Although the coalition government remained in power, personnel were changed in March 2001, with Kemal Dervis as Minister for Economic Affairs and the Treasury leading the economics team. As a well-known World Bank official, he had much greater credibility than his predecessors.¹⁶

In May, a new reform program was set forth.¹⁷ It focused on reducing inflation, achieving debt sustainability,¹⁸ and restoring growth. The measures envisaged were far reaching. Fiscal adjustment was to go further. The Central Bank was to introduce inflation targeting gradually. Financial reforms went much further, with a restructuring of the state banks, a closure of the SDIF (duty loss) banks, increased capital requirements for private banks, and enhanced asset management regulations.¹⁹

From that program onward, major and far-reaching reforms continued through at least the middle of the decade. Not only was there an increase in the primary surplus which was then sustained until the global crisis of 2007, but tax reforms and changes in the fiscal system significantly improved the quality of government expenditures and revenues. Some large subsidy programs were reduced or abandoned, civil servants' compensation was restrained for several years, some infrastructure financing was shifted

¹⁵ Real GDP fell by 7.3 percent in 2001.

¹⁶ See Boulton, 2001.

¹⁷ The Stand-By of December 1999 was followed by a Supplemental Reserve Facility Loan of December 2000, a Standby of February 2002 and a Standby of May 2005. This last program expired in May 2008. (See Annex I, P. 3 of IMF 2010).

¹⁸ See Klingen (2005) for an analysis of debt sustainability prior to and following the 2001 crisis.

¹⁹ See Josefson and Marston (2005) for a detailed account. To give an idea of the extent of restructuring, the number of branches of two big state banks, Halk and Ziraat was reduced from 2,478 in March 2001 to 1,658 by December 2003, while the number of personnel was reduced from 59,831 to 29,787. One large state bank was closed. The government injected about 13 percent of GDP into the state banks (Josefson and Marston P. 55). It is estimated that the total cost to the government of bank restructuring was 32 percent of GDP. Nonperforming loans as a percent of total loans in the private banks fell from 27.6 in 2001 to 6.5 in 2003.

to public-private partnership (PPP) financing, and much more. The BRSA undertook the serious and needed reforms in regulation and supervision of the banking system, although not without political and court challenges. Monetary policy tightened, and after several years, inflation targeting could be adopted. A major program of privatization was undertaken, which significantly reduced the role of state economic enterprises in the economy.²⁰

There is still much that needs to be reformed in Turkey, but the economy and economic structure have been truly transformed. As stated by the Economist (2010):

“...ten years on, Turkey stands transformed. The economy suffered badly in the global recession of 2009, but over the previous five years it had been unusually vigorous, and it has bounced back so quickly this year that it is likely to grow faster than...almost all other European countries....[Turkey] is on the verge of acquiring an investment-grade credit rating, inflation is in single figures, and the government has been able to dump the IMF.” (p. 3)

For present purposes, what is significant is that while the reforms were drastic (and much needed), and the considerable uncertainty that they would succeed, they were immediately successful. Fiscal tightening did not lead to a drop in the rate of economic growth. Almost from the start there was an acceleration in the rate of economic growth, as real GDP grew by 7.8 percent in 2002, and an annual average of 6.5 percent in the following eight years – a rate much higher than had been realized in any period of equal length in the preceding three decades. Inflation began dropping with the rate of inflation in producer prices falling to 25 percent in 2003 and reaching a single-digit 5.9 percent in 2005. Nominal interest rates fell sharply with the nominal Treasury bill rate falling from

²⁰ See OECD (2006), Table 1.1, P. 23 for a concise list of 22 “main economic reforms”.

99 percent in 2001 to 44 percent by 2003 and continuing its decline thereafter. By 2008, the real interest rate on public debt had fallen to 2.8 percent. Meanwhile, the debt/GDP ratio fell from 91 percent of GDP in 2001 to 70 percent in 2003 and 37 percent of GDP by 2007.²¹

As summarized by the OECD,

“The recovery from the 2001 crisis has been impressive. Over the 2002-2005 period, output increased by a third...annual inflation fell steadily, reaching single digits in 2004 for the first time in three decades, while sound fiscal and monetary policies improved confidence and reduced risk premia...” (OECD, 2006, P. 11)

Although reforms lost momentum with the global financial crisis, until that time economic performance, and continuing reforms, were impressive. During the crisis, Turkey’s banking system remained sound, debt indicators rose only gradually, and while the fiscal deficit increased, it did so within moderate limits.

Taking the first six years after the start of the 2001 reform program, Turkish performance was impressive by any standard. After dropping in 2001, real GDP grew by 6.2, 5.3, 9.4, 8.4 and 6.9 percent in the years from 2002 to 2006. Only in 2009 did real GDP fall (by 4.7 percent) during the financial crisis, despite the sharp drop in real GDP in Turkey’s trading partners. The rebound was much more rapid than had been anticipated and, as already pointed out, Turkish growth accelerated quickly.

Brazil: Crisis Defused and Accelerated Growth

While the reforms in Turkey were taken largely in response to the crisis and the outcome led to a marked improvement in fundamentals, sustainability of growth, and greater stability in macroeconomics, the Brazilian story is one which was very similar

²¹ Data in this paragraph are from IMF (2004), IMF (2010) and Moghadam (2005).

until 2002, but then in which crisis was imminent and averted in 2002 after fairly good adherence to a Fund program that started in 1999. Reforms were undertaken thereafter, but the main characteristic of change contrasted with earlier periods was the sustained adherence to more realistic macroeconomic policies. By the middle of the decade, growth had accelerated and appeared sustainable and the inflation rate and debt indicators had fallen markedly. Brazil represents a case of successful crisis prevention.

Brazil had a history of very high inflation until the early 1990s. A series of stop-go cycles had taken place prior to the 1990s, in all of which control of inflation (which had been triple and even quadruple digit) had been the primary objective. The usual pattern had been that a new set of reforms (the most recent had been a change in 1986 to the "Cruzado Plan") was announced and implemented initially with a drop in the inflation rate. Rapidly, however, the program was relaxed and the rate of price increase accelerated again. After the 1986 reforms, for example, the annual inflation rate fell from 229 percent in 1985 to 140 percent in 1986 and then accelerated again, reaching a high of 2,704 percent in 1990.²²

The 1994 reforms were again aimed at greatly reducing the inflation rate, and were based on a "real plan" in which the intended rate of inflation would be announced, and the real depreciated only by a preannounced rate equal to the inflation target. This started after an initial devaluation to a level that was judged to be a realistic real exchange rate. The "nominal anchor" was followed, but actual inflation rates exceeded their preannounced target rates by significant amounts. The inflation rate fell significantly, from 2709 percent in 1991 to 988 percent in 1992, but then rose again. The Brazilian fiscal and current account deficits increased markedly while high interest rates induced

²² Inflation rates are for wholesale prices as reported in IMF (1996, P. 109)

capital inflows. Public debt was growing rapidly and increasingly linked to the exchange rate and the rate of interest. With the Asian crisis, doubts increased about the sustainability of the Brazilian monetary and fiscal policy, including the nominal anchor exchange rate. After President Cardoso was elected to a second term in October 1998, a set of measures was adopted including a reduction in the fiscal deficit, curbing the growth of public debt and a series of structural reforms, supported by an IMF program. The crawling peg exchange rate was, however, maintained.

For a variety of reasons (such as the failure of Congress to enact the fiscal measures), pressures on the currency again grew quickly. The crawling peg was abandoned early in 1999 after serious losses of reserves and a sharp depreciation of the currency. The IMF program was renegotiated and the fiscal targets for 1999 and 2000 were reached. Although public debt remained about the same relative to GDP after the new program, the share of debt linked to foreign exchange and the interest rate increased. But adherence to the IMF program and the implementation of reform policies (including, later in the year, inflation targeting and a clean float in the foreign exchange market) resulted in increased economic activity, and real GDP actually grew in 1999 (by 1 per cent) and 2000 (by 4 percent), contrary to the expectations set forth in the Fund program. However, the real continued to depreciate (by 20 percent in nominal terms against the U.S. dollar in the first half of 2001), and the spread on Brazilian foreign currency bonds rose.

The IMF program was due to end at the end of 2001, and Presidential elections were scheduled for October 2002. The authorities were concerned about efforts to manage without a program or to renegotiate a program in the midst of a Presidential

election, and chose to cancel the 2000 program and to replace it with a 15 month program that would last until the end of the government's term in December 2002. Although the program was announced in August 2001, there was little positive effect, in significant part because of investors' doubts about the new election, and in part because the world economy and finance deteriorated after September 2001.

But the chief factor was the scheduled elections. Mr. Luis Inacio Lula da Silva of the Workers' Party, who had run for President in three previous elections and lost, was again a candidate and polls were showing increased support for him. He had earlier been associated with very left-wing policies, and investors feared a sharp shift in policies, perhaps even including repudiation of the public debt.²³ As Perez and Gerson (2005, P. 114-5) indicated in their analysis,

"In effect, Brazil was now suffering for policies that had not been implemented by a government that had not yet been elected....only an ex post implementation of strong policies would fully assuage investors' fears of policy reversal. What was needed was a device to signal investors that Mr. da Silva's commitment to policies aimed at financial stability was genuine." Without support and a means of assuaging investors, it was clear that Brazil would be in a full-blown financial crisis before and during the election.

There were major risks. Investors might not find an IMF program credible; a new government might not be able to maintain the needed macroeconomic policies; and the ongoing Argentine crisis was leading to investors' reassessment of all emerging markets. On the other hand, Brazilian policies (as set in the 2001 program) appeared to be sufficient to enable growth and reduced inflation if they continued to be implemented, and Mr. Lula did commit (as did the other two Presidential candidates) to continuing

²³ Perez and Gerson, P. 113.

them if elected. A new program was negotiated covering the period until mid-2003. The target primary surplus was raised from the earlier 3.5 percent of GDP target to at least 3.75 percent. In the program, there was also a commitment to maintain inflation targeting, and arrangements for foreign exchange intervention (during the period when international markets were closed) and a floor on foreign exchange reserves were also set.

A major question was how much financing Brazil needed. On one hand, an “ordinary” level of financing might not be sufficient to restore investor confidence. On the other hand, it was desirable that the Brazilian authorities were seen as having sufficient resources so as to be able to meet their financial needs. Ultimately, the program was backed by a \$30 billion loan, much above normal IMF financing.²⁴

Prior to the program’s public announcement on September 6, 2002, each of the major presidential candidates publicly endorsed the major targets of the program. Even so, many were skeptical that the program would succeed in cooling the crisis, and some forecast that the central bank would run out of reserves.²⁵ However, bond spreads peaked (at 2500 basis points!) at the time of the first round of the Presidential elections, and the real depreciated to almost R\$4 per U.S. dollar at the end of October.

After that conditions in the international market gradually improved. President Lula continued publicly to maintain macroeconomic policies for stability as well as to focus on social issues. He appointed a strong economics team, and an increase in the primary surplus to 4.25 percent was announced soon after the new government had assumed office.

²⁴ However, much of the loan could not be drawn upon until 2003, when the new government was in office, and when the IMF staff and board could be assured that the program targets were being met.

²⁵ See, for example, Goldstein (2003).

The crisis was defused. By April 2003, Brazil regained access to international capital markets; by mid 2004, the spreads had fallen to around 500 basis points. Program targets were met, and financial pressures abated. When the 2003 program ended, conditions were sufficiently improved so that the authorities chose to treat a successor program as precautionary. Brazilian economic growth accelerated, reaching 3.2 percent in 2005 and rising above 5 percent in 2008 before the global recession. By 2005, the inflation rate fell to 6.9 percent and the government debt/GDP ratio fell to 48 percent. The \$30 billion loan from the Fund was fully repaid by 2005. By late 2010, the concern in Brazil was not focused on growth, but on the risk that the economy was overheating: the growth rate was expected to be the highest in South America.

Lessons

Prior to the financial crisis, many observers were noting the relatively small volume of outstanding loans made by the Fund, the small number of the crises which had occurred to date, and claiming that the Fund had become “irrelevant”. But, as the experiences with Turkey and Brazil show,²⁶ two major economies were faring considerably better than they would have in the absence of international support. It is inestimable how much smaller Brazilian output would have been in the years following the 2002 election had the new President entered office confronted with a full-blown crisis. In the Turkish case, it is difficult to estimate how Turkey would have emerged from crisis without international support, and how much worse off the country would have been.

²⁶ There are many other cases, of course. The Fund played a crucial role in supporting policy changes in the countries of the former Soviet Union; it supported moves to improve fiscal and monetary policy in many Subsaharan African countries with only modest success initially but which have contributed to Africa's acceleration of growth in recent years; it was instrumental in supporting Uruguay when the crisis in Argentina led to difficulties in that country; and many more.

A first lesson is that the Fund has both prevented crises and enabled a much more rapid recovery than would otherwise have been possible. But, connected to that, in neither case was success at all assured when policy reforms were undertaken. Indeed, the first programs (in 1999) were not followed by sustained growth without further support. At the time that the Turkish program in 2001 and the Brazilian program in 2002 was announced, it was difficult to estimate how private investors would react to policy changes, and in particular whether they would find the Turkish reforms and the Brazilian Presidential commitments sufficiently credible to result in a resumption of functioning markets. For Turkey, a new government was elected shortly after the February 2001 crisis, and it was not possible to know what its economic policies would be. In Brazil, expectations with regard to the frontrunner in the Presidential election turned out to be unduly pessimistic.

A second lesson is that earlier reforms can enable a larger benefit from later reforms in cases where the earlier ones address some fundamental issues, even if they are not sufficiently far-reaching to put the economy on a sustainable growth path. In Turkey's case, the reforms of the 1980s, which opened up the trade regime and removed the high walls of protection that had surrounded the Turkish economy, enabled a much more rapid and a much greater response to the 2001 program than could otherwise have occurred. Had there been fewer firms with experience in and knowledge of the export market, there would have been a smaller response to the changed incentives; that smaller response would have meant a slower turnaround in economic activity, and doubts about the program, and political opposition to it, would surely have been greater. In Brazil's case, the reforms of the educational system, the earlier reduction in trade protection, and

other measures undertaken during President Cardoso's tenure certainly contributed to the speed and strength of the recovery after President Lula was elected.

So while it is certainly the case that reform programs may fall short of correcting enough policy shortcomings to enable rapid growth, they can nonetheless bring about benefits in the short run and bring about more benefits when another reform program is undertaken.

A third, and important, lesson is that in the context of inflationary pressures and rising indebtedness, fiscal consolidation and tightened fiscal and monetary policy need not bring about significant and drawn out periods of austerity. When there are policy reforms that increase prospective returns from some economic activities (such as moving toward a more realistic exchange rate or freeing up the labor market), some or all of the reduction in demand resulting from fiscal consolidation can be offset by the shift of resources into the newly more attractive lines of economic activity. Indeed, in order for a meaningful depreciation of the real exchange rate, for example, to take effect, it can be necessary for resources to be released from other lines of endeavor.

Finally, it should also be noted that observers who are critical of reform programs often contrast economic activity immediately after reforms with that immediately before. When a crisis comes about because ongoing levels of activity are unsustainable, this is not the appropriate comparison. The correct comparison, which is very difficult to estimate, is what would have happened had the government attempted to continue on the unsustainable course (or, even more difficult, what earlier rate of growth would have been sustainable). In cases where spreads on bonds are already sky high and rollover happens only very short term, the relevant question is what would have happened had the

government budget been unaltered and efforts to fund deficits had continued. That the markets would have closed at some point to such governments is a foregone conclusion. One can only guess at the political and economic upheavals attendant upon a government unable to meet its payroll.²⁷ Probably the realistic alternative to reforms at a given time is reforms at a somewhat later date. In that event, the high spreads, the slowdown in economic activity during the crisis periods, the additional borrowing undertaken in a futile effort to sustain policies, are all part of the costs of delay. The relevant political choice is whether to continue to try to hold together an apparently unsustainable set of policies (presumably in the hope that some exogenous event will save them) for a further period of time or to begin reforms earlier. All the evidence indicates that delay raises the costs of reform when it finally takes place.

REFERENCES

Brau, Eduard and Ian McDonald, editors, 2008. Successes of the International Monetary Fund, Palgrave Macmillan, New York.

Economist, October 23, 2010. "A Special Report on Turkey".

Goldstein, Morris, 2003. "Debt Sustainability, Brazil, and the IMF", Peterson Institute for International Economics, February, Working Paper 03-1.

Boulton, Leyla, 2001. "Turkey gets Ready to Swallow the Medicine", Financial Times, March 28, 2001, P. 3.

International Monetary Fund, 1996. International Financial Statistics Yearbook, International Monetary Fund, Washington D. C.

International Monetary Fund, 1999. Letter of Intent.
<http://www.imf.org/external/np/loi/1999/09229>

²⁷ When a country is running a primary deficit, it cannot maintain its current rate of expenditures and taxes without highly inflationary financing or financing from abroad (if reserves are already too low).

International Monetary Fund, 2004. International Financial Statistics Yearbook, International Monetary Fund, Washington D.C.

International Monetary Fund, 2010. "Staff Report for the Article IV Consultation and Post-Program Monitoring", July 13. Available from Fund Website.

Josefsson, Mats and David Marston, "Bank Restructuring and Financial Sector Reform", in Moghadam (2005)

Klingen, Christoph, 2005. "How Much Debt is Too Much?" Pp. 33-38 in Moghadam (2005).

Krueger, Anne O. and Aktan, Okan H., 1992. Swimming against the Tide: Turkish Trade Reform in the 1980s, International Center for Economic Growth, San Francisco.

Lapper, Richard, 2002. "Bailout averts Financial Chaos", Financial Times, September 27, 2002

Moghadam, Reza, 2005. Turkey at the Crossroads: From Crisis Resolution to EU Accession, International Monetary Fund Occasional Paper 242, Washington D.C.

OECD. 2006. OECD Economic Surveys. Turkey, OECD, Paris, October.

Perez, Lorenzo L. and Philip Gerson, 2008, "Brazil: Anchoring Policy Credibility in the Midst of Financial Crisis", Pp. 106-119 in Brau and McDonald (2008).

Van Rijckenham, Caroline and Murat Ocer, 2005. Chronicle of the Turkish Financial Crises of 2000-2001, Bogazici University Press, Istanbul.

Van Rijkeghem, Caroline and Ucer, Murat, 2005. Chronicle of the Turkish Financial Crises of 2000-2001, Bogazici University Press, Istanbul.