FUNDAÇÃO GETÚLIO VARGAS
ESCOLA DE ADMINISTRAÇÃO DE EMPRESAS DE SÃO PAULO

PIERRE-LOUIS BRIGANT

BRAZIL AND TURKEY, A COMPARATIVE ANALYSIS OF BOTH COUNTRIES' ECONOMIC DEVELOPMENT AND INSTITUTIONAL DESIGN FROM THE GREAT DEPRESSION TO THE EARLY 21ST CENTURY

SÃO PAULO
2014

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BRASIL E TURQUIA, UMA ANÁLISE COMPARATIVA DO DESENVOLVIMENTO ECONÔMICO E DO MARCO INSTITUCIONAL DOS DOIS PAÍSES DESDE A GRANDE DEPRESSÃO ATÉ O COMEÇO DO SÉCULO 21

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Orientador Prof. Dr. Antonio Carlos Manfredini da Cunha Oliveira

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____
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____
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____
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“Nothing is possible without men, but nothing lasts without institutions”

Jean Monnet

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Thank you all,
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ABSTRACT

After experiencing strong economic growth in the first decade of the 21st century, Brazil and Turkey have been regarded as two of the most dynamic and promising emerging economies. Nevertheless, several signs of economic difficulties and political tensions have recently been reappearing simultaneously in both countries. We believe that these signs and their simultaneity in the two countries are better understood by taking a retrospective look into both countries' economic history, which reveal to be surprisingly parallel. In a first part, a comprehensive comparison of Brazil and Turkey's economic history is undertaken to show the numerous similarities in the economic policy challenges and choices that both countries went through from the turn of the Great Depression to the first decade of the 21st century. These common economic policy choices define a remarkably analogous development path characterized first by the adoption of the import-substitution industrialization (ISI) model in the context of the world recession in the 1930s, then by the intensification and final crisis of this model in the 1980s, and finally by two decades of stabilization and transition to a liberal economic model. In a second part, the development of economic and political institutions as well as the underlying political economy in both countries are analysed comparatively with a view to providing elements of explanation for the parallel observed in the first part. We contend that the institutional framework set up in both countries throughout this period also shared many fundamental characteristics and contributes to explain the comparable economic policy choices and economic performance. This study intends to give some helpful background to understand the current context in both countries. It is also an invitation to consider emerging economies in a broader historical and comparative perspective in order to better comprehend their institutional weaknesses and adopt a balanced view of their economic potential.

KEY WORDS: Brazil, Turkey, comparative economic history, economic institutions, import-substitution industrialization.

RESUMO

Apos uma década de rápido crescimento econômico na primeira década do século 21, Brasil e Turquia foram considerados duas das economias emergentes mais dinâmicas e promissoras. No entanto, vários sinais de dificuldades econômicas e tensões políticas reapareceram recentemente e simultaneamente nos dois países. Acreditamos que esses sinais e a sua simultaneidade podem ser entendidos melhor com um olhar retrospectivo sobre a história econômica dos dois países, que revela ser surpreendentemente paralela. Numa primeira parte, empreendemos uma comparação abrangente da história econômica brasileira e turca para mostrar as numerosas similaridades entre os desafios de política econômica que os dois países enfrentaram, assim como entre as respostas que eles lhes deram desde a virada da Grande Depressão até a primeira década do século 21. Essas escolhas de política econômica comuns dão forma a uma trajetória de desenvolvimento notavelmente análoga, caracterizada primeiro pela adoção do modelo de industrialização por substituição das importações (ISI) no contexto da recessão mundial dos anos 1930; depois pela intensificação e crise final desse modelo nos anos 1980; e finalmente por duas décadas de estabilização e transição para um modelo econômico mais liberal. Numa segunda parte, o desenvolvimento das instituições econômicas e políticas, assim como da economia política subjacente nos dois países, são analisados comparativamente a fim de prover alguns elementos de explicação do paralelo observado na primeira parte. Sustentamos que o marco institucional estabelecido nos dois países durante esse período também têm varias características fundamentais em comum e contribui a explicar as escolhas de política econômica e as performances econômicas comparáveis, detalhadas na primeira parte. Este estudo aborda elementos do contexto histórico úteis para compreender a situação econômica e política atual nos dois países. Potencialmente também constitui uma tentativa de considerar as economias emergentes numa perspectiva histórica e comparativa mais ampla para entender melhor as suas fraquezas institucionais e adotar um olhar mais equilibrado sobre seu potencial econômico.

PALAVRAS CHAVE: Brasil, Turquia, história econômica comparada, instituições econômicas, industrialização por substituição das importações.

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List of Acronyms

ANATEL	Agência Nacional de Telecomunicações
ANEEL	Agência Nacional da Energia Elétrica
ANP	Agência Nacional do Petróleo, Gás Natural e Biocombustíveis
BRIC	Brazil, Russia, India, China
BRICS	Brazil, Russia, India, China, South Africa
BRL	Brazilian Real
BEFIEX	Comissão para Concessão de Beneficios Fiscais e Programas Especiais de Exportação
BNDE	Banco Nacional de Desenvolvimento Econômico
CIP	Comissão Interministerial de Preços
CNP	Companhia Nacional do Petróleo
CSN	Companhia Siderúrgica Nacional
CONEP	Comissão Nacional de Estabilização de Preços
CTLD	Convertible Turkish Lira Deposit
DASP	Departamento de Administração do Serviço Público
EEC	European Economic Community
EU	European Union
FDI	Foreign Direct Investment
FED	Federal Reserve System
FNM	Fábrica Nacional de Motores
GDP	Gross Domestic Product
GBP	Great Britain Pound
HDPPA	Housing Development and Public Participation Administration
IAA	Instituto Nacional do Álcool
IBC	Instituto Brasileiro do Café
IBGE	Instituto Brasileiro de Geografia e Estatística
ICM	Imposto sobre Circulação de Mercadorias
IMF	International Monetary Fund
II PND	II Plano Nacional de Desenvolvimento
ISI	Import-Substitution Industrialization
LTN	Letras do Tesouro Nacional
N11	Next Eleven

OEEC	Organization for European Economic Cooperation
OPEC	Organization of Petroleum Exporting Countries
ORTN	Obrigações Reajustáveis do Tesouro Nacional
PAEG	Programa de Ação Econômica do Governo
RPP	Republican People's Party
SOE	State-Owned Enterprise
SME	Small and Medium Enterprise
SPO	State Planning Organization
SUMOC	Superintendência da Moeda e do Crédito
TL	Turkish Lira
US	United States
USD	United States Dollar
USSR	Union of Soviet Socialist Republics
WWII	World War II

1. Introduction

Since the publication of Goldman Sachs's famous reports on the BRIC economies in the early 2000'[1], emerging economies have been drawing an increasing amount of attention for their astonishing economic performance. The central forecast made by J.O'Neill – who coined the acronym – and his colleagues was that the economic weight in terms of GDP of these four countries would equal that of the six largest economies by 2039. What initially appeared to many analysts as a particularly strange association of countries and a somewhat absurd forecast actually revealed to be visionary. In the past decade, the world economy has been remodelled and its centre of gravity resolutely moved towards these four countries, and especially China. Their economic growth has been so tremendous that they now all rank in the top ten largest economies, with China ranking second, and the target catch-up year was advanced to 2032.

The success of this intuition has set a trend. It fostered research on other future economic powers and gave rise to an inflation of new sophisticated acronyms aimed at grasping the fast changing reality of the world economy. This is what R.Sharma (2012) called *"the emerging market-mania*" in a book whose title illustrates this movement: *Breakout Nations: In Pursuit of the Next Economic Miracles.*[2] In the last few years, the concept of emerging economies was extended to many other countries, all identified for their recent economic performance and for their potential to become new engines of world growth and to emerge as regional powers. South Africa was enrolled in the initial group and included in the acronym, turning it into BRICS. And other countries such as Mexico, Indonesia and Turkey entered the scope of analysis in another group called the "next 11" (N11).

This trend gained further traction as the impact of the latest global financial crisis seemed to accelerate the transition of the world economic balance closer to these countries. Emerging economies attracted even more attention, as most of them remained nearly unscathed or only punctually affected by the global crisis, while all the developed economies plunged into the deepest recession since the Great Depression in the inter-war period. However, six years after the crisis broke out, economic growth has also been slowing down substantially in these countries. While the American expansionary monetary policy is being

[1] O'Neill, J. (2001). Building Better Global Economic BRICs, Global Economic Paper N°66
Wilson, D. and Purushothaman, R. (2003). Dreaming with BRICs: The Path to 2050, Global Economic Paper N°99

[2] Sharma, R. (2012). *Breakout Nations: In Pursuit of the Next Economic Miracles*, New York: Norton and Company

tapered, many emerging countries are experiencing severe economic instability which could jeopardize their future economic performance. In fact, growth forecasts in most emerging economies have been downgraded. Furthermore, serious doubts are being voiced about the sustainability of their past economic performance into the future, since this slowdown seems to unveil major structural weaknesses.

In consequence, the time might have come to re-examine the concept of emerging economies and the countries that it encompasses under a new light. Instead of adopting an exclusively forward-looking perspective, consisting of building up growth forecasts for these countries by projecting their current economic performance and their growth potential, a retrospective look could be taken to understand the historical process by which these economies emerged so dynamic and apparently powerful. We believe such an approach could shed some interesting light on the concept of emerging economies and contribute to a better understanding of its relevance as well as of its limits.

The reason why emerging economies have been transforming so deeply and quickly the world economic order inherited from the Second World War is because they successfully engaged, at an astonishingly fast pace, in the economic development path that advanced economies completed throughout the last two centuries: the industrialization and then liberalization of their economies. As a result, emerging economies have recently become major players of the world economy, competing with advanced economies on an increasing number of international markets and generating their own growth momentum.

However, this quick adaptation to the world economy was not smooth. Such a fast development was frequently interrupted by deep crises. In the last decades, the world economy has been disrupted by numerous and increasingly destabilizing economic crises originating in emerging countries. Both industrialization and liberalization processes generated major imbalances in all emerging economies, with which economic policy-makers in these countries have been struggling. We contend that looking at how these countries went through such processes can provide some valuable insight to understand the economic difficulties and structural blockades that are appearing now, even more so when this analysis is carried out in a comparative fashion since it allows to build new ties between these countries and give the concept of emerging economies more consistency and historical depth.

The objective of this work is to undertake a comparative analysis of economic history taking into account two of the above-mentioned countries, namely Brazil and Turkey, which have, at first glance, little in common. Located very far from each other, in two regions driven by very different dynamics, Brazil and Turkey have hardly traded with each other until

recently. Nevertheless, these two countries are both recognized as two of the most prominent emerging economies, classified in a group of "large emerging economies" by the IMF[3]. They are both members of the G20, among the twenty largest economies in the world, Brazil ranking 6th and Turkey 18th in terms of GDP at current prices in 2011. Also, the two countries have a comparable level of GDP per capita (in current prices)[4].

Although the two countries have been both regarded as major emerging economies, it is rather uncommon to see them compared and in fact few comparative analyses have been conducted by academics. Yet, last year, Brazil and Turkey simultaneously made the headlines of all international newspapers as a wave of protests swept through both countries. In each case, these demonstrations came as a complete surprise and revealed a deep political crisis. These events brought significant attention to the two countries and begot some interesting comparisons, carried out by some journalists, of the political and economic dynamics at stake. This work builds on this intuition and intends to provide it with a deeper historical background covering the entire 20th century.

A detailed analysis of both countries' economic history shows that they went through an unexpectedly similar economic development path, from the turn of the Great Depression to the first decade of the 21st century, characterized by comparable economic policy challenges and responses. Both countries were pushed into adopting an import substitution industrialization model in the wake of the Great Depression due to their inability to export. They intensified it in the 1960' and 1970' until they were faced with a massive external debt crisis following the two oil shocks. The challenge for both countries was then to stabilize their economies in the 1980'. This stabilization process went along with a liberalization process which exposed both countries to external shocks in the form of repeated international financial crises at the end of 1990'. Finally, Brazil and Turkey experienced a decade of rapid growth in 2000' after a major crisis and a subsequent successful stabilization plan supervised by the IMF.

Going beyond economic policy-making, a flourishing academic literature in the field of development economics has recently been taking a closer look at the level of the underlying economic and political institutions. Through this approach, academics have been intending to provide explanations for the eternal question of what lies at the root of economic

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[3] "IMF Interactions with Emerging Economies", http://www.ieo-imf.org/ieo/files/completedevaluations/O.%20CP%202%20-%20IMF%20Interactions%20with%20Emerging%20Economies.pdf

[4] IMF World Economic Outlook Database, October 2013 . In terms of GDP per capita (current prices), Brazil ranks 55th with about USD 12,800 and Turkey ranks 63rd with about USD 10,400.

development. In this vein, after establishing the interesting and rather unexpected parallel between Brazil and Turkey's economic history, this work will dive into this deeper level of analysis so as to examine both countries' institutional frameworks and intend to explain it.

2. Research Questions and Hypotheses

The objective of this work is twofold. It is first to explore this comparative analysis in order to provide a detailed narrative of the parallel observed between the two countries in terms of economic policy challenges and choices from the Great Depression to the early 21st century. The second objective is then to undertake an analysis of the institutional framework of both countries throughout the same period of time so as to offer some elements of explanation of this parallel economic development.

2.1 A factual comparison

The first analytical chapter of this study intends to investigate Brazil and Turkey's economic history throughout the 20th century in order to highlight the similarities and question the extent to which their economic policies and development can be compared.

In this macroeconomic analysis, special attention is paid to the impact of external shocks on both countries' economies, the economic policy choices that were made in response to these shocks, specifically related to industrialization and trade, and their effects on their economic structure and performance.

Through a purely factual and chronological approach, we intend to build a narrative of both countries' history, shedding light on the similarities in their economic development throughout the period observed. The differences between Brazil and Turkey, as well as the diverging policy choices or distinct timing, are also highlighted. However, we believe that the existence of the latter do not invalidate the relevance of the overall parallel observed, as the similarities far outweigh the divergences.

We contend that the various external shocks observed in the time frame chosen – the Great Depression, the Second World War, the oil shocks and the international financial crises – affected both countries' economies in a similar way and that the corresponding economic policy responses share many fundamental characteristics. These elements reveal a common development path followed by both countries and characterized by the choice of a similar economic model – inward-oriented and state-supported import-substitution industrialization model – and common economic policy issues, namely inflation, fiscal deficits, balance of payments constraints and unsustainable accumulation of external debt.

This historical comparison is structured in three main parts, following a chronological periodization relevant to Brazil and Turkey's economic history. The first section, going from 1929 to 1945, covers the impact of the Great Depression, the subsequent adoption of an

import-substitution industrialization strategy in both countries and the effect of the Second World War on both countries' economies. In the second section, spanning from 1945 to 1980, the intensification of the import-substitution industrialization strategy in both countries and its limits, particularly revealed in the wake of the oil shocks, are examined. The last section begins with the crisis of the economic development model that prevailed in both countries in the beginning of the 1980' and examines the stabilization and liberalization processes in which Brazil and Turkey engaged at different points in time and pace, until diving in a major crisis in the beginning of the 21st century.

2.2 An analysis of both countries' institutional frameworks and its role in their economic development

Through a comparative analysis of the political economy, as well as economic and political institutions in Brazil and Turkey throughout the 20th century, this second analytical chapter intends to identify what might contribute to explain the parallel as well as the divergences in terms of economic policy choices and development illustrated in the previous chapter.

We contend that this deeper level of analysis, inspired from the existing literature on the role of institutions in economic development and specifically on Hall's historical institutionalism (1986), reveals some of the determinants of the economic policy choices made in both countries and provides some relevant guidance to answer such questions as: in which political context and on which foundations was the ISI model established in both countries? How to explain its longevity in spite of the repeated economic crises that both countries experienced from the 1950' on? And finally why did both countries go through so many difficulties when reforming the ISI model from the 1980' onwards? More generally, this chapter aims to address the question of the extent to which the institutional design in both countries offer a potential explanation for the parallel economic development detailed in the previous chapter.

To address these questions, this chapter follows a chronological approach with a periodization similar to the one adopted in the first chapter. However, since the phenomena analysed in this chapter are more abstract and potentially long-lasting than economic policy choices and economic performance, the chronological delimitation is looser. Following the three questions above, this chapter is divided into three subparts covering the establishment of the ISI model in both countries from the 1930' to the end of the 1950', the institutionalization of the ISI model and its resistance to reform in spite of the crises between the end of the 1950'

and the beginning of the 1980', and finally the long reform process until the beginning of the 2000'.

3. Literature Review

The relevant literature for the first and, above all, for the second analytical chapters of this work is reviewed below.

3.1 The existing comparisons of Brazil and Turkey

As explained in the previous chapter, the first objective of this work is to undertake a comparison of Brazil and Turkey's economic policies and performance throughout the 20th century. After a comprehensive research in all relevant academic databases, it appeared that this comparative analysis of the two countries over such a long period of time was never carried out before either in by economists or economic historians.

3.1.1 The limited scope of the existing comparisons in the field of economics

Some academic publications in the field of economics were found to directly and explicitly compare Brazil and Turkey. However, in these works, the two countries are usually included in a wider range of countries and the comparisons support the analysis of a very specific economic point which relates to the recent economic history of both countries, such as the degree of vulnerability to crisis contagion (Akcay and Zenginobuz, 2001; Tasdemir and Yalama, 2010), the volatility spill-overs between their stock markets (Metin and Muradoglu, 2001; Özun, 2007; Erbakan, Okuyan, Kadioglu, 2008; Yalama, 2009) or the sustainability of public debt (Tanner and Samake, 2006).

These papers offer a comparison of Brazil and Turkey but they all adopt such a strictly economic and technical approach that they lack the broader historical perspective looked for in this work.

3.1.2 Some references to Latin America made Turkish economic historians

This comparative analysis is therefore based on the main academic contributions of economic historians on both countries. The main references in the field of the Brazilian and Turkish economic history used in this work are listed below.

For Brazil, C.Furtado, W. Baer, A.Fishlow, E.Cardoso and M.Abreu are widely recognized for several books of reference on the Brazilian industrialization process and economic development during the 20th century. As to Turkey, economic historians like

S.Pamuk, D.Rodrik, M.Celasun and Z.Önis have produced a large literature on the Turkish economic history in the last two centuries.

Among the numerous academic publications used in this work, a collective book supervised by J. Sachs (1990) covering the issue of the external indebtedness throughout the 20th century in sixteen developing countries – among them Brazil and Turkey – deserves to be specifically mentioned. The sections on Brazil and Turkey, written by D.Rodrik and M.Celasun for Turkey and E.Cardoso and A.Fishlow for Brazil, offer a very detailed account of both countries' economic policies and debt management with a specific emphasis on the crisis of the 1980'.

In the Turkish section of this book as well as in many publications of Turkish economic historians, several parallels with Latin America and more specifically with Brazil were established throughout the time frame chosen. Although usually very punctual in time, the repeated references to Brazil in publications on the Turkish economic history contributed to guide the comparison undertaken in this work.

For example, in their historical investigation of Ottoman industrialization, Pamuk and Williamson (2011) made various parallels between the Ottoman Empire and Latin American countries in terms of trade policies and economic development in the late 19th century and early 20th century. Pamuk (2000) also mentioned the work of Diaz-Alejandro (1984) on Latin America during the 1930' in his analysis of the effects of the Great Depression on the Turkish economy. Pointing to the inherent limits of the ISI model in terms of market saturation, again Pamuk (1981) referred specifically to Brazil in contrast with Turkey in their respective management of this constraint. The sharp contrast in the treatment by external creditors of Turkey and Latin American countries during the debt crisis of the 1980' was highlighted by Cecen *et al.* (1994). In turn, Alper and Önis (2003) underlined some similarities in the characteristics of the democratic regime established in Turkey and in some Latin American countries in the end of the 1980'. Finally, Önis (2004) compares T.Özal *"neo-liberal populism"* in the 1980' to other politicians in Latin America, specifically F.Collor de Melo.

These references to Latin America, and specifically Brazil, found in publications on the Turkish economic history demonstrate that such a comparison carry some degree of relevance and therefore give credit to the broad comparative analysis undertaken in this work.

3.2 Institutions and economic development

The objective of the second analytical chapter is to compare Brazil and Turkey's political and economic institutional frameworks as well as political economy in order to understand to what extent they contributed to determine the parallel economic policy choices and economic performance in both countries. This chapter builds on the abundant literature on the link between institutions and economic development reviewed, in its main traits, below.

The debates over the determinants of economic growth and international specialization have been structuring the history of political economy, ever since it became an independent discipline within social sciences. While the focus was previously put on each country's endowment in technology, physical and human capital, in line with the main models of economic growth and comparative advantages, the analysis was recently redirected towards *"deeper social, political and economic processes that have come to be gathered under the rubric of institutions"*[5] (Nunn and Trefler, 2013). The link between institutions and economic development has been largely explored since then both theoretically and empirically, through historical and generally comparative analyses.

3.2.1 Definition of institutions and the link to economic development

In his seminal book, North (1990) stated a famous definition of institutions as: *"the rules or constraints on individual behaviour"* imposed either formally, through laws and political rules, or informally through social norms. Greif (1994, 2006) put the emphasis of his analysis on individual behaviours and extended the definition of institution to the motivations and incentives which determine and drive them. He defined an institution as *"a system of rules, beliefs and norms that conjointly generate a regularity of behaviour"*. In this understanding, organizations embodying institutions (the court for the enforcement of the property right for instance) are only one element of the system. In fact, they are an outcome or a representation of the institution as a whole. To follow with the example of the court and property rights given by Greif (1994), a court and a police force alone do not ensure the enforcement of property rights. The latter results from the conjunction of individuals who respect them and behave accordingly. These individuals are not driven by the mere existence of a court and policemen but by the belief in the sanctions actually associated with the infringement of property rights by those organizations. The court and police force are two organizations which take part in a wider system of beliefs and norms guiding and motivating individuals'

[5] All quotes in the text were taken from the original document already in English. The translation to English (when needed) are those of the authors, unless mentioned otherwise.

behaviour. This system is defined by Greif (2006) as an institution. As such, institutions are endogenous to a society and mostly observable at the level of individual behaviour, above all in social interactions including all types of economic transactions. Micro-level market mechanisms are entirely determined by many institutions that manifest themselves in the behaviour of each individuals involved. In conclusion, this definition of institutions provides a precise understanding of how they influence the economic activity and by extension the economic development of a country.

3.2.2 Institutions and economic outcomes: growth or chronic instability and crisis

The role of institutions and specifically economic institutions in determining long-term economic growth has grown as a natural continuation of the first stream of research on institutions. As mentioned before, the debate over the role of institutions in economic growth has progressively overtaken previous debates centred on the level of technology and the accumulation of human or physical capital. As stated by North and Thomas (1973), *"the factors we have listed (innovation, economies of scale, education, capital accumulation etc.) are not causes of growth; they are growth"*. The main source of economic growth, they argue is institutions, and especially property rights. Institutions determine the incentives given to individuals in a market economy mostly through the system of property rights and therefore guide their behaviour as economic agents. In doing so, economic institutions contribute to shape the allocation of resources and influence decisively the major economic variables such as investments in human or private capital (Acemoglu, Johnson, Robinson, 2005a). Because institutions are endogenous to a society and determine so much its economic performance, research on institutions helps reframe the debate on economic development as a debate over the nature of institutions. The question then becomes: what types of institutions generate long-term growth?

In parallel to this research on the link between economic institutions and economic growth, the same researchers (Acemoglu, Johnson, Robinson and Thaicharoen, 2003) also explored the link between institutions and economic failures, namely instability and crisis. Instead of blaming bad macro-economic policies, the authors looked at the economic and political institutions in search for the deeper cause of economic instability. They note that *"once we control for the effect of institutions, macroeconomic policies appear to have only a minor impact on volatility and crises"*, which suggests that *"distortionary macroeconomic*

policies are more likely to be symptoms of underlying institutional problems rather than the main causes of economic volatility" (Acemoglu, Johnson, Robinson and Thaicharoen, 2003).

3.2.3 The reciprocal relation between domestic institutions and comparative advantage and trade

The link between institutions and the international specialization of a country through the constitution of a comparative advantage is another causal relation that has recently been investigated, notably by Nunn and Trefler (2013). In the same way as the research on the effect of institutions on economic growth overcame the traditional determinants of economic growth, this new stream of research has been structured in opposition with the traditional arguments on endowments as determinants of comparative advantage set up by Ricardo and Hecksher-Olhin. Nunn and Trefler (2013) remark that *"institutional sources of comparative advantage can and do operate through fundamentally different channels than do traditional sources of comparative advantage such as endowments"*. After reviewing several relevant economic institutions – formal and informal – such as the contracting and property-right institutions or cultural beliefs, the authors conclude that *"institutions matter"* for comparative advantages in the same way as they do for economic growth because *"institutions affect costs more in some industries than in others"* and *"such relative cost impacts are better captured by institutional variables than by endowments"*.

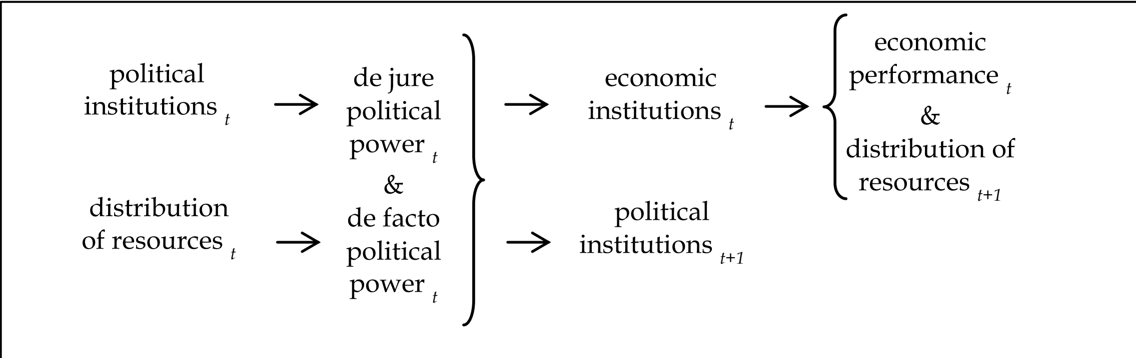
Interestingly, the reverse relation between international trade and domestic institutions also carries relevance. The authors contend that comparative advantages and international trade also influence domestic institutions in response. International trade influences domestic power and politics through the distribution of the wealth that it generates. The characteristics of this distribution, inclusive or exclusive, have a major impact on the institutional development of a country. In this regard, Nunn and Trefler (2013) conclude from several historical empirical studies that *"initial conditions working through their effect on comparative advantage, are crucially important for whether changes in international trade lead to inclusive or exclusive institutional change."* They further observe that the *"heterogeneous institutional responses to changes in international trade patterns are in large part explained by characteristics of the goods initially exported"*.

3.2.4 Economic institutions and political power

Another main characteristic of institutions pointed out by Acemoglu *et al.* (2005a, 2010) is the role they play not only in shaping economic growth but also in the distribution of

income in a society. As such, institutions are intrinsically political because they reflect economic interests. As highlighted by Acemoglu *et al.* (2005a), *"economic institutions are collective choices of the society"* and are strongly related to political institutions (*de jure*) as well as to political power (*de facto*). Both political and economic institutions are slow-changing because they primarily rely on the distribution of political power (*de facto*). Those who hold it tend to design political and economic institutions in such a way that they enhance and reinforce their political power and economic resources. This generates a central mechanism of persistence which makes institutions slow to change (Acemoglu, Johnson and Robinson, 2010). This set of relationships is well summarized in the scheme below.

Graph 3.1 Economic Institutions and Political power relationship scheme



Source: (Acemoglu, Johnson and Robinson, 2010)

This analysis invites researchers to look not only at the fundamental link between economic institutions and economic growth or comparative advantage but even deeper at how economic institutions are determined by political regimes and economic interests. This question is particularly relevant to the case of Brazil and Turkey.

3.2.5 Political regime, the military and economic policy

From the previous findings stemmed another development of this literature on institutions led by the same team of researchers (Acemoglu and Robinson 2008, 2010) which is also especially relevant to the case of Turkey and Brazil, namely the study of the different political regimes and their influence on economic institutions.

In both academic works, Acemoglu and Robinson (2008, 2010) construct a formal model to try to explain, with the concepts of political power *de jure* and *de facto,* how economic institutions and outcomes react to different and changing political regimes. In the first one (2008), they focus on the key role played by the elite in shaping the distribution of political

and economic power. The second one (2010) describes the intertwined political and economic powers at play in the establishment of a non-democratic regime and under which conditions it involves the military in the political game.

In complement to this formal theorization, more empirical works on the influence of political changes and the military on economic policies and performance can be found, including specifically on Brazil and Turkey. For instance, Shin (1990) observed a positive correlation between the influence of the military in the political system and economic growth between 1960 and 1975 through a higher state intervention in the economy. The study was conducted on a sample of 74 countries to which both Brazil and Turkey belong. Specifically on Brazil, the influence that the military had on the economic policies implemented in the 1930s and early 1940' is examined in detail by Hilton (1973). He tempers the commonly held view that the support of the military to the industrialization process in the 1930' was decisive in the adoption of the ISI model. Instead, he demonstrates that the role of the military in the economic policy-making was ambiguous and explains why its apparent support to the industrialization process did not immediately translate into supportive economic policies of the Brazilian government. As for Turkey, a broader reflection on the relation between institutional change and economic growth before 1980 is conducted by Pamuk (2010), building on the literature on institutions presented above. These two works show that Brazil and Turkey present interesting institutional features to be studied in the light of the literature recently developed on the role of institutions in economic development.

3.2.6 The role of institutions in a historical perspective

Finally, to support the historical and comparative approach of this research, it is worth mentioning that many of the most significant contributions to the literature on the role of institutions in economic development were built on both historical and comparative investigations.

In their seminal book, North and Thomas (1973) develop their reflection on the importance of institutions based on an investigation into several Western countries' economic history emphasizing the importance of property rights. They argue that the rising commercial activities in the 16th and 17th century led to the consolidation of property rights in England and laid the ground for the Great Revolution. Similarly, North (1990) explained how the development of sedimentary agriculture was permitted by the Neolithic revolution which introduced communal property rights.

More recently, Acemoglu, Johnson and Robinson (2001, 2005b) explored, in two publications, the consequences of the booming Atlantic trade in the 16th and 17th centuries on institutional development both in Europe (2005b) and in the European colonies (2001). They argue that in the case of Europe, trade permitted the rise of a strong commercial bourgeoisie which advocated for institutional changes in order to have a higher protection of property rights. In European colonies (2001), they point that the economic institutions and performance found in former European colonies today are still profoundly marked by the colonial administration implemented Europeans. They found that the type of colonial administration varied in correlation with the mortality rate of Europeans in the regions observed. The higher the mortality rate, the more extractive the economic institutions set up and the bigger the income gap observed in present times. Another relevant example of this historical and comparative approach is the study conducted by La Porta *et al.* (2007) who show how the different legal traditions spread by conquest and colonization had an influence on the economic performance in the countries where they had been developed (Europe) or introduced (the rest of the world).

Considering the theoretical links established between institutions and economic development as well as the previous works in this field of study, a comparative investigation into Brazil and Turkey's institutional framework seems relevant to understand their economic policy choices and economic performance.

4. Methodology

The main features of the methodological framework in which this research was conducted are presented in this chapter.

4.1 Participants

In this research, Brazil and Turkey's economic history, institutional framework and political economy were examined comparatively from the 1920' to the first decade of the 21st century. The methodology of this research is inspired from the ongoing debate on the research design in social sciences between quantitative and qualitative approaches. Furthermore, specifically for the second analytical chapter, the research was conducted following the framework of the historical institutionalism

4.2 The Qualitative-Quantitative Debate and the Research Design

The long lasting methodological divide and debate between quantitative and qualitative approaches has been reframed lately by an ambitious attempt to reconcile them. In a seminal book, King *et al.* (1994) argued that both qualitative and quantitative analyses are grounded in a similar scientific causal inference and consequently advocated in favour of a common research design introducing quantitative methodological tools into the qualitative approach. This, they claimed, would benefit the latter by enhancing its methodological rigor.

Although the overall success of their attempt was widely recognized, several social scientists (Caporaso, 1995; McKeown, 1999; Mahoney and Rueschemeyer, 2002) pointed to the limits of this ambition to merge both research methodologies under the principles of quantitative analysis, defending the specific characteristics of the qualitative approach and of the social sciences. They contested the "statistic worldview" promoted by King *et al.* (1994) and its underlying assumption that social phenomena could be reduced to a linear causality between independent and homogeneous variables suitable for quantitative analysis. As highlighted by Hanson and Kopstein (2005), this group of authors defend that *"the statistical worldview tends to downplay the severity of the various problems for causal inference posed by social science's typical reliance on observational as opposed to experimental data."*

As this research was deeply embedded in history, we followed the two rules that King *et al.* defined for summarizing historical data: 1. summaries should focus on the outcomes that we wish to describe or explain and 2. summaries must simplify the information at our disposal. However, this research was located at the crossroad of several social sciences,

namely economic history, history and political economy. We consequently also acknowledged the social sciences' intrinsic reliance on observable rather than experimental data and intend to anchor this work in the methodological framework of a qualitative comparative historical research. As highlighted by Mahoney and Rueschemeyer (2003), contemporary comparative historical research inherited a long tradition in social sciences going back as far as Adam Smith, Alexis de Tocqueville or Karl Marx and was also used by prominent social scientists in the twentieth century such as Max Weber and Marc Bloch. In the last decades, this tradition was revived by numerous researchers, especially in the field of economic history and industrial policy[6]. The authors suggest *"that comparative historical analysis is best considered part of a long-standing intellectual project oriented toward the explanation of substantively important outcomes. It is designed by a concern with causal analysis, an emphasis on processes over time and the use of systematic and contextualized comparison"* (Mahoney and Rueschemeyer, 2003).

4.3 Data Analysis

In conformity with this tradition, this work adopted a macro-oriented perspective, using a large amount of observable data and variables on both countries over a long period of time from the 1920' to the 2000'. As such, this analysis could not be reduced to a set of variables that an experimental approach could link in a causal relation. This study did not pretend to be exhaustive and review all qualitative and quantitative data on both countries' economic and political history over the period of time chosen. But it rather relied on the interpretation of the most relevant historical data on both countries (following the two rules regarding historical data of King et al. mentioned earlier).

For both analytical chapters, the first investigating the two countries' economic history and the second digging into their political economy and institutional framework, the relevant material was retrieved from academic publications made by economic historians and political scientists on both countries. This work neither intends to bring about a new interpretation of each country's economic history, nor does it mean to enter and contribute to the debates ongoing in this field in the two countries. Its objective is only to highlight some interesting parallels between Brazil and Turkey's economic development and policy choices throughout

[6] See for example: Chaudhry (1997) on the Middle East, Evans (1995) on industrial policies or Seidman (1994) on Brazil.

the 20th century and then to build a narrative based on both countries institutional framework to provide elements of explanation of this parallel.

Some quantitative data were also mobilized to support the comparison, mainly in the first analytical chapter. These data were primarily taken from leading statistical institutions in both countries or found in the academic publications referred to in the analysis. For Brazil, the Instituto Brasileiro da Geografia e Estatística (IBGE), specifically with its comprehensive publication covering the whole 20th century entitled *Estatísticas do Século XX* (IBGE, 2006), provided the bulk of the data that were needed to conduct this work. The rest was found on the websites of the Central Bank and the Treasury. As for Turkey, most of the data were retrieved from the websites of the Turkish Statistical Institute (Türkstat) and of the Central Bank.

The second analytical chapter is exclusively a qualitative investigation in the field of political economy and development economics, specifically looking at the distribution of economic and political power and the institutional framework shaping economic policy choices in both countries.

To conduct this analysis, a specific analytical framework is used, namely historical institutionalism framework as developed by Hall (1986). Departing from the idea that economic policies are merely responses to economic problems, Hall developed a comparative historical analysis of Britain and France incorporating elements of the political and economic institutional framework of these two countries to explain some of their most significant economic policy choices and responses throughout the 20th century.

For example, one of the questions addressed in his book relates to the inability of the British government to properly respond to the post-war industrial decline of the country. The explanation given encompassed a broad analysis of the interplay of political and economic interests, such as the role of the financial interests and of business associations along with the weakness of the state and clientelist networks developed by political parties, that bound the action of the British government and hindered the formulation of an adequate economic policy to tackle the issue (Queiroz Guimaraes, 2005). It is this approach, applied comparatively to the cases of Brazil and Turkey, which was followed.

5. A parallel economic development path throughout the 20th century

This first analytical chapter will investigate Brazil and Turkey's economic history throughout the 20th century in order to highlight the similarities and explore the extent to which their economic policies and development can be compared.

5.1 The Brazilian and Turkish economies before 1929

To introduce the core of the comparative analysis starting from the impact of the Great Depression, it is worth stepping back and delving into both countries' previous economic history to highlight the common characteristics of the two economies on the eve of the 1929 shock.

The feature that best defines both economies in the 1920' is, above all, the predominance of the agricultural sector and of the rural population over a comparatively small urban and manufacturing sector. This specialization in primary agricultural goods is mostly derived from the trade pattern that both countries experienced in the first half of the 19th century, which hindered the development of manufacturing activities. However, diverging trade policies in the second half of that century allowed Brazil to reach a more advanced stage of industrialization than Turkey. Yet, the economic conditions and the policies implemented by both countries in the 1920' reinforced the international specialization of both economies in the production and exports of primary goods.

5.1.1 The predominance of the agricultural sector

In the 1920', the agricultural sector still held a dominant position in both economies in comparison with a small manufacturing sector.

In Turkey, the share of agricultural employment and GDP kept its importance from 1880 to 1950, at about 80% and 55% respectively (Pamuk, Filiztekin and Altug 2008). According to a census of manufacturing firms realized in 1915, there were only 182 operating manufacturing establishments of non-artisanal character employing only 14,000 workers (Boratav, 1981). Likewise, the Brazilian population was mostly rural in the 1920' with an urbanization rate of only 16% still in 1940 (Abreu, 2008) and the agricultural sector employing more than 70% of the working population (Cardoso and Teles, 2010). A similar census of the manufacturing sector undertaken in 1920 revealed that there were 13,336 manufacturing firms in the country employing 1,300,000 workers (Baer and Kerstenetzky,

1964), about 14% of the working population. These official figures were actually overstating the reality of the Brazilian manufacturing development since "*many factories were no more than small workshops"* (Cardoso and Teles, 2010). It is worth noticing that, although relatively small in both countries, the manufacturing sector was significantly bigger in Brazil. This fact will be examined here.

The weight of the primary sector in both countries' economies was a direct consequence of the trade pattern in which they were embedded in most of the 19th century. In the first half of the 19th century, both countries were relatively open to trade and experienced an appreciation of their terms of trade resulting from the rapid expansion of trade with the industrializing European countries.

In the beginning of the 19th century, the Ottoman Empire adopted a more liberal and reformist turn. After the elimination of the Janissary corps in 1826[7], which was the *"strongest advocate of protectionism"* (Quataert, 1994), several treaties liberalizing trade were signed. The first one was the Anglo-Turkish Commercial Convention signed in 1838 with Great Britain and was followed by others with the major European powers. These treaties fixed low trade tariffs that remained unchanged until the 1920' (Pamuk and Williamson, 2011). In spite of a higher level of flexibility regarding its trade regime, Brazil also remained relatively open until about the end of the 1850'. In the decades immediately following its independence (1822), the mercantilist policies previously imposed by the Portuguese crown were maintained and it was only in the last decades of the century that average tariffs increased substantially (Abreu, Bevilaqua, Pinho, 2000).

In the meantime, the combined revolution in transportation and rapid gains in productivity achieved in European manufacturing plants contributed to dramatically decrease the relative price of manufactured goods, while fostering economic growth and the demand for agricultural commodities used as raw material. As a result, relative prices of primary goods produced by peripheral countries like Brazil and Turkey soared and contributed to determine and deepen their international specialization. As highlighted by Pamuk and Williamson (2011), both the Ottoman empire and Latin America experienced the same process: Latin America's *"terms of trade underwent a steady increase from the 1810s to the early 1890s, and, like in the Ottoman Empire, the improvement was especially dramatic*

[7] The Janissaries were elite soldiers of the Ottoman Empire who formed a very powerful political force which had increasingly affirmed its power against the Sultan in the 17th and18th centuries through various revolts. In 1826, the Sultan Mahmud II ordered the execution of all of them in Istanbul. This was an important step in the modernization of the Empire that he initiated and which was then carried on by his sons with the "Reorganization" or *Tanzimat* movement from 1839 to 1876.

during the first four decades: the annual rate of increase was 1.3 per cent between the half-decade 1815–19 and the half-decade 1890–4, equivalent to almost a tripling over the 75 years; and the rate between 1815–19 and 1855–9 was even greater, about 2.1 per cent per annum" (Williamson, 2006). Over the same period of time (1815-1859), the Ottoman terms of trade multiplied by 2.6, growing at an annual rate of 2.4% (Pamuk and Williamson, 2011).

The natural consequence of such an appreciation of peripheral countries' terms of trade was a surge in imports, creating a situation of so-called "Dutch disease" (Pamuk and Williamson, 2011), where the local import-competing activities progressively disappeared because of their loss of competitiveness in comparison with imported goods and the subsequent reinforcement of the specialization in the production and export of primary goods.

Following the end of the Napoleonic wars, Great Britain extended its trade and flooded peripheral countries, like present-day Turkey or Brazil, with its manufactured goods. The Ottoman imports from Great Britain grew by 3.3% annually from 1840 to 1913 (Pamuk, 1987) while Brazil absorbed ten times as much British production as India in the 1840' and 1850' (Thorner, 1951). This surge of imports, further stimulated by the simultaneous construction of the first railways in the 1850' in both countries (mostly financed by British capital), led to a dramatic de-industrialization of the Ottoman Empire up to the 1860'.*"Booming terms of trade contributed to Ottoman de-industrialization in the nineteenth century, and especially up to the late 1850s. That is, as export prices rose and import prices fell, labour and other resources were pulled out of industry (and non-tradable sectors) and into the export sector so as to augment its capacity"* (Pamuk and Williamson, 2011)[8].

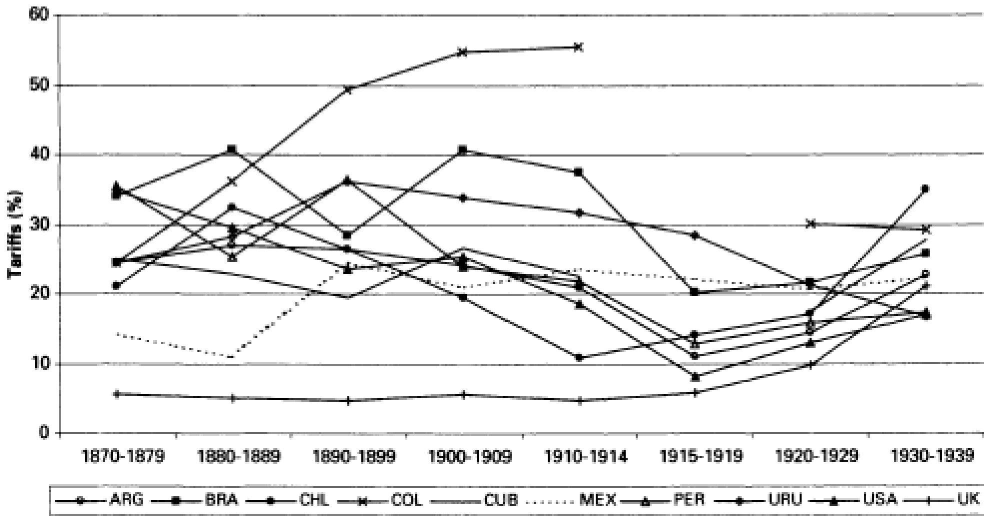
5.1.2 The difference in the level of industrialization stemming from diverging trade policies in the second half of the 19th century

In spite of the common trade patterns to which both the Ottoman Empire and Brazil were exposed in the 19th century, the significant difference in the level of industrialization of both countries observed in the 1920' stems from diverging trade policies adopted in the second half of the 19th century. Differently from the Ottoman Empire, Brazil managed to maintain and even develop its manufacturing sector in the end of the 19th century thanks to a higher level of flexibility in the design of its trade regime. The higher import tariffs implemented progressively compensated for the appreciation of the terms of trade so that the

[8] The authors describe this phenomenon as the progressive loss of the proto-industrial activities, mainly in textile weaving, mostly between 1815 and 1860. This was the result of the end of the Napoleonic wars and the resuming trade flows, the rapid development of British manufactures and the liberal trade policies adopted by the Ottoman Empire in the 19th century. As an example, the spinning output of the Ottoman Empire fell from 11,550 tons per year in 1820-22 to 3000 tons per year in 1870-71.

nascent domestic industrial or proto-industrial activities were not swept away by the competition with the European manufactures (Suzigan, 1986 and Villela, 1993).

Graph. 5.1 Import tariffs in various Latin American countries from 1870 to 1939



Source: Coatsworth and Williamson (2004)

The first breach to its open trade policy occurred with the increase in import tariffs in 1844, known as the *Tarifa Alves Branco* named after the Finance Minister who introduced them. From then on, the average import tariffs applied by Brazilian customs fluctuated between 20% and 40%, reaching its highest peaks in the last two decades of the century (Abreu, Bevilaqua, Pinho, 2000). As noted by Williamson (2006), *"average tariff rates in protectionist Latin America and the US were about 30 per cent in the middle of the period (1865-1905), or more than four times that of the Ottoman Empire"*, making Latin America *"the most protectionist in the world, from at least 1865 up to World War I"* (Coatsworth and Williamson, 2004). As shown in Graph 3.1 below, Brazil was among the most protectionist Latin American countries in the late 19th and early 20th centuries and provided an explicit support to the import-substitution process, notably through the *Lei dos Similares* adopted in 1911 (Abreu, Bevilaqua, Pinho, 2000). By contrast, the Ottoman Empire was locked into low import tariffs (7.5% on average between 1865 and 1905) by the trade treaties signed earlier in the century and could not provide any support to the infant industries (Pamuk and Williamson, 2011).

Consequently, Brazil experienced its first wave of import-substitution industrialization before 1930 while the Ottoman Empire went through a continuing de-industrialization

process. Brazil’s industrial output increased fivefold from 1900 to 1919 (Abreu, Bevilaqua and Pinho, 2000), with the First World War providing a significant push to import-substitution industrialization because of the reduction of the supply of manufactured goods that it provoked: industrial output in Brazil grew by 212% between 1914 and 1918 (Baer, 1965). In the Ottoman Empire however, the de-industrialization process went on. A temporary decrease of the terms of trade between 1855 and 1879 (by 27%) provided a slight relief to local import-competing manufactures and generated a modest wave of factory building. But most of the proto-industrial activities had already disappeared after the import boom of the first half of the century (Pamuk and Williamson, 2011).

5.1.3 The economic context and policies implemented in the 1920’ reinforced the specialization of both economies in the production and export of primary goods.

In spite of the diverging paths followed by Brazil and Turkey at the turn of the 20th century, the 1920’ were more favourable to the primary sector in both countries and contributed, through the international economic context and the economic policies implemented, to reinforce their economic specialization.

Although the Turkish Republic was proclaimed in 1923, after the end of the war of Independence, the newly founded Turkey did not recover its autonomy to define its trade policy. The Treaty of Lausanne, signed in 1923, settled the last territorial claims with Turkey’s neighbours and the main European powers, but in exchange compelled the country to maintain the same trade regime inherited from the Ottoman Empire until 1929 (Boratav, 1981). This clause deprived the Turkish government of its control over trade policy and of its ability to support industrialization through import tariffs, although the latter was set as its main economic objective.

In order to achieve that goal, several important public initiatives were taken to incentivize private capital accumulation in the industrial sector. In 1924, a private investment bank (*İş Bankası*) was established with the support of the Turkish government to finance private industrial projects. In addition, the Law of Encouragement of the Industry, passed in 1927, provided a wide range of incentives to domestic private capital to be invested in industrial plants, mostly through generous subsidies and long term protection to monopolies (Boratav, 1981).

However, these measures were not successful in generating the expected industrialization momentum because of the paucity of private capital available and the weak

entrepreneurial spirit of its elites (Boratav, 1981). The low level of maturity of the domestic market was also a main constraint as pointed out by Singer (1984) for whom *"these measures tended to be abortive, in no small part because the required inputs and markets were still too scarce and profits in industry still too uncertain to allow a substantial industrial advance."* Despite a high growth rate of the industrial output of 7.2% p.a. between 1923 and 1929 (Pamuk, 2000), the Turkish economy experienced *"little structural change"* (Singer, 1984). The main engine of growth remained the primary sector whose output grew at an annual rate of 13.9% over the same period (Pamuk, 2000)[9].

In Brazil, throughout the 1920', the international context proved unfavourable to industrialization and economic policies were much more influenced by the interests of the coffee producers and exporters than oriented towards the support of the industrialization process. The end of the First World War and the subsequent economic recovery of Western economies along with resuming trade flows dealt a harsh blow to the industrial growth experienced in the previous decade. The competition from manufactured products exported by Western economies caused the industrial output to stagnate. Simultaneously, repeating the pattern observed in the first half of the 19th century, commodity prices surged and the terms of trade appreciated, pushing the country back into its original Ricardian specialization, increasingly relying on coffee exports (Baer and Kerstenetzky, 1964).

This trend was further supported by the economic policies adopted under the influence of the coffee producers under the so-called Coffee and Milk Politics prevalent during that period. Instead of compensating the appreciation of the terms of trade with higher import tariffs, the protectionist trade regime adopted in the previous decades was substantially loosened and the average import tariff fell to about 20% in the 1920', compared to over 40% in the beginning of the century (Coatsworth and Williamson, 2004). Furthermore, the coffee valorisation program initiated in 1907, following the *Convênio de Taubaté*, an agreement signed in 1906 between the coffee producers and the governors of Brazil's larger states, was intensified. The purchase of unsalable stocks of coffee to support its international market price came to absorb up to one third of the harvest and provided a massive incentive for the production of the commodity, which doubled between 1925 and 1929 (Cardoso, 1981).

As a consequence of these various factors, the primary sector had been reinforced in its dominant position in both Brazil and Turkey by the end of the 1920'. Primary goods for export represented the most important sector in both economies. It amounted to nearly 90% of

[9] The rates are in nominal terms. As a general note, all quantitative information given in this chapter are given in nominal terms, unless indicated otherwise.

Turkish exports (Bulutay, Tezel and Yildirim, 1974), while coffee represented more than 70% of Brazil's exports. Although they had reached a different level of industrial development, the two countries had a comparable economic profile in the 1920', typical of the *"poor periphery"* (Pamuk and Williamson, 2011), characterized by the predominance of agriculture in the economy, an international specialization in the export of primary goods strengthened by international trade patterns and a relatively small manufacturing sector.

An additional similarity between the two countries, which revealed critical for the economic policy-making in the following decade, was the very high level of foreign-denominated public debt that both countries had accumulated which made them particularly vulnerable to an external shock, such as the Great Depression. Brazil had accumulated a huge external debt to finance its coffee support program implemented by the State of Sao Paulo from 1924 onwards and became heavily dependent on foreign capital inflows. In 1928, Brazilian public foreign debt had reached USD 1,142 million (Abreu, 2008a). Likewise, Turkey had inherited a huge external debt from the last years of the Ottoman Empire; two thirds were kept outstanding under the Treaty of Lausanne. The first repayment was due in 1929.

5.2 1929-1945: Brazil and Turkey *"virtually pushed"*[10] into a new and similar economic model of import-substitution industrialization after the Great Depression

As all peripheral economies specialized in the export of primary goods, Brazil and Turkey were profoundly affected by the deep recession in which all Western economies plunged during the 1930'. The sudden drop of the international demand for primary goods deprived them from their main source of income, pushing them to adopt a new economic model throughout the 1930' and 1940'. Facing this challenge, the economic policy response engineered by both countries shared very similar features in terms of more protectionist trade policies and higher state involvement in the economy, leading both countries to an analogous development pattern, driven by import-substitution industrialization (ISI).

5.2.1 The impact of the Great Depression and the similar economic policy challenges to Brazil and Turkey

Because both Turkey and Brazil heavily relied on their agricultural output and exports, the sudden drop of the international demand for primary goods by Western economies and the

[10] Taken from Krueger (1974), this expression actually applies to both countries.

subsequent fall of international commodity prices affected both countries similarly. Their external terms of trade quickly deteriorated and deprived them from the capacity to import.

While Brazil's export sector was largely dominated by coffee, in Turkey, the main agricultural commodities exported were cotton, tobacco and dried fruits (like hazelnuts). Their prices declined by about 50% between 1928 and 1932 and caused a deterioration of the external terms of trade of about 20% over the same period (Pamuk, 2000). Simultaneously, the international coffee price index, the dominant driver of Brazil's external terms of trade, tumbled from 100 in 1928 to 63.7 in 1930 (Malan and Bonelli, 1977). This led to the deterioration of the external terms of trade by 20% (Abreu, 2008a). In 1931, the international coffee price amounted to only one third of its 1925-1929 average level (Baer, 1965).

The drop of international commodity prices had an even stronger and more decisive impact on Turkey's domestic terms of trade. A significant share of Turkey's agricultural output was absorbed by the domestic market. At that time, the entire production of wheat, the most important agricultural commodity produced in Turkey, was destined to the internal market (Boratav, 1981). The domestic terms of trade for agricultural commodities declined by 31% between 1928 and 1932, even more than the country's external terms of trade (Pamuk, 2000).

Whether on the international market or on both countries' domestic markets, the effects of the Great Depression caused the terms of trade for primary goods to significantly deteriorate and hence rendered manufactured goods relatively more expensive and attractive to produce in both Turkey and Brazil.

The deterioration of both countries' external terms of trade also quickly drained their foreign exchange reserves and put them in a difficult position considering the very high external debt that they both had built in the previous decades. The effects of the Great Depression contributed, along with other factors, to push Brazil and Turkey into an external debt crisis that they managed very differently throughout the decade.

Turkey experienced a first foreign exchange crisis in June 1929, before the Great Depression broke out, when the first repayment of its external debt was due as established by the Treaty of Lausanne (1923). This crisis, predating the October 1929 financial crash, resulted exclusively from speculative behaviour (Boratav, 1981). The weight of the external debt was nevertheless compounded by the subsequent effects of the Great Depression and led Turkey to suspend its repayment in 1930. The renegotiation process, conducted in the context of the world crisis, was concluded favourably the same year with the reduction by half of

annual repayments (Pamuk, 2000). This substantial debt relief provided the Turkish government with fiscal leeway to conduct its economic policies later in the decade.

Table 5.1 Impact of the Great Depression on the Brazilian and Turkish terms of trade (Index: 1928=100 or in million USD or GBP)

Turkey	**1928-29**	**1932-33**	**1938-39**
External terms of trade*	100	79	68
Internal terms of trade**			
Agricultural prices/non-agricultural prices	100	69	81
Cereal Prices/non-agricultural prices	100	55	57
Trade flows			
Value of imports in million USD (nominal)	124	41	93
Brazil	**1928-29**	**1932-33**	**1938-39**
International Coffee prices	100	63	60
External terms of trade*	100	60	42
Value of Imports in million GBP (nominal)	90.7	21.7	31.8

Source: Pamuk (2000), Pakdemirli (1991), Malan and Bonelli (1977), Abreu (2008), IBGE (2006)

* relative prices of total exports in terms of imports

** understood as inter-sectorial terms of trade, i.e. relative prices of a certain type of goods compared to another type of goods, all domestically produced.

Brazil's external debt stress also began before the Great Depression broke out, with the sudden end of the capital inflows in mid-1928, coming as a precursory sign to the changing international economic environment. The coffee support program operated by the State of Sao Paulo had become dependent on the continuous capital inflows which had built up Brazil's external debt throughout the first decades of the 20th century (Cardoso, 1981), very much in what can be qualified as a *"snowball effect"* (Abreu, 2008a). In the following year, the deterioration of the external terms of trade and increasing capital outflows, caused by the political instability in 1930, put the Brazilian balance of payments under growing pressure. The foreign exchange reserves vanished from GBP 31 million in September 1929 to nearly zero in November 1930 when G.Vargas came to power. Brazil's external debt had then

reached its peak in a period going from 1825 to 1955, totalling more than GBP 250 million (Abreu, 2006), with a debt-export ratio reaching 5 in 1931 up from 2.36 in 1928 (Abreu, 2008a). In this context, the coffee support program was suspended as early as 1929 and debt servicing was suspended in 1930 and 1931. However, differently from Turkey, the external debt issue was left pending throughout the decade and only finally settled in 1943, after several rounds of negotiations (1934, 1940) and a default in 1937 (Cardoso and Teles, 2010).

Because of their similar macroeconomic profile, Brazil and Turkey were affected in a very similar way by the effects of the Great Depression. Both countries were faced with a sudden impossibility to import, due to the deterioration of their external terms of trade and an external debt crisis. The economic policy answers that followed provided the conditions and incentives for a wave of import-substitution industrialization in both countries.

5.2.1.1 The challenge to manage the constraints of the balance of payments

The most pressing issue that the Brazilian and Turkish governments had to address in 1930 was to reduce the growing pressure that the deteriorating terms of trade were exerting on their balance of payments. Unable to pay for the same level of imports due to foreign exchange reserves scarcity, both countries had to change radically their trade regime and reduce the value of their imports. Following the global trend of growing protectionism in the 1930', Brazil and Turkey adopted tighter import controls in the first years of the decade, as a first policy answer to the effects of the Great Depression.

As set by the Treaty of Lausanne, the Turkish government regained control over its trade policy in 1929 and passed a law that year imposing higher import tariffs, going from an average of 13% to 46%. In 1931, another law established a list of goods subject to import quotas (Boratav, 1981). In Brazil, the main instrument used for import controls was the foreign exchange regime. With the arrival of O.Aranha to the Finance Ministry in 1931, a complete control over the foreign exchange market was instituted. Banco do Brasil was given monopoly over all foreign exchange cover operations according to a system of import licenses.

The import control mechanisms established in both countries aimed at allocating the scarce foreign exchange reserves in the most efficient way to stimulate the process of import substitution industrialization. Therefore, the level of protection was adjusted according to the

type of good in order to favour the imports of capital goods and raw materials necessary to promote domestic manufactures.

In Turkey, the average import tariff grew to 60% by the end of the decade and the list of goods submitted to import quotas was extended following the development of the domestic manufacturing activities. Similarly in Brazil, foreign exchange controls became a constant feature of the economic policy conducted in the 1930'. The foreign exchange regime was subject to several reforms throughout the decade aiming to adapt it to the needs of the growing industrial sector and the availability of foreign exchange reserves. In 1933, a system of multiple exchange rates was introduced, relying to some extent on market mechanisms supporting the imports of selected goods. But in 1937, due to further constraints on the balance of payments, the former system of government monopoly was re-established (Abreu, 2008a).

Another instrument used by both countries' governments to control imports and manage their balance of payments constraints were bilateral trade treaties, signed with major trading partners, so as to organize a type of barter trade with accepted clearing mechanisms. Trade between Brazil and Germany expanded rapidly after 1934 on the basis of an informal compensation agreement between Banco do Brasil and the Reichsbank. In 1938, Germany received 20% of Brazilian exports. In 1935, Brazil signed and ratified the Reciprocal Trade Act with the United States which also stimulated bilateral trade, with Brazilian traditional primary exports (mostly coffee) being exchanged against US manufactured goods (Abreu, 2008a). Turkey also developed strong bilateral trade relations in the early 1930', notably with Germany. In the second half of the 1930', 80% of its trade was conducted within the framework of such agreements (Pamuk, 2000).

The direct consequence of such arrangements was a quick and drastic observed reduction of trade volumes in both countries. The amount of Turkish imports was divided by more than 2.5 between 1929 and 1932, from USD 124 million to USD 41 million (Pamuk, 2000), while Brazilian imports declined by 60% in volume and 70% in value over the same period. As a result, both countries' degrees of openness plummeted to reach historical lows. In Turkey, it tumbled from 28.6% in 1924 to 8% in 1945 (Pamuk, 2008c) and reached 5.4% in Brazil in 1932 (Abreu, 2008a). With the simultaneous adoption of protectionist measures, Brazil and Turkey were following the trend that swept the world in the wake of the Great Depression and coping with their immediate balance of payments constraints.

Meanwhile, this first economic policy response to the post-1929 economic environment set the basis in both countries for a new economic model. Indeed, those restrictive trade regimes, through the protection of the domestic market that they ensured, indirectly provided another push to import-substitution industrialization, in addition to the disruption of relative prices in favour of manufactured goods occurred in 1929. In Brazil, import controls were considered *"the most important instrument of industrial policy"* in the decade since the share of imported goods in domestic demand (using 1939 prices) had fallen from 45% in 1919 to 20% in 1939 (Abreu, Bevilaqua, Pinho, 2000). As a direct consequence of the protectionist measures adopted by the Turkish government, industrial output grew by 14.6% between 1930 and 1932 (Boratav, 1981). In Brazil, industrial output resumed to growth in 1931 after plunging by 6.7% in 1930 (Abreu, Bevilaqua and Pinho, 2000).

5.2.1.2 The challenge to sustain the economic activity and change its structure of production: a different stance adopted by Brazil and Turkey

The second economic challenge that was posed to Brazil and Turkey's governments in the 1930' was to support the economic activity that was hit by the shock of the Great Depression. Despite the good performance of the manufacturing sector, Brazil's GDP per capita fell by 3.4% in 1930 and 4.6% in 1931 (Cardoso and Teles, 2010). Likewise, the Turkish economy plunged in a harsh recession in 1932 with its GDP contracting by over 10% (Görmez and Yigit, 2009).

After recovering from their debt crisis in 1929-1930, including a Funding loan in 1931 for Brazil[11], both countries regained fiscal leeway and entered in a second phase of their economic policy response to the Great Depression, characterized by an increased level of fiscal spending and state intervention in the economy, which directly or indirectly provided another push for industrialization. Indeed, Brazil and Turkey differed in the orientation of their fiscal policy, as well as in the nature of their state intervention. These differences reflected the distinct economic conditions and level of industrialization achieved in both countries. They also are the sign of a different stance adopted by both countries regarding the industrialization process in the 1930', which can be explained through an analysis of the underlying political economy[12].

[11] This Funding loan was in fact a three-year federal debt rescheduling agreement obtained by the Brazilian government with its foreign creditors. The core of the indebtedness problem was not solved and actually remained throughout the 1930'. But this funding loan provided an immediate relief to the Brazilian government.
[12] This analysis is undertaken in the next chapter.

From the beginning of the 1930' onwards, Brazil and Turkey heavily invested in transportation infrastructures. The Turkish government nationalized all the railway concessions that had been allocated to foreign investors under the Ottoman rule and extended the network throughout the decade, notably to the remote Eastern regions of the country. No less than half of Turkey's public investments went for railways in the 1930' (Pamuk, 2000). In Brazil, public investments were directed to the road network which had been given the priority already in the late 1920', as illustrated by President Washington Luis's motto: *"Governar é abrir estradas"*, which can be translated into *"Governing is opening roads."*[13]

Another common trait of Brazil and Turkey's fiscal policies was agricultural prices support. Both governments set up a price-support program directed to the producers of their main commodities. However, such a program was neither implemented at the same scale, nor given the same importance in the policy mix in both countries.

In Brazil, thanks to the Funding Loan signed in 1931, the coffee support program was restarted under the authority of the federal Government. This program was already a key aspect of Sao Paulo state's fiscal policy since its creation in 1907 and especially in the 1920' (Abreu, Bevilaqua and Pinho, 2000). Leaning on Brazil's dominant position on the world coffee market as its biggest supplier by far, the objective of the coffee support program was to sustain the price of coffee on the international market by buying and stockpiling production surplus in order to control the world supply of coffee and therefore its prices. As mentioned before, the program had been abandoned in 1929 due to the lack of external funding to finance it but was resumed in 1931, with the creation of the *Departamento Nacional do Café*. Massive quantities of coffee were bought and mostly destroyed in the 1930': it is estimated that approximately one third of the total production of the decade was suppressed (Nicholls, 1970). Another fiscal policy providing direct support to the coffee growers was the *Reajustamento Econômico*, a program of debt relief set up in 1933.

Likewise, a share of Turkey's fiscal spending also went to agricultural producers, mostly wheat farmers, in a price-support program created in 1932 comparable to the coffee-support program in Brazil. Commodity surpluses were also bought first by the Agricultural Bank (*Ziraat Bankasi*), which also expanded its credits to producers, and then by the Soil Product Office (*Toprak Mahsulleri Ofisi)* in order to maintain the price level and guarantee a certain level of income to the producers. Nevertheless, this program was never given in

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[13] Loose translation

Turkey the central importance that the coffee-support program took in the Brazilian policy-mix in the 1930' and therefore never reached a comparable scale (Pamuk, 2000).

Turkey's fiscal policy at that time was nearly entirely concentrated on the promotion of industrialization, which had been given the absolute priority in the Turkish government's economic agenda. The latter included a massive program of direct investment in the industrial sector through a Five-Year Industrial Plan designed with the help of Soviet advisers and initiated in 1934 (Boratav, 1981). It is estimated that, overall in the 1930', public investments amounted to 5% of GDP, up from 3% in the 1920', and represented half of the total investment rate (10% of GDP) (Pamuk, 2000). This surge in public investment was combined with an increased state intervention in the economy, embodied by the strategic concept of *etatism*.

Coined in 1931 as one of the six arrows of Kemalism[14], *etatism* became the guiding principle of the Turkish government in terms of state involvement in the economy and gave rise to a model of mixed economy with the creation of several State-Owned Enterprises (SOEs) in a wide range of industrial activities, such as consumer goods and steel production. As such, the state emerged, in the framework of *etatist* policies, as the *"major productive and investing agent"* in the Turkish economy (Boratav, 1981).

In Brazil too, the level of state intervention in the economy was enhanced in the 1930' but differently from Turkey. Instead of direct intervention as an investor or entrepreneur, the Brazilian state acted as a supervisor to the economic activities through the creation of an influential *Conselho Federal de Comércio Exterior* in 1934, overlooking all issues related to economic development, as well as other product-specific institutes at state level, such as the *Instituto Brasileiro do Café* (IBC) and the *Instituto do Açucar e do Alcool* (IAA).

In sum, Brazil and Turkey's governments both increased their level of fiscal spending and intervention in the economy in order to stimulate the economic activity in the 1930'. However, they did not proceed in the same way and hence did not provide the same type of support to the industrialization process.

With the coffee support program, Brazil aimed at sustaining not only the income of coffee producers but also the economic activity through the injection of capital and purchasing power in the most important sector of its economy at the time (Nicholls, 1970). In doing so, Brazil was providing an indirect support to industrialization through a massive

[14] The other five arrows, or pillars of Kemalism, were: Republicanism, Populism, Secularism, Reformism and Nationalism.

demand stimulus mostly financed by expansionary fiscal and monetary policies (with fiscal deficits of 12% of expenditures[15] on average between 1931 and 1933), hence acting on a Keynesian vein *avant la lettre*. As pointed out by Furtado (1971):

> *"it is important to observe that the value of the product that was destroyed was much smaller than the income that was created. We were, in fact, building the famous pyramids that would then be mentioned by Keynes. In doing so, the policy of support to coffee producers during the Great Depression became the largest stimulator of national income growth. Unconsciously, Brazil was undertaking an anti-cyclical policy of a larger scope than the ones implemented in industrialized countries at the time."*

In reverse, the Turkish government chose to directly invest in the supply side (Okyar, 1979), and to take a stake in the industrial sector with the creation of SOEs producing industrial goods and creating backward linkages for a dense network of Small and Medium Enterprises (SMEs) which employed most of the workforce (75% of employment in industry (Tezel, 1986)) and generated the bulk of the industrial growth in the 1930' (Pamuk, 2000). As such, the Turkish state became *"a strategic agent of capital accumulation"* (Boratav, 1981) but without relying on fiscal imbalances and monetary expansion, as Brazil did. Turkey's 1934 Five-Year Industrial Plan received marginal financial support from the Soviet Union and Great Britain, but was above all a process of *"self-reliant industrialization without external deficits and without chronic indebtedness"* (Boratav, 1981). Pamuk (2008c) also stressed this important feature of Turkey's economic policies in the 1930': *"Etatism did not lead to large shifts in fiscal and monetary policies. Government budgets remained balanced, and the regime made no attempt to take advantage of deficit finance. In fact, 'balanced budget, strong money' was the government's motto for its macroeconomic policy."*

Some elements explaining such a divergence in the design of fiscal policies and the nature of the state intervention can be found in the specific features of both countries' economic structures at the time at which both countries' governments sought to adapt their policy response. As shown above, the agricultural sector was the first victim of the effects of the Great Depression in both countries and the major channel through which both countries' economies were hit. Yet, Turkish agriculture quickly recovered from the blow and grew substantially throughout the decade thanks to internal dynamics. According to Pamuk (1987), the extension of cultivated areas, the extension of the railway network to the East and

[15] Given in terms of expenditures and not of GDP in (Abreu, 2008a).

demographic growth after the war of Independence contribute to a significant extent to explain why agricultural output increased by 50 to 70% in the decade, or 4% per year. The price support program or extension of credit to agricultural producers played a minor role in this growth. The resilience of Turkish agriculture pulled the growth of the rest of the economy and allowed the Turkish government to dedicate most of its fiscal resources to the industrial sector. As highlighted by Pamuk (2000), *"without this performance from the countryside, protection of domestic industry alone would not have allowed the urban sector to achieve such high rates of growth."* By contrast, the Brazilian coffee production was entirely dependent on the conditions on the world market since the domestic market was irrelevant for it (Abreu, 1994b). There was no relevant domestic demand that could stimulate the coffee sector.

Table 5.2 Growth performance and fiscal deficits, 1924-1938

Turkey	**1924-1929**	**1929-1932**	**1933-1938**
GDP average growth rate (% pa.)	10.9	1.5	9.1
Industrial output average growth rate % pa.)	8.5	14.8	10.2
Fiscal deficits (annual average in % of GDP)	-0.6	0.6	0.1
Brazil			
GDP average growth rate (% pa.)	2.6	-0.7	7.1
Industrial output average growth rate (% pa.)	4	1.7	9.7
Fiscal deficits (annual average in % of GDP)	-2.8	-5.4	-4.2

Sources: For Turkey, Pamuk (2000), Görmez and Yigit (2009), Pakdemirli (1991). For Brazil, IBGE (2006).

Another difference lies in the level of industrial production capacity in both countries. Brazil's industrial growth in the 1930' was mostly achieved through the utilization of previously existing production capacity (Nicholls, 1970). Conversely, such a capacity was inexistent in Turkey in spite of the incentives to invest that the Turkish governments had put

in place in the 1920'. Hence direct investment in the manufacturing sector was much more necessary in Turkey than in Brazil, just in the same way as direct support to coffee producers was more needed than to agricultural producers in Turkey.

5.2.1.3 The distinct economic policy orientation adopted in both countries led to a very similar result in terms of GDP and manufacturing sector growth.

Despite the discrepancy between Brazil and Turkey in terms of economic policy answer to the Great Depression, both economies recovered quite fast, from a sudden slowdown until 1932, and experienced a quick growth led by the booming industrial sector. Turkey's economy grew at an average of 9.1% per year from 1933 to 1938 (Boratav, 1981) and Brazil's economy experienced a remarkable growth of about 7.1% per year between 1933 and 1938 after a quick recession (Fishlow, 1980), as shown in Table 3.2.

Spearheading this recovery was a dynamic industrial sector which benefited, in both countries, from the protected domestic market that the trade barriers reserved to local players, as well as from the direct or indirect support that both governments ensured through their fiscal policies. As shown in Table 3.2, Turkish industrial output grew at 14.8% pa from 1929 to 1933 (Pamuk, 2000) while in Brazil, it grew by 9.7% p.a. between 1933 and 1938. It actually doubled overall between 1928 and 1939 (Abreu, 2008a). In addition, import-substitution industrialization occurred for both countries in the same type of goods, mostly consumer goods, notably textiles.

On the eve of the Second World War, both countries had undergone a similar external shock in 1929 and resolutely entered a protectionist import-substitution-industrialization economic model, both *"virtually pushed"* by the effects of the Great Depression as Krueger (1974) put it for Turkey. The 1930' opened the *"high noon period of import substitution industrialization in Brazil"* (Abreu, Bevilaqua and Pinho, 2000). The industrialization process was further stimulated by substantial fiscal support provided either directly in Turkey with a supply-led push or indirectly in Brazil through a demand-led pull.

The divergence in the level of state intervention in the economy between the two countries disappeared with the second military coup of G.Vargas in 1937 and the advent of the *Estado Novo* with its new economic goals for the Brazilian state at the turn of the 1940'.

5.2.2 The opposite effects of World War II on the Brazilian and Turkish economies

Turkey and Brazil experienced the Second World War in a very different way. The sudden slackening of international trade flows considerably hindered the imports of the necessary capital goods and raw material for both economies' industrial development in the initial stage of the war. However, the disparate distance to the main battlefields determined a distinct impact of the war on both economies as well as a different degree of involvement in it. Although Turkey never entered the war, it maintained a war economy which drained its resources and pushed it in a deep recession. In reverse, the Second World War provided the Brazilian economy with a second push in favour of import-substitution industrialization with partially secured trade thanks to privileged relationships with the United States and Great Britain and a deeper level of state involvement in the economy.

5.2.2.1 Slowing down industrialization due to input shortages

The quick growth of the industrial output that both Brazil and Turkey experienced in the 1930' was highly dependent on the import of certain inputs, specifically capital goods that were still mostly produced abroad.

Table 5.3 GDP and Industrial output growth rates in Brazil and Turkey during the Second World War (1939-1945)

Turkey	**1939-1945**	
GDP average growth rate (% pa.)	-2	
Industrial output average growth rate (% pa.)	-3	
Brazil	**1939-1942**	**1942-1945**
GDP average growth rate (% pa.)	0.9	6.4
Industrial output average growth rate (% pa.)	1.6	9.8

Sources: For Turkey, Bulutay *et al*. (1974). For Brazil, Haddad (1978) and IBGE (2006)

In 1939, capital goods represented less than 5% of the Brazilian industrial added value (Fishlow, 1972). The onset of the Second World War had the immediate effect of considerably reducing the international trade flows, notably because of the German submarine

warfare, consequently depriving both countries of the inputs required to fuel their industrial growth.

However, this situation affected Turkey throughout the war but Brazil only until 1942. Input shortages caused the Turkish industrial output to contract by 3% per year from 1939 to 1945 (Bulutay, Tezel and Yildirim, 1974) and the share of manufacturing in GDP to decline from 17% in 1939 to 13% in 1946 (Pamuk, 2000). The interruption of the Second Five-Year Industrial Plan (initiated in 1939) or, more metaphorically, the fact that the innovative funicular installed in the European part of Istanbul in 1875 had, due to shortages of coal, to stop running during the war were also illustrative of the negative impact of the war on the industrial development of the country. In Brazil too, the industrial output growth abruptly slowed down from 9.3% in 1939 to 1.6% annually until 1942, including a quick contraction of 2.7% in 1940. But from 1942 to 1945, it boomed again at an annual growth rate of 9.8% (Haddad, 1978).

The distinct impact of the war on both economies is tightly linked to the relative distance to the main battlefields and the corresponding level of military mobilization of both countries.

5.2.2.2 The war represented a harsh drain on Turkey's economy due to military mobilization.

As early as 1939, Turkey opted for *"armed neutrality with full-scale mobilization"* (Pamuk, 1991). Throughout the Second World War, the Turkish government maintained a permanent army of one million soldiers, compared to a total population of 18 million people. The corresponding fiscal spending and transfer of resources represented a very heavy drain on the Turkish economy. As about 80% of the Turkish population was still rural, the mobilization of young men for the army was particularly felt in the agricultural sector which experienced labour shortages as well as shortages of horses, since 40% of them were drafted for military purpose. In consequence, the volume of land under cultivation fell by 10% between 1939 and 1945 (according to official statistics) and the agricultural output decreased by 1.4% annually over the same period. This decline in agricultural output was especially severe after 1942 and generated serious grain shortages in urban areas, in spite of the program of forced purchases of agricultural supplies below market prices established by the Turkish government throughout the war (Pamuk, 1991). Overall, the Turkish economy shrank by 35% during the Second World War (Pamuk, 2000). This long recession was accompanied by a

running inflation fuelled by supply shortages and the monetary expansion enacted to finance the fiscal deficits caused by military expenditures.

5.2.2.3 A new stimulus to ISI in Brazil

Contrasting with Turkey, the Brazilian economy did not suffer as much from the effects of the Second World War, notably on trade. It even experienced a very quick export-led growth which provided a further boost to its industrial development. Brazil's GDP grew by 6.4% between 1942 and 1945 (Abreu, 2008a), mostly pulled by the growth of the industrial output of 13.5% in 1943 and 10.7% in 1944 (Haddad, 1978).

From the very beginning of the war, both the United States and Great Britain perceived the strategic importance that Brazil (as well as Argentina) could represent: its remoteness from the battlefields spared it from the damages of the war and, combined with its rich natural resources, made it a perfect rear base to secure strategic supplies. However, at the onset of the conflict, Brazil's position was not clear. As mentioned before, Germany had become, throughout the 1930', one of Brazil's largest commercial partners and, when the war broke out, G.Vargas adopted a neutral position. In consequence, Brazil received special diplomatic attention from both the United States and Great Britain in their quest to rally Brazil to their side. As the war went on, Brazil benefitted from the favours of the two belligerents and developed stronger trade relations with both countries so that it finally engaged in the conflict becoming one of their strategic allies (Abreu, 2008a).

In 1939, to cope with the rapid deterioration of international coffee prices, due to falling international demand, the United States took over the coffee support program abandoned by G.Vargas after the 1937 military coup with the creation of the Inter-American Coffee Agreement. The objective was to ease the negative impact of the sudden closure of Europe to trade for Brazil's coffee growers. The Anglo-Brazilian Payment Agreement and the Washington Agreement were subsequently signed, in 1940 and 1942 respectively, to favour bilateral trade, specifically oriented towards the supply of basic raw material by Brazil to support both US and UK war effort. Brazilian exports were carried by American ships specially protected by the British and US navies from German submarines.

In addition to supplying commodities, the contribution of Brazil to the war effort was meant to be extended to heavy manufacturing, particularly to steel production, following the recommendations of the Mission Cooke in 1943 (Baer, 1965). The United States provided financial support and all the necessary inputs for the construction of a steel mill in Brazil installed in Volta Redonda (Abreu, 2008a). Although Brazil only supplied raw material to the

United States during the war since the Volta Redonda steel mill only became operational in 1945, its construction still represented the first step taken by Brazil in heavy industries.

The strong industrial growth experienced by Brazil in the second half of the war was also stimulated by internal and regional dynamics. The interruption of imports into the country generated a new wave of import-substitution industrialization in sectors unaffected by the shortages of imported capital goods. In the same way as during the First World War, the industrial output grew to satisfy a growing domestic demand through the intensification of the use of existing production capacities (Baer, 1965). Moreover, the demand for manufactured goods even expanded beyond the Brazilian domestic market since all developing countries in regions which were previously depending on the imports of Western manufactured goods became another outlet of Brazilian industries, especially textile. By the end of the war, Brazil was ranking among the biggest exporters of fabric in the world (Baer, 1965).

Besides the growth of the industrial output, the share of manufactured goods in the Brazilian economy and total exports reveals the surge in import-substitution that the specific context of the war allowed. The share of manufacturing in the Brazilian GDP rose from 17.4% in 1939 to 21.7% in 1947 (Baer, 1965), allowing 96% of consumer non-durables demanded in Brazil to be produced locally in 1949 (Bergsman, 1970). Between 1940 and 1945, the share of manufactured goods in total Brazilian exports jumped to 13.5% from nil in 1930 (IBGE, 2006).

Another positive economic effect of the war was that the hike in exports volumes and also in commodity prices combined with the import shortages caused the foreign exchange reserves to increase tenfold during the war. This favourable situation allowed Brazil to finally settle its external debt issues with its creditors in 1943 (Abreu 2008a).

5.2.2.4 The Brazilian state adopted a more direct mode of intervention in the industrialization only after the turn of the *Estado Novo* in the early 1940'.

The import-substitution industrialization spurt observed in Brazil during the war did not only respond to the push of the Western powers and market incentives; it was also accompanied by a significant change in the involvement of the federal State in the economy. With the initiation of the *Estado Novo* in 1937, came a turning point in the Brazilian economic policy, with an avowed political will to foster the industrialization process in Brazil through a direct state support and intervention in the economy. In the beginning of the 1940', within the framework of the *Plano Nacional de Obras Públicas e Reaparelhamento da Defesa Nacional*, a group of major SOEs were created including the *Companhia Siderúrgica*

Nacional (CSN) in Volta Redonda, which received domestic political and financial support of the Brazilian government and especially of the military (Corsi, 2008). As pointed out by Abreu *et al* (2000), the Volta Redonda steel mill *"was the first significant tangible demonstration that direct government intervention could be effective in industry."* The other main SOEs created at that time were the successful *Companhia Vale do Rio Doce* in the mining sector and the less successful *Companhia Nacional Álcalis* and *Fábrica Nacional de Motores* (FNM) in the automotive industry.

The normative and centralized power of the federal State over the economic activity was also enhanced through the creation of various institutions. The *Coordenação da Mobilização Econômica,* as well as several sector-specific defence institutes, strictly organized the Brazilian economy for the war effort, especially after it finally entered the war in 1942. Likewise, the *Conselho Nacional do Petróleo* (CNP) was created to regulate and supervise the oil industry after the discovery of oil in Bahia. The central control over the federal states was also increased through the creation of the *Departamento de Administração do Serviço Público* (DASP), which controlled the public services and budget decisions at both federal and state levels (Abreu, 2008a).

Throughout the Second World War, Brazil and Turkey's economies experienced diverging fates and found themselves in very distinct dynamics: the Brazilian economy was launched in a strong momentum of industrial growth, whereas the Turkish economy was exhausted by six years of a costly and painful war economy.

Nevertheless, over the fifteen years that had gone by since the 1929 shock, both countries had adopted, at their own pace, a similar economic model characterized by a heavily protectionist trade regime and above all a very strong state, intervening directly in the economic sphere and becoming the main actor – as investor, regulator and producer in the import-substitution industrialization process.

5.3 1945-1980: Apogee and limits of the ISI model

The decade following the Second World War was characterized by a major divergence in both countries' economic policy choices driven by the beginning of the Cold War and internal political changes. While Turkey temporarily favoured a return to its former specialization in primary goods, Brazil intensified its import-substitution industrialization strategy. However, chronic macroeconomic and balance-of-payments imbalances led both

countries to a severe debt crisis. Combined with political unrest at the turn of the 1960', this crisis led the two countries to a military coup. The stabilization plans implemented in the following years laid the basis of subsequent *"economic miracles"* until the first oil shock.

5.3.1 From 1945 to early 1960': diverging post-WWII economic policy choices nevertheless leading to a similar economic and political crisis

Despite their diverging economic fates during the Second World War, Brazil and Turkey inherited two common economic imbalances in the immediate post-war period: very high inflation rates and a consequently over-valued exchange rate; to which they gave distinct economic policy responses. The liberalization of the political system in both countries, combined with the beginning of the Cold War, contributed to drift the two countries further apart regarding the choice of an engine of growth. By the end of the 1940', Brazil had confirmed its state-led import-substitution industrialization strategy, while Turkey had returned to policies favouring agricultural and export-led growth. In spite of these different economic development paths, both countries experienced a comparable economic and political crisis in the second half of the 1950'.

5.3.1.1 Common economic challenges in the immediate post-WWII but diverging policy responses

Although both countries had very dissimilar economic performance during the Second World War, they both came out of it with a significant inflation and highly over-valued exchange rates.

The chronic fiscal deficits and expansionary monetary policies run by both Turkish and Brazilian governments in the last years of the war, combined with the supply shortages, fuelled an inflationary spiral. In Turkey, the fiscal deficits, peaking at 2.5% of GDP in 1941 (Dogruel and Suut Dogruel, 2006), were due to the heavy military spending added to the purchases of agricultural commodities for urban areas (Singer, 1984). During the war, the money supply expanded more than threefold and the price level was multiplied by four in Turkey (Singer, 1984). In Brazil, the massive direct investments that the government undertook in the industrial sector through the creation of major SOEs generated fiscal imbalances, also financed by monetary expansion. Fiscal deficits rose from 11.4% of expenditures in 1939 to 24.5% in 1942 while compulsory borrowing by the federal state was implemented through war bonds (*obrigações de guerra*) and credit expanded by 20% after 1942. Simultaneously, the rationing system put in place for some products created an

additional inflationary pressure so that inflation in Brazil ranged from 15% to 20% after 1941 (Abreu, 2008a).

The natural consequence of the high inflation during the war, considering the absence of devaluation, was the overvaluation of both countries' exchange rates. In 1946, the Brazilian cruzeiro was *"grotesquely overvalued"* against the US dollar, by over 60% compared to its 1939 level in real terms (Abreu, 2008a). In Turkey too, the exchange rate was not adjusted throughout the 1930' and until 1946, resulting in a substantial over-valuation at the end of the war.

Faced with these common economic challenges. Brazil and Turkey adopted two different policy responses. The Turkish government chose to devalue its currency by nearly 120% in 1946, from 1.28 to 2.8 Turkish Lira per US dollar (Okay, 1979). By contrast, the Brazilian government emphasized economic stabilization and maintained the value of the cruzeiro unchanged while liberalizing trade in order to let cheaper imports flow into the country. A massive import boom followed, with imports increasing by 84% in 1946 and 72% in 1947, financed by the large foreign reserves accumulated during the war (Abreu, 2008a).

5.3.1.2 The US foreign policy in the context of the Cold War and the liberalization of both countries' political systems contributed to tear the two countries further apart in terms of economic policy choices

In the years following the end of the Second World War, the United States adopted a much more interventionist foreign policy than during the 1920' and decisively influenced the foreign policy, internal politics and economic policy choices of numerous countries. Among them, Brazil and Turkey were specifically receptive since both countries were experiencing a liberalization of their political system which opened space for a debate over the orientation of their economic policies. And in fact, the very different stance and action taken by US authorities towards both countries in the immediate post-war period contributed to push them further into diverging economic paths.

Immediately after the war, the allocation of US economic help was primarily guided by security considerations and by the perceived Soviet threat. In this regard, J. F. Dulles, Secretary of State from 1953 to 1959 and artisan of the "rollback" policy which followed Truman's "containment" policy, summed up the motivations that prevailed in the allocation of US economic help at that time in these enlightening words (reported in an official memo):

"all of us would like to see our economic objectives in the under-developed countries (sic) achieved through the use of private capital investment. But some of the most critical of these under-developed countries existed under conditions where they will have to be able to see genuine hope of a transformation provided by the West, or else they will turn to the USSR. So large were these under-developed areas that if they turn to the Soviet Union, the area of the Free World will shrink by another two-thirds. Accordingly, we have got to provide economic development assistance, and furthermore, we must as a nation realize more fully the importance of this assistance for our national Security."[16]

Following this logic, Turkey received much more attention from the US than Brazil at that time since it was much closer to the USSR and hence more vulnerable to the Soviet threat, especially due to its ambiguous role during the war. Even before the end of the war, Stalin manifested his ambition to annex three regions of the Eastern Anatolia to punish Turkey for its narrow collusion with Nazi Germany under the cover of its official neutrality. Indeed, the Turkish government only broke diplomatic relations with Germany in August 1944. Before then, it had signed a *"friendship and non-aggression treaty"* in June 1941, some days before the Operation Barbarossa was launched by the German army to invade the USSR, and repeatedly turned a blind eye to the passage of the German Navy through the straights of Dardanelles and Bosphorus (Bozarslan, 2004). In comparison, Brazil was far from the Soviet threat and did not represent such a strategic country for the US foreign policy concerns in the wake of the Second World War. In consequence, Turkey received much more economic help from the United States than Brazil.

Strongly encouraged by the United States, the Turkish government proceeded to a strong *rapprochement* with the Western block from 1945 to 1950. Turkey joined all the newly founded Bretton Woods and United Nations institutions as well as the Council of Europe in 1949 and NATO in 1951, becoming the closest ally to the US in the growingly unstable Near-East (Bozarslan, 2004). Moreover, Turkey was one of the most strategic targets of the Truman doctrine and was therefore included in the beneficiary countries of the Marshall Plan in 1948.

In comparison to the massive economic help that Turkey received, the Brazilian expectations of US support, specifically for the much-needed infrastructure investments, were strongly disappointed since *"there was no Brazilian version of the Marshall Plan"* (Abreu, 2008a). While the Brazilian government expected to be rewarded for its military and logistical support to the US army during the war, the US economic help provided to Brazil was indeed

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[16] In "Review of Basic National Security Policy: Foreign Economic Issues Relating to National Security, in United States (1987), p.182 (found in Abreu, Bevilaqua and Pinho, 2000, p.30)

much smaller in size and restricted in time. Following President Truman's Point IV encouraging the transfer of US technological knowledge to developing countries in 1949, the Joint Brazil-United States Economic Development Commission (*Comissão Mista Brasil-Estados Unidos para o Desenvolvimento Econômico*) was created in 1950 to promote infrastructure projects to be financed by the Export and Import Bank (Eximbank) and the International Bank for Reconstruction and Development (IBRD). Some loans were granted, notably to Brazilian SOEs but nothing comparable in size to the Marshall Plan in Turkey. In addition, the election of a Republican President in 1952, D.D.Eisenhower, brought a reversal of US foreign policy and the abandonment of the Point IV which meant the actual drying-up of US economic help to Brazil (Abreu, 2008a).

This diverging US foreign policy unfolded in the context of a simultaneous liberalization of both countries' political regimes and a subsequent debate over the orientation of economic policies. In both cases, the nature of the US intervention had an influence on the outcome of this debate and the policy choices made by Brazil and Turkey by the end of the 1940'.

Immediately after the end of the war, both Brazil and Turkey abandoned the dictatorial regime that had prevailed in the previous decade and adopted a multiparty system, opening space to debate on the orientation of the economic policies.

In Turkey, I.Inönü, M.Kemal's successor after his death in 1938, endorsed the transition to a multi-party system in 1946 with the creation of the Democratic Party and the organization of free elections from that year onwards (Bozarslan, 2004). This new opposition party gathered many intellectuals and businessmen who had grown critical of the mixed economy model pointing to the inefficiencies of the SOEs (Okyar, 1979). They advocated for a rupture with the *etatist* and inward-oriented economic development prevailing since the Great Depression in favour of a more liberal economic regime, driven by private investments and freer trade. As such, the Democratic Party gained strong support in rural areas, among agricultural producers and landowners highly dissatisfied with the Republican Party's focus on the development of urban and industrialized areas (Parvin and Hiç, 1984). The Democratic Party was also characterized by its admiration for the *American model,* which inspired their desire to turn Turkey into a "little America" (Bozarslan, 2004). With the growing influence of this party, the Turkish political class became increasingly receptive to the economic agenda promoted by the US. Indeed, the Marshall Plan in Turkey did not only strategically draw the country closer to the Western block, but also decisively contributed to inflect its economic

policies towards a more liberal stance, well fitted to the economic interests of Western countries. Along with the US economic help came strong incentives given to the Turkish government to come back to the country's former specialization in primary goods, much needed in Western Europe, in order to provide a not-less-needed outlet to US manufactures, which production had soared during the war (Krueger, 1974). These recommendations were specifically made by the *American Economic Mission* to Turkey, led by Max Thornburg, in its report published in 1949 (Pamuk, 1981).

Also in Brazil, the end of the war brought the return to democracy and gave rise to a debate on the foundations of the economic model. Some months after the end of the war, G.Vargas was deposed and General Dutra, who had been appointed by Vargas himself as his successor, was elected. As the international environment changed and the country was entering a new era, the debate initiated before the end of war between two prominent public figures such as the industrialist R.Simonsen and the engineer and economist E.Gudin, became particularly relevant. Supported by the industrialists in São Paulo, the former advocated for the continuation of the state-led and protectionist import-substitution model, while the latter defended the return to a more liberal economic model driven by exports of primary goods and favourable to agricultural producers and exporters (Simonsen and Gudin, 1977). However, in this debate, very similar to the one happening in Turkey, the US played an opposite role in comparison with Turkey. The little economic support provided to Brazil encouraged the government to confirm its inward orientation and focus on import-substitution industrialization as its main engine of growth (Abreu, 2008a).

5.3.1.3 Diverging economic policy orientation at the turn of the 1950': Brazil choosing ISI as its engine of growth while Turkey returned to agricultural export-led growth

Indeed, in the late 1940', Brazil and Turkey drifted away from each other in terms of economic policy orientation. While Turkey was progressively liberalizing its economic model and returning to a specialization in agricultural production and exports, Brazil quickly came back to a protectionist import-substitution model. At the turn of the 1950', the debate was temporarily concluded in the two countries with a different answer as they were engaged in distinct development paths.

In Turkey, the 1950 elections brought the Democratic Party to power and confirmed a reorientation of the economic policy towards a more liberal model, led by the growth of the agricultural output and exports. The trade regime was progressively liberalized in agreement

with the Organization of European Economic Cooperation, which managed the Marshall Plan, driving the rate of openness up from a level of about 5% in 1945 to 20% of GDP in 1954 (Pamuk, 2008c). The agricultural sector received direct support from the Turkish government. State lands were distributed so that the area under cultivation increased by more than 40% between 1946 and 1954 (Aktan, 1957). Price support programs were established through the purchase of stocks, notably of wheat, by SOEs and state agencies like the Soil Product Office (*Toprak Mahsulleri Ofisi*). And the financial resources obtained through the Marshall Plan were used to enhance the capital-intensity of the production through the import of agricultural machinery, bringing the number of tractors from less than 2,000 in 1948 to nearly 38,000 in 1954. Combined with particularly good weather conditions and a hike in international demand for primary goods in the context of the Korean War, these measures contributed to a boom in agricultural output which pulled the whole economy forward. The agricultural output doubled from 1947 to 1953 and the overall economy grew at an astonishing rate of 11% annually between 1950 and 1953 (Singer, 1984). Regarding the industrial sector, although the Democratic Party did not apply its original program to privatize SOEs, the initiative was left to the private sector in the beginning of the 1950', including to foreign investors. The legal environment was made more conducive to foreign investments. In 1951, a law of encouragement of private foreign investments in Turkey was passed and then extended to the transfer of profits to the home country in 1954. The same year, the Petroleum law opened this sector of the Turkish economy to foreign investments (Okyar, 1979). As a result, between 1948 and 1954, private investments represented 60% of the total capital formation in Turkey (Singer, 1984), and the share of industrial employment in private companies grew from 54% in 1950 to 61% in 1954 (Cillov, 1962). Nevertheless, the overall growth of the Turkish economy, driven by agricultural exports, was mostly leaning on relatively weak foundations: the punctual expansion of international demand and exceptional weather conditions. The disappearance of those two factors in 1953-1954 led the Turkish economy into a crisis.

By contrast, Brazil defined the import-substitution industrialization as *"the principal method for the government to modernize and raise the rate of growth of the economy"* (Baer, 1995). The surge in imports in 1946 and 1947 soon revealed to be unsustainable as the foreign exchange reserves accumulated during the war were entirely spent. Already in 1947, foreign exchange reserves scarcity and constraints on the balance of payments forced the Brazilian government to adopt a new set of protectionist measures through import licenses (Baer, 1965). The emphasis on stabilization and fiscal orthodoxy chosen in the immediate post-war period lasted until the appointment of G. da Silva, an industrialist, as Finance Minister in

1949. With the presidential elections approaching, expansionary fiscal and monetary policies were adopted, notably through the Bank of Brazil (*Banco do Brasil*) which increased credits to finance a new industrial boom. In 1950, credit in real terms increased by 20% and between 1945 and 1955, the industrial output grew by nearly 10% per year, faster than the overall economy growing at 7.1% annually (Abreu, 2008a). Meanwhile, after the election of G.Vargas in 1950, the stabilization of inflation came back on top of the economic agenda. The economic policy outline chosen was inspired by the Campos Salles-Rodrigues Alves policies at the beginning of the 20th century and was divided in two steps: economic stabilization preceding investments in infrastructure, with the help of foreign capital, namely the very expected US help. To counter inflation, in addition to restrictive fiscal and monetary policies, the trade regime was temporarily liberalized as in 1946. The strong export growth observed since 1949 – pulled by the effect of the Korean War on international demand as in Turkey – had previously provided comfortable foreign reserves, which allowed for such a relaxation of the trade regime. But the sudden increase in the distribution of import licenses following this reform, combined with the exchange rate maintained over-valued since 1946, led to a considerable surge of imports and subsequent tensions in the balance of payments. Imports soared by 80% from 1950 to 1951 and a trade deficit of almost USD 300 million was accumulated by the end of 1952 (Vianna, 1990). In addition, the expansionary monetary policy conducted by the Bank of Brazil (*Banco do Brasil*) - with credit to the private sector expanding by 66% in 1951 and 40% in 1952 - cancelled the fiscal surplus generated over the same period and led to the failure of the stabilization in 1953. By the end of 1954, Brazil's external debt had reached a new peak at USD 1,317 million (Abreu, 2008a). Finally, the interruption of the US economic financing of infrastructure projects after the election of Eisenhower in 1952, led to the creation of a public entity responsible for funding such projects, the *Banco Nacional de Desenvolvimento Econômico* (BNDE). In 1953, the attempts to stabilize the economy had failed and the external financial resources expected to finance infrastructure projects had vanished. The Brazilian state was on the verge of a major foreign exchange and debt crisis.

5.3.1.4 Returning to protectionism after a foreign exchange crisis in 1953-1954, an intensification of ISI brought both countries on the verge of a debt crisis.

As noted before, even if Brazil and Turkey followed divergent economic policies, both countries found themselves in a vulnerable position at the turn of 1953-1954. In Brazil, mismanagement of economic policies had provoked a surge in inflation - still above 20% in

1954, and external indebtedness. And in Turkey, short-term indebtedness and current account deficits had risen from 1952 onwards (Krueger, 1974). In 1953, the end of the Korean War caused agricultural commodity prices to plummet, notably the international price of coffee (Abreu, Bevilaqua, Pinho, 2000), and further deteriorated both countries' balance of payments situation. The situation was compounded in Turkey by a disastrous crop, with the agricultural output declining by 20% between 1953 and 1954, which plunged the economy in a deep recession. The Turkish GDP declined by 8.8% that year (Okay, 1979). In this context, both countries were led to return to protectionist trade regimes.

The introduction of a multiple exchange rate regime in Brazil in 1953 meant an effective devaluation of the cruzeiro designed to stimulate exports. By 1955, there were no less than twelve different exchange rates ranging from 18.82 to 78.90 cruzeiros per US dollar in function of the type of imported good (Baer, 1965). In Turkey too, import controls were tightened in 1953 through the establishment of a strict import licensing system and a multiple exchange rate regime with rates ranging from TL 2.82 to TL 5.75 per US dollar (Krueger, 1974). As a result, the rate of openness fell back to its post-war level of around 5% between 1953 and 1958 (Pamuk, 2008c).

This turning point opened a period of intensified import-substitution industrialization, supported in both countries by an expansion of fiscal spending. Both governments supported the agricultural sector with price support programs, while simultaneously investing in the industrial sector. However, the relative use of those two levers of economic policy was reversed between the two countries compared to the 1930'. This time the Turkish government provided a mostly demand-led support through the agricultural sector, while the Brazilian government massively invested and incentivized private investments in the supply of industrial goods. In both cases, the stimuli were financed by expansionary fiscal and monetary policies which fuelled growing inflationary pressures and led both countries to an external debt crisis in 1958-1959. Although Brazil protracted the crisis through continuous investments to maintain growth, both countries were plunged at the turn of the 1960' in a deep economic and political upheaval resulting in a military coup.

In Brazil, a quick stabilization plan conducted by E.Gudin in 1954 brought some relief to the economy, particularly through the drastic reduction of budget expenditures by 36% and the obtaining of a US loan of USD 300 million. But it was rapidly interrupted and the election of J.Kubitschek the following year opened the *Golden Age* of import-substitution industrialization with the launching, in 1956, of the *Plano de Metas,* a very ambitious

investment plan, famously designed to *"achieve fifty years of development in five years"* (Abreu, Bevilaqua and Pinho, 2000). The main objectives of the plan were to promote and complete import-substitution industrialization in consumer durables, especially on the auto-industry, and to upgrade the energy and transportation infrastructure, mainly the electricity and the road network – preferred to an overhaul of the railway system. Beyond this, the most symbolic project of the plan was obviously the construction of the new capital town of Brasilia, which best epitomized the ambitious and somewhat excessive leap forward that the *Plano de Metas* meant to represent for the country. In the words of President J. Kubitschek, Brasilia was conceived as the *"key of a development process meant to transform Brazil from an economic archipelago into an integrated continent"* (Lafer, 2002).

The success of the plan relied on three main pillars. The first one was a strictly controlled trade regime inherited from the 1953 reform and reinforced in 1957 by the *Lei de Tarifas,* which introduced heavy import tariffs, going up to 150%, designed to support local manufacturers (Cardoso and Teles, 2010). The second pillar was a growing inflow of foreign direct investments (FDIs) to finance part of the investments required. Conceived as a response to the falling export earnings and as a way to finance the industrialization process, the Instruction 113 (*Instrução 113*), adopted by the Superintendence of Money and Credit (*SUMOC*) in 1955, included all industrial activities in a system of incentives to FDIs (Baer, 1965). Finally, the rest of the investment was undertaken by the public sector under the supervision of the Development Council (*Conselho de Desenvolvimento*) reporting directly to the President of the Republic.

The share of the public sector in total investments grew from 25% before 1956 to more than a third until 1960 (Abreu, 2008a), notably through the creation or reinforcement of major SOEs in the energy, transportation or steel sectors. Petrobras and Eletrobras were created by G.Vargas in 1953-1954, but really expanded their activities significantly in the second half of the 1950' thanks to the ambitious production goals set by the Plan. Similarly, the railway network was nationalized in 1957, with the creation of the *Rede Ferroviária Federal* (Estache, Goldstein and Pittman, 2000) and the construction of two new steel mills (*USIMINAS* and *COSIPA*) was undertaken.

The rate of investment was raised from about 14-15% of GDP in 1956 to a peak of 18% in 1959. This surge in investments stimulated GDP growth, reaching an average of 9.3% annually over the period of the plan, from 1957 to 1961. In terms of industrial development, the plan was also very successful as the industrial output grew faster than the overall economy, by 11.4% p.a. between 1956 and 1961 (Abreu, 2008a), and as it produced a

"decisive change in industrial structure" characterized by a significant deepening of import-substitution industrialization. Not only did the share of the industrial sector in the GDP grew from 24% in 1950 to 32% in 1960, but also did the share of the industrial value added of capital goods more than double, going from 5.2% in 1949 to 11.1% in 1959 (Abreu, Bevilaqua and Pinho, 2000).

However, the cost implied by this plan was a dreadful macroeconomic management, leading Brazil to a debt crisis and even further to a political crisis. The massive public investments implied by the plan were mostly financed by expansionary fiscal and monetary policies which caused inflation to soar. These imbalances were further compounded by the intensification of the coffee support program restarted in 1953 after the fall of commodity prices, which also represented a massive drain on public spending, up to three times the cost of building Brasilia (Orenstein and Sochaczewski, 1990). Chronic fiscal deficits reached up to 40% of the expenditures in 1957 (Abreu, 2008a). The BNDE, whose activities evolved from its original role as financer of infrastructures to public development bank, focused on manufacturing, and the Banco do Brasil were the main sources of funds during that period (Cardoso and Teles, 2010). The expanded credit was heavily subsidized by a negative real interest rate, with a nominal interest rate set at 12% while the inflation rate remained above 20% on average between 1956 and 1961 (Villela, 2005). In the end of the 1950', the two institutions held close to 60% of the total banking credits outstanding in the country (Abreu, 2008a). In addition, most of the inflows of private capital, incentivized by SUMOC's *Instrução 113*, came in the form of medium-term supplier credits, putting additional pressure on the balance of payments (Cardoso and Fishlow, 1990). Inflation was contained at 7% in 1957 but it significantly accelerated in early 1958 with a monthly rate of 2.6% in May and an annual rate of 24.3% (Orenstein and Sochaczewski, 1990).

In Turkey, the 1953-1954 downturn was also followed by a return to the import-substitution model and an intensification of the industrialization process, supported by the Turkish government. However, the intervention of the Turkish state in the economy went from a supply-led to a predominantly demand-led policy model.

The main driver of economic policy used after 1954 by the Democratic Party, in power throughout the 1950', was a reinforcement of the price support program for agricultural commodities. This mechanism had already benefitted the main agricultural commodities since the beginning of the 1950' and was intensified after 1954 to compensate for the decline in export earnings. Growing stocks of cereals were purchased by SOEs and state agencies like

the Soil Product Office (*Toprak Mahsulleri Ofisi*). In addition, the protectionist trade regime - strengthened by the establishment of *ad valorem* tariffs, exchange taxes and import licenses until 1958 - provided investment opportunities in the industrial sector in which SOEs took a significant part. The investment rate increased from an average of 11% of GDP between 1950 and 1953 to 14% from 1954 to 1958. These investments were equally shared between the public and private sector as the share of the public sector in the gross capital formation grew from 42% in 1955 to 50% in 1960 (Krueger, 1974). In consequence, the public sector increased its participation in the industrial value added from 37% in 1950 to 48% in 1960 (Land, 1970).

As a result of those combined efforts, the economic growth bounced back from a deep contraction of 8.8% in 1954 to a growth averaging 6.4% annually between 1955 and 1958 (Krueger, 1974). The growing manufacturing sector attracted a rising number of workers, growing cumulatively by 38% between 1954 and 1959 (Cillov, 1962). Contrasting with Brazil, the emphasis of this period of industrialization was on non-durable consumer goods. Some private investments were used to import machinery, initiating the production of consumer durables, which later became the focus of the second wave of industrialization in the 1960' (Singer, 1984).

As in Brazil, this period was characterized by poor macroeconomic management and growing imbalances. High inflation and mounting external debt also led Turkey to a deep crisis in 1958. The investments that fuelled the growth of the industrial output were financed either by external debt or by expansionary monetary policies. The purchase of cereals by the Soil Product Office, as well as the growing deficits of SOEs – whose selling prices had been frozen by the government to curb inflation – were both financed by a fourfold expansion of credit created by the Central Bank from 1950 to 1958 (Okay, 1979). This caused inflation to accelerate dramatically and the price index to double between 1955 and 1959. In addition, the continuous deterioration of the balance of payments resulting from the fall in export earnings (from 396 million USD in 1953 to 247 million USD in 1958) was financed by a growing external debt, exceeding USD 1 billion in 1958, more than four times the level of exports that year (Krueger, 1974).

5.3.1.5 The crisis of 1958 and its political consequences

In mid-1958, both Brazil and Turkey were faced with the grim limits of their economic policies characterized by high inflation and foreign indebtedness. They had to resort to an IMF-backed stabilization plans. Nevertheless, commitment to stabilization proved

politically difficult to maintain in both countries. The subsequent abandonment of macroeconomic discipline plunged both countries in political crises that resulted in military coups.

In Turkey, in spite of growing import restrictions from 1954 to 1958, the pressures on the balance of payments rose. In July 1958, the country found itself completely unable to face its external-debt-servicing obligations and was on the verge of international default. Intense negotiations with the IMF followed in order to obtain a loan that would relieve the tension over the balance of payments. In exchange for a rescheduling of the external debt and substantial loans granted by the IMF, the OEEC and the United States, totalling USD 359 million, a Stabilization Program was launched under the supervision of the Fund. The main targets of the program were the trade regime on the one hand and fiscal and monetary policies on the other hand. The macroeconomic policy mix was restrictive, so as to curb the inflationary pressures, notably through ceilings imposed on Central Bank's and commercial banks' credits and an adjustment of SOEs' selling prices, allowing them to cover their operational costs and investments. The trade regime was liberalized to let imports in, while a first devaluation relieved the balance of payments through a surge in exports. The positive effects of such measures on the balance of payments were immediate as exports nearly doubled in value between the last quarter of 1958 and the second quarter of 1959, from USD 214 million to USD 419 million (Krueger, 1974). In this context, the government's commitment to stabilization weakened. The adoption of an inflationary budget and the return to credit expansion in the end of 1959 accelerated a latent political crisis that the deterioration of the economic situation, especially the slackening growth (from 5.2% in 1958 to 3.7% in 1960), had already sharpened. In May 1960, after a violent repression of student protests, the escalating tension between the government and the army resulted in the creation of a National Union Committee by the military, overthrowing the government of the Democratic Party.

In Brazil, the crisis took longer to unfold because the economic situation was not as critical as in Turkey. The Monetary Stabilization Program (*Programa de Estabilização Monetária*) launched in October 1958 by Lucas Lopes, Finance Minister, came as a response to the accelerating inflation that year, but not because the government had come on the verge of an external debt crisis and was forced to do so as in Turkey. The growth momentum was still at its peak with a growth over 10% in 1958 and just below that level in 1959. Nevertheless, the growing macroeconomic imbalances were reducing Brazil's

creditworthiness and were becoming obstacles to obtain new funding to support the investments scheduled by the Plano de Metas (Orenstein and Sochaczewski, 1990).

Beyond negotiating with the IMF to obtain a loan, the program included a substantial reduction of fiscal deficits to 20% of expenditures that year compared to 40% in 1957, as well as of credit expansion (Abreu, 2008a). However, tensions between the Ministry of Finance and Banco do Brasil led to a lack of coordination of the fiscal and monetary efforts, which ruined the efficacy of the plan (Orenstein and Sochaczewski, 1990). By mid-1959, one year after the launching of the plan, inflation had even accelerated to a monthly rate of 5% and the plan had grown extremely unpopular, as it jeopardized many of the projects initiated under the *Plano de Metas*. Under pressure, Lucas Lopes was replaced in the Ministry of Finance by Banco do Brasil's director, S.Paes de Almeida, in the summer 1959 and the protracted negotiations with the IMF were suddenly discontinued in what became a famous political move (*"ruptura com o Fundo"*). Clear priority was again given to development over stabilization and new sources of funding were found to support increasing public expenditures, notably through short-term swap loans guaranteed by gold reserves (Orenstein and Sochaczewski, 1990). The fiscal deficit started to rise again - to 26% of expenditures in 1959 - bringing inflation to a higher annual rate of 40% in the same year (Abreu, 2008a).

But this was only buying time at a high expense and postponing the unavoidable need to adjust. The end of J.Kubitschek's tenure in 1961 marked the beginning of a deep political crisis underpinned by unsustainable macroeconomic imbalances inherited from the Plano de Metas and the failure of all stabilization attempts (Abreu, 2008a). The dreadful macroeconomic management, prevailing during the Plano de Metas, became particularly explosive once the growth momentum was suddenly lost in the beginning of the 1960'. Economic growth tumbled from 8.6% per year in 1961 to 0.6% per year in 1963. The weight of the external debt, which had doubled in terms of GDP between 1955 and 1960, the accelerating inflation, reaching 50% a year in 1962, and growing pressures on the balance of payments resulted in a poisonous mix that the following governments had to cope with. The resignation of President J.Quadros in August 1961 put an end to an attempt to stabilize the economy and left the country in an uncertain political situation with the accession of Vice-President J.Goulart to the Presidency. The temporary change to a controversial parliamentary regime between 1961 and 1963 further accentuated the political instability, leading to the resignation of Prime Minister T.Neves in July 1962 and the unsuccessful attempt of his successor, F.C.San Tiago Dantas, to win approval in Congress. The political crisis led to an utter failure to conduct sound economic policies and a complete loss of control of the main

macroeconomic variables, such as public expenditures and inflation. A last stabilization attempt, designed by C.Furtado (the *Plano Trienal*), failed in May 1963 and was followed by a military coup in April 1964, amidst the tensions of the Cold War.

After divergent economic policy choices at the turn of the 1950', both countries pushed the model of inward-oriented and state-led import-substitution industrialization to its limits in the second half of the decade. The lack of commitment to macroeconomic stability characterized both countries' governments throughout the decade and resulted in a major economic crisis in 1958, which added to growing political tensions and led to the breakdown of the political system.

Another common feature of both countries before their respective military coups was the nationalist discourse that both governments adopted and the consequent deterioration of their relations with the US and the international institutions promoting similar economic agendas. This contrasts sharply with the efforts deployed by both countries' governments to gain American favours and the influence the US yielded in both, Brazil and Turkey, in the immediate post-war period. In Turkey, the leaders of the Democratic Party, who had been so inspired by the US model in the beginning of the decade, became increasingly hostile to the US economic policy recommendations and international institutions (Okyar, 1979). The emphasis on the return to macroeconomic balance and the support to investments directed towards productivity gains was conflicting with the macroeconomic objectives and management of the Turkish government (Maxfield and Nolt 1990). In several instances, the Turkish government entered in open conflict with advocates of such economic agenda, criticizing the economic policies implemented, for instance by the World Bank, with which relations were broken off in mid-1950' and for the rest of the decade (Okyar, 1979). Similarly, in Brazil, the rupture of the negotiations with the IMF in 1959 was politically exploited by J.Kubitschek to assert his nationalist stance and was also a symbol of the deterioration of the relations with the Western institutions (Abreu, 2008a). The military regimes established after the coups in both countries were to restore a closer relationship with the US and a more harmonious interface with its economic agenda through new economic policies.

5.3.2 From the turn of the 1960' until the first oil shock: journey from stabilization to economic miracle

In both countries, the military coups were followed by successful stabilization efforts, which laid the ground for a period of strong growth fuelled by a spur in industrial output until

the first oil shock in 1973. These years came to be called “economic miracle”. The decade preceding the oil shock was also characterized in both countries by the introduction of export incentives to deal with the balance of payments constraints and a subsequent growth of manufactured exports. However, this new growth orientation did not profoundly alter the fundamentally inward-oriented ISI model previously adopted by both countries.

Due to its earlier commitment to stabilization – from 1960 onwards, Turkey experienced a first phase of strong economic growth when Brazil was still going through its own period of stabilization. This earlier phase of Turkey’s economic miracle corresponded to its first Five-Year Development plan implemented from 1963 to 1968 and primarily focused on import substitution industrialization. It was only during the second Turkish Five-Year Development plan (from 1968 to 1973) that both countries find themselves in a similar economic dynamic again, characterized by high growth of manufacturing output and exports.

5.3.2.1 In Brazil and Turkey, the military coup was followed by a successful stabilization plan, although both countries followed slightly different goals and approaches.

The establishment of military regimes in Brazil and more briefly in Turkey was accompanied by a strong commitment to implement the much-needed stabilization plans that civil governments had failed to see through in the previous years. In the three years following both countries’ respective military coups, from 1960 to 1963 in Turkey and from 1964 to 1967 in Brazil, the economic policies were predominantly restrictive and primarily focused on the recovery of economic stability. Nevertheless, it is worth noticing that, unlike Turkey, the Brazilian government efforts also pursued an objective of economic growth in addition to stabilization and engaged in significant structural reforms.

In Turkey, the National Unity Committee, set up by the military after the “May Revolution” to replace the Democratic government, reneged the expansionary budget adopted by the Menderes government in January 1960 and demonstrated a complete adherence to the Stabilization Program initiated in 1958. Fiscal and monetary policies were significantly tightened. Fiscal deficits were turned into small surpluses from 1960 onwards and ceilings on Central Bank’s credit policy were re-established and enforced so that the expansion of the global money supply tumbled from 17.3% in 1959 to 6.4% in 1960 and was maintained below 10% per year until 1963 (Krueger, 1974). Those restrictive fiscal and monetary policies were very successful in significantly and durably reducing the inflationary pressures. Indeed, the

inflation level fell from nearly 30% in 1959 to less than 3% in 1960 and remained below 8% per year throughout the decade (Görmez and Yigit, 2009).

The Turkish Stabilization Plan also included a reform of the exchange rate regime and a temporary liberalization of the trade regime. The multiple exchange rate arrangement was abolished and the Turkish Lira further devalued by up to 80% compared to the set of exchange rates established in 1958. The unified exchange rate was fixed at TL 9 per USD compared to the highest exchange rate after 1958 of TL 4.9 per USD. This devaluation contributed to relieve the pressure on the balance of payments as exports grew by nearly 60% in nominal value between 1958 and 1963, while imports stalled between 1959 and 1961, due to slowing economic growth and even a recession in 1961. This provided an opportunity for a significant liberalization of the import controls through the extension of the *Liberalized List*, a list of goods for which import licenses were automatic (Okay, 1979).

The last main achievement of the military government was the creation of the State Planning Organization (*Devlet Planlama Teskilati* or SPO), in 1960, to coordinate the economic policies adopted to support the industrialization process. The creation of this new institution was in line with the stabilization objective, since it was conceived as a response to the highly criticized *ad hoc* character of the policies implemented in the previous decade. The point was to avoid phenomena such as over-investment or redundant investments, hence improving control over budget allocation and reducing fiscal deficits (Okyar, 1979). As such, the SPO soon became a key actor in the Turkish bureaucracy, playing the central role in the decision-making process. After the 1961 elections and the return to power of the Republican Party, the main mission assigned to the SPO was to design a new development plan, promoting a further stage in import-substitution industrialization.

In Brazil, stabilization was pursued as the main economic policy objective under the presidency of H.Castelo Branco, between 1964 and 1967. In April 1964, the duo R.Campos, at the head of the newly created Planning Ministry, and O.Bulhões, Finance Minister, launched the Program of Economic Action of the Government (*Programa de Açao Econômica do Governo* or PAEG) with the primary objective to rein in inflation, which had reached nearly 80% in 1963. However, contrasting with Turkey, a gradual approach, rather than a "shock therapy", was chosen to achieve this goal therefore *"the struggle against inflation was always tempered by the concern not to threaten the expansion of the production"* (Resende, 1982). This dual concern, about inflation and economic growth, stemmed from the short period of stagflation experienced in 1963 that the military

government meant to address. That year, simultaneously with accelerating inflation, economic growth had plummeted to 0.6% from an average over 8% per year between 1957 and 1962 (Hermann, 2005a). The determination to sustain economic growth and the consequent gradual approach adopted by the Brazilian government determined the focus and pace of the stabilization plan throughout the three years of its implementation.

Among the first achievements of the PAEG was the debt rescheduling, quickly obtained in August 1964, and the subsequent foreign loans granted by the United States and European countries in reward for the strong commitment to stabilization demonstrated by the government. As in Turkey, the PAEG focused on the reduction of fiscal imbalances and monetary expansion, in order to break the inflationary spiral of the early 1960'. In addition to the choice of a gradual adjustment, another significant difference to the Turkish stabilization process was the set of structural reforms in which the Brazilian government engaged to reinforce its fiscal and monetary restrictions, and increase allocative efficiency.

Budget deficits were reduced from 3.8% of GDP in 1963 to 0.9% in 1966, not only through direct spending cuts, but also via a comprehensive reform of the SOEs designed to reduce their deficits. A remarkable example of this was the postal services which were completely overhauled and became much more efficient, to the point that they even gained prestige in the eyes of Brazilians (Abreu, 2008a). In both cases, spending cuts occurred mostly in operational costs and did not affect substantially the level of public investment. In fact, the public sector even increased its share of total investments from an average of 37.5% between 1961 and 1963 to 46.4% in 1965, notably through the creation of new SOEs such as Embratel, the long distance telecom provider (Abreu, 2008a). Another initiative which considerably contributed to restore fiscal equilibrium was the reform of the tax system, including an improvement in tax collection and the introduction of better designed taxes such as the *Imposto sobre Circulação de Mercadorias* (ICM) a tax on added value in 1965 (Cardoso and Teles, 2010). The overall tax burden went up from 16% of GDP in 1963 to 21% in 1967 and 25% in 1973 (Hermann, 2005a). The particularly regressive and centralizing character of this tax reform provides evidence on how the restrictive political context in effect at that time, with the main political actors of the opposition muzzled, facilitated the reform process undertaken by the government (Abreu, 2008a).

A stricter control over monetary and credit policies was also implemented with the same concern about sustaining the economic activity and the same drive towards structural reforms. Credit policies were initially restrictive, with total credit outstanding in real terms falling by 10% in 1964, before being relaxed, allowing total credit to return to a moderate

growth of about 9% annually in 1965 and 1966, in order to support the private sector (Abreu, 2008a). Besides this flexible credit policy, a crucial reform of the financial system was undertaken with the aim of reducing the recourse to monetary and credit expansion aiming to the emergence of private sources of long-term financing to sustain the economic development. The restructuring of the financial market was initiated with the creation, in 1964, of the Central Bank of Brazil, replacing Banco do Brasil's SUMOC (*Superintendência da Moeda e do Crédito*) in the design and implementation of monetary policy, and of the National Monetary Council (*Conselho Monetário Nacional*), responsible to set monetary policy guidelines (Hermann, 2005a). The role of the various actors on the Brazilian financial market was clarified and regulated, especially investment banks in providing long-term financing. Moreover, and very significantly, a mechanism of monetary correction was implemented to guarantee positive real rates of return over benchmark inflation rates to private investors. This mechanism was applied to the newly created national market for public debt, with inflation-indexed Treasury bonds – such as the Adjustable Obligation of the National Treasury (*Obrigações Reajustáveis do Tesouro Nacional* or *ORTN*) and the Letters of the National Treasury (*Letras do Tesouro Nacional* or *LTN*) – which financed an increasing share of the fiscal deficits (55% in 1965 and up to 86% in 1966), hence avoiding the need of monetization (Hermann, 2005a). In addition, the capital account was also substantially liberalized to attract foreign capital, especially with the abrogation of a 1962 law limiting profit remittances. As a result of these measures, foreign capital inflows grew quickly. They increased 36-fold, from USD 66 million in 1967 to USD 2,410 million in 1973 (Coes, 1995). In parallel, the share of credit outstanding held by public institutions decreased from 46.3% in 1964 to 30.4% in 1967 (Abreu, 2008a).

Finally, the mechanism of monetary correction, mentioned above for financial assets, was extended to the wages and salaries of the public sector and then of the private sector to partially lessen the effects of inflation and ideally diminish the need for restrictive and potentially recessive stabilization processes. The correction of labour income was based on the average inflation over the preceding two years, and not its peak, so that real salaries actually decreased over the period by about 7% annually from 1965 to 1967 (Abreu, 2008a). This mechanism of monetary correction, conceived as a "magical tool" against inflation and its painful side-effects later proved to be an actual driver of the inflationary spiral. In terms of inflation control, the stabilization efforts implemented by the Brazilian government between 1964 and 1967 were not fully rewarded since inflation remained high. Although significantly

reduced from its level of 1964 (92%), it still amounted to 39% in 1966, well above the target of 10% set in the PAEG.

Table 5.4 The Stabilization Plans in Turkey (1958-1962) and Brazil (1964-1967)

Turkey	**1957**	**1958**	**1959**	**1960**	**1961**	**1962**
Inflation rate (% p.a.)	13.5	20.5	28.5	2.3	-0.7	2.6
Fiscal balance (% of GDP)	-0.4	-0.2	-0.2	1	0.5	0.5
Expansion of the global money supply, in nominal terms (% p.a.)	28.2	8	17.3	6.4	8.3	9.3
GDP growth rate (% p.a.)	6.3	5.2	3.9	3.7	-1.6	6.1
Brazil	**1962**	**1963**	**1964**	**1965**	**1966**	**1967**
Inflation rate (% p.a.)	51.6	79.9	92.1	34.2	39.1	25
Expansion of the global money supply, in nominal terms (% p.a.)	62	75	67	46	31	na.*
GDP growth rate (% p.a.)	6.6	0.6	3.4	2.4	6.7	4.2

Sources: For Turkey, Krueger (1974), Gömez and Yigit (2009). For Brazil, IBGE (2006)
* in 1967 a new currency was introduced: Cruzeiros Novos replaced the Cruzeiros making the comparison in terms of the growth of the money supply potentially misleading.

The diverging approach to stabilization in Turkey and Brazil produced slightly different results. Both countries achieved a rescheduling of their external debt and a more balanced fiscal situation, regaining the trust of international creditors. Then, the shock therapy applied in Turkey was very effective in sustainably reducing the inflation from about 30% to an average below 8% for the rest of the 1960'. But that goal was achieved at the expense of economic growth, given that the Turkish economy plunged in a recession in 1961. In Brazil, the PAEG was the first stabilization plan fully implemented since the very beginning of the 20th century and the Campos Salles government (1898-1902). The gradual and flexible approach adopted by Campos-Bulhões allowed to avoid the recessionary effects of stabilization, maintaining a reasonably high level of economic growth, at an average of 4.2% annually between 1964 and 1967. This was in line with the *"mission to 'save' the country from economic and political chaos"* (Vianna, 1990) that the military had given itself when

taking power and which, almost by definition, meant that recession was to be avoided. However, the stabilization objective was not as successfully met as in Turkey since inflation remained high, at nearly 40% annually in 1966.

5.3.2.2 The introduction of an export-orientation in both countries fuelled economic growth in the beginning of the 1970' but did not change the main features of the economic model.

The 1960' were also characterized in both countries by an inflexion of the trade policy, through the establishment of export-promotion schemes. Despite having significantly advanced in the industrialization process since the 1930', Brazil and Turkey were both still very dependent on their primary exporting sector to earn foreign reserves and pay for their imports since their manufacturing sectors were almost exclusively inward-oriented. Coffee still accounted for about 60% of Brazil's exports at the end of the 1950' (Abreu and Bevilaqua, 2000), while up to 78% of Turkey's exports were still made up by agricultural products in 1968 (Alkin, 1975). Therefore, the fall in agricultural commodity prices in the second half of the 1950' pushed both countries into external debt crises in the very same way as it did in the 1930'. To deal with the serious constraints on the balance of payments, the Brazilian and Turkish governments chose, in the second half of the 1960', to take advantage of their newly developed manufacturing base in order to diversify their exports through the promotion of manufacturing exports. In both countries, a first set of incentives were established in the mid-1960' and then intensified from 1967-1968 onwards. This new orientation of both economies provided substantial stimuli to growth until the first oil shock, but failed to bring about a comprehensive reform of the economic model. Due to the interplay of political and economic interests[17], the fundamentally protectionist economic model remained in place and was to determine the economic development of the following decade.

In Brazil and Turkey, the first measures to promote exports – and especially manufactured exports – were introduced in 1963-1964, which corresponded to the beginning of the first Five-Year Development Plan in Turkey and the introduction of PAEG in Brazil. Nevertheless, those measures were not significant until 1967-1968. These years in both countries again represented an important watershed in terms of economic policy.

In Brazil, 1967 marked the end of the presidency of H.Castelo Branco and the beginning of the presidency of Costa e Silva, who changed priority to economic growth over stabilization and opened an era of unprecedented expansion known as the *"economic*

[17] Detailed in the next chapter.

miracle". In Turkey, 1967-1968 witnessed the transition between the two Five-Year Development plans launched during the 1960'. The second development plan (1968-1972) was characterized by a significant shift in Turkey's foreign trade policy and an intensification of the export drive by the Demirel government – in place from 1965 on – through incentives.

In Turkey, the debate over export incentives started in the beginning of the 1960', when the first Five-Year Plan (1963-1968) was being designed by the SPO. The necessity to compensate exporters for the chronic overvaluation of the exchange rate was recognized and the growth and diversification of exports was listed as one of the plan's objectives. As a result, several measures were taken in 1964. A tax rebate mechanism, an exemption of custom taxes and an access to subsidized credits for exporters were established (Tekin, 2006). Moreover, the registration of export prices required to all exporters – very constraining in the 1950' – was relaxed in the beginning of the 1960'. However, these measures were not very significant until they were intensified from 1968 onwards, as Tekin (2006) pointed out: *"the subsidy system was far from having the effect of devaluation since the coverage and amount of these subsidies was highly limited and they were often adjusted to the new conditions too late. (...) The primary concern of the foreign trade regime during the period (1963-1968) was import substitution through import restrictions and overvalued exchange rates."* Similarly, an Export Promotion Agency was created in mid-1960' but was given too small a budget to really have a substantial impact in terms of export promotion (Krueger, 1974).

The intensification of the export drive came as the current account deficit widened under the pressure of growing imports, required by the further import-substitution step taken during the first Five-Year Development Plan. Between 1961 and 1970, exports grew by 5.9% per year (in nominal terms), while imports were rising at 6.7% per year (Dervis and Robinson, 1978). This gap between export and import growth rates naturally caused the trade deficit to widen. It was multiplied by nearly 2.5 between 1965 and 1968 and further to 3.3 until 1970. Facing growing pressure on the balance of payments, the SPO emphasized the promotion of non-traditional exports and a further batch of export incentives was introduced in 1968, among them the abolition of stamp duties and transaction tax on export financing, as well as the reduction of the legal maximum nominal interest rate for credits to exporters from 9% to 6% p.a. But, in spite of these measures, the level of subsidies remained low, as illustrated by the amount of export credits, which represented less than 2% of Central Bank's total credits in 1969 (Okay, 1979). This was also testified by the little reaction of exports, which increased by 18.5% in value between 1968 and 1970, compared to 24% for imports. As highlighted by Krueger (1974), during the 1960', *"government policies designed to encourage import-*

substitution provided far more powerful incentives than those aimed at increased export earnings".

The major shift in Turkish incentives towards the promotion and diversification of exports came with a reform of the foreign trade regime in August 1970, including a massive devaluation of the Turkish Lira from TL 9 per USD to TL 15 (Tekin, 2006). This measure once again came as a result of the pressures on the balance of payments, which led the Turkish government to apply for an adjustment loan from the IMF, as the amount of commercial arrears grew USD 38 million in 1968 to USD 240 million in 1970 (Tekin, 2006). However, the devaluation of the Turkish Lira was part of a new economic agenda adopted by the Demirel government not only to promote the growth and diversification of exports, but also to achieve some extent of trade liberalization. The mind-set of Turkish main economic policy-makers towards manufactured exports had definitely evolved, as Dervis and Robinson (1978) pointed out: *"at the State Planning Organization in particular, the failure of any manufactured exports to materialize was perceived as a serious bottleneck to further growth and as an indication that Turkey's industrial development was lacking an important dimension."*

This shift in economic orientation was also in line with the negotiation process taking place with the European Economic Community (EEC). After the signature of an Association Agreement in 1963 and the end of a seven-year preparatory stage, an "Additional Protocol" was concluded in July 1970, defining the progressive alignment of custom tariffs between Turkey and the EEC. As part of the August 1970 reform package, the tax rebate system was simplified and further tax refunds were granted to exporters. Moreover, increased export credits were channelled through a *Foreign Exchange Equalization Fund,* which provided subsidized credits to projects with export potential. The promotion of manufactured exports also came through the lower exchange rate maintained for the traditional exports (agricultural commodities), at TL 12 per USD instead of TL 15 per USD for all other exports (Tekin, 2006). Besides export incentives, several reforms contributed to a relative relaxation of the import control system, which had become extremely restrictive by the end of the 1960'. The stamp duty and advance deposit requirements for imports were both substantially reduced compared to their 1969 level (Krueger, 1974).

Table 5.5 Relevant elements of Brazil's and Turkey's Balance of Payments 1967-1973 (in current million USD)

Turkey	1967	1968	1969	1970	1971	1972	1973
Trade Balance	-162	-268	-264	-360	-494	-678	-719
Imports	-685	-764	-801	-948	-1171	-1563	-2036
Exports	523	496	537	588	677	885	1317
Services balance	34	27	35	181	366	640	1261
Services	-14	-9	-5	4	21	44	79
Profit/Interest Remittances	-45	-71	-101	-96	-126	-144	-1
Workers' remittances	93	107	141	273	471	740	1183
Current Account Balance	-114	-231	-221	-171	-122	-8	497
Brazil	**1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**
Trade Balance	213	26	318	232	-343	-241	7
Imports	-1441	-1855	-1993	-2507	-3247	-4232	-6192
Exports	1654	1881	2311	2739	2904	3991	6199
Services balance	-566	-630	-713	-1092	-1300	-1452	-2119
Services	-278	-333	-377	-473	-572	-743	-1027
Profit/Interest Remittances	-288	-297	-337	-619	-729	-709	-1093
Workers' remittances	77	22	31	21	14	5	27
Current Account Balance	-276	-582	-364	-839	-1630	-1688	-2085
Capital Account	49	680	936	1281	2173	3793	4111
Credit (short and long-term)	66	502	709	843	1699	3067	2410
FDIs	115	135	207	378	448	441	1148

Sources: For Turkey, World Bank (1975). For Brazil, IBGE (2006)

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In Brazil too, a new orientation was given to the economic model, in the mid-1960', defined by the promotion of a higher level of integration with the international markets, both in terms of exports promotion and liberalization of import controls (Fishlow, 1980). Similarly to Turkey, the Brazilian stabilization plan (PAEG) included some extent of import control liberalization. The number of goods listed in the special category of imports was reduced in 1965 and an import tariff reform introduced in 1967 reduced the average protection of manufactured goods from 99% to 48% (Abreu, 2008a). In parallel, a system of tax exemptions for exports was introduced and the exchange rates were unified, including a small devaluation in 1964 and 1965. Moreover, a National Council of Foreign Trade (*Conselho Nacional do Comércio Exterior*) was created to promote exports. But here again, the latter only became effectively active after 1967, when the emphasis of the economic policy was to resume strong economic growth and export promotion was intensified.

From 1967 onwards, subsidies and special credits for manufactured exports sharply increased, until amounting to an equivalent devaluation of up to 70% of the exchange rate (Abreu, Bevilaqua, Pinho, 2000). An additional system of import rebates based on export performance was established in 1972 as the Special Program of Fiscal Incentives for Exports (*Comissão para Concessão de Benefícios Fiscais e Programas Especiais de Exportação* or *BEFIEX*). Additionally, a crawling peg was established in 1968 so that the exchange rate was adjusted on a regular basis through monthly mini-devaluations (of about 2% on average) in order to boost the export sector. From 1968 to 1973, the exchange rate of the Brazilian currency was gradually devalued by about 50% (Hermann, 2005a).

In both countries, the intensification of the export promotion policies produced a strong growth in exports in the beginning of the 1970', especially manufactured exports. In Turkey, exports grew by an annual average of 25% between 1969 and 1973, which represents an explosion compared to the 3% annual average growth from 1950 to 1969 (Dervis and

Robinson, 1978). This growth was pulled by the exports of manufactured goods, which increased nearly fourfold in nominal value between 1968 and 1974 and came to represent 27% of total Turkish exports revenues in 1972, up from 12% in 1968. As noted by Tekin (2006): *"by the early seventies, the 1970 reform proved to be the most successful foreign trade policy measures in Turkey."* Likewise, Brazil experienced an export boom led by manufactured goods. The value of exports revenues was multiplied by more than three in nominal USD terms between 1968 and 1973 while the share of manufactured goods in total exports jumped from 6.2% in 1966 to 23% in 1973, and even 33% including semi-manufactured goods (Abreu, 2008a).

Yet, although both countries saw their current account situation improving considerably in the beginning of the 1970', the surge in exports and foreign earnings did not sustainably solve the disequilibria of the balance of payments. The immediate constraint disappeared but, in their own ways, Brazil and Turkey both became increasingly dependent on capital inflows during this period of export growth.

In Turkey, the import-substitution industrialization strategy pursued throughout the decade created a growing need for imports of capital goods. Although export earnings quickly grew from 1970 onwards, imports still increased faster. As a result, the trade deficit widened nearly fourfold between 1967 and 1973. Only the huge growth in workers' remittances, at an annual average of 70% between 1969 and 1973, allowed the current account balance to improve, until switching from deficit to large surplus in 1973, for the first time since the end of the Second World War (Dervis and Robinson, 1978).

In Brazil, the deficit of the balance of services widened more than fourfold between 1965 and 1973 (from USD 446 million to USD 2,119 million) resulting in a large current account deficit by 1973. The latter went from a surplus in 1965-1967 to a deficit of over USD 2 billion in 1973, equivalent to 2.3% of GDP. This current account deficit was compensated by a significant growth in capital inflows which were multiplied by 36 between 1967 and 1973, as previously mentioned. In the late 1960', Brazil was one of the main destinations for lenders on the Eurodollar market. The bulk of these capital inflows - nearly 60% - were short and medium-term loans, so that the Brazilian external debt reached 17% of GDP in 1973. This growing dependency on foreign debt was pointed out by Fishlow (1980), who highlighted that the Brazilian economic miracle was a *"debt-led rather than export-led growth."*

Finally, it is worth noticing that in both Brazil and Turkey, the many incentives provided to exporters and the relative liberalization of the trade regime did not lead to a structural change of the economic model. The foundations of the ISI economic model were not affected. Either because of a lack of real commitment to trade liberalization or because of the strong opposition from vested interests that this economic agenda met, the new orientation given to the economic model was abandoned or reversed in both countries by 1973[18].

In Turkey, the political opposition to the August 1970 reforms was so strong that the political climate quickly deteriorated and finally led to a military coup in March 1971, in the form of an ultimatum given by the military to the Demirel government to leave power. The main features of the foreign trade reforms initiated in August 1970 were maintained since they were met with an immediate success in terms of boosting exports and alleviating pressures on the balance of payments. However, all the key economic policymakers were replaced. And as the external situation improved and foreign reserves accumulated, none of the necessary follow-up reforms were adopted, so that the reform process lost momentum and the new orientation of the economic model was finally abandoned (Tekin, 2006). Between 1970 and 1973, the acceleration of inflation, at 18.2% annually on average compared to about 10% worldwide, progressively erased the benefits of the devaluation for exporters as the exchange rate appreciated by 30% (Dervis and Robinson, 1978). Moreover, in the beginning of 1973, the third development plan was launched, putting again the emphasis on import substitution industrialization.

In the same way in Brazil, the outward-orientation promoted in the late 1960' did not lead to a comprehensive change in the foreign trade regime, mainly due to a lack of commitment to liberalism. The export promotion policies corresponded more to a correction of the anti-export bias that prevailed in the heyday of import-substitution, than to a real reorientation of the economic model (Abreu, 2004a). Regarding imports, although import tariffs were reduced considerably, they remained relatively high, considering their original level. The average tariff on manufactured goods was reduced from 183% in 1963 to 48% in 1967, which still characterizes the Brazilian foreign exchange regime as protectionist. In addition, this relative liberalization of the trade regime was quickly reversed in the following years. The average tariffs, weighted by added value, which had fallen to 37% in 1967 were already raised to 66% in 1969 (Abreu, 2004a). This trend was further accentuated after the first oil shock, as explained by Coes (1995):

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[18] We will elaborate on this in the next chapter.

"Despite much progress in liberalizing export transactions, Brazilian trade policies on the import side were at best timid and at worst severely restrictive in the post-1964 period. The essential feature of Brazil's trade regime during this period was its maintenance of administrative control over import flows. At times trade policy permitted a high volume of import, particularly in the boom years between 1968 and 1973. Trade authorities never relinquished their control, however, so that it was relatively easy for them to reverse the trend toward greater openness to imports after the first oil shock in 1974, while increasing the level of incentives for exports."

5.3.2.3 The stabilization plans laid the basis of a period of strong growth until the first oil shock in 1973.

After the success of their respective stabilization plans, both countries experienced a period of exponential economic growth once again led by the manufacturing sector, notably through exports, until the beginning of the 1970' and the first oil shock. This period of prosperity, marked in both countries by an increasing level of investment and a relatively low inflation, lasted a full decade in Turkey, between 1963 and 1973, while it started in 1968 in Brazil and remained famously known as the "economic miracle".

Between 1963 and 1973, the Turkish economy grew at an average annual rate over 6%. In terms of economic policy orientation, this decade can be divided into two phases in function of the two Five-Year Development Plans implemented by the SPO: the first one, between 1963 and 1967, emphasizing import substitution industrialization while during the second one, from 1968 to 1972, export incentives were progressively intensified, culminating in the devaluation and export boom between 1970 and 1973.

The first plan was designed and implemented by a government led by the Republican Party, which came back to power in 1961 after its electoral defeat in 1950. Defending the Kemalist inheritance, the Republican Party was the most ardent promoter of the *etatist* economic model established in the 1930'. Therefore, this development plan marked the first decisive choice to return to the import substitution industrialization model after the end of the Second World War in Turkey, comparable in this way to the Plano de Metas in Brazil. In fact, this economic policy choice prevailed throughout the 1960' and up until 1977, with the exception of the short episode of the August 1970 trade liberalization reforms.

As stated in the official text of the SPO, the ambitious objective of the plan was to *"deepen import-substitution efforts as much as possible"* (Krueger, 1974). Among the driving ideas underlying this original economic policy orientation was a generalized pessimism regarding Turkey's export potential in both the agricultural or manufacturing sectors. The

agricultural sector was considered unproductive and inelastic, while regarding the manufacturing sector's export potential, the words of B.Tuncer, one of the first director of the SPO, reveal the vision of the decision-makers at the time: *"the development plans were based on the belief that the manufacturing sector's export potential was non-existent and, even if production were to be increased, great difficulties would be encountered in trying to market the products abroad."* (Tekin, 2006). The export sectors were deemed inappropriate as long-term growth engines. Consequently, the first Five-Year Development Plans set ambitious goals in terms of development of new local manufacturing activities, particularly in consumer goods. For this purpose, the level of investment jumped from 15% of GDP in 1963 to over 20% in 1972. These investments were coordinated by the SPO through the SOEs as well as through incentives for the private sector. In fact, the share of public investment in total investment increased from 50% in 1960 to nearly 56% in 1969 (Okay, 1979). Investments were channelled in priority towards infrastructure and manufacturing activities, especially towards utilities and consumer goods, and generated a strong growth of the manufacturing output of a cumulated 80% between 1963 and 1970, or about 9% annually.

Table 5.6 GDP growth, Investment and Inflation rates 1963-1973

Turkey	**1963-1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**	**1968-1973**
GDP growth rates (% p.a.)	6.7	6.7	6.2	5.8	9.1	6	4.4	6.4
Investment rates (% of GDP)	15.4	18	20	21	18	20.1	18.1	19.2
Inflation rates (% p.a.)	4.4	0.4	6.5	8.1	16.3	18	20.5	11.6
Brazil	**1963-1967**	**1968**	**1969**	**1970**	**1971**	**1972**	**1973**	**1968-1973**
GDP growth rates (% p.a.)	3.5	9.8	9.5	10.4	11.3	11.9	14	11.2
Investment rates (% of GDP)	15.8	18.7	19.1	18.8	19.9	20.3	20.4	19.5
Inflation rates (% p.a.)	54.1	25.5	19.3	19.3	19.5	15.7	15.6	19.2

Sources: For Turkey Krueger (1974), Görmez and Yigit (2009), Rodrik and Celasun (1990). For Brazil, IBGE (2006)

The inward orientation of the first development plan is illustrated by an analysis of the sources of the Turkish economic growth in that period undertaken by Çeçen *et al.* (1994). Their analysis shows that, from 1963 to 1967, import substitution was responsible for 8.3% of the economic growth. With the domestic final demand, this represented the overwhelming majority (92%) of total GDP growth over the period. This is mainly explained by the resurgence, after the relative trade liberalization in the early 1960', of a highly protectionist trade regime. Stricter import controls came as a response to resuming pressures on the balance of payments in 1963, when the trade deficit more than doubled compared to 1961. But they were also purposely designed to stimulate import substitution as they specifically targeted consumer goods - whose imports were drastically reduced from 15.2% of total imports in 1963 to 8% in 1967 - while favouring imports of capital goods. Overall, the value of imports fell from 9.8% of GDP in 1963 to 6.6% in 1968.

During the second development plan, the manufacturing sector remained the main recipient of the growing flow of investments, reaching a new high of more than 19% of GDP. But the manufactured output was increasingly destined to be exported. Between 1968 and 1973, export growth represented more than 16% of total GDP growth compared to only 4% during the first development plan, while, by contrast, import substitution contribution to growth was negative (Çeçen, Dogruel and Dogruel, 1994). However, as explained earlier, this export boom was primarily a result of the positive effect of the 1970 devaluation, which quickly faded away when inflation accelerated in the following years.

In Brazil, the link between the successful stabilization plan and the economic miracle was mentioned by Veloso, Villela and Giambiagi (2008), who claim that it came as a delayed consequence of the structural reforms introduced from 1964 and 1967. When A. da Costa e Silva replaced H.Castelo Branco in the Presidency in March 1967, he appointed A.Delfim Netto at the head of the Finance Ministry and a developmentalist stance was adopted. The main economic policy target was again economic growth. Yet, as inflation remained higher than planned in the PAEG, stabilization objectives were maintained in parallel with the pursuit of faster economic growth. Hence, the Strategic Development Plan (*Plano Estratégico de Desenvolvimento*) adopted in 1968 included ambitious growth targets in industrial output and infrastructure while establishing strong mechanisms of price control. The credit policy was relaxed to finance increasing investments and real credit expanded by 32% yearly from 1967 to 1973. But simultaneously, prices and wages were kept under control by the CONEP (*Comissão Nacional de Estabilização de Preços*) and then the CIP (*Comissão Interministerial*

de Preços) (Abreu, 2008a). As a result, the investment rate went from an average of 15% of GDP between 1963 and 1967 to more than 20% in 1973. This surge in investment, mostly financed by capital inflows and destined to the manufacturing sector, fuelled an average GDP growth rate of 11% annually until 1973 and an even stronger industrial growth mounting to 13.5% annually. Infrastructure was another engine of this growth since the length of paved road and the electricity generating capacity both doubled (Abreu, 2008a). At the same time, the objective to reduce the inflation rate was also met since it continuously slowed down throughout the period until reaching 15% in 1973, its lowest level since mid-1950'.

It is precisely the combination, observed in both countries, of an exceptionally high growth, along with relatively low inflation rates and the absence of accelerating pressure on the balance of payments thanks to increasing capital inflows, which inspired the expression "economic miracle" in Brazil and generated an unbridled optimism about the future in Turkey. However this illusion did not last and what was described as a *"false sense of security"* for Turkey also applies to Brazil (Dervis and Robinson, 1978). The second half of the 1970', starting with a dramatic increase in oil prices, showed that this boom in capital inflows was not sustainable and that even more serious imbalances were pending for both countries.

5.3.3 From the first oil shock to the debt crisis, the last wave of import-substitution industrialization

The post-World War II international economic environment, shaped by the Bretton Woods Agreements and characterized by abundant supply of cheap oil, provided conditions conducive to global economic growth until the beginning of the 1970'. Then it suddenly fell apart after two major disruptions in its foundation. First in 1971 when, facing the erosion of the US gold reserves, Nixon ended the convertibility of the US dollar to gold, leading to the collapse, two years later, of the monetary system adopted in Bretton Woods. And then in October 1973, when the main oil producers and exporters decided a unilateral contraction of oil exports, provoking an immediate increase of international oil prices.

These major structural changes in the international economic environment opened an era of necessary adjustments to which all countries were subjected. However, the strategies followed varied among them. As all oil-importing economies, Brazil and Turkey were severely affected by the first oil shock. Facing a rise of their import bills threatening the growth momentum experienced in the previous years, the Brazilian and Turkish governments

opted for the same economic policy answer in 1973-1974. Both countries undertook a further intensification of import-substitution industrialization mostly financed by a quick accumulation of external debt. This spiral of indebtedness led both countries into the most severe debt crisis of their history and what turned out to be the final crisis of the import-substitution industrialization model. As in the turn of the 1960', the timing between the two countries slightly differs with Turkey plunging into crisis earlier than Brazil. Their immediate management of the debt crisis also differs and had a decisive impact on their economic development in the following two decades.

Table 5.7 Relevant elements of Brazil's and Turkey's Balance of Payments, 1973-1980 (in current million USD)

Turkey	**1973**	**1974**	**1975**	**1976**	**1977**	**1978**	**1979**	**1980**
Trade Balance	-769	-2245	-3101	-2912	-3753	-2311	-2808	-4999
Imports	-2086	-3777	-4738	-4872	-5506	-4599	-5069	-7909
Exports	1317	1532	1401	1960	1753	2288	2261	2910
Workers' remittances	1183	1426	1437	1120	1107	983	1694	2071
Current Account Balance	488	-719	-1879	-2029	-3140	-1595	-1203	-3661
Net foreign borrowing	91	205	1145	1935	2765	1644	1170	2358
Short-term capital	-258	-8	749	1283	1965	844	194	126
Brazil	**1973**	**1974**	**1975**	**1976**	**1977**	**1978**	**1979**	**1980**
Trade Balance	7	-4690	-3540	-2255	97	-1024	-2839	-2823
Imports	-6192	-12641	-12210	-12383	-12023	-13683	-18084	-22955
Exports	6199	7951	8670	10128	12120	12659	15244	20132
Services balance	-2092	-2813	-3469	-4171	-4923	-5059	-7869	-9916
Current Account Balance	-2085	-7504	-6999	-6426	-4826	-6983	-10708	-12739
Capital Account	4111	6531	6374	8499	6151	11884	7624	9610
Credit (short and long-term)	2410	5432	5381	5817	4011	8827	6107	7196
FDIs	1148	1154	1095	1219	1685	2056	2210	1544

Sources: For Turkey, OECD reports on Turkey, Central Bank of Turkey, Ministry of Finance, Rodrik and Celasun (1990). For Brazil, IBGE (2006)

5.3.3.1 The oil shock contributed to swell the import bill and deteriorate the terms of trade of both countries.

In the beginning of the 1970', both Brazil and Turkey, as many other countries, were heavily dependent on imports to satisfy their needs for oil. Brazil was the biggest importer of oil among developing countries and its imports of oil represented no less than 80% of its total consumption (Fishlow, 1980). Likewise, Turkey imported 70% of its total oil needs throughout the 1970' (Rodrik and Celasun, 1990). Therefore, the sudden fourfold increase in international oil prices, resulting from the unilateral decision of the members of the Organization of the Petroleum Exporting Countries (OPEC) to reduce production in October 1973, considerably affected the Brazilian and Turkish economy. The price of the barrel, passing from USD 2.80 to USD 11.80, contributed to substantially raise both countries' import bills and consequently caused a deterioration of their terms of trade. In Brazil, the value of imports more than doubled between 1973 and 1974 pulling the trade balance from equilibrium in 1973 to a USD 4.7 billion deficit in 1974. In Turkey, the negative impact of the oil shock on the terms of trade was evaluated at 7.1% of its GDP (Balassa, 1984). Adding to this the declining international demand for Turkish exports and workers' remittances in the following years, the first oil shock is estimated to have cost the Turkish economy up to 9.4% of GDP between 1974 and 1976 (Rodrik and Celasun, 1990). The immediate effect on the Turkish import bill was also tremendous as the value of total imports increased by 85% from 1973 to 1974, causing the trade deficit to triple.

5.3.3.2 Facing the impact of the oil shock, both countries chose to sustain growth through a last wave of import-substitution industrialization, which generated large macroeconomic imbalances.

Facing this sudden change in their terms of trade and the necessity to adjust, both countries' governments made a similar economic policy choice. The rising cost of oil represented a major threat to the exceptional growth momentum that both countries were experiencing since the mid-1960'. In a difficult political context, both governments opted for sustained economic growth. Instead of a recessive adjustment strategy through restrictive fiscal and monetary policies aiming at scaling down oil consumption in response to the new relative prices, they chose to stimulate economic growth through a new wave of import substitution industrialization and massive public investments. Differently from Turkey, in Brazil, the objective was to structurally reduce oil dependency through investments specifically targeting alternative sources of energy. However, the immediate effect of this

growth strategy was to delay the adjustment and widen even more the current account deficits hence preparing a harsher crisis at the turn of the next decade.

In the aftermath of the first oil shock both countries chose to pursue or launch a very ambitious investment plan designed to deepen import-substitution industrialization.

At the time of first oil shock, the Turkish government had already launched, in the beginning of the year, a third Five-Year Development Plan which concentrated on the development of higher added-value industrial activities. This plan had been conceived in the context of the generalized optimism accompanying the strong economic expansion of the early 1970'. As mentioned before, the growing inflow of workers' remittances, peaking at USD 1,426 million in 1974, appeared to have alleviated for good the constraint on the balance of payments. In 1973, Turkey had among the highest foreign reserves-to-import ratio in the world. The foreign reserves accumulated then amounted to one year of imports (Dervis and Robinson, 1978). Furthermore, in the perspective of the full membership of the Customs Union foreseen in the Additional Protocol signed with the EEC in 1970, Turkish economic policymakers designed ambitious development goals to upgrade the national manufacturing sector to the level of its future trade partners. When the oil shock occurred, the Turkish government chose not to interrupt and inflect the development plan. Instead it maintained the high level of investments planned in order to attain its very ambitious targets and to sustain economic growth. As a result, the investment rate grew from 18% in 1973 to 25% in 1977. Most of this growth was supported by a tremendous rise in public investment which rose from 7% to 13% of GDP, hence representing more than half of the total investment. These investments went primarily to the manufacturing and transportation sectors, which received respectively 36.7% and 21.6% of the total investment undertaken in the period (Rodrik and Celasun, 1990). In addition, the Turkish government set up a public fund to subsidize the price of gasoline. The point was to temporarily insulate the Turkish economy from the negative effects of the oil shock. However, the downside of this mechanism was that it acted as a disincentive to adapt and adjust to the new price of oil. As such, the Turkish government delayed the adjustment by weakening any substitution effect (Dervis and Robinson, 1978). In this regard, Brazil made a very different policy choice.

The end of 1973 was a moment of political transition in Brazil with the arrival to the presidency of E.Geisel in March 1974. After a quick attempt with restrictive economic policies, the need to maintain the high level of economic growth in spite of the negative impact of the oil shock rapidly came on top of his administration's agenda. The choice to

deepen import-substitution industrialization came in part from the diagnosis that exports, even with a devaluation of the Brazilian currency, could not be a viable engine of growth considering the depressed international demand due to the recession starting in Western countries (Cardoso and Fishlow, 1990). In a way, Brazilian policymakers felt in 1974 the same pessimism about export potential as Turkish policymakers in the beginning of the 1960' and drew a similar economic policy conclusion from it: the growth momentum had to be created from the inside.

The Second National Development Plan (*II Plano Nacional de Desenvolvimento* or II PND) was launched in the end of 1974 with the ambitious idea to *"cover the gap between under-development and development"* (Hermann, 2005b) and a special focus on the substitution of oil imports through the support to alternative sources of energy. Unlike in Turkey where economic policies delayed the adjustment, the Brazilian development plan was meant to accompany the transition (Hermann, 2005b). However, as will be detailed below, in the medium-run it did delay adjustment by generating a massive inflow of capital into the economy. As stated by Cardoso and Fishlow (1990), by early 1975, *"Brazil was to be an 'isle of tranquillity' in the midst of international economic turbulence."* The investment rate grew from an average of 19.5% of GDP during the "economic miracle" to 22.5% during the implementation of the II PND, mostly benefitting the infrastructure and energy sectors. They were mostly undertaken by public entities and directed to the development of alternative sources of energy like hydroelectricity and the production of ethanol. By mid-1970', 80% of hydroelectric generating capacity was government-owned (Baer, 1978). Following the same objective to reduce the dependency on oil of the country, the Brazilian railways were given a new development boost with the adoption of a National Railroad Plan in 1974 (Estache, Goldstein and Pittman, 2001).

The development plans undertaken in both countries were successful in sustaining the economic growth momentum inherited from the previous years. The Turkish economy grew at an annual average over 7% from 1973 to 1977 and the Brazilian economy at 6.7% per year between 1974 and 1978. But in turn, they also gave rise to economic imbalances. The current account deficit widened and deepened both countries' reliance on a growing external debt.

In Brazil, the reform of the financial system introduced by the PAEG had failed to stimulate the emergence of private sources of long term financing. The relaxation of the legal framework defining the role of each type of financial institution was progressively enacted, encouraging the concentration of the actors on the financial market and their specialization in

short-term financing (Studart, 2005). Consequently, the burden of financing the long-term investments of the II PND fell back on the public sector. This was made through rising fiscal deficits and also with the contribution of public banks like the BNDE, which increased its share of total investments to 8.7% between 1974 and 1978, compared to 4% on average in the previous decade (Monteiro Filho, 1995). The accompanying expansion of the money supply, by 14.8% annually throughout the II PND, fuelled an acceleration of inflation. The level of inflation doubled from 19.5% on average during the economic miracle to 38% per year during the II PND.

Table 5.8 Economic performance during the Third Five-Year Development Plan in Turkey and the II PND in Brazil

Turkey	**1973**	**1974**	**1975**	**1976**	**1977**	**1973-77**
GDP growth rate (% p.a.)	4.1	8.8	8.9	8.9	4.9	7.12
Investment rate (% of GDP)	18.1	20.7	22.5	24.7	25	22.2
Fiscal deficits (% of GDP)	2	5.1	6.1	6.6	10.6	6.08
Inflation rate (% p.a.)	20.5	29.9	10.1	15.6	24.1	20.04
Brazil	**1974**	**1975**	**1976**	**1977**	**1978**	**1974-1978**
GDP growth rate (% p.a.)	8.2	5.2	10.3	4.9	5	6.72
Investment rate (% of GDP)	21.9	23.3	22.5	21.3	22.3	22.26
Inflation rate (% p.a.)	34.6	29.4	46.3	38.8	40.8	37.98

Sources: For Turkey, Central Bank of Turkey, SPO. For Brazil, IBGE (2006).

Moreover, this new wave of import substitution industrialization contributed to put the current account of the balance of payments under growing pressure as its deficit was multiplied by more than 3 from 1973 to 1978. The value of imports more than doubled between 1974 and 1978 first as a result of the oil shock but also because of the investment strategy adopted. As highlighted by Cardoso and Fishlow (1990), *"import substitution can only alleviate balance of payments problems in the short run when there is significant excess*

capacity to be exploited". However, in 1973, the Brazilian economy had reached its highest level of production capacity utilization after the Second World War. Investments were very much needed to sustain growth and were very import-intensive. The faster growth of imports compared to exports, notably because of an overvalued exchange rate, brought the trade balance from equilibrium in 1973 to an average deficit of USD 2.3 billion between 1974 and 1978. In fact, the bulk of this current account deficit stemmed from a growing deficit of the balance of services, from an average of USD 1.2 billion between 1968 and 1973 to USD 4.3 billion between 1974 and 1978, specifically made of interest payments which increased fivefold. This reflects the explosion of the external debt to finance the current account deficit which was another common feature of the two countries throughout this decade.

The Turkish economy also experienced rising imbalances linked to the implementation of the third Five-Year Development Plan. Fiscal deficits widened, from 2% of GDP in 1973 to 10.6% in 1977, as the public investment rate and savings rate evolved in an opposite direction. While public investments were nearly doubled in terms of GDP, government savings rate declined from 8.8% of GDP in 1973 to 6.4% in 1977. About half of the fiscal deficits were financed by monetary expansion, hence generating an increase of inflation from an annual average of 11.6% during the second development plan to 20.5% during this development plan. Because of the constant gap with world inflation of about 10% was only partly covered by a gradual devaluation of the Turkish Lira (about 5% annually), the exchange rate became increasingly overvalued. In 1976, it had come back to its pre-devaluation 1970 level, cancelling all the benefits to the exporting sectors. In fact, the growth of exports in value considerably slackened to a cumulated 33% from 1973 to 1978 compared to 150% from 1967 to 1973. Simultaneously, the value of imports was multiplied by more than two and half, causing the trade deficit to explode from USD 770 million in 1973 to USD 3.8 billion in 1977. Adding to this, a 40% drop in workers' remittances between 1975 and 1978, the current account balance also plunged in large deficits in Turkey: from a surplus in 1973 to a deficit of more than USD 3 billion in 1977, representing 9% of GDP (Dervis and Robinson, 1978).

5.3.3.3 The investments were mostly financed through massive external borrowings.

In order to finance their investments and the massive current account deficits accumulated, both countries entered a cycle of mushrooming external indebtedness facilitated by an exceptional liquidity on the international financial markets. At that time, borrowing

from abroad was, for both countries, the easiest way to carry out their development plans and avoid recession since it made *"ambitious growth targets (...) compatible with continuing increases in consumption and did not require large increases in domestic savings"* (Cardoso and Fishlow, 1990). But this strategy was not exempt of risks to which Brazil and Turkey became increasingly exposed as their external debt built up.

In the wake of the first oil shock, the huge cash inflows generated, for the oil producing countries, by the rising oil prices (commonly called petro-dollars) were massively injected in the international financial market to be recycled. The upsurge in available capital provoked a fall of the nominal interest rates. Simultaneously, the expansionary monetary policy implemented by the United States in a context of accelerating inflation in developed countries created favourable conditions for Brazil and Turkey to attract foreign capital. In an attempt to stimulate the economic activity and attain full employment in a period of recession, the US prime rate, one of the nominal rates of reference on the international financial market, was brought down from 10.8% in 1974 to 6.8% in 1977 (Hermann, 2005b). The combined effects of a low nominal interest rate and accelerating inflation (from 8.8% in 1973 to 14% in 1980 in the US) resulted in negative real interest rates in developed countries and created a major incentive for international investors to look for higher returns in dynamic developing economies like Brazil and Turkey, which in turn were in need of capital inflows (Coes, 1995).

Taking advantage of this favourable context, both countries' governments adopted measures to preserve their attractiveness on the international financial market. The Turkish government established the "convertible Turkish Lira deposit" (CTLD), a system by which it allowed non-residents to open deposit accounts in Turkish commercial banks and provided them with a *"blanket protection against foreign exchange risk"* guaranteed by the Turkish Central Bank for both principal and interests (Rodrik and Celasun, 1990). With this scheme, effective from 1975 to 1977, all deposits in foreign currency received by the Turkish commercial banks were turned over to the Central Bank in exchange for the corresponding amount in Turkish Lira. This liability in Turkish Lira allowed commercial banks to expand credits to domestic firms while the foreign currency provided the Central Bank with a liability to finance public investments. When the payment of principal and interests was due, the Central Bank credited the Turkish commercial bank's account of the corresponding amount in foreign currency, hence entirely covering foreign exchange risks. Therefore, the CTLD scheme acted as a strong incentive not only for Turkish commercial banks but also for all private companies to compete to attract foreign deposits in order to extend domestic credit (Rodrik and Celasun, 1990). Likewise, Brazil's Central Bank maintained its nominal interest

rate higher than the international average so as to guarantee high returns to international investors. It also played a key role in guaranteeing access to foreign capital for domestic borrowers through two legal dispositions adopted during the PAEG facilitating the entrance of foreign loans. First, the Law 4131 passed in 1962 and amended in 1964 allowed final domestic borrowers to directly contract loans from foreign lenders after approval of the Central Bank. The Resolution 63, adopted in 1967 by the Central Bank authorized domestic commercial banks to obtain foreign loans and to grant domestic loans on the base of this amount after registering it in the Central Bank. Although the mechanism appears to be similar to the CTLD scheme in Turkey, the main difference is that the foreign exchange risk was not covered by the Central Bank, it was entirely born by the final borrower (Coes, 1995). From 1972 to 1981, capital inflows under Law 4131 and Resolution 63 represented an average of 77% of total capital inflows in Brazil.

From 1973 onwards, Brazil and Turkey received massive capital inflows and accumulated a huge external debt. In Brazil, the capital account surplus grew from USD 4.1 billion in 1973 to USD 11.9 billion in 1978. Consequently, the total external debt was multiplied by more than 5 between 1973 and 1982. It reached USD 40 billion in 1978, representing 25% of GDP and went up to USD 70 billion in 1982 (Fishlow, 1980). In Turkey, the amount of net foreign borrowing increased thirtyfold between 1973 and 1977, reaching USD 2.8 billion that year. And the total external debt represented 40% of GDP in 1978 (Dervis and Robinson, 1978). This easy access to foreign borrowing and the strategy of growing external indebtedness adopted by both countries' governments not only allowed to sustain economic growth but also contributed to postpone the adjustment to the new prices of oil. As pointed out by Cardoso and Fishlow (1990), *"borrowing could postpone the contractionary effects of the petroleum 'tax' and permit domestic expansion to proceed. (...) There was no imperative to cut back on consumption of energy or on other imports if the greater cost could be covered by borrowing."*

However, the borrowing scheme in both countries bore a high risk because foreign capital came mostly in the form short-term loans denominated in foreign currency, mostly US dollars in Brazil and Deutsche Mark in Turkey, and at floating interest rates. Both countries quickly found themselves engaged in an accelerating spiral of growing indebtedness which evolved from a *"growth-led debt model"* (Cardoso and Fishlow, 1990) to a *"debt-led debt model"* (Coes, 1995). Capital inflows were progressively dedicated more to debt-servicing obligations than to financing investments. In this context, Brazil and Turkey became increasingly dependent on foreign capital and therefore vulnerable to external shocks such as

a sudden loss of confidence of foreign investors in the country's solvency and a subsequent reduction of capital inflows or rising interest rates on the international financial markets. In fact, each country experienced one of those two scenarios by the end of the 1970'.

5.3.3.4 The accumulated external debt led both countries into a debt crisis which was managed in a very different way.

The spiral of external indebtedness in which Brazil and Turkey were both engaged led them to a severe debt crisis when capital inflows abruptly collapsed. Once again, the crisis came earlier in Turkey than in Brazil or in any other developing countries. As Rodrik and Celasun (1990) underline when they write that *"unlike practically all other newly industrializing countries experiencing debt difficulties, Turkey got into trouble after the first oil shock, rather than the second one."* Turkey plunged in a debt crisis in 1977 while Brazil did so after the Mexican default in August 1982.

Part of the explanation for Turkey's earlier crisis is to be found in the *"intrinsically destabilizing features"* of the CTLD borrowing scheme (Rodrik and Celasun, 1990). According to Rodrik and Celasun (1990), the CTLD scheme fuelled a spiral of over-borrowing as there was an inherent asymmetry between the risks and the benefits: it was driven by the private sector while the foreign reserves mostly served to finance public spending and the risk was entirely borne by the Central Bank. The authors explain below the intrinsic risk in the CTLD mechanism:

> *"The scheme not only subsidized foreign borrowing, it also made the level of subsidization directly proportional to the expected rate of depreciation of the lira and, hence, to the magnitude of the current exchange rate disequilibrium. The combination gave rise to a potentially explosive scenario: the CTLD scheme would engender over-borrowing as long as the lira was expected to depreciate against some major currency; the over-borrowing would then cause the present exchange rate to become (more) overvalued; this in turn would fuel expectations of further depreciation, further over-borrowing, and so on until foreign bankers would discover the transversality condition and refuse to play along."*

This is exactly what happened in July 1977 when foreign lenders refused to roll over existing credits or provide new capital. The external constraint suddenly reappeared as the current account deficit drained foreign reserves. By the end of the year, foreign reserves only amounted to one month of imports and commercial arrears reached USD 2 billion (Dervis and Robinson, 1978). The foreign exchange shortage pushed the Turkish economy in an external debt crisis and led the Turkish government to call the IMF for help in the beginning of 1978. Until January 1980, two unsuccessful stabilization plans were launched in a very unstable

political climate and under the supervision of the IMF. They were designed primarily to reduce the current account deficits by cutting down public spending. Although the current account deficit was substantially reduced from USD 3.4 billion in 1977 to USD 1.2 billion in 1979, this was made primarily by a reduction of investment and an accelerating inflation instead of nominal spending cuts (Rodrik and Celasun, 1990). The investment rate declined from 25% of GDP in 1977 to 18.5% in 1978 while fiscal deficits remained very high, at 7.9% and 8.9% of GDP in 1978 and 1979. After declining by 2.9% in 1978, real public spending grew again in 1979 and 1980 so that by 1979, the level of public expenditure had come back to its 1977 level. The result of this incapacity to reduce public spending was an acceleration of inflation from 24% in 1977 to 107.2% in 1980 and the subsequent failure of the several devaluations to boost export competitiveness.

Besides the failed stabilization plans, the three successive governments, in place between July 1977 and mid-1980, engaged in a comprehensive debt renegotiation with all creditors which, in turn, revealed extremely successful. In this process, Turkey benefitted from the early outbreak of its debt crisis and the fact that it was not competing with other countries for foreign help, as would be the case for Brazil (on which more below). Indeed, Turkey accounted for 69% of the total debt rescheduled between 1978 and 1980 (Rodrik and Celasun, 1990). Another key factor of success were the resuming international tensions in the context of the Cold War which, one again, played in favour of Turkey due to its strategic geographical position between Europe, the USSR and the Middle East. Turkey's economic difficulties were initially ignored by most Western countries as their diplomatic relations were dominated by the arms embargo imposed by the US after the invasion of Cyprus by the Turkish army in 1974. However, Turkey soon became the centre of the Western Block's attention when the stability of the Middle East broke down after the Iranian revolution and the fall of the Shah in early 1979. The *New York Times* perfectly summarized, in its January, 3rd of 1979 editorial, the switch in Western powers' perception of Turkey at that time: *"The strategic importance of Turkey is too great for Ankara's fate to be left in the hands of the International Monetary Fund and commercial banks abroad."*[19] In the same month, the Big Four (the US, West Germany, France and the UK) decided, during their Guadeloupe Summit, to launch a *"rescue operation"* which resulted in the agreement of OECD countries to grant a USD 1-billion emergency loan to Turkey in May 1979. This loan triggered a flow of foreign help from a broad range of international institutions including the European Investment Bank

[19] Found in Rodrik and Celasun (1990)

or even the Organization of Petroleum Exporting Countries (OPEC). The amounts of foreign medium and long-term loans granted to Turkey between 1979 and 1981 were unheard of. They represented double the amount of cumulated medium and long-term loans received between 1975 and 1978, during the external debt boom (Rodrik and Celasun, 1990).

Table 5.9 Economic performance of Brazil and Turkey during their respective debt crisis

Turkey	**1977**	**1978**	**1979**	**1980**	
GDP growth rate (% p.a.)	4.9	4.3	-0.6	-1	
Investment rate (% of GDP)	25	18.5	18.3	21.4	
Fiscal deficits (% of GDP)	10.6	7.9	8.9		
Inflation rate (% p.a.)	24.1	52.6	63.9	107.2	
Brazil	**1979**	**1980**	**1981**	**1982**	**1983**
GDP growth rate (% p.a.)	6.8	9.2	-4.3	0.8	-2.9
Investment rate (% of GDP)	23.4	23.6	24.3	23	19.9
Inflation rate (% p.a.)	77.2	110.2	95.2	99.7	211

Sources: For Turkey, Central Bank of Turkey, Rodrik and Celasun (1990). For Brazil, IBGE (2006).

Commenting on this massive inflow of foreign help to Turkey, the *Stuttgarter Zeitung* wisely titled in June 1979: *"Ecevit (Turkey's Prime Minister from January 1978 to November 1979) turned geography into dollars"*[20]. In parallel, this renewed international attention contributed to facilitate the debt renegotiation process which was successfully carried out until 1982 and concluded with very favourable conditions for Turkey. In total, nearly USD 10 billion of external debt, mostly short-term, was rescheduled from May 1978 to March 1982 with up to 5 years grace period (IMF, 1983). Therefore, the successive Turkish governments between 1977 and 1979, in spite of political instability, managed to renegotiate all the accumulated external debt before most developing countries plunged in their own debt crisis, among them Brazil. It is in this context that T.Özal, newly appointed as Finance Minister, launched an ambitious reform package involving the establishment of market mechanisms

[20] Found in Rodrik and Celasun (1990)

and trade liberalization in January 1980 which ensured a decade of strong economic growth and made Turkey an example of *"life after debt"* (Rodrik and Celasun, 1990).

As many other developing countries, Brazil experienced the acute phase of its external debt crisis in 1982, after the Mexican debt moratorium dried capital markets up for all Latin American countries. This time lag compared to Turkey is partly due to the fact that Brazil's borrowing scheme was not as inherently unstable as Turkey's CTLD scheme. As a result, Brazil could attract foreign capital until 1982 and delayed its external debt crisis. As pointed out by Coes (1995): *"Brazil was only country able to avoid an external payments crisis in the late 1970' because lenders were willing to finance debt service through further lending. After the Mexican crisis in 1982, Brazil's own crisis could no longer be postponed."*

Brazil's external debt situation was severely affected by the second oil shock in 1979 and even more by its negative consequences on the international financial market. By then, Brazil was much more vulnerable to an increase in international oil prices than in 1973, since it imported 86% of its total oil consumption, compared to 80% in 1973 (Studart, 2005). The impact of the oil shock can be observed in the upsurge of the value of imports by 28% between 1979 and 1980. However, the main impact of the oil shock on the Brazilian economy was indirect. It came from the shift towards restrictive monetary policy in the US and was channelled through the international financial market. With the appointment of P.Volcker as the head of the US Federal Reserve in August 1979, the struggle against the accelerating inflation replaced full employment on top of the institution's economic agenda. The US prime rate, which had remained extremely low throughout the 1970', was suddenly raised from 11.5% in August 1979 to 19.8% in April 1980, causing the real prime rate to jump from close to zero to nearly 10% per year over the same period (FED statistics). As Brazil's external debt was mostly contracted at floating interest rates indexed on the US prime rate or the Libor, its debt-servicing obligations soared. Interest payments on Brazil's external debt more than tripled from USD 4.2 billion in 1978 to USD 13.6 billion in 1982 (Coes, 1995). And in spite of the trade balance turning positive in 1981 and 1982, the current account deficit kept widening until reaching USD 16.2 billion in 1982 up from USD 7 billion in 1978. Although capital inflows continued increasing from 1979 to 1982, they were no longer sufficient to cover the current account deficit, implying a reduction of the foreign reserves from USD 12 billion in 1978 to USD 4 billion in 1982, then amounting to only 2.5 months of imports.

The impact of the external shocks was compounded by inadequate and unsuccessful economic policies adopted between 1979 and 1982. The economic policy choices made in this

period contribute to explain the delay in the unfolding of the debt crisis but also some of the difficulties experienced by Brazil until the end of the decade.

Table 5.10 Brazil's Balance of Payments 1979-1983
(in million USD)

Brazil	**1979**	**1980**	**1981**	**1982**	**1983**
Trade Balance	-2839	-2823	1202	780	6470
Imports	-18084	-22955	-22091	-19395	-15429
Exports	15244	20132	23293	20175	21899
Services balance	-7869	-9916	-13094	-17039	-13354
Current Account Balance	-10708	-12739	-11706	-16273	-6773
Capital Account	7624	9610	12746	12101	7419
Credit (short and long-term)	6107	7196	11720	5797	5918
Official Loans (IMF)	0	0	0	4177	-1481
FDIs	2210	1544	2315	2740	1138

Sources: IBGE (2006)

In March 1979, with the accession to the Presidency of J.B.Figueiredo, M.H.Simonsen, Finance Minister during the Geisel presidency, became Minister of Planning. Perceiving the worsening economic environment, he adopted a strictly orthodox economic policy mix designed to reduce the economic imbalances generated by a long decade of sustained economic growth, which he himself labelled as *"war economy"*. This plan included a restriction on fiscal and monetary policy, as well as a reform package aiming at enhancing the role of market signals, notably the exchange rate, and lessening controls over market mechanisms (Cardoso and Fishlow, 1990). But after the severe effects of the second oil shock on the economy, M.H.Simonsen lost political support, including among his peers in the government and resigned in August 1979. He was replaced by A.Delfim Netto, who was Finance minister during the "Brazilian miracle" (1968-1973) and promised to adopt a new policy of growth support amidst a world recession. Once again, the necessary adjustments were postponed in favour of economic expansion. A maxi-devaluation of 30% was implemented in December 1979 to boost exports and redirect domestic demand towards domestic goods. But this measure did not improve the trade balance as the acceleration of inflation from 40.8% in 1978 to 110.2% in 1980 quickly cancelled the real benefits of the

devaluation in terms of external competitiveness, and also because the growth of imports, notably due to the oil shock, compensated the subsequent growth of exports. Moreover, inflation was fuelled by the shortening of the indexation of wages from an annual to a biannual frequency (Hermann, 2005b). Another objective of A.Delfim Netto's supply-side approach was to stimulate the growth of the agricultural and energy sector through credits and subsidies (Cardoso and Fishlow, 1990). This was made through a reallocation of public funds from investments to operational expenses. Public investments were substantially reduced from a share of 40.2% of total investments between 1974 and 1978 to 28.8% in 1979 and 1980, while operational expenses remained at 22.5% of GDP (Hermann, 2005b). Hence, budget deficits remained high and had to be monetized, fuelling further inflationary pressures (Cardoso and Fishlow, 1990). Economic growth was indeed maintained at a high level of 9% in 1980, but arguably more as a result of the inertial effects of the investments realized during the II PND than as the direct result of a somewhat confusing set of economic measures adopted then (Hermann, 2005b). A quote from Lamounier and Moura (1986) reveals how inappropriate to the global economic context the policy intended in 1979-1980 by A.Delfim Netto was and in which mind-set the Brazilian policy makers were at that time:

> *"The monumental failure of that heterodox experiment of economic policy can, in part, be explained by the attempt to implement a strategy of economic growth without consideration for the accentuated deterioration in the conditions of the international economy in 1979 and 1980. (...) It cannot be said, however, that there had been a generalized inability, among the government technocrats, to interpret the unequivocal signals of economic difficulty arising from the international economy. The predominant attitude was to try to exorcize such ghosts with the optimistic rhetoric inherited from the years of the Brazilian miracle."*

The heterodox adjustment attempted by A.Delfim Netto was abandoned in 1981 in favour of an orthodox adjustment emphasizing restrictive fiscal and monetary policies in order to reduce domestic absorption. High real interest rates severely curbed monetary expansion and contributed to provoke the deepest recession since the Great Depression, with a contraction of GDP by 4.3%, as well as to pull inflation down to 95.2% from 110% in 1980. These measures convinced foreign investors to renew their exposure to Brazil stimulating a new wave of USD 13 billion short-term capital flows which fuelled rising investments (to 24.3% of GDP in 1981) and financed persistently high fiscal deficits, reaching 8.5% of GDP in 1982. This strange mix of recessive stabilization objectives with persistent debt-led expansion of spending was also judged inadequate and drew harsh criticisms, notably from Cardoso and Fishlow (1990) who wrote:

"The primary effect of the recession was to unloose a new flow of capital from commercial banks, placing Brazil further in debt. Instead of conceding the need for more fundamental changes and then implementing such changes, Delfim's primary stabilization objective was to retain international creditworthiness and avert a liquidity crisis. (...) Brazil lacked a program of real adjustment or coherent strategy for coping with its expanding, and increasingly short-term and interbank, debt. (...) It was a poor recession, just as the preceding period had been a false prosperity."

Despite experiencing balance of payments deficits since 1979, the Brazilian government insisted on its ability to manage the situation alone until the Mexican government declared a debt moratorium in August 1982 and consequently closed the international capital market for all Latin American countries, spreading the debt crisis throughout the continent. From 1981 to 1982, capital flows entering Brazil more than halved and the Brazilian government then resorted to request a loan from the IMF, at the peak of the developing countries' debt crisis. An emergency loan was granted after the agreement was signed in December 1982 (Hermann, 2005b), accompanied by much harsher conditions as compared to the way Turkey was treated between 1979 and 1981 (Rodrik and Celasun, 1990).

5.3.4 Concluding remarks

The borrowing scheme adopted by the two countries acted as a temporary painkiller after the first oil shock and even the second one for Brazil. It allowed both countries to alleviate the balance of payments constraints and to maintain economic growth through a last wave of import-substitution industrialization, independently from the structural changes occurred in the international economic environment. However, this spiral of external indebtedness also exposed Brazil and Turkey to growing imbalances and risks as soon as capital inflows dried up. This last episode of import-substitution industrialization led the model to its exhaustion. What made the difference between Brazil and Turkey is the timing of their debt crisis and the way both governments managed it.

The deeply unstable Turkish borrowing scheme led the country to an early debt crisis in mid-1977, which paradoxically contributed to facilitate the conclusion of the debt renegotiation process before the major debt crisis of 1982 in developing countries. The huge inflow of foreign help and the especially clement debt rescheduling conditions from which Turkey benefitted between 1979 and 1982 created a favourable environment for the introduction of a comprehensive reform package in January 1980 by T.Özal. By contrast, the stabilization and reform attempt of M.H.Simonsen in 1979 in Brazil was discarded and

replaced by another episode of heterodox policies focusing on economic growth, postponing the necessary adjustments and only delaying the crisis. In a repeated scenario of the end-of-1950' payment and debt crisis, the Brazilian economy ended up paying a higher price for a protracted unbalanced economic growth. The large external debt and economic imbalances generated by the II PND worsened after 1979 and were left to be dealt with as a generalized debt crisis hit most highly-indebted developing countries. This diverging management of a very similar external debt crisis decisively impacted the economic performance of both countries in the 1980' and their diverging ability to engage in the necessary economic reforms.

5.4 1980-2000': Drifting apart in the process of economic liberalization and stabilization until a last crisis at the turn of the 21st century

The major external debt crisis in which Brazil and Turkey plunged at the end of the 1970' made it clear in both countries that the inward-looking ISI model which had prevailed since the 1930' had definitely reached its limits. The immediate challenge for the Brazilian and Turkish governments to curb the disastrous impact of the crisis on the economy and proceed to the adjustments that had been delayed throughout the 1970' did not come alone. This time, it was sensed that a successful stabilization plan would certainly not be sufficient to launch a new cycle of sustained economic growth. Structural reforms had to be implemented to put the Brazilian and Turkish economies on a new growth path. In Turkey, Dervis and Robinson (1978) were predicting, just after the Turkish economy entered its debt crisis, that: *"it is economic policy and internal reform that must pull Turkey out of the crisis. Very important strategy decisions have to be made and priorities determined."* This also held true for Brazil in 1983. In both countries, these structural reforms would involve a gradual shift towards freer market mechanisms in the economy and a progressive integration to the international markets.

Over the last two decades of the 20th century, Brazil and Turkey went through a similar process of economic stabilization and liberalization. But the two countries went at a different pace through this process, both experiencing alternatively a decade of unsuccessful stabilization characterized by recurrent macroeconomic imbalances and erratic growth. However, despite following diverging paths, Brazil and Turkey were finally both dragged into a last major crisis at the end of the 1990' after undergoing repeated external shocks caused by the sequence of financial crises in developing countries from the mid-1990' onwards. The

sustained stabilization efforts that followed completed the reforms initiated throughout the two previous decades and allowed both countries to experience strong and stable economic growth in the following years.

The reform process under way in the Brazilian and Turkish economies in the two decades under scrutiny in this last section is not restricted to the economic model. It also affected both countries at a deeper layer, at the level of their economic and political institutions. These are examined in details in the next chapter. For this reason, the last sections of both chapters are closely articulated and intend to illustrate the relevance of the interaction between economic and political institutions on one side and economic performance on the other side.

5.4.1 1980': Turkey designed in a new economic model while Brazil failed to stabilize its economy

As explained in the previous section, the immediate economic policy response to the external debt crisis substantially differed in both countries. The diverging circumstances driving Brazil and Turkey into the crisis combined with geopolitical considerations contributed to determine the different treatment that external lenders reserved to Brazil and Turkey. The conditions of the debt renegotiations and the subsequently distinctive burden of the external constraint throughout the 1980' played a decisive role in shaping both countries' governments' leeway to design economic policy. Independently from specific institutional characteristics, examined in the next chapter, this stands among the main drivers behind the diverging paths followed by both countries in the decade following their external debt crisis: while Turkey, flooded with foreign help, quickly stabilized and experienced recovery thanks to early structural reforms; Brazil got bogged down in a lengthy and constraining debt renegotiation process which contributed to doom stabilization efforts and did not provide space for reforms, underlying the so-called "lost decade".

5.4.1.1 The diverging conditions of both countries' debt renegotiations largely contributed to determine the success or failure of their early stabilization efforts.

The long grace period for external debt repayment and the massive external financial help granted to the Turkish government from the end of 1979 onwards suddenly alleviated the heavy external constraint on the economy which had compromised all previous stabilization attempts. These favourable conditions released the pressure on Turkey's balance of payments as the Turkish economy was not anymore required to generate surpluses to serve the external

debt. On the contrary, more than USD 2 billion of net transfers flowed in Turkey from 1980 to 1985 and outflowing transfers abroad only started significantly after 1985 (over 1% of GDP), which meant that Turkey was granted up to eight years of relative grace period before actually repaying its external debt (Rodrik, 1990).

By contrast, as pointed out by Çeçen *et al.* (1994), *"none of the Latin American countries benefitted from external financial support commensurate with the one Turkey managed to receive during this period."* Indeed, Brazil was imposed much stricter debt rescheduling conditions by international creditors. In stark contrast with Turkey, Brazil was not granted any grace period but put instead under pressure to generate net transfers abroad immediately. The IMF bailout loan negotiated in December 1982 was conditioned on the achievement of a USD 6-million trade surplus already in 1983. As a result, by the end of 1984, only two years after the official default on its external debt, Brazil's current account was slightly positive, up from a USD 16-billion deficit in 1982. To compare, this was only achieved in 1988 in Turkey. Moreover, interest payments by 1983 and 1984 represented about half of total exports (Cardoso and Fishlow, 1990). In these conditions, the debt renegotiation process engaged in 1982 advanced slowly and was strictly subjected to the capacity of the Brazilian economy to bear the weight of its external debt-servicing obligations.

As previously mentioned, the weight of the external constraint, released in Turkey while maintained in Brazil, largely contributed to determine the fate of the adjustment measures launched by both governments in the first half of the 1980'. The Turkish government was given generous leeway to launch adjustment reforms redesigning the economic model and achieved a nearly immediate stabilization; whereas the permanent external constraint doomed the stabilization efforts undertaken by the Brazilian government.

After two unsuccessful stabilization attempts until 1979, Finance Minister T.Özal launched a first reform package not only targeting the stabilization of the economy through an adjustment of internal demand under the effect of a liberalization of relative prices but also targeting, simultaneously, a reorientation of the Turkish economy towards international markets and a quick return to economic growth led by exports.

From January 1980 onwards, most prices were liberalized and adjusted upwards. The Turkish Central Bank raised the base interest rate and left the determination of other interest rates to market mechanisms. In parallel, price-setting mechanisms in the private sector were scraped after the suppression of the Price Control Committee. SOEs were also allowed to set selling prices according to their costs and price support mechanisms, notably to agricultural commodities, were abandoned (Aktan, 1997). Finally, the Turkish Lira was devalued by

nearly 50% in 1980 and then at an annual average rate of 4% between 1981 and 1988 within a crawling peg (Rodrik, 1990). In addition to these price adjustments, a restriction on domestic credit creation by the Central Bank and a tax reform designed to increase fiscal revenues, notably through the introduction of a Value Added Tax, also contributed to the contraction of domestic absorption and to the reduction of the fiscal deficits.

Table 5.11 Performance of the Turkish economy 1980-1988

Turkey	1980	1981	1982	1983	1984	1985	1986	1987	1988	1980-1988 average
GDP growth (% p.a.)	-1.1	4.1	4.5	3.3	5.9	5.1	8.1	7.4	3.4	4.5
Exports (in current million USD)	2910	4703	5746	5728	7133	7958	7457	10190	11662	17.8*
Current Account balance (% of GDP)	-5.5	-3.5	-2.1	-3.5	-2.8	-1.9	-2.6	-1.4	2.1	-2.4
Inflation (% p.a.)	107.2	36.8	25.2	30.6	52	43.4	29.4	32	68.4	47.2
fiscal balance (% of GDP)	-3.3	-0.8	-2	-2.6	-4.2	-1.7	-1.2	-3.9	-3.6	-3.1

Sources: Central Bank of Turkey, Rodrik (1990)

The alleviation of the external constraint played a major role in the success of these stabilization measures since it considerably reduced the need for the Turkish government to resort to inflationary fiscal policies to finance external debt payments, by-passing the classic transfer problem (Rodrik, 1990). In the absence of such heavy external debt payments, total public deficits (including SOEs accounts) were reduced from 10% of GDP in 1980 to 5.4% in 1981, even though a system of generous export subsidies was set up and public investments maintained. As a result, inflation dramatically declined from 107% in 1980 to 25% in 1982 while economic growth bounced over 4% in 1981 and 1982. The unwavering support of international creditors and institutions like the IMF was crucial to ensure the success of the Özal government's economic reforms. It allowed the Turkish economy a rather painless stabilization and the possibility to start redesigning the foundations of its economic model with a quick success in terms of economic growth.

In Brazil too, price adjustments and stabilization efforts were implemented in the wake of the external debt crisis, in 1983 and 1984. But, by contrast with Turkey, they were unsuccessful in curbing inflation, largely because of the pressure that the much stricter debt

renegotiation conditions put on the Brazilian economy in general and on fiscal policies in particular.

Table 5.12 Economic performance of Brazil between 1982 and 1988

Brazil	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**
GDP growth (% p.a.)	0.8	-2.9	5.4	7.8	7.5	3.5	-0.1
Inflation (% p.a.)	99.7	211	223.9	235	65	415	1037
Exports (in current million USD)	20175	21899	27005	25639	22349	26224	33789
Current Account Balance (in current million USD)	-16273	-6773	95	-248	-5323	-1438	4180

Sources: IBGE (2006), Abreu (2008).

The stabilization measures implemented by the Brazilian government were somehow similar to the ones undertaken by the Özal government in Turkey. The domestic currency was also devalued by 30% in 1983 to boost exports and strict monetary policy led to the contraction of the money supply and domestic credit, by 36% and 26% respectively. Additionally, restrictive fiscal policies were adopted, also through the upward adjustment SOEs' selling prices and the suppression of public subsidies. However, these efforts to contain fiscal imbalances systematically failed due to the rising interest payments on external debt. In spite of an increasing primary fiscal surplus in 1983 and 1984 (from 1.7% to 4.2%), the nominal fiscal deficit kept growing, from 13.3% in 1981 to 24.6% in 1984 (Hermann, 2005). In the meantime, debt renegotiations stalled. Between 1982 and 1984, seven Letters of Intent were exchanged between the IMF and the Brazilian government, mostly to revise the targets of fiscal deficit that the Brazilian government could not meet. The failure of the stabilization measures materialized in the rising inflation in the following years, from 99.7% in 1982 to 235% in 1985. As Cardoso and Fishlow (1990) highlighted, *"improving the external accounts had become an important source of internal disequilibrium."* Brazil remained in this trap of the external constraint throughout the 1980', justifying its name of "lost decade".

5.4.1.2 This initial success or failure of the stabilization efforts determined the diverging economic policy choices of both countries in the rest of the decade.

The success of the stabilization in Turkey allowed the Özal government to move further in the structural reforms transforming Turkey's economic model. In reverse, the struggle against inflation remained at the forefront of Brazilian governments' policy agenda throughout the decade, turning *de facto* unfeasible structural reforms until the late 1980'.

The quick stabilization and return to economic growth provided Turkey with what L. Taylor (1990) called a *"long leash"*, in other words a window of opportunity to implement economic reforms that no other highly indebted developing country was given in the 1980'. After the parliamentary elections organized by the military regime in November 1983, T.Özal became Prime Minister and launched a second round of measures continuing the profound overhaul of the economic model. The trade regime was gradually liberalized with the introduction of a New Import Regime in 1983. The number of products subject to import licenses went down from 821 in 1983 to 16 in 1989 and the number of import prohibitions was drastically reduced from 224 in 1984 to 4 in 1986 (Aktan, 1997). In addition, capital flows were also facilitated by the liberalization of the foreign exchange regime from 1984 onwards and incentives given to attract Foreign Direct Investments. Besides structural reforms, the government continued sustaining the economic activity through increased investments. The level of domestic investment was maintained and even increased throughout the decade from 18.3% of GDP in 1979 to 25.4% in 1987, mostly supported by rising public investments, from 9.5% to 13.3% over the same period (Rodrik, 1990).

In reverse, the Brazilian economy remained constrained until the end of the decade by the burden of its debt servicing obligations. Consequently, it fell in a spiral of increasing public indebtedness and accelerating inflation which contributed to render all stabilization plans chronically unsuccessful, provided no space to implement economic reforms and gradually threatened long-term growth. In addition to the heavy burden of the external constraint, the mechanism of indexation applied to wages and prices since the end of the 1960' was the other main reason explaining the chronic failure of stabilization attempts throughout the 1980'. Inherited from the PAEG (1964-1967), this mechanism will be examined in the next chapter as it constituted one of the main economic institutions of the ISI model in Brazil. The focus in this chapter is on the decisive role that the external debt played during the decade in the chronic failure of stabilization efforts.

Unlike Turkey, Brazil' external debt obligations kept increasing after 1982 as the debt renegotiations stalled and the government resorted to increasing public indebtedness. Foreign interest payments represented 5% of GDP in 1984 and 1985 and remained high until the end of the 1980' (Batista, 1987). From 1985 to 1989, annual trade surpluses averaging USD 13.4 billion did not even cover interest payments amounting to USD 13.9 billion per year (Barros de Castro, 2005a). To finance the outflowing transfers required by international creditors, Brazilian governments, which owned 80% of the external debt, resorted to increasing internal and external indebtedness, fuelling rising interest rates on the domestic capital market and subsequently increasing the weight of the interest payments. Between 1982 and 1985, the domestic debt was multiplied by 56 in nominal cruzeiros and the external debt reached USD 103 billion in 1988, up from USD 70 billion in 1982 (Coes, 1995). This spiral of growing indebtedness and interest payments put the successive Brazilian governments in a continuous struggle to avoid another debt crisis and economic collapse while their top priority remained to contain inflation (Studart, 2005). The unorthodox stabilization plans launched from 1986 onwards not only failed at taming the inertial inflation but also generated an acceleration of inflation and an overshooting of interest rates after each failure. In 1987, after the failure of the Plano Cruzado, the increasing interest payments led Brazil in a second debt crisis when the government declared a moratorium on its foreign debt interest payments. Inflation was reaching 1037% in 1988.

In this context of chronically unsuccessful stabilization, the Brazilian governments were not given any leeway to engage in the necessary reforms of the ISI model. In this regard, the role of international institutions such as the IMF was very different in Brazil than in Turkey. While it contributed to create the conditions for the implementation of structural reforms in Turkey and supported them; in Brazil, *"especially after the 1982 debt crisis, financial objectives were dominant and pressures by international organizations, such as the IMF, to implement trade liberalization were really rather modest"* (Abreu, 2004b).

Finally, the massive net transfers abroad imposed on the Brazilian economy represented a drain on its resources that affected primarily the level of investment and subsequently compromised its long-term growth prospects. Indeed, the investment rate dramatically fell from an average of 23% of GDP between 1975 and 1981 to 19% between 1983 and 1986 (IBGE, 2006). On the one hand, this was the result of restrictive fiscal policies for which public investments were slashed. They represented only 27% of total investments in 1984 compared to 40% in 1974-78. In fact, public investments were the first target for the reduction of public spending and their reduction was made under pressure. They were not cut

methodically based on the level of expected return but across the board so that many public projects were stopped in the middle of their implementation (Batista, 1987). This affected particularly public infrastructure which quickly deteriorated due to underinvestment throughout the 1980' and caused productivity to decline (Cardoso and Teles, 2010). The backwardness in infrastructure development, still observable in Brazil today, largely dates back from this period. On the other hand, investments in the private sector were also reduced as a result of the crowding out of private actors on domestic capital markets and the subsequently rising interest rates (Coes, 1995). The lack of private investments also had a negative impact on the economic activity. It led, for instance, to the contraction of the production of capital goods by 30% between 1980 and 1990 (Barros de Castro, 2005b).

In this regard again, the conclusion of the debt renegotiations process and the reduction of net transfers abroad were identified by Batista (1987) as the determining factors for a return to a sustainable level of investment and growth. Cardoso and Fishlow (1990) came to the same conclusion as to the level of inflation underlining that *"debt relief would have permitted smaller trade surpluses for interest service and would have provided a buffer against resumption of higher inflation rates."* In sum, the net transfers demanded by international creditors to settle Brazil's external debt came at too high for the Brazilian economy to achieve stabilization during the 1980'. Complying with these demands implied persistent fiscal imbalances, which were the cause of the prolonged debt renegotiation process, accelerating inflation and a mortgage on future growth.

5.4.1.3 Two common features in terms of economic policies and performance in the 1980'

In spite of the diverging external constraints and subsequent economic policy orientations throughout the decade, two common features can be identified in terms of economic performance and macroeconomic management between Brazil and Turkey. First of all, both countries experienced a boom of exports in the 1980', although it did not occur for the same reasons. It resulted from a reorientation of the economic model implemented by design in Turkey whereas in Brazil, it was the result of a constraint to generate net foreign transfers.

In Brazil, exports grew much faster than GDP between 1982 and 1989, by an annual average of 6.8% compared to 3.1% for GDP. This stemmed from the combination of temporary and structural changes. On the one hand, the devaluation of the cruzeiro in 1983 provided an initial stimulus to the export sector. And, on the other hand, it was an outcome

and a sign of success of the last development plan, the II PND launched in 1974, which promoted manufacturing activities. It is precisely the manufacturing which provided the bulk of the export growth since it represented 56% of exports in 1984 compared to 23% in 1973 (Hermann, 2005b). Nevertheless, as explained before, such growth was guided by the pressure imposed on the Brazilian economy to run trade surplus and generate net transfers abroad more than by a reorientation of the economic model shaped by adequate economic policy choices (Batista, 1987). Conversely, this is what happened in Turkey and what fuelled the export-led growth that the country experienced in the 1980'. Indeed, exports were multiplied by 5 in nominal value from 1980 to 1988 and went from 2.6% of GDP in 1979 to 8% in 1990. Manufacturing exports also quickly grew until representing 80% of total exports in 1985, up from 36% in 1980 (Çeçen, Suut Dogruel, Dogruel, 1994). Illustrating the magnitude of such change, this new economic model stimulated what Pamuk (2008c) qualified as a third wave of industrialization, mainly located in the centre of Anatolia and composed of medium-sized manufacturing companies serving primarily foreign markets. In fact, the strong growth of exports observed in Brazil and Turkey did not stem from the same conditions and when analysed, contribute to reveal the diverging paths followed by both countries.

Another similarity between the two countries in terms of economic management is the relaxation of economic policy discipline in the second half of the decade. Interestingly, this corresponded in both countries to the progressive return to democratic rule, which officially began in 1985 in Brazil and in 1983 in Turkey.

In Brazil, the second half of the 1980' was characterized by a weaker commitment to orthodox stabilization program and a deterioration of macroeconomic performance. The return to democratic rule in 1985 coincided with loosening ties with the IMF and a progressive reorientation of the stabilization efforts. From 1985 onwards, Brazilian governments became less inclined to engage in the orthodox adjustments recommended by the IMF that had proven both costly and unsuccessful. This new strategy was notably encouraged by the large foreign reserves accumulated thanks to the surge in exports which provided some confidence that the external constraint was temporary alleviated. Heterodox stabilization plans adopted from 1986 to 1992 moved away from restrictive economic policies and focused on the inertial component of inflation. The repeated failures of those plans fuelled inflationary pressures and led to persistent problems of fiscal deficits. By the end of the decade, inflation had reached a peak of 1783% in 1989 and operational public deficit reached 7% in 1989 compared to 3% in 1984. In fact, chronic fiscal deficits contributed to the

failure of the stabilization plans by contributing to generate the excess demand which fed inflationary pressures (Barros de Castro, 2005a).

In Turkey too, the initial efforts to reduce macroeconomic imbalances were progressively abandoned. The necessary adjustment and stabilization of the economy, only halfway achieved in the beginning of the decade with significant external financial help, were never completed (Rodrik, 1990). Total public deficits (including SOEs) remained at the level that they reached in 1981, at around 5-6% of GDP (a level comparable to the period preceding the external debt crisis, between 1973 and 1976) until the end of the decade (Akyüz and Boratav, 2003). These fiscal imbalances were partially financed through external debt, which grew from 26% of GDP in 1981 to 53% in 1988, but also increasingly through domestic lending (Özatay, 2000). The share of public deficits covered by domestic debt came up to 80% in 1988, causing related interest payments to triple between 1985 and 1988 (Rodrik, 1990). Although Turkey benefitted from much more favourable debt renegotiation conditions than Brazil, the level of public indebtedness did not decline. Instead, just like in Brazil, the recourse to domestic debt progressively replaced external debt. Inflation in Turkey remained persistently higher than initially targeted, at an annual average of 40.5% from 1981 to 1988. Even though much lower and more stable in Turkey as compared to Brazil, inflation in Turkey actually shared, by the end of the 1980', some characteristics with Brazilian inflation in terms of inertia: ingrained inflationary expectations and informal system of price adjustments to external shocks were also feeding back into inflationary pressures (Rodrik, 1990). The persistence of such macroeconomic imbalances led Rodrik (1990) to draw a severe appraisal of the decade writing that: *"it is now clear that the opportunity afforded by the favourable conjuncture in the early 1980' was missed."* It is in this context of failed stabilization that the Özal government made the decision to liberalize the capital account in 1989, conceived as a way to attract foreign capital to finance public debt and stimulate economic growth.

In conclusion, in spite of a radically different treatment from international creditors and subsequently diverging economic paths throughout the decade, Brazil and Turkey both found themselves, at the turn of the 1990', with a failed stabilization and persistent macroeconomic imbalances. This mostly resulted from an absence of economic policy space given to Brazil as opposed to a missed opportunity in Turkey. In both cases, besides the external constraint, domestic dynamics also played a major in the choice of economic policies and the poor results achieved. This will be analysed in the next chapter.

5.4.2 1990': The decade of reform and stabilization in Brazil as opposed to the "lost decade" of the Turkish economy.

In the 1990', the roles seemed to be inverted between Brazil and Turkey when compared with the previous decade. A wave of structural reforms were gradually implemented in Brazil and paved the way for an eventual stabilization of the economy. In the meantime, Turkey plunged in a decade of chronic instability characterized by disastrous economic policies and boom-and-bust cycles. In the second half of the decade, both countries' paths met again in the mayhem of the repeated international financial crises to which they had become particularly vulnerable after the liberalization of their capital account. Driven into a last major financial crisis in the end of the 1990', both seized the opportunity to complete the stabilization and liberalization processes started in the previous two decades and propel their economies in a cycle of stable growth.

5.4.2.1 Debt renegotiation and trade liberalization opening the way for a successful stabilization in Brazil

After a decade of unsuccessful stabilization plans, Brazilian policy makers were resolute to initiate structural reforms of the economic model (Abreu, 2004b). With the election of F.Collor de Melo for the Presidency in 1989, Brazil finally took the reform bend analogously to what happened in Turkey with T.Özal from 1980 onwards. Under F.Collor de Melo's short tenure (1990-1992), the liberalization of the Brazilian economy and the debt renegotiation process were considerably pushed forward. Although F.Collor de Melo's two unorthodox stabilization plans completely failed, the two structural processes initiated had a decisive impact on the future performance of the Brazilian economy as they laid the basis for the successful stabilization plan launched by Cardoso in 1994.

The reform process was initiated through the gradual liberalization of the trade regime. Initiated in 1988 with a reduction of the average tariff (weighed by added value) from 67.8% that year to 37% in 1990, it was dramatically intensified from 1990 onwards when the Collor government undertook to overhaul the country's trade policy and further reinforced by the signature of the Treaty of Asuncion in 1991 foreseeing the creation of the Mercosur by 1994. It took the form of a reduction of all non-tariff barriers, notably import prohibitions and licensing system dating back to 1947. The average tariff was progressively taken down to 10.4% in 1995. This gradual reduction of import tariffs was meant to stimulate local producers, allowing them to adapt to international markets (Barros de Castro, 2005b). This shift in trade policy was also reflected in the new stance adopted by the Brazilian government

on the international scene. For the first time, Brazil played a proactive role in the international trade negotiations, notably on issues related to agricultural products, in a meeting held in Brussels in November 1990 as part of the Uruguay Round (Ricupero, 1993).

Another significant turn in Brazil's economic policy was the new and finally conclusive momentum given to the debt renegotiation process with the initiative launched in 1991 by the Brazilian government to proceed within the framework of the Brady Plan (Abreu, 2008b). After a decade of arduous and repeatedly suspended negotiations, a final agreement was reached with the IMF and international creditors in 1993, settling the bulk of Brazil's external debt and eventually alleviating the heavy external constraint weighing on the Brazilian economy. As a matter of comparison, this external debt agreement resembled, in relative magnitude, the one achieved in 1943 rescheduling the massive debt accumulated in the 1930' (Abreu, 2008a).

The progressive liberalization of the Brazilian economy and the conclusion of the debt renegotiation process created favourable conditions to finally achieve the stabilization of the economy. This came with Cardoso's nomination to the Ministry of Finance in May 1993 and the successful implementation of the Real Plan (Plano Real) in the following months. The success of the Real Plan was largely explained by the new approach to achieve stabilization, benefitting, in that, from the lessons of the past failures (Barros de Castro, 2005a). On the one hand, the innovation of the Real Plan stemmed from the emphasis on fiscal adjustment and monetary restriction as a condition for the stabilization of the economy. The Plano Real was built on different a diagnosis of the Brazilian inflation as compared to its predecessors in that it recognized the impact of economic policy imbalances on the inflationary spiral and reintroduced elements of fiscal and monetary orthodoxy. On the other hand, the designers of the Real Plan also recognized the inertial character of the Brazilian inflation implied by the indexation mechanism and relied on a new solution engineered to meet the challenge of the desindexation of the Brazilian economy[21]. It was this combination of orthodox and heterodox policies which ensured the success of the Plano Real in stabilizing the Brazilian economy.

The return to fiscal and monetary orthodoxy came as the first step of the plan. Fiscal adjustments were implemented as soon as Cardoso became Minister of Finance with the launching of the Immediate Action Plan (*Plano de Ação Imediata*) in May 1993. The plan included structural reforms of the patterns of public spending, new taxes and the launching of a Social Emergency Fund. These measures allowed a very quick and substantial reduction of

[21] Detailed in the next chapter.

fiscal deficits from 44.2% of GDP in 1994 to 7% in 1995 (with a primary surplus of 5.2% of GDP more than doubling from 1993 level of 2.3%). Although not leading to fiscal equilibrium, this considerable improvement of fiscal balance laid the basis for the success of the second and decisive phase of the Real Plan: the desindexation of the economy. This step was effectively implemented between March and June 1994 and permitted to taper inflation from 47% in June 1994 to 1.5% in September 1994. In the following months and years, economic policies strove to preserve the Real Plan's major achievement, namely keep inflation low. For this purpose, specific attention was paid to the stability and credibility of the Real, the new currency introduced by the plan, closely monitored through an initial exchange rate peg with the US dollar and a tight monetary policy maintaining the prime rate (Selic) at a high level of about 20% p.a. The recently liberalized trade policies also played an important role to control inflationary pressures. A surge in imports, increasing by 51% in 1995 and by 21% annually between 1995 and 1997, provided the additional supply to respond to the rising demand emerging as a result of the positive effect of the sudden reduction of inflation on the purchasing power of most Brazilians. Hence, trade policies were instrumental in alleviating inflationary pressures appearing in the domestic market. The combined effects of these economic policies guaranteed that inflation continued on a downward slope in the years following the end of the Real Plan. From 14.8% in 1995, inflation was further reduced to 1.7% in 1998 (Barros de Castro, 2005a).

The sustained stabilization of the Brazilian economy stimulated investments, notably attracting foreign investors, and led to a return to economic growth. After a recession of 1.2% annually between 1990 and 1992, the success of the Real Plan restored foreign investors' confidence and spurred a massive inflow of investments boosting economic growth. Portfolio investments increased fourfold between 1993 and 1994, going from USD 12 billion in 1993 to USD 50.6 billion, and were accompanied by a sustained growth of Foreign Direct Investments from USD 799 million in 1993 to USD 30.5 billion in 2000. As a result, the Brazilian economy experienced a cycle of strong and sustained economic growth of an annual average of 4.2% between 1993 and 1997.

However, in spite of the successful stabilization and economic policy efforts to preserve it, the second half of the 1990' was also characterized by growing macroeconomic imbalances which contributed to weaken the Brazilian economy. Although considerably reduced during the Real Plan, fiscal imbalances persisted and even deepened in the following years. The primary fiscal balance went from a surplus of 5.2% of GDP in 1994 to a deficit of 1% in 1997, leading to a substantial rise in gross public indebtedness from 30% of GDP to

48.7% in 1998. Likewise, the surge of imports as well as increasing interest payments and profit remittances drove the current account into a large deficit, growing from USD 676 million in 1993 to USD 33.4 billion in 1998.

Table 5.13 Performance of the Brazilian Economy 1993-1999

Brazil	1993	1994	1995	1996	1997	1998	1999
GDP growth (% p.a.)	4.9	5.9	4.2	2.7	3.3	0.1	0.8
Inflation (% p.a.)	2708.6	916.2	14.8	9.3	7.5	1.7	8.9
Nominal fiscal deficits (% of GDP)	27.8	44.2	7.3	5.9	6.1	7.5	5.8
Public debt (% of GDP)	27	30	30.1	33.3	34.3	41.7	48.7

Sources: IBGE (2006), IMF World Economic Outlook Database October 2013

5.4.2.2 In Turkey, the 1990' were characterized by a deterioration of economic policy-making and increasing economic imbalances.

In contrast with Brazil, the 1990' were considered Turkey's "lost decade" or "decade to forget" (Pamuk, 2008c), characterized by protracted economic imbalances inherited from the failure to stabilize the economy and increased by the liberalization of the capital account (Rodrik, 1990). The continuous deterioration of the economic situation in Turkey was accompanied by rising fiscal deficits and inflation combined with boom-and-bust cycles following the volatile international capital flows and high current account balance. This situation was closely linked to the instability of Turkey's political system and to the weakness of its political and economic institutions, which considerably undermined economic policy making by favouring short-sighted policy choices[22].

Throughout the 1990', fiscal imbalances substantially increased as the Turkish economy became increasingly connected to international financial markets and its domestic capital markets expanded. Turkish governments progressively engaged in a spiral of rising public indebtedness fuelled by chronic fiscal deficits and rising interest payments mostly financed by short-term capital flows ("hot money"). By the end of the decade, nominal fiscal deficits reached 24% of GDP as interests on the public debt absorbed up to 77% of fiscal

[22] Detailed in the next chapter.

revenues (Boratav and Yeldan, 2001). In parallel, the public debt grew from 28.8% of GDP in 1990 to 59% in 2000.

Table 5.14 Performance of the Turkish economy 1990-1999

Turkey	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Average 1990-1999
GDP growth (% p.a.)	9.3	0.9	6	8	-5.5	7.2	7	7.5	3.1	-4.7	3.9
Current Account balance (% of GDP)	-1.7	0.1	-0.6	-3.6	2.2	-1.5	-1.3	-1.3	1.1	-0.9	-0.8
Inflation (% p.a.)	60.3	66	70.1	66.1	106.3	93.7	82.3	85.7	84.6	64.9	78.0
Fiscal balance (% of GDP)	-7.6	-11.3	-12.4	-13.1	-10.2	-6.4	-13.2	-13.1	-15.9	-24.5	-12.8

Sources: Central Bank of Turkey, Akyüz and Boratav, 2003

Taking advantage of the liberalization of the capital account, the Turkish government adopted a policy consisting in maintaining interest rates at a high real level on Treasury bonds to attract foreign short-term capital flows. Between 1992 and 1999, the average annual interest rate paid on Turkish government bonds was of 32% in real terms. Logically, these high interest rates offered by the Turkish Treasury also attracted a growing share of domestic capital creating a phenomenon of crowding out comparable to what happened in Brazil in the 1980'. The portion of public debt funded in the domestic capital market kept increasing from 9.4% in 1993 to 41.4% in 1999 and government bonds represented 23% of total financial assets in 1999, up from 10% in 1990 (Bakir and Önis, 2010). In fact, Treasury bonds became the main source of profits for the major industrial groups in Turkey which reserved an increasing share of their working capital to purchase government debt (Boratav, 2007). The share of financial profits in the total net profits of Turkish major companies jumped from 33% in 1990 to 219% in 1999 (Yeldan, 2001). The financialization of the Turkish economy led and encouraged by the government diverted many resources from productive investments and increased the level of risk, notably through the high exposition to both public debt and foreign capital flows born by the Turkish commercial banks.

The persistent imbalances of the public sector and the increasing exposure to international capital flows had repercussions on the overall performance of the Turkish economy. Inflation significantly rose during the 1990': from an average of 47.2% between 1980 and 1988, it reached 78% on average between 1990 and 1999, peaking at 106% in 1994

(Verez, 2003). The latter represents a return to its 1980 level and underlines the failure of the stabilization efforts since the external debt crisis. However, inflation in Turkey remained relatively high but also stable. It did not accelerate, as in Brazil throughout the 1980' and beginning of the 1990', partly because fiscal deficits were financed by rising domestic public debt and not expansionary monetary policies (Özatay, 2000). The current account of the balance of payments recorded a high deficit most of the decade, especially in the second half of it, peaking over 3% of GDP in 1993 and 1996. Finally, the 1990' were also characterized by a highly erratic level of economic growth, following boom-and-bust mostly guided by foreign capital flows, contrasting with the 1980' when economic growth was driven by exports (Boratav and Yeldan, 2001). When analysed closer, the quite strong average GDP growth of 3.9% between 1990 and 1999 reveals a very high volatility illustrated by a standard deviation of 5.05. For instance, the Turkish economy grew by 8% in 1993 before contracting by -5.5% in 1994. The combination of chronic fiscal imbalances financed by mounting short-term debt and uncontrolled inflation weakened the Turkish economy and increased its volatility (Verez, 2003). In fact, this irregular pattern of growth was also observed in Brazil throughout the 1980' when boom-and-bust cycles were dubbed *"vôos de galinhas"* or chicken run.

5.4.2.3 The liberalization of the capital account increased both countries' vulnerability to external shocks and led them to a major financial and economic crisis at the turn of the 21st century.

Although following very different economic dynamics throughout the decade, both countries remained weakened by persisting internal imbalances while becoming increasingly integrated with international markets – and more specifically with capital markets, since both liberalized their capital account in the end of the 1980' for Turkey and at the beginning of the 1990' for Brazil. The persisting internal imbalances combined with a higher exposition to capital flows contributed to augment both countries' vulnerability to external shocks. The latter materialized in the rising volatility of capital flows caused by a wave of financial crises originating in and sweeping through developing countries in the second half of the 1990'. Starting in Mexico in 1995, following through East-Asian countries in 1997, Russia in 1998 and finally Argentina in 2001, this series of financial crises provoked dramatical capital movements on the international markets which deeply affected many developing economies. Among them, Brazil and Turkey faced repeated capital flights and were finally pushed into their own financial and economic crisis by the end of the decade.

However, it is worth noticing that economic policy makers in Turkey and Brazil were not equally equipped to handle the wave of external shocks which assailed the two countries in the second half of the 1990'. In Brazil, the achievement of the stabilization and the return to economic growth provided powerful tools for economic policy-makers to respond to the financial crises. In this regard, there is no comparison with the situation in Turkey where the deteriorated economic situation and weakened economic policy laid the ground for much harsher blows suffered by the Turkish economy. Each crisis affected much more severely the Turkish economy and the financial and economic crisis in which both economies plunged at the end of the decade was also much deeper in Turkey.

a. The first experiences with capital flights, from mid-1990' to the Asian crisis.

Until 1998, the Brazilian economy weathered the impact of the Mexican and Asian financial crises nearly unscathed thanks to timely and adequate economic policy answers. In reverse, the Turkish economy followed the pace of international capital flows throughout the decade. Already in an internal crisis even before the Mexican crisis broke out, it suffered a harsh blow from the Asian crisis and did not recover before the outbreak of the Russian crisis.

Between 1990 and 1993, nearly USD 25 billion of foreign capital (mostly short-term) flowed in Turkey to finance increasing fiscal deficits. In the end of 1993, an attempt by the newly elected Turkish government (after Özal sudden death) to change the fiscal deficits' financing scheme and control interest rates led to the degradation of the sovereign grade and a loss of confidence in Turkish bonds which triggered massive capital outflows, representing 4.8% of Turkish GDP (Özatay, 2000). As a result, the exchange rate of the Turkish lira plunged, foreign reserves quickly declined and the Turkish economy dived in a deep recession with the GDP contracting by 5.5% in 1994 (Akyüz and Boratav, 2003). The Turkish government launched a stabilization package in April 1994 with the support of an IMF bailout loan which allowed the achievement of a primary fiscal surplus of 2.7% and a reduction of the public debt on GDP ratio in 1995. This improvement of the public finance permitted a return to normal financing conditions for the Turkish government and led to a new boom in capital inflows of more than USD 26 billion from 1995 to 1997, boosting economic growth over 7% annually. The outbreak of the Asian crisis in the last quarter of 1997 put a sudden end to this boom cycle and initiated a rapid slide of the Turkish economy into its own financial and economic crisis. Capital inflows dramatically slowed down from 5.8% of GDP in 1997 to

1.8% in 1998 and economic growth more than halved between the two years (Akyüz and Boratav, 2003).

In Brazil, both the “Tequila Effect” following the Mexican crisis and the blast wave of the Asian crisis were properly managed by the Cardoso government through a swift and convincing economic policy response. As for Turkey, vast and sudden capital flights caused foreign reserves to drop by USD 12 billion in 1995 and USD 10.4 billion in 1997. But each time, the Brazilian government quickly reacted by doubling the base interest rate (Selic, from about 20% p.a. to 40%) and engaging in a gradual devaluation of the Real within a crawling peg regime. In 1997, the policy response to the Asian crisis also included a fiscal package aimed at enhancing revenues by 2.5% of GDP. In both cases, these measures were instrumental in regaining foreign investors’ confidence and quickly attracting new capital inflows. As a result, economic downturn was avoided, with a GDP growth maintained at 4.2% in 1995 and 3.3% in 1997, and, above all, the stabilization achieved by the Real Plan was preserved since inflation kept declining to a record low of 1.7% in 1998. However, a rising public debt, due to the higher interest rates, and an increasing current account deficit driven by the overvaluation of the Real, made the Brazilian economy more vulnerable to the upcoming external shock (Barros de Castro, 2005b).

b. The impact of the Russian crisis opened a long period of financial and economic turmoil in both countries

For both Turkey and Brazil, the impact of the Russian crisis was harsher than the previous ones as it stroke them in a weaker position. Turkey had already entered a downward cycle after the Asian crisis while Brazil’s economic fundamentals had deteriorated as a result of the measures adopted to deal with the two previous financial crises. The contagion effect of the Russian crisis, in the last months of 1998, triggered a financial crisis and opened, in both countries, a long period of economic turmoil going roughly from 1999 to 2003. This period of crisis did not unfold similarly and did not reveal the same economic difficulties. In Turkey, the financial crisis added to the large internal imbalances and developed into a full-fledged economic crisis, while in Brazil the return to economic growth was largely delayed by the impact of a second external shock: the impact of the Argentinian crisis and the September 11th attacks in 2001. Although divergent in depth and nature, this period of crisis was characterized in Brazil and Turkey by the implementation of major stabilization measures which were endorsed by the next governments and laid the foundations of a decade of quick and stable growth.

As remarked earlier, the Russian crisis caused another severe wave of capital flights from both Brazil and Turkey which put the two countries under great pressure, leading them to seek financial support from the IMF. In Brazil, foreign reserves decreased from USD 70.2 billion in July 1998 to USD 42.6 billion in October 1998 while more than USD 7 billion were retrieved from Turkey in the end of 1998. The massive capital outflows from Brazil put the Real, still pegged to the US dollar, under intense pressure and drastically reduced the level of growth of the Brazilian economy which fell from 3.3% in 1997 to 0.1% in 1998. In this situation, Cardoso signed a bailout agreement with the IMF for a total amount of USD 41.5 billion in November 1998, just after being re-elected. The first instalment of USD 9.3 billion came as a relief along with a set of stabilization measures already implemented to cope with the two earlier financial crises. They included an increase of the base rate (Selic) back to about 40% p.a., a gradual widening of the crawling peg of the Real to allow a slight devaluation and a reduction of fiscal expenditures to achieve a primary surplus equivalent to 3% of GDP. But these measures were not sufficient to convince investors and reduce the pressure on the Real. Capital flights intensified in January 1999 after an important structural stabilization reform stalled in the Brazilian Congress. By mid-January, the pressure came to such an extent that the crawling peg, which had been preserved by the Brazilian government and the Central Bank since the Real Plan, was abandoned and a floating exchange rate regime was de facto adopted. Surprisingly, what followed was nothing comparable to the financial and economic turmoil in which plunged Mexico after floating the peso in 1995. The Real did depreciate initially from its initial level of BRL 1.2 per USD, but by the end of the year, it had recovered some strength from a low of BRL 2.16 to BRL 1.8 per USD. And the Brazilian economy did not dive in a recession in 1999, nor did inflation soar. Instead, economic growth picked up to 4.3% in 2000 as FDIs progressively resumed, growing by 13% that year, and inflation remained low at an annual level of 7%. A new series of external shocks in 2001, namely the Argentinian crisis and the September 11th attacks caused a new wave of capital flights which, combined with a domestic energy supply crisis, stopped the dynamic and provoked a slight deterioration of the economic indicators in spite of continuous stabilization efforts carried out by the government. The Brazilian economy slowed down to a growth of 1.1% in 2003. In parallel, the public debt kept increasing from 66% of GDP in 2000 to 79% in 2003 and inflation reached 14.7%, although the primary surplus was maintained over 3% of GDP since 1999. With a slower economic growth, higher public debt indicators and inflation slightly accelerating, the performance of the Brazilian economy at the end of Cardoso's

second mandate did not reflect the extent of the achievement in terms of improving the economic fundamentals (Barros de Castro, 2005b).

Contrasting with Brazil, the long duration of the Turkish crisis largely stemmed from and revealed the depth of the accumulated internal imbalances. Adding to the impact of the Russian crisis, the devastating Izmit earthquake, in August 1999, caused the Turkish economy to enter a deep recession, contracting by 4.7% in 1999. In December of that year, the Turkish government also sought the IMF for financial help. Nevertheless, the challenge was harder than in Brazil since inflation had remained high throughout the decade and still had to be tackled. In consequence, the Turkish government launched, in the beginning of 2000, an exchange-rate-based stabilization plan very much inspired on the success of the Real Plan in Brazil. Along with fiscal adjustments, the value of the Turkish Lira was tied to a crawling peg based on a basket of US dollar and Euro. The only difference with Brazil's Real plan was that the exit from this peg was scheduled to 18 months later and announced from the onset of the plan (Akyüz and Boratav, 2003). In spite of meeting primary fiscal surplus targets, inflation did not decline as much as planned. It had only come down to 55% in 2000 from 64.9% in 1999, largely exceeding the target of 25% set in the stabilization plan. It consequently caused a progressive overvaluation of the Turkish Lira and a deterioration of the current account as imports increased by 37% while exports remained stable (Boratav and Yeldan, 2001). After a new surge in capital inflows in the beginning of the year pushing economic growth to 7% in 2000, rising pressures on the Turkish Lira eroded the confidence of foreign as well as domestic agents in the Turkish currency and led to a new wave of capital flights in November 2000 which particularly affected the fragile Turkish banking sector. Adding to the financial and exchange rate crisis, a banking crisis broke out as the Turkish commercial banks could no longer rely on foreign capital to finance their assets amidst rising interest rates and a liquidity squeeze (Boratav and Yeldan, 2001). As in Brazil, a new bailout loan negotiated with the IMF in December 2000 and rising interest rates were not sufficient to preserve the crawling peg. Following a new wave of capital flights in February 2001, the crawling peg was also abandoned and a floating exchange rate regime adopted. However, this had a much stronger impact on the Turkish economy. In spite of sustained stabilization efforts supervised by K.Dervis, the newly appointed Minister of the Economy, from May 2001 onwards, the situation of the Turkish economy deteriorated dramatically. The exchange rate of the Turkish Lira soared from 0.69 TL per USD in February 2001 to 1.58 TL per USD in October 2001 and inflation increased to 66%. The investment rate dropped from 20.7% in 2000 to 15.1%, the public debt reached 77% of GDP and the Turkish economy declined by 5.7% in 2001.

But, the measures initiated by K.Dervis would ensure a durable stabilization and bring their benefits in the coming years, somehow replicating Brazil in a different time frame.

5.4.2.4 The successful stabilization efforts following the 2000-2001 crisis were continued by the following governments in both countries and laid the basis for a decade of strong and stable growth.

In both countries, the stabilization efforts initiated in the wake of the financial crisis did not produce immediate positive results as they were followed by a period of slowdown, and even recession in Turkey, accompanied by a deterioration of the economic fundamentals. Nevertheless, these stabilization measures, endorsed and continued by the subsequent governments in both countries, bore fruits in the following years. In fact, they laid the basis for a period of strong and stable growth. A sign of the strength of these foundations is to be found in the fact that both the dynamism of the Brazilian and Turkish economies were only slightly interrupted by the 2008 global financial crisis.

In Brazil, the efforts to maintain fiscal discipline and reduce the public debt were continued by F.H.Cardoso's successor, L.Lula da Silva, elected in October 2002. The primary fiscal surplus target of 3% of GDP was systematically respected and even surpassed over 4% in 2008 leading to a reduction of the public debt from 79% in 2002 to 63% of GDP in 2008. Inflation decreased to 4.5% in 2007 while economic growth averaged 4.2% between 2003 and 2008. Similarly, the government of the Justice and Development Party (AK Party) of R.T.Erdogan, also elected in 2002, observed the fiscal discipline initiated by K.Dervis in 2001. Large primary fiscal surplus, averaging 5% of GDP between 2002 and 2008, led to the progressive reduction of nominal fiscal deficits, until reaching equilibrium in 2006, as well as of the public debt, going from 73.7% of GDP in 2002 to 40% in 2008. These fiscal efforts translated into a final success in curbing inflation, from 66% in 2001 to an average of 13.5% between 2002 and 2008, and a strong economic growth of 5.9% annually over the same period.

The limited impact that the 2008 global financial crisis had on both economies came as an additional evidence of the strength of the growth cycle in which they were engaged. Both economies experienced a brief contraction of GDP in 2009, of 0.3% in Brazil and 4.6% in Turkey, from which they swiftly recovered. Economic growth in both countries bounced back in 2010 to 7.5% in Brazil and 9.2% in Turkey, while inflation remained controlled, below 10% in both countries.

Table 5.15 Brazil and Turkey's stabilization measures and economic performance 1999-2010

Brazil	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
GDP growth (% p.a.)	0.3	4.3	1.3	2.7	1.1	5.7	3.2	4	6.1	5.2	-0.3	7.5
Inflation (% p.a.)	4.9	7	6.8	8.5	14.7	6.6	6.9	4.2	3.6	5.7	4.9	5
Primary fiscal surplus (% of GDP)	3.1	3.4	3.4	3.2	3.3	3.9	3.9	3.3	3.5	4.1	2.2	2.5
Fiscal balance (% of GDP)	-5.3	-3.4	-2.6	-4.4	-5.2	-2.7	-3.5	-3.5	-2.7	-1.4	-3.1	-2.7
Public debt (% of GDP)	48.7	66.7	70.2	79.8	74.8	70.8	69.2	66.7	65.2	63.5	66.9	65.2
Turkey												
GDP growth (% p.a.)	-3.4	6.8	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7	-4.8	9.2
Inflation (% p.a.)	64.9	55	54.2	45.1	25.3	8.6	8.2	9.6	8.8	10.4	6.3	8.6
Primary fiscal surplus (% of GDP)	-2	2.8	5.5	na.	na.	5.2	5.1	5.1	3.2	2	-1.1	1.4
Fiscal balance (% of GDP)	-24.2	-19.1	-19.5	-13.9	-10	-3.9	-0.3	0	-1.7	-2.3	-5.6	-2.3
Public debt (% of GDP)	na.	51.6	77.9	74	67.7	59.6	52.7	46.5	39.9	40	46.1	42.4

Source: IMF, WEO Database October 2013

*na.: not available

5.4.3 Concluding remarks

In conclusion, it took two decades to Brazil and Turkey to progressively abandon the ISI economic model and definitely engage in the liberalization and stabilization process. The return to rapid economic growth experienced by both countries after their respective financial and economic crisis is the result of this successful transition to a more opened and integrated economic model. As pointed out in the introduction of this work, the economic progress accomplished by Brazil and Turkey in the past decade propelled both countries in the exclusive club of emerging countries which attracted much interest and investments, especially after the 2008 financial crisis plunged most developed economies in recession.

As examined, the boundary conditions of the debt renegotiation process and subsequent external constraint in the 1980' as well as the varying degrees of commitment of

both countries' governments to lead stabilization reforms to their end are among the most determining reasons explaining the divergence between both countries throughout the liberalization and stabilization process. Looking at a deeper level of analysis, the characteristic and evolution of economic and political institutions in Brazil and Turkey throughout the period provides other relevant elements of explanation, which are examined in the next chapter.

5.5 Conclusion

This comprehensive comparative narrative of Brazil and Turkey's economic histories illustrates the overall parallel in the economic development path followed by the two countries from the 1920' to the beginning of the 21st century. Both economies found themselves in corresponding stages of development and economic dynamics throughout that period, they were affected in comparable ways by the external shocks represented by the Great Depression in the 1920', the Second World War, the oil shocks in the 1970' or the international financial crises of the 1990'; and finally opted, though sometimes with a time lag, for similar economic policy responses.

Two major divergences in terms of economic policy choices between the two countries throughout this period ought to be highlighted. The first one was the temporary drift in the post-WWII period when the Turkish Democrat Party's government chose to return to the promotion of an economic model based on the exports of primary goods while Brazilian policy-makers confirmed the ISI model as the country's main engine of growth. The second one occurred after the debt crisis of the 1980' and lasted about two decades, when Turkey and Brazil engaged, at their own pace, into the stabilization and liberalization processes, dealing with very different external constraints determined in part by the geopolitical context.

However, in the first case Turkey swiftly returned to the ISI model in the second half of the 1950' and in the second case, the difference mostly lays in the timing of the policy choices rather than in their sheer nature. Therefore, these differences are substantial enough to add some nuance to the parallel observed between the two countries' economic development throughout the 20th century but not to call into question its actual relevance.

The summary table below gathers the main elements of convergence and divergence between the two countries' economic development as highlighted in this chapter.

Table 5.16 Summary of the comparison between Brazil and Turkey's economic policy choices and performance from the 1930' to the first decade of the 21st century

Period of time	Main Elements of Convergence	Main Elements of Divergence
pre-1930'	• Two peripheral economies dominated by exports of primary goods • Relatively small manufacturing sector because of unfavorable evolution of terms of trade throughout the 19th century • International specialization in primary goods reinforced during the 1920' (coffee valorization program in Brazil and failure to spur industrialization in Turkey)	• Higher degree of freedom in the determination of trade policies in Brazil, leading the country further in the initiation of the industrialization process
1930'	• Similarly negative impact of the Great Depression on both countries' terms of trade, emphasizing their external debt problems • Progressive establishment of the ISI model through protectionist measures (import tariffs and bilateral trade treaties) as well as increased fiscal spending and state intervention in the economy • Ensuring quick recovery led by the growth of the manufacturing sector	• Different orientation of fiscal policy (supply-led in Turkey vs. demand-led in Brazil) • Different level of state intervention (etatism in Turkey meant direct intervention in the productive sector through SOEs vs. regulatory agencies in Brazil until late 1930')
WWII	• Increasing direct state intervention in the economy during the Estado Novo (early 1940') in Brazil, with the creation of SOEs, bringing both countries' ISI model closer • Both countries inherited very high inflation and an overvalued exchange rate from the war	• Strong wave of industrialization in Brazil thanks to its trade partnerships with the US and Great-Britain • Situation of war economy in Turkey putting a harsh drain on the whole economic activity
1945-1954	• Decisive role of the US foreign policy in the determination of both countries' diverging economic policy orientation	**Major divergence** • Turkey reverting to a primary economy • While Brazil made ISI its main engine of growth
Late 1950'-early 1960'	• Similar negative impact of the end of the Korean War on both countries' terms of trade (1953-1954) • Intensification of ISI along with major macroeconomic imbalances, leading to a balance of payments crisis (late 1950') • Political crisis leading to a military coup (early 1960')	• Supply-led ISI in Brazil (Plano de Metas) while it was predominantly demand-led in Turkey (agricultural subsidies) • Weaker commitment to fiscal discipline and stabilization in Brazil postponing the crisis until the early 1960'
1960'-1973	• Successful stabilization plan paving the way for a new wave of ISI and an economic miracle in both countries	
1973-early 1980'	• Similar choice after the first oil shock of intensification of the ISI model • Increasing macroeconomic imbalances and external indebtedness leading to a major crisis by the end of the 1980'	• Higher level of risk embedded in the Turkish borrowing scheme contributing to explain the earlier break-out of the debt crisis
1980'	• Both countries faced with similar economic challenges: running inflation, very heavy external indebtedness, an exhausted ISI model	**Major Divergence** • Much more favourable debt renegotiation conditions granted to Turkey thanks to its earlier crisis and to the context of the Cold War • Turkey consequently achieving a relatively painless stabilization and gaining economic policy leeway to engage in the liberalization process • While Brazil remained plagued by a very heavy external constraint, struggling against inflation and unable to engage any reform throughout the decade, the "lost decade"
1990'	• Both countries increasingly vulnerable to international financial crisis after the liberalization of their capital account, leading both countries to a major financial crisis at the end of the decade (after the Russian crisis in 1998)	• Brazil engaging in a successful decade of stabilization and liberalization reforms • While Turkey went through a decade of chronic instability and macroeconomic imbalances (its "lost decade") • The repeated financial and economic crises in the 1990' were consequently much more severe in Turkey than in Brazil where the economy was more stable
2000'	• Both countries entered the decade in a deep economic crisis and took strong stabilization measures • These measures were endorsed and followed up by the succeeding governments in both countries (Erdogan in Turkey and Lula da Silva in Brazil) • This successful stabilization largely contributed to the strong economic growth experienced throughout the decade, also driven by the favourable global economic context (rising trade and commodity prices)	

From this abundantly illustrated factual observation of a parallel between both countries' economic policy choices and performance arises the interrogation of the potential elements of explanation. We believe that looking at the institutional design and the political economy in both countries might shed light upon such a question. This is what is undertaken in the next chapter.

6. A comparative study of economic and political institutions

Through a comparative analysis of the political economy, economic and political institutions in Brazil and Turkey in the 20th century, this second analytical chapter intends to identify what might contribute to explain the overall parallel as well as the divergences in terms of economic policy choices and development observed previously.

6.1 1930-1960: the establishment of the ISI economic model

As explained in the previous chapter, the model of import-substitution industrialization was in part imposed onto Brazil and Turkey by the constraining circumstances of the Great Depression. Left with restricted capacity to import after 1929, both countries suddenly had to replace imported goods by domestic production to supply their internal demand. This inescapable economic logic applied to numerous developing countries engaged in the same trade pattern, as analysed by Diaz-Alejandro (1984) and Maddison (1985). But what is remarkable regarding Brazil and Turkey is that, more than just a series of comparable economic policy responses to the Great Depression, the ISI economic model was established with similar features and on the same political and economic institutions. It took root in a set of very similar ideas largely influenced by the military and new economic theories formulated in comparable terms in both countries. It was then developed through a growing central bureaucracy using common economic policy tools and closely linked to an industrial bourgeoisie which benefitted from and strongly supported this economic model. These common foundations of the ISI model determined the parallel economic development path that Brazil and Turkey followed until the 1980'.

The establishment of the ISI model in both countries was a long process that can be roughly framed between the beginning of the 1930' and the end of the 1950'. By the end of this period, the institutional framework of the model was in place and already under stress in both countries. However, this process did not go exactly at the same pace in Brazil and Turkey. The different level of state support to the industrialization process, the distinct structure and influence of the agricultural bourgeoisie and the immediate concerns of the Brazilian military in the 1930' offer some elements of explanation of the time lag observed between both countries in terms of institutionalization of the ISI model.

6.1.1 The economic nationalism of the military and early formulations of the dependency theory were at the root of the choice of the ISI model in Brazil and Turkey

First of all, the political context in which the ISI model emerged in Brazil and Turkey share many characteristics. The nature of the political debates and the presence of the military in power or very close to it throughout the 1930' and 1940' shaped in a very similar way the main ideas underlying the choice and development of the ISI model in both countries and determined some of its most fundamental features.

Not only responding to the impact of the Great Depression, the ISI model also came as a solution to an intense theoretical and ideological debate, ongoing in both countries between the 1920' and the 1940', on the orientation of their economic development and the role of the state in the economy. These debates were articulated along two main dichotomies: the degree of integration into the world market, which can schematically be expressed as an opposition between free trade and protectionism, and the arbitrage between state intervention and private initiative. These oppositions were present in Turkey among the founders of the Republic and briefly came into the very strictly controlled political arena during the short life of the Free Republican Party, the opposition party created by M.Kemal between August and November 1930 (Hale, 1980). Likewise, the famous controversy of economic planning (*A Controvérsia do Planejamento Econômico*) between R.Simonsen, favourable to a model of planned industrialization involving significant protection from world competition, and E.Gudin, advocating for market mechanisms and free trade based on the Ricardian concept of comparative advantage, epitomized these oppositions in Brazil (Lopes Rodrigues, 2012).

The strong influence of the military in Brazil and Turkey played a decisive role in tilting the debate towards the choice of an inward-looking model promoting industrialization. By the 1930', the military had taken, in both countries, a leading position in the debate on the modernization of the state and of the economy through a generation of young officers, formed in the previous decades, which had reached positions of influence, if not direct power, and maintained strong ties with both countries' political leaders M.Kemal and G.Vargas. Interestingly, these young military officers in Turkey, called the "Young Turks", who arrived in power in 1908 and to whom M.Kemal identified, inspired their Brazilian counterparts who were named after them "Jovens Turcos" (Skidmore, 2000). They were also very active in the 1920' in Brazil and they highly influenced, among others, General Goes Monteiro who led the 1930 revolution, which brought G.Vargas to power, and became his Minister of War during

the 1930’ (Carvalho, 2005). The influence of the military increased further with the coup of 1937 and the establishment of the *Estado Novo*.

In Brazil and Turkey, the economic ideas promoted by the military were shaped by both countries’ close history and by the perception of their external environment. The Turkish Republic was created in 1923 after a decade of destructive war against the European powers which had always been until then its main trading partners. In Brazil, rising tensions with its neighbours culminating in the Chaco War (1932-1935) increased the perception of an uncertain and a growingly hostile immediate environment. On top of this, the military elite in both countries was looking at the rapid rearmament in Europe throughout the 1930’, as many others, with the strong conviction that *“all countries were actively preparing for a new conflagration”* as Goes Monteiro warned G.Vargas in 1934 (Hilton, 1973). The acute perception of an imminent external threat spurred the military in Brazil and Turkey to advocate for economic self-sufficiency and the development of basic industries on their territory, notably in order to produce domestically the most needed armaments. These ideas were adopted and exposed by G.Vargas as early as in his January 1930 presidential platform speech in which he pleaded in favour of a solution to what he called the “steel problem” for the sake of national security (Vargas, 1938). But in fact, these ideas only came into action after 1937, with the establishment of the dictatorship of the *Estado Novo* during which economic nationalism became a pillar of the regime (Corsi, 2008). By contrast, the concern over economic independence appeared right after the proclamation of the Turkish Republic and was largely inherited from the peculiarities of the fall of the Ottoman Empire. The economic power exerted by European countries over the Ottoman Empire, through the system of capitulations (commercial concessions to European powers in the Ottoman Empire) and the foreign debt, left a very deep scar in the memory of the leaders of the Turkish Republic. Nationalism was one of the six arrows of Kemalism and translated into a strong economic nationalism which inspired many economic policy choices of the 1930’ (Okyar, 1979).

These preoccupations expressed by the military leaders were further strengthened by early formulations of the dependent development theory advanced by influential economists in both countries. Some decades before this theory became popular worldwide, they pointed out the center-periphery dichotomy and associated the economic vulnerability of their countries to their dependency on Western countries to obtain manufactured goods.

In Turkey, the analysis, made in the introduction of the First Five-Year Plan (1934), of the country’s economic development until 1929 was particularly critical of the role Western

powers which, *"functioning as the workshop of the world, dispatched manufactures to the non-industrialized nations where the existing means of production, inundated by this big industry, were destroyed and the independent communities of yesterday were thus subjected to the hegemony of big capital and were transformed into legally independent, but economically dependent entities. This relation of dependence between the industrial countries of the West and the agricultural and primary producing countries created a state of affairs in which the industrial countries developed further and the primary gradually disintegrated"* (Boratav, 1981).

Likewise, the Argentinian economist R.Prebisch conducted, in the early 1940', a similar historical analysis of the development of Great Britain and the United States throughout the 19th and early 20th century in similar terms, enunciating for the first time the famous centre-periphery dichotomy, and concluded that *"the rest of the world was forced to seek a means of inward-directed development ('crecer hacia adentro')"* (Love, 1980). His ideas on the dependency in which Latin American countries as well as all peripheral countries exporting primary goods were immersed, became very influential in Brazil's economic policy debates. Specifically, R.Prebisch recommended to promote industrialization based on an analysis of the prospect of evolution of international relative prices, which were then unfavourable to primary goods exporters. Such arguments were mobilized by R.Simonsen in his debate with E.Gudin and found a resounding echo in the whole developing world after the creation of the Economic Commission for Latin America (ECLA) by the United Nations in 1948 which was, for long, led by R.Prebisch (Lopes Rodrigues, 2012).

In both countries, these economic theories led to the rejection of the Ricardian free-trade argument of the comparative advantage, qualified as *"nothing but the national economics of Britain"* by the main ideologist of the Turkish Republic – Z.Gökalp – resulting in the adoption of an inward-looking protectionist model of economic development promoting industrialization. These comparable ideological foundations of the ISI model contribute to explain why it survived long after the impact of the Great Depression had vanished.

6.1.2 The increasing economic power of the bureaucracy through a higher level of state intervention and new economic policy instruments and institutions

The ISI model was also established in Brazil and Turkey through an increasing intervention of the state in the economy. It responded to the emergency of the economic crisis but was also in line with the new economic ideas underlying the adoption of the ISI model. Whether it is through a direct intervention in the economy, as in Turkey, or through increased

supervision of the economic activity, as in Brazil, the state in both countries progressively affirmed its authority over the economy in the 1930' and 1940'.

With the establishment of *etatism* in 1931 in Turkey, the state became "*the major productive and investing agent"* (Boratav, 1981). Many state-owned enterprises (SOEs) were created to take over monopolies previously granted to private companies and massive public investments were undertaken in the strategic manufacturing and mining sectors. In Brazil, state intervention initially took the form of powerful regulatory and planning agencies, such as the Federal Council of External Trade (*Conselho Federal do Comércio Exterior*) created in 1934. As direct investment of the Brazilian Federal state in the economy really started under the *Estado Novo* and then the Second World War (Monteiro and Cunha, 1974), this new economic institutional framework progressively gave the central bureaucracy a leading role in economic policy-making.

In addition to SOEs and regulatory or planning agencies, the influence of the bureaucracy was also exerted in both countries through a spate of economic policy tools, which rapidly became key economic institutions as well.

The first of them was an import control system established in the immediate aftermath of the Great Depression which profoundly shaped the inward-orientation of the economic model. From 1929 to 1931, the Turkish government passed a number of laws establishing the legal frame of protectionism. A first law, voted in 1929, established a semi-official Society of National Economy and Savings, in charge of discouraging the consumption of foreign goods which entered in competition with local goods. Another one, passed in 1931, allowed the government to impose quantitative quotas and controls on imports (Boratav, 1981). Meanwhile, the value of the Turkish Lira was protected by a law voted in 1930 preventing any manipulation of the foreign exchange rate throughout the 1930'. In Brazil, import controls were established from 1931 on, mostly through a system of multiple foreign exchange rates regulating the use of foreign reserves (Baer, 1965).

Once again, these measures were, in both countries, not only a response to the balance of payments crisis caused by the Great Depression. They actually represented a decisive and durable turn in both countries' trade policies as they were *"closely related to new ideas on the role of the State"* (Abreu, 2008a). Abreu et al (2000) also pointed out about Brazil that *"it is difficult to exaggerate the importance of the transition in 1930 to a regime of almost permanent government intervention in the distribution of foreign exchange cover which was to survive in other disguises until well into the 1990'."* Although the Turkish government made use of different tools, the turn in the trade policy initiated in 1929 was equally decisive

and long lasting. In both Brazil and Turkey, import controls became a key economic instrument of the central bureaucracy and one of the strongest components of the institutional framework.

Along with import controls, another common feature of both countries' trade policies throughout the 1930' to the 1960' was the structural overvaluation of their currency's exchange rate. As a result of the protection of its value, the Turkish Lira appreciated by 40% against the dollar and the sterling throughout the 1930' (Pamuk, 2000). In the following decades, both governments systematically let their currency appreciate to an overvalued level which, combined with import controls, had considerable distributional effects. They allowed manufacturing sectors to *"benefit from absolute protection due to import controls, which prohibited imports of competitive goods, and also from access to inputs and capital goods, purchased at the overvalued exchange rate"* (Abreu, Bevilaqua, Pinho, 2000). In reverse, it also became a strong anti-export bias since the negative impact for the exporting sector was not fully compensated by the price support mechanisms set up in both countries. This trade policy therefore represented an indirect transfer from the primary to the secondary sector illustrating the objective of both countries' economic policies.

The second major economic policy tool in the hands of both countries' bureaucracies was the set of numerous price control mechanisms. Initially focused on the agricultural sector, they were progressively extended to various economic sectors and types of prices. Both Turkey and Brazil established price support mechanisms for their main agricultural products. Created in 1907, the coffee valorisation program in Brazil was taken over by the Federal state and significantly intensified throughout the 1930'. Later on, new institutions like the Federal Commission of Supply and Prices (*Comissão Federal de Abastecimento e Preços* or COFAP) in the 1950' and 1960' or the Inter-ministerial Price Council (*Conselho Interministerial de Preços* or CIP) in the 1970', were created to control other strategic prices in the Brazilian economy (Abreu, 2008a).

In Turkey too, the purchases of the Soil Product Office provided an initial support to the agricultural sector through control over selling prices. From the 1930' onwards, this institution became crucial for all agricultural products through the fixation of all selling prices. This mechanism was specifically intensified by the Democrat Party after the deep demand crisis of 1954, in addition to minimum export prices set until 1958 (Krueger, 1974). Price control was also made one of the pillars of *etatism* and extended to manufactured goods with the creation of SOEs in the 1930' (Boratav, 1981).

Another price which came under the authority of the central bureaucracy was the interest rate, providing a powerful tool to channel the available capital to predefined sectors, projects or even companies like the SOEs. In Brazil, from the 1930' on, a usury law blocked the benchmark interest rate at a level of 12%, well below the level of inflation observed in the 1940' or 1950' (Abreu, 2008a). In Turkey, legal ceilings were imposed on banks below market rates, also creating a type of financial repression.

Finally, the establishment of powerful public and development banks increased the power wielded by the central bureaucracy over the allocation of capital and foreign reserves in the economy. These institutions were instrumental in pushing the process of industrialization forward in both countries by providing long-term financing to prioritized sectors such as manufacturing and heavy industries. As such, they were responding to a pressing need since both Brazil and Turkey, as it was generally the case in developing countries engaging in a process of late industrialization, were severely lacking financial resources partly due to an inadequately developed financial system that did not promote savings and to the afore-mentioned financial repressions.

In both countries, state-controlled banks created or expanded in the 1930' progressively replaced the foreign banks that were dominating their domestic markets in the beginning of the 20th century. In Brazil, a group of public banks led by Banco do Brasil reduced the share of financial assets owned by foreign banks from 25% in 1930 to 5.2% in 1945 and 1.2% in 1964 (Abreu, 2008a). In Turkey, the momentum supporting the development of the banking sector under the control of the state gained further traction throughout the 1930' with the creation of an impressive number of state-owned banks such as Sümerbank (1933), Belediyerler Bank (1933), Etibank (1935), Denizbank and Halk Bank (both in 1938). These institutions mostly provided long-term financing to SOEs in specific sectors, such as the manufacturing sector for Sümerbank or the mining sector for Etibank, and became key actors of the initial stage of industrialization in Turkey (Öztürk, Gültekin-Karakas and Hisarciklilar, 2010). In Brazil, Banco do Brasil became the executive arm of the Federal government in the management of import controls through the allocation of scarce foreign reserves. It also played the role of a development bank, supporting both agricultural and manufacturing sectors with the *Carteira de Crédito Agrícola e Industrial* (Studart, 2005).

With the ambitious development plans designed in both countries in the 1950' and 1960', long-term financing became again a bottleneck, giving birth to a new development bank in both countries. In Brazil, as pointed out by Baer, *"the lack of a capital market to finance long-term investments forced the State to become the country's principal supplier of*

long-term capital through the creation and subsequent expansion of the National Economic Development Bank (BNDE)" (Baer, 1978). This institution created in 1952 mirrored and closely followed its Turkish counterpart, the Turkish Industrial Development Bank established in 1950 (Öztürk, Gültekin-Karakas and Hisarciklilar, 2010). These two development banks played a leading role in the plans launched by both countries' governments until the end of the 1970', not only on funding but also on technical support and project implementation (Willis, 1995).

6.1.3 The emergence of a domestic industrial bourgeoisie tightly linked to the bureaucracy

The new economic policies implemented in both countries also had a significant impact on the distribution of economic and political power. The social fabric dramatically changed throughout the 1930' accompanying the establishment of the ISI model. As such, Brazil and Turkey perfectly illustrate the thesis of Touraine (1977), who advocates that the action of the state in peripheral countries is one of the main determinants for class existence. Indeed, the beginning of the industrialization process and the increasing state intervention encouraged the emergence of a new bourgeoisie tightly linked to the manufacturing sector as well as to the strengthening public bureaucracy in both countries. This new class of industrialists became one of the main pillars of the ISI model, from which it fully benefitted. Nonetheless, due to major differences in the landowning structures, this emergence of a domestic industrial bourgeoisie unfolded very differently in the two countries. And this turned out to have a significant impact on the level of commitment of the state to directly promote industrialization as well as on the level and nature of its intervention in the economy in the 1930'. As pointed out in the previous chapter, while the Turkish state massively invested into the industrialization process in the 1930', the Brazilian federal state dedicated the majority of its resources to the support of coffee growers.

In Turkey, a class of industrialists emerged as a completely new social group, replacing previous dominants groups, which rapidly disappeared from the political arena after the shock of the Great Depression. On the one hand, this phenomenon stems from the intrinsic weakness of the agricultural producers. In stark contrast with Brazil, the economic weight of the primary and exporting sector did not translate into a strong political power because of its fragmentation among commodities requiring very different production structures. Cotton, tobacco and dried fruits were the main agricultural commodities exported by the Turkish economy and none of them represented more than 10% of total exports (Pamuk, 1987).

Moreover, these commodities required very different type of soils and production structures so that producers were also very different and scattered throughout the Turkish territory. The division of the primary sector was enhanced by the landowning structure inherited from the Ottoman system of land property rights, the *miri* system, which prevented the emergence of large land properties (Biyik and Yavuz, 2003). Indeed, *"the Ottoman government supported small peasant production as peasant households were easier to tax than large landowners and because the latter were more likely to pose political problems to the Central Government"* (Pamuk, 2008a). In consequence, still in 1957, 97% of the Turkish farms were small family-owned farms, with a surface below 50 hectares (Aktan, 1957). This double fragmentation of the agricultural sector in Turkey, among different commodities and among numerous small farms, explains why this dominant sector of the Turkish economy wielded little political power and therefore had little influence over the economic policy choices made by the government in the 1930'.

The only social group which actually exerted strong political influence was the outward-oriented commercial bourgeoisie acting as intermediary between agricultural producers and European importers of Turkish primary goods. However, the long decade of war that preceded the independence of the Turkish Republic considerably weakened this social group. Because many of these merchants were not ethnically Turks but rather traditionally of Greek, Armenian or Western-European origins, most of them had to leave the country during the war or after the independence. Those who remained arouse wariness among the strongly nationalist new Turkish state leaders, especially after the 1929 monetary and debt crisis, during which they were accused of speculative inventory building. In fact, one of the Turkish leaders' main objectives from the 1920' on was to promote the emergence of a domestic urban and inward-oriented bourgeoisie based on the manufacturing sector to replace this economic elite whose strong ties with foreign countries were deemed suspicious (Boratav, 1981). From the beginning of the 1920' onwards, the economic policies adopted by the Turkish government were pushing in this direction. Until 1929, numerous incentives were given to private entrepreneurs to invest in the manufacturing sector and initiate the industrialization process. Through its direct intervention in the economy, the Turkish state became a "*strategic agent of private accumulation"* in the 1930' and accelerated the emergence of a class of industrialists (Boratav, 1981). Many of them, recruited among the political and administrative personnel, were appointed to manage the SOEs or benefitted from the backward linkages generated by these SOEs, creating a network of Small and Medium Enterprises (SMEs) which became their main suppliers (Pamuk, 2000). In both cases, they

were characterized by their strong ties with the central bureaucracy and their subsequent support to the ISI model.

In Brazil, the transition from an agricultural bourgeoisie to an industrial bourgeoisie was much longer and smoother than in Turkey in large part because of the strong influence retained by the former and the subsequently ambivalent state intervention throughout the 1930’ with regard to the industrialization process. The producers of agricultural commodities revealed to be a much more homogeneous and powerful group, as compared to their Turkish counterparts, dominated by coffee producers which represented over 70% of total exports in 1929 and about 10% of GDP (Baer, 2008). Coffee growers owned large land properties which were very well connected to the rich commercial and industrial centre of Brazil, Sao Paulo, as well as to the main exporting infrastructure, the harbour of Santos. As a result, they were able to transform their huge economic power into a strong political influence, which they intensely used in the first decades of the 20th century, and especially in the 1930’, to inflect economic policies in their favour. The high economic weight and political influence wielded by coffee growers is the main determinant explaining why the Brazilian Federal state dedicated most of its resources, after 1929, to support the price of coffee, instead of investing directly into the development of the manufacturing sector as the Turkish government did.

In addition to their own political influence, coffee growers and agricultural producers in general received further indirect support from the Brazilian military whose main and pressing concern throughout the 1930’ was to renew the equipment and armament of their troops, deemed highly improper to face a growing external threat. As Brazil did not have the ability to produce them, they had to be imported from countries like Germany and the United States to provide for the immediate needs of the Brazilian army. In consequence, the military strove to secure as large a share of the scarce foreign reserves as possible to such imports and also played a leading role in promoting the bilateral trade treaties signed with the United States and Germany in the 1930’, which basically involved an exchange between Brazilian primary goods and modern armament and manufactured products. Therefore, in spite of pleading in favour of the development of a strong manufacturing base, the Brazilian military actually contributed to provide, through these bilateral treaties, a precious outlet for Brazilian agricultural producers at a time when the international demand had plummeted. As a result, in the 1930’, *“a convenient alliance was being forged between the export sector, urban consumers interested in cheaper goods and the military planners”* (Hilton, 1973).

However, in several ways, this direct support of the Brazilian state to agricultural producers also represented an indirect stimulus to the industrialization process and therefore

to the emergence of an industrial bourgeoisie. As explained in the previous chapter, the coffee valorisation programme had a multiplier effect in the Brazilian economy through the support of the internal demand, which notably benefitted the domestic manufacturing sector. Moreover, the restrictive foreign exchange regime insulated domestic manufacturers from international competition and also had a significant distributional impact in their favour (Faucher and Baggio-Huerre, 1980). Finally, the relative interpenetration between coffee growers and industrialists also ensured this indirect link. Because the former accumulated significant capital since the end of the 19th century, they massively invested in the nascent manufacturing sector in order to diversify their activity. In 1901, Dean (1969) reported that approximately 45% of workers employed in industrial activities in the state of Sao Paulo were working in firms controlled by coffee producers. There was therefore a certain degree of convergence of interests between coffee growers and industrialists in the 1930' and the strong support of the Federal state to coffee growers somehow eased and accelerated their transition to the manufacturing sector (Dean, 1969).

This relative convergence of interests did not prevent conflicts between coffee growers and the other industrialists, not linked to the agricultural bourgeoisie, over the distribution of economic policy support (Furtado, 1959). Such conflicts very clearly appeared in the strong opposition of many industrialists to the signature of bilateral trade treaties in the mid-1930' and also even more in the Controversy on Economic Planning opposing R.Simonsen, the industrialist from Sao Paulo, to E.Gudin, championing the exporting sector. It is only after the second military coup establishing the *Estado Novo* in 1937 that a change was initiated in the orientation of the state intervention in the Brazilian economy. The coffee valorisation program was substantially scaled down and the first direct investments in the manufacturing sector were undertaken by the Federal state, in accordance with the economic ideas promoted by G.Vargas and the military. The *Plano de Nacional de Obras Públicas e Reaparelhamento da Defesa Nacional*, launched at that time, aimed at developing basic manufactures, transportation infrastructure and energy plants. The best example of such public investments was the construction of the first steel mill in Brazil in Volta Redonda in the beginning of the 1940' (Corsi, 2008). However, this example is actually among the only ones since the difficult context of the Second World War did not allow the fulfilment of all the ambitions of the plan. This economic policy turn towards direct state support to the industrialization process actually preceded the golden era of the ISI model in Brazil. As noted by Baer (1965), *"the industrialization process taking place before WWII cannot be credited to government policies consciously adopted to stimulate industrial activities. It was the consequence of*

external circumstances (like the interruption of supply during WWI) or of measures taken by the Brazilian authorities under balance of payments constrains (like the import controls instituted in the 1930')."

The real choice to maintain the ISI model and make it the main source of economic growth came, in Brazil, after the Second World War. This choice of the ISI model *by design*, as opposed to its adoption *by accident* during the 1930', represented the victory of R.Simonsen's views over E.Gudin's and the symbolic moment when industrialists finally took the ascendancy over the coffee growers and other agricultural producers in influencing economic policy choices. Strong ties between the bureaucracy and the new class of industrialists, similar to those developed in Turkey from the 1930' onwards, consolidated in the 1940' and especially in the 1950' with J.Kubitschek's Plano de Metas.

In contrast, Turkish political leaders demonstrated a strong commitment to industrialization and to the renewal of the local bourgeoisie since the creation of the Turkish Republic. As noted by Pamuk (2000), *"the former military officers, bureaucrats and intellectuals who assumed the positions of leadership in the new nation state founded in 1923 strove, from the outset, to create a national economy. Industrialization and the creation of a Turkish bourgeoisie were viewed as the key ingredients of economic development."* They consequently saw the context of the Great Depression not so much as an accident to cope with but as an opportunity to materialize this project and implement their economic agenda. This explains why Turkish political leaders took a much more active stance in the management of the Great Depression and why the ISI model became the official economic policy from the beginning of the 1930' onwards. They perceived the urgency to seize this opportunity to catch up in terms of economic development and even the potentially high future cost of missing it (Boratav, 1981).

6.1.4 Concluding remarks

It is both the opposing characteristics of the agricultural bourgeoisie in the two countries and the distinct level of commitment of the state to support the industrialization process which explain the delay in the emergence of the industrial bourgeoisie. In both cases however, the latter was tightly linked to the growing power of the central bureaucracy. In Brazil and Turkey, the ISI model was gradually established on similar main pillars: economic nationalism inspired by the military, a powerful central bureaucracy using common economic policy tools and a new industrial bourgeoisie beneficiary of the ISI model. After the Second

World War, these pillars became the main economic institutions on which the ISI model strengthened and which made it so resistant to reform attempts.

6.2 1960-1980: The institutionalization of the ISI model and its resilience to repeated crises and reform attempts

From the late 1950’ to the beginning of the 1980’, the ISI model allowed both countries to experience periods of unprecedented economic growth accompanied by very significant steps forward in terms of economic development. As explained in the previous chapter, Brazil and Turkey benefitted from an economic miracle from the mid-1960’ to the beginning of the 1970’, characterized by an astonishingly high and stable economic growth pulled by the industrialization process, precisely when the ISI model found itself at its apogee. Nevertheless, it is also undeniable that this model showed its limits in various occasions throughout this same period. In both countries, it generated major economic imbalances and negative by-products, which led to repeated economic crises until the 1980’.

6.2.1 In spite of the many distortions generated by the main features of the ISI model, it remained in place until the 1980’.

The main economic distortions observed in both Brazil and Turkey between the late 1950’ and the 1980’ are mostly linked to the main features of the economic model adopted by both countries in the previous decades.

As pointed out by Pamuk (1981), the ISI model intrinsically bears two types of limitations which, if not properly addressed, lead to its crisis. It is either limited by a saturation of the domestic market or by the scarcity of foreign reserves. Both Brazil and Turkey were spared from the former thanks to the quick growth of their respective population, the rapid urbanization process and the expansion of the domestic market provided by the high rates of economic growth experienced during the period.

Nonetheless, the inward-looking development strategy adopted by both countries confronted them repeatedly with the second limitation. The strong anti-export bias, implied by distorted prices and an overvalued exchange rate, put increasing pressure on their foreign reserves and led them to repeated balance of payments crises. Between the end of the 1950’ and the 1980’, Brazil and Turkey experienced cyclical economic growth interspersed with foreign exchange and balance of payments crises, which were usually followed by a devaluation of their currency. In addition, the scarcity of foreign reserves limited the availability of imported goods and constrained the development of the manufacturing

activities in both countries because of their constant dependence on capital goods imports. The reliance on growing amounts of external debts and on monetary expansion in order to finance the massive investments required to develop the manufacturing also strained both countries' balances of payments and fuelled inflationary pressures.

Another structural distortion, resulting from the main features of the ISI model, was the weak labour absorption by the manufacturing sector, precisely at a time of quick demographic growth in both countries. Indeed, the ISI model encouraged and even subsidized capital accumulation, notably through preferential foreign exchange rates, at the expense of the abundant labour (Delfim Netto, 2005). Between 1963 and 1977, although the Turkish population was growing at an annual rate of 3%, the labour force employed in manufacturing only grew by 6.3% annually, compared to 12.8% for the capital. Here again, the main economic policy features of the ISI model were identified as the main explanation for this distortion by Çeçen *et al.* (1994): *"undoubtedly, high tariff and quota regimes, together with unrealistic exchange rate and interest-rate policies, are the major causes behind this non-optimal capital intensiveness of the manufacturing sector."*

Many economists, analysing the performance of the ISI model in both countries, highlighted the negative impact of these numerous distortions on the economic performance and argued that it was unduly pushed to its limits. In a general analysis of Latin American economic performance until 1980', Taylor (1998) highlighted the critical role of the price distortions caused by ISI economic policies in reducing capital accumulation and economic growth so that, by the 1970', *"import substitution, as a source of growth, was exhausted by the progress of import substitution itself"* (Abreu, Bevilaqua and Pinho, 2000). Similarly, Dervis and Robinson (1978) as well as Krueger (1989) argued that the excessive inward-looking orientation of the Turkish economy caused a loss of economic growth during the 1960' and 1970'. Underlining the anachronism of the ISI model in Turkey, Okyar (1979) noted that *"the days of following the paths of inward-looking nationalism and of seeking ways to ensure self-sufficiency for a single country are passed."*

In spite of all these imbalances and repeated crises, the main economic tools and features of the ISI model set up in the 1930' and 1940' remained mostly unchanged until the 1980'. We contend that a comparative analysis of the economic institutions and political economy in both countries sheds light on some reasons explaining the longevity of the ISI model and its resilience to crisis. In Brazil and Turkey, the main features of the model were progressively captured, reinforced and finally institutionalized by those who benefitted from them, mainly the central bureaucracy, large industrialists and foreign companies settled in

both countries. This combination of vested interests among tightly linked and powerful groups ensured that the ISI model resisted both the crises that it produced and the reform attempts that followed.

6.2.2 The impossibility to adopt an outward-looking economic model before the 1960'

Before examining this phenomenon of institutionalization in both countries, some elements of explanation as to why some features of the ISI model were not abandoned or reformed in Brazil and Turkey in the post-war period can be found in the international economic context of that period. In fact, the latter left little alternative and leeway to developing countries still dependent on imports of manufactured goods with regards to their trade and foreign exchange policies. As Abreu *et al.* (2000) underlined, *"the possibility of following a manufactured-based, outward-oriented strategy was not available at least until the mid-1960'."*

This is first due to the international monetary system established in Bretton Woods on fixed exchange rates. It represented a particularly tight constraint for all developing countries that depended exclusively on exports of primary goods to obtain foreign reserves, especially as international prices of such goods collapsed after the mid-1950'. Both Brazil and Turkey were exactly in this situation since, until the beginning of the 1960', about 90% of Turkish exports was still primary goods (Pamuk, 2010) and coffee still represented about 70% of total Brazilian exports (Abreu, 2008a). In the continuation of the 1930', Brazil and Turkey had little choice but to maintain tight import controls and regularly devalue their currency to deal with recurring balance of payments crises.

In addition, the international trade patterns of the post-war period were also unfavourable to developing countries. The first rounds of trade liberalization negotiations of the GATT were limited to the trade of capital and technology-intensive products among industrialized countries, leaving developing countries out (Abreu, Bevilaqua and Pinho, 2000). As a result, primary goods or more basic manufactured goods were subject to higher levels of tariff and non-tariff barriers (Balassa, 1965). This higher level of protection on primary and consumer goods made the option of an export-led industrialization model simply impossible and contributes to explain the choice in Brazil and Turkey to maintain the inward-looking orientation of the ISI model until the 1960'. It is precisely in the 1960' that East-Asian countries adopted an outward-oriented development model with the famously successful wild-geese-flying pattern (Abreu, Bevilaqua and Pinho, 2000). The reason why,

instead of following such a path after the 1960', Brazil and Turkey maintained the inward-orientation and the economic policy instruments of the traditional ISI model adopted in the 1930' and 1940' is partially to be found in the institutionalization of these features of the ISI model.

6.2.3 The convenience of the ISI model for various interest groups constituted the basis for its resilience in both countries, in spite of the many economic distortions it created.

In both countries, the ISI model created many opportunities of rent-extraction both for the state bureaucracy and for the private manufacturing companies operating in the domestic market. The reinforcement and increasing intertwining of these complementary vested interests in Brazil and Turkey lie at the root of the institutionalization of the ISI model.

6.2.3.1 The strength of the central bureaucracy and the self-reinforcement of ISI economic tools

On one side, the economic policy instruments and institutions created in the 1930' and 1940' by the Brazilian and Turkish states became very convenient for policy-makers to control the economic activity, obtain easy financing resources and eventually achieve political goals. Through the establishment of the ISI model, both countries' state bureaucracy and political elite acquired an immense power over the economy to which they naturally clang.

The examples of the SOEs in Turkey and more specifically of Banco do Brasil in Brazil provide an insight of how such institutions got progressively entrenched in the ISI model and in the political system of both countries.

In Turkey, the main SOEs created in the 1930' were originally conceived as temporary vehicles to stimulate the industrialization process. Their creation was justified by C. Bayar, Minister of the Economy between 1932 and 1938, in the following way: *"if we were to leave the industrialization of the country and, consequently, the welfare of the people entirely to private initiative and the capital on which this initiative would depend, we would have to wait at least two centuries. Our principle is to undertake ourselves, to encourage and support private enterprise. We wholeheartedly desire the development of private initiative in the industrial sphere, and we are continually investigating the best ways of achieving it"* (Hale, 1981). Translating this spirit, the law defining the legal framework of their action provided SOEs with an equal status in the economy with regards to the private sector and clearly mentioned the perspective of a transfer to private capital when the intervention of the state

would no longer be required (Boratav, 1931). However, already during the Second World War, this fundamental law was broken as SOEs were clearly favoured in the supply of necessary inputs at the expense of private companies (Singer, 1984). In the end of the 1940', A.Menderes, leader of the newly founded Democratic Party, campaigned denouncing the excesses of *etatism* and advocating for the privatization of many SOEs. Nevertheless, during his time in office throughout the 1950', none of the SOEs was privatized in part because it would have been hard to attract enough private capital but also because they represented convenient instruments for economic policy-making (Krueger, 1974). In spite of being *"non-competitive, badly managed and increasingly staffed"* (Özay, 1983), Turkish SOEs were maintained and even reinforced throughout the 1960' and 1970' as they turned out to be crucial tools to achieve political objectives such as job creation or regional development. For instance, employment in SOEs grew by 52% from 1973 to 1977, and 44% of public investments were earmarked for SOEs in 1977 although they only represented 7% of the Turkish GDP (Özay, 1983). In Brazil, SOEs also became entrenched in spite of becoming a drain on public finances. In an analysis of the economic institutions during the presidency of J.Kubitschek, C.Lafer (1970) identified only few *"pockets of efficiency"* among the public entities through which economic policies were channelled and implemented.

Banco do Brasil represents another example of an institution which was granted extensive power in the Brazilian economy and became an essential instrument of economic policies. From the 1930' on, Banco do Brasil took a central position in the economic policy-making. It was given the responsibility to manage the import control system through a monopoly in the foreign exchange market. Banco do Brasil was therefore the recipient of the earnings provided by the multiple foreign exchange regime set up at that time. It also became strongly linked to the central bureaucracy as the leading public bank, channelling financial resources to the manufacturing sector and increasingly financing economic policies. Finally, Banco do Brasil housed the SUMOC (*Superintendência de Moeda e Crédito*) an entity endowed with the attributions of a central bank, from its creation in 1945. These crucial roles carried out in addition to its commercial banking activities put the bank in a sort of institutional loophole which became extremely convenient for the successive Brazilian governments. Even after the creation of the Central Bank of Brazil in 1964, the status of Banco do Brasil remained ambiguous (Orenstein and Sochaczewski, 1990). The institutional loophole between SUMOC, Banco do Brasil and the Treasury allowed the monetization of fiscal deficits and expansive credit policies which were first massively used by J.Kubitschek during the Plano de Metas (Cardoso and Teles, 2010).

Throughout the 1950', Banco do Brasil also became the stronghold of various vested interests which resisted several stabilization efforts by entering in overt conflict with the Ministry of Finance (Orenstein and Sochaczewski, 1990). In the 1950' and 1960', the Turkish Central Bank played a similar role to Banco do Brasil, controlling interest rates to favour the manufacturing sector, expanding credit, notably to SOEs, and monetizing fiscal deficits under the strong influence of the bureaucracy and the political power (Krueger, 1974).

These institutions, and the economic policy instruments that they represented, were preserved in both countries because they provided the bureaucracy and the political elite with a control over as well as a type of rent from the economic activity. As underlined by Abreu (1994), *"rent appropriation is known to be extremely addictive"* with strong evidence from Brazil and Turkey. For instance, the multiple exchange rate system adopted in Brazil and managed, in a position of monopoly, by Banco do Brasil quickly became an important source of revenues for the Brazilian government which contribute to explain the preservation of the protectionist regime (Orenstein and Sochaczewski, 1990. In a system called *"confisco cambial"* (Oliveira, 1975), all earnings generated by each foreign transaction were gathered in the *Fundo de Ágios e Bonificações*. Similarly in Turkey, the attribution of import licenses generated easy resources to the state bureaucracy (Krueger, 1974b).

It is precisely according to these rent extraction mechanisms that both countries' political systems evolved, from the 1960' on, away from democratic practices and towards an authoritarian management of the economy by the bureaucracy. After more than a decade of democratic rule, the turn of the 1960' was marked, in both countries, by military coups that opened a new era of domination of the political sphere by the military, either through repeated coups in Turkey or through a twenty-year military dictatorship in Brazil. In both cases, the two following decades were characterized by the reinforcement of the ISI model. This was mostly ensured by the bureaucracy which, situated at the core of the economic policy-making and controlling those powerful economic policy tools and institutions, entered in a system of distribution of favours and resources in order to push the industrialization process forward. In Turkey, this system was qualified of *"distributional state"* or *"grant economy"* (Özay, 1983), described by Çetin (2010) in the following words: *"in the last 50 years, public funds were predominantly channelled to specific groups in Turkey. Because of the existence of distributive polity, governmental interventions in the markets deviated from well-defined political goals and converged to create and extract the rent-seeking activities."* In turn, the Brazilian case represented among the best examples of O'Donnell's (1973) bureaucratic authoritarianism model in which *"government policy was increasingly to depend on the*

dissemination of systems of incentive based on the use of discretionary instruments which favoured specific sectors or projects in detriment of others. These, in spite of the occasional, but increasingly rare, lip-service to the virtues of the market, cannot be seen as more than a refurbished system of organized rent-extraction to systematically benefit sectors selected on the basis of their political leverage" (Abreu, 2008a). In both countries, a system of patronage politics dominated the political and economic spheres.

6.2.3.2 The resistance of private vested interests

On the other side of this scope, the private sector progressively organized itself to capture the favours granted by the bureaucracy and benefit from artificial and privileged conditions to prosper. To the rent-extraction mechanisms of the bureaucratic interventions responded a rent-seeking behaviour pervading the private sector. It is this strong interpenetration of the central bureaucracy with the private sector - mainly private industrialists, who were the principal beneficiaries of the ISI model - which pulled the Brazilian and Turkish economies forward until the end of the 1970'.

In both countries, the protectionist trade regime, structured through the attribution of foreign exchange cover, import tariffs or licenses; the directed credit policy and the system of subsidies all created rent-seeking opportunities which shaped the development of the domestic manufacturing sector. They created and maintained private companies in an oligopolistic, if not monopolistic, position, in many cases willingly through a "national champion" policy for instance (Abreu, 2004a), which inevitably gave rise to negative by-products such as non-competitive pricing policies detrimental to the final consumer (Delfim Netto, 2005). In Turkey, the second wave of industrialization in the 1960' was led by big family conglomerates (Pamuk, 2008b) which owned most of the commercial banks. One of the latters' main functions was to channel public subsidies to their sister companies in their respective conglomerates, somehow acting like public banks (Öztürk, Gültekin-Karakas and Hisarciklilar, 2010). From the late 1960' onwards, the creation of export incentives, such as subsidies or duties exemption, generated in both countries new rent-seeking opportunities that private companies quickly competed to capture. Rent-seeking became a new field and a key factor of competition among private companies (Krueger, 1974b). These favourable conditions reserved to domestic players also attracted foreign companies which strove to reap the same benefits by investing in both countries. Multinational companies, mainly US-based, became another pillar of industrial growth in both countries (Baer and Villela, 1980). In Brazil for instance, they entered in direct negotiations with the government during the

presidency of J.Kubitschek (Villela, 2005). Likewise, US firms established in Turkey won the battle for political influence in Congress against US-based exporting firms. As a result, they managed to obtain the support of the US diplomacy which tended to promote the maintaining of trade barriers by the Turkish government (Maxfield and Nolt, 1990).

These private companies benefitting from the main features of the ISI model naturally organized to voice their interests and build stronger ties with the bureaucracy. The main industrialists' organization in both countries, FIESP (*Federação das Indústrias do Estado de São Paulo* or Federation of the Industries of the State of Sao Paulo) in Brazil and TÜSIAD (*Türk Sanayicileri ve İşadamları Derneği* or Turkish Industry and Business Association) in Turkey, became vocal and powerful actors of the economic and political spheres. In various occasions, they proved to be fierce defenders of the ISI model and successfully contributed to shape economic policy choices. In Turkey for instance, even the negotiating power given to labor unions by the 1961 constitution and the subsequent wage increases were granted with the assent of the Turkish industrialists who saw in this an opportunity to expand domestic demand and keep away the prospect of market saturation (Pamuk, 2008c). In both countries, the adoption of a last industrialization plan in 1973-1974 was partially achieved by the influence and even explicit pressure of industrialists. In Brazil, industrialists had heavily invested to satisfy the growing domestic demand during the economic miracle and were dependent on sustained economic growth to ensure their returns. The II PND, adopted in 1974 and injecting massive public investments into the economy, largely came as a result of their successful lobbying (Hermann, 2005). Likewise in Turkey, at this same period, the political context was such that *"the alternating governments – the Republican People's Party (RPP) in 1974 and the Justice Party (JP) during 1975-1977- could, therefore, not afford to suspend the well-rooted distributional and allocational mechanisms of populism"* (Boratav, 1986).

In Brazil and Turkey, the combined actions of vested bureaucratic and private sector interests illustrated and confirmed the assertion that *"an ISI regime becomes difficult to dislodge owing to the power of vested interest groups who continue to benefit from the existing system of protection and subsidies"* (Pamuk, 2008c). In the case of Brazil, this alliance of interests was also obvious: *"by 1970, it had become explicit government policy that economic development depended on a close alliance between the government and the private sector"* (Fishlow, 1980).

6.2.4 Two failed attempts to reform the ISI model in the 1960' illustrating the interplay of vested interests and the role of the military

Not only promoting and reinforcing the ISI model, these vested interests defended it in spite of its repeated crises and largely contributed to the failure of one main reform attempt undertaken in the late 1960' in each country. The following examples show the decisive interplay between the bureaucracy, the industrialists and also the military in both countries leading to the preservation of the ISI model into the 1970'.

6.2.4.1 The weight of vested interests

The second half of the 1960' was characterized in both countries by an attempt to redesign and reorient the economic model through trade liberalization measures and export incentives. However, these reforms stalled and were finally deprived of their real potential to deeply amend the economic model. In Turkey, the ambitious 1970 reform package introduced by S.Demirel aimed to restore the Turkish economic model on the principle of the comparative advantage (Tekin, 2006). It was abandoned in the following years largely because of the resistance it encountered among the bureaucracy at the head of the main SOEs, as well as among the industrialists who opposed trade liberalization to preserve the protection from which they benefitted. Paradoxically, their opposition was mostly felt in 1972 and 1973, after the reforms had shown their efficiency and produced a very positive impact on the level of economic activity through an export boom. Tekin (2006) wrote that *"the point when foreign exchange became relatively abundant seemed to be the defining moment for the fate of the reform. Since the core reason for the 1970 reform was the balance of payments difficulties (…), the protectionist groups began, at this juncture, to campaign that the reform measures be discarded"*.

In Brazil, the trade liberalization measures, initiated in the framework of the PAEG from 1964 onwards, were retrospectively qualified as a *"half-hearted"* reform attempt. Similarly to Turkey, these measures were not carried out after the end of the program in 1967 and protectionism was not really called into question. *"In fact, the* de facto *multiple exchange rate system which took root in the late 1960' would seem to be as discretionary as, say, the* de jure *1953-1957 multiple exchange rate regime"* (Abreu, 2008a). This was the result of combined pressures not only from domestic manufacturing companies but also from foreign companies established in Brazil (Coes, 1991). A similar fate was reserved to the ambition, clearly stated in the PAEG, to rein in state intervention and the influence of the bureaucracy in the economy. About this, Fishlow (1980) underlined that *"for all its frank commitment to*

capitalism as the source of capital accumulation, the model never corresponded to a free enterprise prototype. Government participation increased after the military intervention." Another sign of the resilience of the ISI model after the PAEG was the persistence of the institutional loophole surrounding Banco do Brasil in spite of the creation of the Brazilian Central Bank in 1964. Banco do Brasil's account in the latter (*conta movimento*) was allowed to remain unsettled, undermining the effectiveness of the Central Bank's monetary as it left the door open to further monetizing of fiscal deficits. In 1966, the debt in this account represented 5.7% of the monetary base and it increased in the next years up to 21% in 1968 (Fishlow, 1980). For all these reasons, the PAEG was considered in Brazil a *"missed opportunity to overhaul the traditional ISI model"* (Abreu, Bevilaqua and Pinho, 2000).

In both countries, vested interests translated into intense lobbying from industrialists as well as inertia from the bureaucracy which ensured the preservation of the ISI model with its main features. Precisely because these features were so crucially beneficial to the industrialists and the bureaucracy, they became entrenched and finally institutionalized. The following decades in both countries were characterized by an accentuation of the intertwined rent-extracting and rent-seeking mechanisms.

6.2.4.2 The role of the military

These two frustrated reform attempts also shed light on the key role played by the military in both countries in the preservation of the ISI model from the 1960' until the 1980'.

In Turkey, the military coups in 1960 and 1971 contributed to the return to power of the Republican People's Party (RPP). The RPP and the military were the guardians of the Kemalist inheritance such as *etatism* and the ISI model established in the 1930'. In 1960, the military put an end to the decade of Democratic Party's rule characterized by the contestation of the *etatist* economic model and the promotion of an agrarian economy based on the Ricardian principle of comparative advantage. The new Constitution, subsequently adopted in 1961, proclaimed the mixed economy as the official economic model of the country (Okyar, 1979). In 1971, the military overthrew again a government opposed to the RPP, the Justice Party of S.Demirel created in the political continuity of the Democratic Party after its dissolution in 1960. By doing so, the military decisively interrupted the reforms enacted in 1970 and led to their progressive abandonment and failure (Rodrik and Celasun, 1990). Although the main policy-makers were maintained in their position, they were progressively deprived from the real policy-making power so that the reforms lost momentum (Tekin, 2006).

In Brazil as well, the military played a decisive role in the preservation of the ISI model throughout its whole implementation period. The initial support that the military provided to ISI in the 1930' persisted through the following decades as highlighted by Abreu *et al.* (2000):*"after 1930 and well into the 1980', political support by the military was often essential to explain the high priority accorded to import substitution industrialization."* After two decades of democratic rule following the Second World War, the influence of the military in the political sphere resumed to its highest level after the 1964 military coup. And this is when its support to the ISI model was most visible. In spite of the avowed objective of the PAEG to reduce the intervention of the state in the economy, the military largely contributed to maintain and even increase the power of the central bureaucracy. In the years following the military coup, new SOEs, such as Eletrobras and Embratel, as well as planning institutions were created; and retired military personnel were appointed to head them (Abreu, Bevilaqua and Pinho, 2000). As a result, public investment expanded from an average of 37.5% of total investment in 1961-1963 to 46.4% in 1965 and SOEs produced up to 30% of manufactured output in 1973 compared to 17% in 1966 (Abreu, 2008a). When A. da Costa e Silva's presidency started in 1967 and A.Delfim Netto was appointed to the Ministry of Finance, the focus of Brazil's economic policy switched back to an ISI-led economic growth and the resulting "economic miracle".

6.2.5 Concluding remarks

In both countries, a combination of vested private interests, bureaucratic entrenchment and political inertia enhanced by the influence of the military contribute to explain the failure to reform the ISI model and the institutionalization of its main features. The model was therefore preserved until the end of the 1970' in spite of the economic distortions that it created. In this context, only the complete exhaustion of the ISI model and the unprecedented external debt crisis of the 1980 could initiate the reform process.

The longevity of the ISI model can also be related to a set of widely shared certainties about the potential of this model and of state intervention to ensure economic prosperity. These beliefs were not built in theoretical debates but rather in the experience of both countries' economic performance throughout the 20th century. They actually came to belong to the psychology or imaginary of both countries' policy-makers, becoming a kind of faith in the economic model which tended to make them blind to its inherent limits.

The incontestable success of the ISI model in boosting economic growth and structurally changing both countries' economies until the 1960' left a strong mark in the

minds of Brazilian and Turkish policy-makers, and contributed to tilt their choices in favour of this model. In Brazil, the belief that the combination of protectionism and economic growth was systematic progressively reinforced throughout the first half of the 20th century (Abreu, 2004a). It was first inherited from the pre-1930 period, when the high protection of the domestic market, made possible by the strong market power that Brazil enjoyed with coffee, spurred a first wave of industrialization and economic growth. This belief was then reinforced by the outstanding economic performance coinciding with the high-noon of the ISI period until the early 1960'. Likewise in Turkey, the success of *etatism* in the 1930' and its status as one of the pillars of the Kemalist inheritance gave it a strong aura among Turkish policy-makers in the following decades, especially those belonging to the Republican People's Party (Özay, 1983).

In parallel, similarly ingrained certainties developed in both countries in relation to the intervention of the state. In Brazil, the success of voluntarist developmentalism, which found its strongest expression during J.Kubitschek's *Plano de Metas*, gave rise to a widespread belief in the unbridled effectiveness of government intervention and the power of political will to triumph over any economic restrictions (Abreu, 1994a). This belief underlying economic policy-making, dubbed *"macroeconomia do homem cordial"* (Abreu, 2004a), explains the indifference in front of such economic distortion as fiscal deficits or accelerating inflation, observed specifically in the 1950'. In Turkey, *etatism "perpetuated a collective psychology of State paternalism"* inherited from the Ottoman Empire's almighty Sultans (Özay, 1983).

The depth of the debt crisis in which Brazil and Turkey plunged at the turn of the 1980' strongly shook those beliefs and decisively weakened the vested interests in both countries, laying the base for a necessary reform of the economic model. This was, however, a long process in both countries which entailed not only reforming the main features of the economic model, in terms of trade policy notably, but also dismantling the institutions of the ISI model and replacing them with new ones more appropriate to a new growth model. The interaction between the stabilization and liberalization efforts on one side and the renewal of the foundations of the economic model will be addressed in the following section. Along this reform path, the divergence between both countries may be explained precisely by the degree of coordination between those two levels of reform.

6.3 1980-2000': The role of economic and political institutions in the reform process

The debt crisis of the late 1970' and early 1980' considerably affected the faith that Brazilian and Turkish policy-makers had in the ISI model and decisively weakened the vested interests that played in its favour. As such, it created political space for a reform of the economic model. However, the political context in both countries, as well as the economic and political institutions inherited from the ISI model, played a determining role in the unfolding of the reform process throughout the 1980' and 1990'. The challenge was not only to launch and carry out structural reforms of the economic model in place. It also lied in the successful dismantling of the institutional framework of the ISI model and in the subsequent building of new underlying institutions to support the economic model established. The interaction between the stabilization and liberalization efforts on one side, and the renewal of the underlying institutions of the economic model on the other side, provides an explanation of the diverging paths followed by the two countries throughout those two decades in spite of the very similar challenges that they faced.

The purpose of this last section is to examine the role that economic and political institutions played in the transition from the ISI model to a liberal economic model in Brazil and Turkey, contrasting both countries' progress in the economic reform process with the change of their institutional framework and examining the degree of coordination between these two spheres.

6.3.1 The role of the political context in the 1980'

In addition to the substantially different external treatment that Brazil and Turkey received during the debt crisis in the beginning of the 1980' – mostly linked to geopolitical considerations as explained in the previous chapter – the distinct political context of the early 1980' also contributes to explain the diverging economic paths followed by both countries along that decade. While the authoritarian regime established in Turkey after the 1980 military coup favoured the implementation of structural reforms, the progressive democratization of the Brazilian regime in the early 1980' made these same reforms more difficult to launch. This contributes to explain why the economic institutions of the ISI model remained throughout the 1980' in Brazil, while Turkey managed to reform them swiftly.

Unlike the previous military coup, in 1971, that had stopped and finally reverted the reforms introduced by S.Demirel, the 1980 military coup in Turkey did not interfere in the

economic reforms launched by T.Özal earlier that year. Instead, the latter was maintained in the key decision-making position, as Deputy Prime Minister, and his reform program received full support from the military. The particularly authoritarian regime established in the aftermath of the military coup even facilitated the reform process by considerably reducing the power of the political opposition. This support was specifically instrumental in the determination of wages. After trade unions were banned, wages were fixed by a central authority, the High Arbitration Council (*Yüksek Hakem Kurulu*). This mechanism ensured the downward flexibility of wages which became key in the successful control of inflation by the Turkish government (Çeçen, Suut Dogruel, Dogruel, 1994). As pointed out by Rodrik (1990), *"this breathing spell allowed T.Özal to implement a set of radical policies which would have been unimaginable in normal times."*

Moreover, the political economy in Turkey also turned favourable to reforms. Throughout the 1980', the reforms carried out by T.Özal, promoting the outward orientation of the Turkish economy, notably through export subsidies, gave rise to a new class of industrialists who emerged as a strong pro-trade coalition and became a major political support of the new economic model. Mostly based in the central provinces of Turkey, as opposed to the traditional north-western industrial centres, these industrialists, also called Anatolian Tigers, stemmed from a third wave of industrialization boosted by the promotion of exports (Pamuk, 2008b). Consequently, they supported the process of economic liberalization and gathered in a rival industrial interest group (MÜSIAD) in 1990, which advocated for open trade policies and supported T.Özal's reforms. This association gathered mostly SMEs and progressively counterbalanced the power of TÜSIAD, the main industrialists' association (Bugra, 1998).

By contrast, in Brazil, the process of political relaxation initiated in the late 1970' made the regime increasingly democratic and rendered the adjustment measures recommended by the IMF more difficult to adopt because of their political cost. The latter contributed to weaken the commitment of the successive governments to orthodox stabilization until 1985. The shock therapy and radical structural reforms implemented in Turkey were impossible in an increasingly democratic regime characterized by a rising level of political accountability. Many letters of intents were exchanged between the Brazilian governments and the IMF, mainly because of the incapacity of the former to reduce fiscal deficits. This came not only from the pressure of external debt payments, but also from an endogenous pressure rooted in the progressive democratization of the political regime. In a climate of rising civil society claims to develop social policies and provide compensations for

the harshness of the crisis, fiscal discipline was too politically painful to be adopted through a more open decision-making process. For instance, the reduction of the coefficient of inflation indexation of prices and wages from 100% to 80% was voted in 1984 by the Brazilian Congress only under high pressure of the IMF (Cardoso and Fishlow, 1990). This difficult vote illustrates the little downward flexibility that wages would have in the 1980' in Brazil, as trade unions were acquiring a growing negotiation power throughout the democratization process (Hermann, 2005a). This contrasts not only with Turkey at the same time but also with what happened during the PAEG, just after the 1964 military coup, when the decreasing real wages by 15% between 1964 and 1967 was instrumental in reducing the inflation. *"The wage cut made room both for budget balancing and for improved external competitiveness, while at the same time bankrolling a cut in the rate of inflation."* (Cardoso and Fishlow, 1990)

6.3.2 Brazil remained trapped in its ISI institutions throughout the 1980'

Under the pressure of international creditors to generate positive net transfers abroad and in an increasingly open and democratic political regime, structural reforms were impossible to launch and the Brazilian governments found themselves trapped in the institutional framework of the ISI model. Generalized monetary indexation, loopholes between fiscal and monetary institutions as well as restrictive trade policies maintained economic imbalances and fuelled inflationary pressures until the end of the 1980'. At least as much as the weight of the external pressure, this institutional framework can be held responsible for the "lost decade" of the Brazilian economy.

The mechanism of monetary indexation, initially conceived as a solution to manage inflationary pressures, rendered inflation rates extremely rigid downwards and became a *"trap for the government"* throughout the decade (Hermann, 2005). It largely participated in the failure of the orthodox stabilization plan in the first half of the 1980', while the second half of the 1980' was dedicated to several unsuccessful attempts to abandon the indexation system which also failed.

Monetary indexation had been introduced in 1964, in the framework of the PAEG, to neutralize inflationary pressures and avoid the acceleration of inflation. Until the mid-1970', this mechanism was widely praised among Brazilian policy-makers for its success in ensuring a relative control over inflation. While the Brazilian economy was experiencing a period of unprecedented growth, notably during its economic miracle (1968-1973), inflation was driven

down from a 92.5% in 1964 to 15.6% in 1973 thanks to a stable environment. However, the main flaw of this system was revealed after the first oil shock. From then on, it absorbed and tended to magnify the impact of all adverse supply shocks – oil shocks, rise of interest rates, bad crop in 1983, upwards adjustment of public sector prices or reduction of public subsidies – on the level of prices, increasing the inflation inertia which kept feeding the mechanism. This led Brazil into an inflationary spiral which brought inflation close to an annual level of 2700% in 1993, in spite of the numerous efforts to reduce the aggregate demand, notably through restrictive monetary and fiscal policies, throughout the 1980'.

Nevertheless, in parallel, indexation was also used by the Brazilian governments to attract foreign capital in order to finance current account deficits and rising public debt. With the adoption of Resolution 432 and 230 (*Resolução 432* and *Resolução 230*) in 1979, the mechanism of indexation was extended to public debt vehicles offering a hedge (in the form of a regular adjustment) against not only the level of inflation but also the exchange rate depreciation (Hermann, 2005). This mechanism fuelled a spiral of public indebtedness since it increased the weight of debt servicing, hence also increasing the need to attract new capital to finance this debt. By 1985, Federal bonds represented 30% of total financial assets in the Brazilian markets, whereas they were quasi inexistent by mid-1960'. As a result, the frequency of their readjustments rose up to a monthly readjustment, which, in turn, was feeding in the inflationary spiral (Cardoso and Fishlow, 1990). Similar pressure came from trade unions to shorten the wage cycles. From an annual cycle, wage-setting periods were made biannual in 1979 and then quarterly in 1984. As a consequence, indexation evolved from a backward-looking mechanism adjusting prices and wages on the basis of past inflation towards a forward-looking mechanism in which inflationary expectations in the future were building future inflation (Hermann, 2005).

The inertial component of inflation and the indexation mechanism as its main driver became the main target of Brazilian governments' policies from mid-1980' onwards. However, this institutional trap was deeply entrenched and revealed much harder to dismantle than expected. The challenge of the desindexation of the Brazilian economy was the subject of intense economic policy debates mostly centred around two alternative options. The first one, proposed by the economist F. Lopes and known as "heterodox shock", was to freeze all prices and wages to break the inertial inflation. The other one, promoted by the two economists P.Arida and A.L.Resende and named after them "Larida" proposal, consisted in creating a stable unit of account in parallel to the currency to progressively neutralize inflationary expectations (Barros de Castro, 2005a).

Between 1986 and 1992, the price freeze option prevailed and was repeatedly implemented in no less than 6 heterodox stabilization plans which all failed after some months. The difficulty came from the lack of synchronization of relative prices at the moment of the price freeze so that they all necessarily generated, at a certain point in time, distortions of relative prices which were unsustainable and led to their abandonment, systematically followed by an overshooting of inflation. In addition, the succession of such plans created a learning process among economic agents anticipating the unfolding of the plans, which progressively diminished their effectiveness. The Cruzado Plan in 1986 was the longest-lived one. All the following ones were shorter in time and less effective in breaking the inflationary spiral so that inflation kept accelerating after each failure (Abreu, 2008b). In consequence, the challenge of dismantling the mechanism of indexation in the Brazilian remained illusive and unmet through the 1980'. Only the adoption of the alternative method, in the middle of the next decade, would be successful.

Besides the indexation, two institutional loopholes also contributed to perpetuate economic imbalances by indirectly discouraging fiscal discipline. The first one, also inherited from the ISI model and deeply entrenched, was the porosity between Banco do Brasil and the Central Bank through the *conta movimento*. This convenient extra-budgetary resource for the Brazilian governments was difficult to dismantle and made fiscal discipline harder to observe. The *conta movimento* was abolished in 1986 (Hermann, 2005). The new Constitution adopted two years later also weakened fiscal discipline by earmarking and decentralizing many fiscal revenues without the corresponding fiscal expenditure obligations. In addition, this deprived the Federal state, which bore the bulk of the public debt, from much-needed resources. Hence, *"the structural obstacles to fiscal adjustment were strengthened by the new constitution"* (Abreu, 2008b).

Finally, the trade regime, inherited from the 1970', remained, until the end of the 1980', highly protectionist hence depriving the Brazilian economy from the benefits of cheaper imports on the level of inflation. In 1984 the level of import penetration was extremely low (4.3%), below its level of the beginning of the 1960', and the average effective import tariffs were still at 67.8% in 1987. The absence of trade reform resulted from the repeated failures to stabilize the economy which *"drastically reduced the degrees of freedom to define and implement foreign economic policies"* (Abreu, 2004b). In the meantime, the IMF was focusing on orthodox fiscal measures and providing little incentives for trade reform.

Throughout the 1980', Brazilian policy-makers found themselves confronted with the dual, and generally conflicting, challenges to achieve stabilization and growth, while consolidating the newly established democratic institutions (Bresser-Pereira, Maravall and Przeworski, 1994). The democratization process combined with the persistence of the institutional framework of the ISI model in spite of its crisis largely contributed to the failure of the stabilization efforts until the end of the 1980'. In fact, Turkey also experienced the same challenge from the end of the 1980' onwards, as its political regime democratized while its apparent economic stability vanished. Here again, institutions played a decisive role, but this time more for their weakness or absence than for their persistence.

6.3.3 The lack of adequate institutions led Turkey to its "lost decade"

The legacy of the long "Özal decade" (1980-1993) is controversial. On the one hand, the major structural reforms of the economic model introduced from January 1980 onwards led to a quick reorientation of the Turkish economy, accompanied by its quick stabilization and return to growth. On the other hand, T.Özal, through his exercise of power, left Turkey with weak political institutions and no developed economic institutions. Patronage politics and corruption grew along with the progressive democratization of the regime in the second half of the 1980'. These weak political institutions hindered the creation of a new set of economic institutions adapted to the liberal economic model established, so that the stabilization achieved in the beginning of the decade progressively vanished and chronic macroeconomic imbalances resumed. The destabilizing effects of this inadequacy between economic model and institutions were amplified by the financial liberalization and led to a decade of political instability and repeated economic crises in the 1990', the "lost decade" of the Turkish economy.

T.Özal's particularly autocratic governing practices reflected a lack of commitment to and consideration of representative institutions, as well as of the rule of law. Even after the adoption of the new Constitution in 1982 and the progressive establishment of a parliamentary regime in the following years, many reforms were imposed in a top-down fashion, through cabinet decrees. To do so, T.Özal created new layers of administration with *ad hoc* entities headed by the so-called "Özal Princes", a handful of young and loyal economists, who wielded high economic-policy making power (Önis, 2004). The objective was to by-pass the traditional state bureaucracy and parliamentary institutions in order to avoid potential blockades and accelerate the reforms.

Besides neglecting the importance of such institutions, T.Özal established highly destabilizing rules of the game in the economic and political spheres, characterized by vote-catching and corruption. In spite of setting up a liberal economic model, T.Özal failed to reform the institutions on which the ISI model lied and to build a new institutional framework. Instead, he largely contributed to the perpetuation of the populist practices observed in the previous decades using distributional fiscal policies to serve political interests. The creation of extra-budgetary funds provided the Turkish government with a large leeway to make arbitrary fiscal spending decisions based on political patronage. At their heights, such funds came to amount altogether to 25% of the regular budget (Rodrik, 1990). By the end of the decade, increasing pressure was also exerted on the Central Bank to provide easy credit to specific sectors (Akyüz and Boratav, 2003). These expansionary policies mechanically caused inflation to fluctuate throughout the decade. Interestingly, these fluctuations followed electoral cycles after 1983, when the first parliamentary elections were organized. Inflation accelerated in 1984 as well as in 1988, after the 1987 elections, illustrating the link between economic policies and political vote-catching practices (Rodrik, 1990). The progressive return to democracy generated popular demands to adjust real wages that the Turkish government was very much inclined to satisfy in spite of the negative impact on macroeconomic stability since T.Özal considered inflation a *"necessary cost of economic growth"* (Bakir and Önis, 2010). This climate of distributional economic policies maintained rent-seeking behaviour and even fostered corruption among circles of power. Corruption scandals involving fictitious exports reported by private companies to enhance the level of subsidies received from the state came out publicly and affected the highest spheres of the power. However, the response from the Turkish government to these allegations was to modestly call for *"economic punishment for economic crimes"* (Önis, 2004). By doing so, it set a precedent of impunity which had a lasting effect in the Turkish political and economic spheres. From the end of the 1980' to the beginning of the 2000', Transparency International's corruption perception index in Turkey substantially deteriorated from 4.05 to 3.2 (out of 10).

As underlined by Waterbury (1992), the ambiguity and even the paradox of the Özal decade in Turkey precisely lies in the dichotomy between the early and successful commitment to structural economic reforms in favour of market mechanisms on one side; while, on the other side, the level of state intervention remained through the persisting system of political patronage and distributional policies serving a network of interests and maintaining the coalition of the government. By ignoring the rule of law and the need to

create strong economic institutions to counter-balance market forces, T.Özal contributed to durably weaken the Turkish economy and democracy (Önis, 2004).

The inadequacy between Turkey's economic model and its political and economic institutions was further enhanced by the quick liberalization of the financial account in 1989 (Alper and Önis, 2003), a move for which the Turkish economy revealed highly unprepared as stabilization had not been completely achieved (Akyüz and Boratav, 2003). To the increased economic instability, resulting from the volatility of capital flows, corresponded a period of high political instability which reduced the capacity of Turkish politicians to define and implement economic policy responses. Throughout the 1990', Turkey had no less than eleven short-lived governments, gathering parties with radically opposed views in terms of economic policy. This fragmentation of the economic policy formulation resulted in a decade of *"politics without policy"*, with dreadful consequences for the Turkish economy (Cetin, 2010). In addition to persistent fiscal imbalances and inflationary pressures, *"conflicting views of coalition parties delayed the institutionalization of economic change"* (Cetin, 2010). This contributed to maintain the Turkish economy in an extremely unstable path and led to several crises caused as much by internal imbalances as by external shocks.

Political instability and the system of political patronage systematically reduced the governments' commitment to build strong institutions to curb the adverse effects of the increased economic instability. The long delays of the privatization process and of the establishment of a banking regulation in the 1990' are illustrative of the impact of the weak political institutions. Because these processes were not given a proper legal structure or simply ignored during the 1980', they both became highly politicized and captive of clientelist political parties and rent-seeking behaviour in the 1990'.

The privatization process was initiated in the mid-1980' with the creation of the Housing Development and Public Participation Administration (HDPPA) in 1984. However, the law providing a strong legal framework to the privatization process was only voted in 1994. Before then, privatization was run by government decrees and remained subject to the commitment of the executive power to push it forward, leaving little autonomy to the HDPPA. Therefore, as the political system became increasingly unstable at the turn of the 1990', the privatization process stalled since political parties' level of commitment and capacity to wield significant executive power diminished. In addition, privatization became hostage of the clientelist logic of the Turkish political system in which political parties strove to build and preserve their political base. In this context, the absence of a strong legal

framework and of an autonomous institution to lead such a process made it vulnerable to the many obstacles put on its way by political opponents. This explains why the pace of privatizations remained low in Turkey, with relatively small proceeds, until the end of the 1990' (Ercan and Önis, 2001).

The regulation of the banking sector also experienced such politicization and delays, though with much harsher consequences for the Turkish economy. In spite of the rising level of risk born by the banking sector, the banking regulation remained extremely weak throughout the 1990'. The level of interpenetration between the banking sector and the political sphere did not change in the 1980' and even increased after the liberalization of the capital account. In the 1990', banks *"had largely become instrument for channelling deposits into political rent distribution"* (Bakir and Önis, 2010). The commitment of the successive governments to establish a strong regulatory system to frame the banking activities and avoid their excesses was therefore weak throughout the decade. As pointed out by Bakir and Önis (2010),*"this politicization process was responsible for the poor supervision and regulation of the banking sector, which mainly generated inadequate internal and external control, poor risk assessment and management mechanisms, and poor corporate governance in the banking sector."* Indeed, the absence of adequate regulation created a permissive environment for Turkish banks allowing them to take on an increasing level of risk. By the end of the 1990', Turkish banks' open foreign exchange position represented 210% of their equity and 28% of their loans were non-performing. The accumulated losses of the two largest public banks amounted to 12% of GDP in 2000 (Bakir and Önis, 2010). This unsustainable level of risk born by Turkish banks led to a major banking crisis in 2001 that considerably worsened the economic crisis and plunged the Turkish economy in a deep recession. After being nominated Minister of the economy, K.Dervis immediately diagnosed that *"the current crisis has stemmed from the problems of the banking sector"*.

More generally, the series of economic crises in the 1990' were caused not only by the instability of the external financial environment but also, and above all, by the weaknesses of its institutions and the excessive imbalances that they generated in the public indebtedness and in the banking sector. This is especially true for the last one in 2000-2001.

In conclusion, the political and economic instability of the Turkish economy in 1990' is, in large part, the consequence of the lack of proper institution building associated with the economic reforms of the 1980'. This is the link Çetin (2010) highlighted when he wrote: *"liberalization created a rent-seeking society rather than a credible economic and political*

institutional environment. The institutional endowment of the pre-1980 had continued during the 1980' and the 1990' as well."

6.3.4 The time of reforms and institution building in Brazil

By contrast with Turkey, the Brazilian political institutions became stronger throughout the 1990' and finally allowed the transition to a new economic model carried out simultaneously with the creation of a new institutional framework.

Concluding the democratization process, the new Brazilian Constitution was adopted in 1988 and the first President of the so-called *Nova República* was elected in a direct popular vote in 1989. Beyond these first important steps, the new democratic regime demonstrated the strength of its institutions in a major ordeal which came in the shape of an impeachment procedure launched for corruption allegations against F.Collor de Melo only two years after the presidential election. Such procedure, although politically motivated, first revealed a very strict treatment of corruption in the higher spheres of the Brazilian state, in sharp contrast with what happened in Turkey at the same time. It was then successfully carried to an end, leaving the Vice-President, I.Franco, take office until the end of the mandate, in 1994, as established by the Constitution. The fact that the new democratic institutions resisted such an early blow was also a remarkable sign of their strength. And what is even more outstanding is that this difficult context did not hamper economic policy-making as significant economic reforms, such as the liberalization or debt renegotiation processes, were launched and, some of them, completed during this time.

This period of strengthening of the political institutions opened the way for a decade of stable political environment, which was instrumental in completing the economic reforms. Just like T.Özal in the 1980' in Turkey, this decade was marked in Brazil by the personality of F.H.Cardoso who embodied the transitional reforms. From 1993 when he was appointed to the Ministry of Finance, until 2002, when his second presidential mandate ended, F.H.Cardoso was at the helm of economic policy. However, contrasting with the Özal decade, the "Cardoso decade" was characterized not only by structural reforms changing the economic model but also by the establishment of a new institutional framework sustaining the reforms.

The main achievement of F.H.Cardoso's first years in office was to finally succeed in dealing with the mechanism of indexation and to tackle inflation with the implementation of the Real Plan. To meet the challenge of desindexation, the Real Plan benefitted from the past experiences of all the previous failed stabilization attempts and built its success on a different

approach, avoiding the old mistakes (Barros de Castro, 2005b). The Larida approach, the alternative to price-freezing, was adopted and represented the key success factor of the stabilization. With the creation of a parallel unit of account (*Unidade Real de Valor* or URV), F.H.Cardoso's team managed to break the inflationary expectations. The inertial component of inflation was absorbed into the URV. During several months, the URV coexisted with the nominal currency. All Brazilians were then invited, on a voluntary basis, to indicate their price in URV and adjust relative prices through negotiation before the old currency was eventually replaced by the new currency called Real. As the Real was stable, pegged to the USD, inflationary expectations sharply declined. Being gradual and fully voluntary, this mechanism avoided the trap in which all the price-freeze stabilization attempts had fallen, that is to maintain price distortions which generated unsustainable inflationary pressures (Barros de Castro, 2005b).

The successful desindexation of the Brazilian economy was accompanied by significant reforms of the economic institutions, which were instrumental in reducing fiscal deficits and restrict monetary expansion. Consequently, these institutional reforms contributed to limit the surge of demand emanating from the successful control over inflation.

The PAI (*Plano de Ação Imediata*), launched in 1995, included a comprehensive reform of the administration and of the social security system specifically designed to support the effort of reduction of fiscal deficits. This reform notably intended to limit the level of fiscal spending involved by the Constitution. Among them, the pension system was particularly generous as it granted Brazilian workers with a full pension after only about thirty-five years of contribution. In order to modify the structure of incentives of the pension system, a new mechanism, the *Fator Previdenciário*, was introduced in order to proportionate the level of pension to the number of years worked and the age of retirement.

The banking sector, deeply affected by the lower inflation, was restructured with the support of a public fund (PROER for program for restructuring financial institutions) dedicated to guarantee the solvency of Brazilian banks through the protection of their assets. The support of this institution was instrumental in avoiding a full-fledged banking crisis in 1995 when capital outflows, following the Mexican crisis, threatened Brazilian banks. After this, a consolidation of the banking sector was promoted through the privatization of several public banks and the increased opening of Brazilian banks' capital to the participation of foreign investors (Studart, 2005). This restructuration also played an important role in accompanying the adaptation of Brazilian banks to the revolution that the suddenly low level of inflation represented for them. These new conditions on the domestic financial market

forced them to completely remodel their business practices. Finally, the Central Bank's power of regulation and supervision of the banking sector was increased (Barros de Castro, 2005b). These efforts targeting the banking sector were crucial to ensure the stability of the new Brazilian currency, the Real, which was pegged to the US dollar. The example of Turkey is particularly telling in this regard, since the failure of the exchange-rate stabilization plan adopted in 1999 was partly due to a major banking crisis (Akyüz and Boratav, 2003).

Finally, the process of privatization, initiated by F.Collor de Melo in 1990 with the launching of the National Plan of "de-statization" (*Plano Nacional de Desestatização*), was substantially accelerated, benefitting from a strong legal framework and a stable political environment. Most of the 33 companies privatized between 1990 and 1994 were sold in the last two years, generating USD 8.6 billion. And privatization revenues increased to USD 11 billion from 1994 to 1998 (Barros de Castro, 2005b). This process was accompanied by the creation of sectorial regulatory agencies, such as ANATEL (*Agência Nacional de Telecomunicações*) for the telecommunication sector, ANP (*Agência Nacional do Petróleo, Gás Natural e Biocombustíveis*) for the oil sector and ANEEL (*Agência Nacional da Energia Elétrica*) for the electricity sector.

In conclusion, the transformation of the Brazilian economy undertaken during the first mandate of F.H.Cardoso included simultaneously liberalization and stabilization reforms redesigning the economic model, as well as profound reforms of the institutional framework. As such, F.H.Cardoso applied in parallel the main elements of the Washington Consensus, namely the economic liberalization and stabilization, in parallel with what came to be known as the post-Washington Consensus, that is to say the construction of strong regulatory institutions to frame the new economic model (Stiglitz, 1998). This ensured the sustainability of the stabilization achieved and substantially reduced the type of internal disequilibria found in Turkey throughout the 1990'. In the second half of the 1990', the main elements of destabilization of the Brazilian economy came mostly from the outside, namely from the repeated external shocks which put the Brazilian economy and led it into crisis from 1999 onwards.

6.3.5 The completion of the institutional framework after the 2000-2001 crisis

After the most serious financial and economic crisis since the turn of the 1980', a new wave of institutional reforms was undertaken in both countries along with their respective stabilization plans. In Brazil, most of the regulatory institutions had already been set up in the

previous years, but a last set of reforms was undertaken to strengthen the institutional framework. In Turkey also, some institutional reforms had been slowly initiated but many others were implemented in the post-crisis period with the help of a double anchor, the IMF and the EU.

In Brazil, the stabilization plan adopted in November 1998, in the aftermaths of the Russian financial crisis, included major institutional reforms anchoring fiscal and monetary discipline into the future economic policy-making. The highlight of this new wave of reform was the Law on Fiscal Responsibility voted in 2000, which redefined the fiscal relations between the Federal government and the states, constraining current fiscal expenditures with a mandatory primary surplus target of 3%. Moreover, the activities of the Central Bank were restructured and its autonomy reinforced both in the monetary policy-making and in the supervision of the banking sector. The adoption of inflation targeting as its main objective contributed to increase the transparency of the monetary policy (Barros de Castro, 2005b). Fiscal primary surplus, inflation targeting and floating exchange rates constituted the so-called macroeconomic policy tripod, the main legacy of F.H.Cardoso's decade in terms of economic policy.

In Turkey, a new momentum in favour of institutional reforms had been initiated from mid-1990' onwards under the influence of the significant acceleration of its rapprochement with the EU, which acted as a first anchor. In preparation for its full membership to the EU Customs Union in 1995, the Turkish government finally provided a strong legal framework to the privatization process with the creation of the Competition Board in 1994. In the Helsinki Summit of 1999, Turkey was then accepted as a candidate to the full membership to the EU. Because this candidacy implied the adoption of the *acquis communautaire*, it gave an even stronger incentive in favour of deep reforms, both in the economic and political spheres (Önis, 2003). In addition and support to the external anchor of the EU, came the IMF from 1999, when the financial crisis started affecting the Turkish economy and a bailout plan was signed, including a set of reform objectives. The economic reforms promoted by the EU as part of the *acquis communautaire* were in line with the institutional reforms called for by the IMF, putting a strong emphasis on the establishment of a strong regulatory framework. From 1999 onwards, the EU and the IMF therefore acted as a double external anchor to foster reforms aimed at reinforcing the economic institutional framework in Turkey. The deep crisis in which Turkey plunged by the end of the 2000 favoured the emergence of a pro-reform coalition, which was led by K.Dervis from March 2001 onwards. Considered a *"policy*

entrepreneur" (Bakir, 2009), he was previously working at the World Bank and was known for his commitment to economic reforms.

As a result of the double anchor and of the economic crisis, several key reforms were achieved. First of all, the privatization process was tremendously accelerated in 2000 with proceeds jumping to USD 2,400 billion that year from an average of about USD 500 billion throughout the 1990' (Ercan and Önis, 2001). Moreover, after the 2001 banking crisis, the banking system was finally restructured and regulated. Several banks, which found themselves in a situation of bankruptcy, were bailed out by a Savings and Deposit Insurance Funds (Bakir and Önis, 2010). The prudential principles of Basel II were adopted and the Banking Regulatory and Supervisory Authority (BRSA), initially created in 1999, was eventually established and made fully operational after the appointment of K.Dervis in 2001 (Önis, 2004). Finally, a new law reinforced the autonomy of the Central Bank and made inflation targeting its main monetary policy tool.

This set of institutional reforms, in addition to the successful stabilization of the Turkish economy, came as a second step of the liberal transition of the 1980'. As such, K.Dervis ensured the transition from the Washington Consensus to the post-Washington Consensus in Turkey and provided the necessary institutional complement to T.Özal's economic reforms, a decade later.

6.3.6 This new institutional framework contributed to ensure the stability of economic growth in the following decade in both countries

The economic crisis was followed in both countries by a period of political stability with the accession to power of L.Lula da Silva in Brazil and R.T.Erdogan in Turkey which promoted the continuity and sustainability of the reforms implemented. In both countries, the new institutional framework was endorsed and reinforced by the following government and actually constituted a strong basis that ensured the stability of the economic growth experienced in the next years, even facing the 2008 global financial crisis.

In Turkey, the political reforms implemented in the wake of the Helsinki Summit to comply with the EU conditions led to a reinforcement of the democratic institutions and eventually to a significant improvement of the political environment. To the decade of chronic political instability succeeded a long period of political stability with the election of the AKP in 2002 and the accession of R.T.Erdogan to the position of Prime Minister in 2003. This political stability allowed to maintain a continuity in the economic policy-making, since the Transition Programme designed by K.Dervis's administration in 2002 for the following two

years was adopted and implemented by the new AKP government. The stable macroeconomic environment that resulted from this continuity in economic policy-making was one of the key factors for the strong economic recovery that the Turkish economy experienced in the following years. This link between political stability and economic growth was underlined by Bakir and Önis (2010) to characterize this period: *“the move towards democratic consolidation in Turkey, with much greater emphasis on accountability, the strengthening of institutions and the rule of law, helped to create an environment conducive to improved economic performance.”*

Likewise in Brazil, in spite of his strong historical opposition to the economic policies implemented by his predecessor, L.Lula da Silva maintained the institutional framework he inherited and ensured the continuity of economic policy-making in terms of commitment to fiscal and monetary discipline. In a letter to all Brazilian citizens prior to his election, he detailed his economic program. Although critical of the reforms achieved, he voiced a strong commitment to carry on the efforts to reduce fiscal imbalances and the public debt, hence honouring all previous engagements of the Brazilian Federal state. The successful stabilization and structural economic reforms implemented during the two mandates of F.H.Cardoso were undoubtedly decisive in providing the ground for the period of strong economic growth that the Brazilian economy experienced.

6.4 Conclusion

The examples of Brazil and Turkey over the last two decades of the 20th century illustrate the decisive impact of political and economic institutions on the economic policy choices and performance.

After the adoption and progressive institutionalization of the ISI model in both countries from the 1930’ to the end of the 1970’, the transition to a new economic model involved various challenges and turned out to be a much more arduous path than expected. The challenge for both countries after the 1980’ debt crisis was not only to reform their economic model but also to set up new economic institutions to consolidate the newly established economic model.

In Turkey, the inadequacy between the liberal economic model adopted in the beginning of the 1980’ and the institutional framework inherited from the ISI period led to poor economic performance and major internal crises throughout the 1990’. Similarly, in Brazil, the economic institutions of the ISI model persisted throughout the 1980’ and largely

contributed to impede a successful stabilization of the economy. However, once reforms were undertaken from the very end of the 1980' onwards, they encompassed both the economic model and the necessary regulatory institutions.

In this sense, the focus of the Washington Consensus on the retraction of the state intervention in the economy proved to proceed from an incomplete analysis. What was needed was a transformation of the role of the state in the economy from being a direct producer to becoming a regulator, allowing markets to perform their allocational tasks efficiently and sustainably. Recent economic research showed that it is not the sheer size of the state intervention in the economy but the nature of its intervention that matters. The idea that markets work better when the state efficiently plays its role of regulator and facilitator has been emerging in the end of the 1990' from the shortcomings of the Washington Consensus (Rodrik, 2012). It progressively became a crucial addendum to the Washington Consensus justifying the denomination of Post-Washington Consensus (Stiglitz, 1998). Throughout the 1980' and 1990', Brazil and Turkey went through a process of economic and institutional reforms characterized by the adoption of the Washington Consensus and the Post-Washington Consensus. Both countries followed their own pace in this process and illustrate the complementarity between the two components of the reform process.

In fact, although the concepts were not coined at that time, one can say that Turkey adopted the Washington Consensus without immediately following with the Post-Washington Consensus. The gap between the two phases of reform generated the chronic imbalances observed from the end of the 1980' until the beginning of the 2000'. In reverse, the Brazilian reform process included, in a single decade the elements of the Washington Consensus and the Post-Washington Consensus. This contributes to explain the more stable performance of the Brazilian economy throughout the second half of the 1990' and its better resistance to the successive external shocks as compared to Turkey.

The examples of Brazil and Turkey also demonstrate how the quality of the political institutions favours or interferes in the process of reform of the economic model and of the economic institutions.

Both countries experienced a deterioration of their political institutions as they came back to a democratic regime. One of the manifestations of this was the increasing corruption observed in the late 1980'. However, it was not dealt with in the same way in both countries and this had a decisive impact on the institutional framework. In Turkey, comparably more intense laxity dominated and corruption dragged along the whole 1990', considerably hindering the establishment of an adequate institutional framework. Whereas in Brazil, the

case of corruption detected in the beginning of the 1990' resulted in a procedure of impeachment, which contributed, along with other elements, to stabilize the political institutions and favour economic and institutional reforms.

In addition, the stability of the political environment also proved to be crucial to foster economic and institutional reforms. In both countries, the most prolific periods for reforms coincided with political stability, either guaranteed by an authoritarian regime or by well-established democratic institutions. Interestingly, these periods of stability and reforms were also associated, in both countries, with a strong political personality who came to embody the transition: T.Özal in Turkey and F.H.Cardoso in Brazil

To close the circle of this chapter, it is interesting to notice that both countries actually came back, in the last two decades, to the original debate of the 1930' on their degree of integration into world markets and the level of state intervention. But this time, their answer was different. Both countries tended toward the free trade and private sector alternative, taking significant steps in this direction throughout the past three decades. However, several remains of the former economic model are still present and many reforms are still pending. In spite of the strong economic performance of the past decade, it seems that both countries are still in search for their new economic model which, for now, looks more like a blend of various economic traditions rather than the liberal model advocated in the Post-Washington Consensus.

7. General Conclusion

This broad comparative work offers an interestingly and unexpectedly well-functioning parallel between Brazil and Turkey's economic development throughout the 20th century. This parallel is articulated around the adoption of a model of late industrialization through Import Substitution, its progressive institutionalization and its final dismantling in favour of a more liberal economic model. At each of these three major steps in their economic development, the economic policy challenges and choices made in Brazil and Turkey shared many characteristics.

Although many of the limits and excesses of the ISI model have been detailed in this study, it is important to point out that they do not cancel the outstanding achievements that it permitted. The ISI model, initially adopted as the only economic option to face the impact of the Great Depression, provided an exceptional boost to both countries' economic development. It ensured an extremely high economic growth, which allowed them to quickly modernize the economic structures from an agricultural to a strong industrial base. According to Maddison's (1985) statistical data, the average annual GDP[23] growth rates experienced by Brazil and Turkey from 1929 to 1980 were 5.7% and 4.9% respectively – rates substantially higher than those of many industrialized countries. In terms of GDP per capita, the performance was also impressive with an annual growth of 3% in Brazil and 2.4% in Turkey throughout the same period.

In addition, the strong industrial bases that Brazil and Turkey built during this period of time became a key element of their successful integration into the world economy, which started slowly from the 1960s onwards and intensified after the liberalization of the trade regime. The growth of manufactured exports and the international competitiveness of both countries owe much to the intense support to the industrialization process provided with the ISI model.

However, progressively captured in a network of vested interests, the ISI model became institutionalized. Several of its main features came to be highly entrenched and immune to any reform attempts in spite of their inadequacy with the changing economic context and despite the numerous imbalances that it generated. Rent-seeking behaviour pervaded the public and the private sectors, the oligopolistic position granted to domestic companies by the protectionist trade regime reduced their competitiveness and the weight of external constraints grew as import-substitution was exhausted. The model was preserved in

[23] In 1990 Purchasing Power Parity adjusted US dollars (Maddison, 1985).

both countries at the expense of macroeconomic stability, through massive public spending fuelling external debt and inflationary pressure.

After the external debt crisis of the 1980', Brazil and Turkey initiated a transition of two decades toward a more liberal economic model. The delays in the economic reforms and in the building of a new institutional framework created many imbalances and crises, which contributed to explain the long duration of the transition. Each country experienced a "lost decade" and it took them another major financial crisis before completing the first set of necessary reforms. Only after strong regulatory institutions and macroeconomic discipline were established did both economies recover and entered a cycle of strong and stable economic growth, averaging 4% in Brazil and nearly 5.5% in Turkey between 2002 and 2011.

This decade of prosperity propelled them to the front of the international stage, drawing increasing attention, particularly from foreign investors, who poured capital into both countries' economies. In the meantime, boosted by their growing economic strength, Brazil and Turkey emerged as regional powers and asserted their international ambitions. Brazil progressively took the lead in Mercosur while Turkey strove to rebuild its diplomatic ties with its neighbours and to become a regional example of economic prosperity combined with an ongoing democratization process.

This decade also contributed to bring the two countries closer. Both countries sought to reinforce their diplomatic relations and actually developed a strong bilateral cooperation in the past decade. Trade expanded quickly with, for instance, Turkish exports to Brazil increasing more than ten-fold between 2001 and 2012[24]. In May 2010, an Action Plan for a Strategic Partnership was signed as a result of intense diplomatic interactions involving a first presidential visit to Turkey made by President L.Lula da Silva in 2009 followed by an official visit of the Turkish Prime Minister, R.T.Erdogan. This partnership set ambitious trade objectives and laid the ground for a broader cooperation, including in the military. Finally, the joint diplomatic initiative conducted by the two countries in the delicate Iranian nuclear negotiation process in 2010 also bore witness to their rapprochement and to the new role they intended to play on the international scene.

The little immediate impact of the global financial crisis in 2008 on both countries boosted this confidence, as it seemed to demonstrate the success of the transition and to promise bright future growth prospects. However, since 2012, economic growth rate has

[24] Source Turkish Ministry of Foreign Affairs **http://www.mfa.gov.tr/relations-between-turkey-and-brazil.en.mfa**

substantially decreased in both countries. In Turkey, GDP growth went from 9.2% in 2010 to 2.2% in 2012, while it dropped from 7.5% to 0.9% in Brazil over the same period.

Along with this abrupt economic slowdown, social and political tensions suddenly surfaced through massive demonstrations in May and June last year against the incumbent governments' policies. Although rooted in the specific context of each country and targeting different issues, these two simultaneous and spontaneous episodes of widespread protests were initiated and embodied mostly by middle class citizens who were well-integrated in the Brazilian and Turkish societies. They were set in motion mainly through social media and expressed a general discontent with the way economic policies and political choices were made in both countries, specifically pointing to the problem of corruption. The various symbolic interactions between Brazilian and Turkish protesters – such as a Brazilian flag carried in the streets of Istanbul or a slogan saying "Brazil will be another Turkey" adopted by Brazilian protesters – show a certain degree of concordance in the inspirations underlying these two movements.

Both the economic slowdown and last year's massive protests are signs that Brazil and Turkey find themselves at a turning point that the present study may help to analyse. The two countries have apparently come to the limits of the growth momentum generated by the structural reforms completed in the early 2000s. The fruits of these reforms were reaped in good part thanks to the reestablishment of macroeconomic stability, which ensured the sustainability of the economic growth cycle but also thanks to particularly favourable economic conditions. The combination of the cheap credit provided by the very low interest rates in the US and the trade boom and soaring commodity prices – mostly generated by the astonishing growth of the Chinese economy – played a major role in ensuring a quick and relatively easy economic growth to Brazil and Turkey in the 2000s.

However, the structural reforms undertaken in the 1990s and early 2000s did not solve all the problems and bottlenecks of the Brazilian and Turkish economies. Important economic challenges and institutional weaknesses remain to be addressed. The reform momentum was somehow lost during this boom period. The size of the current account deficit, the low level of investments and the poor development and performance of infrastructure in such key sectors as energy and transportation are all obstacles to both countries' potential growth and require further structural reforms.

Unfortunately, the significantly deteriorated economic and political climate in both countries provides no easy ground for reform. Some practices observed in the past are reappearing. State intervention in the Brazilian economy has been increasing in the past years,

particularly in the manufacturing and banking sector. Lately, the Brazilian government has shown a renewed inclination to resume control over several key prices and manipulate the level of inflation, which picked up from 3.6% in 2007 to 6.6% in early 2014 and is actually flirting with the target ceiling of the Central Bank. In Turkey, after more than ten years in power, R.T.Erdogan has been facing mounting opposition and criticisms for some policy choices, notably related to urban planning and infrastructure, and for his authoritarian governing style. The constitutional reform stalled and the political climate has become extremely tense as regular protests have been ongoing since May 2013. Since the end of last year, the tension has grown a level up after corruption allegations touched ministers of the Turkish government and even members of the Prime Minister's family. Finally, both countries' currencies have been under pressure and have depreciated significantly in the last months as a result of the phasing-out of the FED's quantitative easing. In their latest report published in 2013, Morgan Stanley Global Emerging Markets Equity team classified Brazil and Turkey among the "Fragile Five", the most vulnerable emerging economies[25]. Likewise, in her first audience in Congress on February 11, Janet Yellen, who recently took office at the head of the US Federal Reserve, voiced specific concerns about Turkey and Brazil that she considered most precarious of all[26].

All of these are important signs of a loss of impetus of the growth dynamic but also, and above all, indications that both countries are still looking for their economic and political model. In both countries, the legacy of the liberal reforms is being progressively re-examined (Önis and Senses, 2005; Amann and Baer, 2002). Lately, both countries' economic policy-makers seem to have taken some distance from the liberal policy agenda and have been increasingly blending it with ideas and practices inherited from the ISI model. Brazilian and Turkish economists and political scientists have been closely following the creation of what some of them qualified as a potential hybrid model.

In Brazil, the debate over the level of state intervention in the economy still lays in the background of economic policy debates. The ideas underlying the ISI model are still being defended, notably by industrialists, and have proven particularly resilient to the liberalization process initiated in the 1990'. The renewed voices in favour of state intervention and the positive responses that these claims obtain have been shaping what some call a liberal neo-

[25] Morgan Stanley Global Emerging Markets Equity Team, "Tales from Emerging World", December 2013 https://www.morganstanley.com/public/Tales_from_the_Emerging_World_Fragile_Five.pdf

[26] Les Echos, "Le Brésil tente de restaurer sa crédibilité", T.Oger, February 22, 2014. http://www.lesechos.fr/economie-politique/monde/actu/0203329594297-le-bresil-tente-de-restaurer-sa-credibilite-652097.php

developmentalist model (Ban, 2013). In Turkey, the influence of the European Union and international financial institutions has been significantly diminished in the past years and the reform agenda that they promoted has lost ground (Burak Güven, 2012).

In this context, pending interrogations are plenty as Brazil and Turkey seem to find themselves at a crucial crossroad in their economic development: will both countries manage to undertake the structural reforms that will unlock their growth potential? Is the institutional framework in place in both countries strong and adaptable enough to support this difficult pass and incentivize these reforms? Will both countries be able to keep building their economic model without falling in the traps of the past?

This year is an important electoral year for both countries with presidential elections upcoming in August in Turkey and October in Brazil. The economic and political challenges in both countries are very high. Let us hope that the lessons from the past will be remembered in the two countries and that structural reforms will be successfully undertaken aiming to put them back onto a sustainable growth path and to increase the welfare of their respective populations.

Finally, to put this work in a broader perspective, the case of Brazil and Turkey's economic development in the past decades lends further credit to the idea that, especially in the case of emerging economies, institutions and past institutional development matter. In consequence, this work might also be read as an invitation to take a closer look at these countries through a historical perspective in order to remain aware of the institutional weaknesses inherited from their past economic development that still need to be addressed.

Contrasting with the surprise generated by the protests in Brazil and Turkey, R.Sharma noted, about all emerging economies, that *"all these countries we celebrated for doing so well have their own faultlines. And that's the biggest mistake we made: we looked at their successes and forgot their domestic issues."*[27]

[27] The Washington Post, Wonkblog, "The protests in Turkey and Brazil shouldn't surprise you" by E.Klein, July 2, 2013. http://www.washingtonpost.com/blogs/wonkblog/wp/2013/07/02/the-protests-in-turkey-brazil-and-egypt-shouldnt-surprise-you/

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