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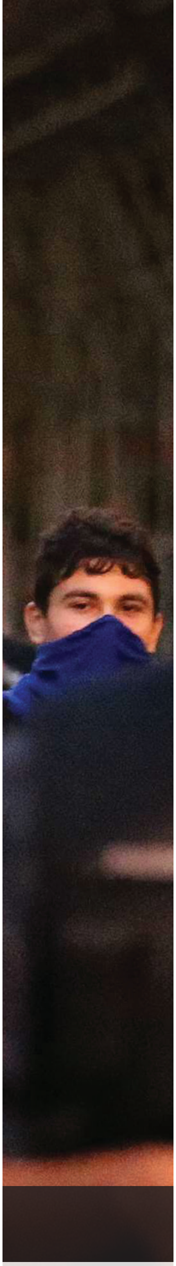

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Just Another BRIC in the Wall? A Comparison of Recent Brazilian and Turkish Economic Developments

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ABSTRACT *This paper compares various macro-prudential and policy tools, set against various aspects of the countries' recent political economies, used by Brazil and Turkey to address some issues currently affecting the more attractive emerging markets: international capital inflows, inflation, and, current account deficits. By looking at two of these vibrant emerging economies, and examining their respective approaches to managing the domestic side effects of increased liquidity in the global financial system, this paper seeks to divine lessons for other policy makers and analysts.*

As emerging markets have become exponentially more fashionable, both as an academic concept and as a home for investors seeking greater returns than are broadly possible in the world's slowed developed economies, comparison of two of the most important emerging markets, Brazil and Turkey, is timely. It goes without saying that the two have significant differences. They are disparate in size (in terms of both population and landmass); exist in profoundly different contemporary regional and geopolitical contexts; and have relatively different historical contexts in their paths to becoming fully democratic nation states. What they share is what this article will focus on. This is not limited to an increased attention on their remarkable potential for growth, but a recent history of serious structural economic development abridged by economic crises.

The international economic environment, characterized by low growth rates and dominated by the quantitative easing of many central banks, has retained its ability to affect the two nations' domestic economies rapidly and profoundly. This is well documented. In October 2012, Ben Bernanke, in his role as

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U.S. Federal Reserve Chairman, addressed the issue specifically at a seminar in Tokyo: "Concerns have been raised about the spillover effects of our policies on our trading partners. In particular, some critics have argued that the Fed's asset purchases, and accommodative monetary policy more generally, encourage capital flows to emerging market economies. These capital flows are said to cause undesirable currency appreciation, too much liquidity leading to asset bubbles or inflation, or economic disruptions as capital inflows quickly give way to outflows."[1] The environment created by the monetary policies of key central banks is one that has serious implications for policy makers in emerging markets – particularly those with histories of inflation.

This paper compares some of the varying macro-prudential and policy tools used by Brazil and Turkey in the aftermath of the global financial crisis. The comparison is valuable. It illustrates two approaches that might be taken to address current and common problems affecting emerging markets: international capital inflows, inflation, and current account deficits. To this end, looking at how Brasilia and Ankara have plotted their courses in attempting to use policy measures to manage the massively increased levels of liquidity now found in the global financial system, despite obvious structural differences in the economies, is worthwhile. This is particularly so when the shared elements in the two countries' history are considered.

Lula brought stability and legitimacy to Brazil's young democracy. This legitimacy, in turn, helped to provide a degree of popular underpinning to the stability and legitimacy of the country's financial system and currency

In Brazil and Turkey, inflationary episodes, coupled with a dependence on external debt, have frequently accompanied political instability. Political stability is no longer the concern they once were for either country. However, the memory how the two once combined is worth assessing. It may shed light on how the combination's lingering aftertaste has shaped current governments contemporary approaches to new dilemmas. This paper argues that the apparently successful deployment of "unorthodox" policy by the Turkish Central Bank, when set against Brazil's more conservative approach, has paid substantial dividends over the last twelve months for Turkey. Brazil's approach has, at the time of writing, seemed far less adroit.

Both face what has come to be known as the policy 'trilemma' – how to effectively manage exchange rates; interest rates; and deal with the flow of money caused by loose monetary policies around the world. In managing the wave of global liquidity, which has sought out markets with yield, is it acceptable to argue that extraordinary times call for extraordinary measures – and justify the risk of following "unorthodox" policies? In this paper, I suggest that Turkey's approach has, for the time being, been the more effective. Whether this will hold two years from now, only time and the chairman of the U.S. Federal Reserve seem likely to tell.

Two Countries, Both Alike in Dignity

The last twelve months have seen increasing disparities in international perceptions of two of the world's most prominent emerging markets. Brazil has long been lionized as one of Jim O'Neill's, former Chairman of Goldman Sachs Asset Management, four rising economic powerhouses; alongside China, Russia and India. Turkey has, until recently, been treated more with the approach of *cave emptor* – its inflationary history and current account deficit, combined with long memories of political instability, have acted as red flags for international investors.

On the surface, the similarities seem rare. The vast difference in scale should set the two entirely apart. According to World Bank estimates, Brazil had a population of around 197 million in 2011, making it nearly three times more populous than Turkey. This is underscored by raw geography – when placed against Brazil's 3,288,000 square miles, Turkey's not inconsiderable 302,500 square miles seem small. These simple disparities are enhanced by the economic differences. One is a multi-faceted commodity exporting superpower with a vast internal market, famously the first consonant in the BRIC moniker, while the other is a consumption driven and energy importing economy with a complicated neighbourhood. The difference in natural endowments underlines the scale of Turkey's ambitions. It is the Ankara's intention to be one of the ten largest economies in time for the 100th anniversary of the founding of the Turkish Republic in 2023. Meanwhile, Brazil became the world's sixth largest economy in 2011 with GDP of \$2.5 trillion, as it overtook the United Kingdom.

However, when scale is stripped away, key data indicate interesting similarities. While an arbitrary measure, the difference in GDP per capita (as of 2011) is notable, with Turkey's \$14,700 comparing favourably to Brazil's \$11,900.[2] Both countries came through the international financial crisis relatively unscathed and returned rapidly to growth. Both have subsequently slowed, as the international environment has evolved. A tidal wave of global liquidity, searching for high yielding economies (or, more precisely, economies which actually demonstrate growth potential) has added to concerns, whether perceived or real, of currency "wars" waged against emerging markets. Meanwhile, consumption slowdowns due to political and economic factors in some of Brazil

BRAZIL, Fortaleza: Anti-government demonstrators run away from tear gas.

AFP / Yuri Cortez

and Turkey's major export markets have added to an environment where the moves of their respective central banks have been watched closely.

Why Brazil vs. Turkey?

This paper contends that an analysis can be conducted on the premise that both economies suffer from a similar weakness – they are finance constrained. This constraint is vital. It means that external financing is needed. This forces economies to rely on international capital to support their development. It means that interest rates come to be used as a tool to attract capital inflows. This opens the countries to the effects of the market forces loosed by the U.S. Federal Reserve, among others, exceedingly accommodative monetary policy of the last few years. Therefore, an analysis of some elements of macro-prudential policies applied in reaction to this environment is useful in presenting two different approaches to economic management.[3] By understanding Brazil and Turkey's recent economic past, looking at what has followed since 2008, and assessing their respective approaches, it may draw some insights for economic policy making in emerging markets.

A brief look at the recent histories of the two economies shows the main villains to be political and economic instability. Put simply, both economies have faced a similar enemy over the last 30 years – inflation.

Hyperinflation and the Plano Real

In Brazil's case, the story begins with the rash of privatizations, which accompanied the liberalizing reforms of the 1980s. As time came due on Brazil's ruling military junta, a slow march towards full democracy began. This period of political change was accompanied by significant economic difficulties. It drew to a close with a moribund economy and high and accelerating inflation. This happened despite three attempts to break the threat of inflation. Brazil's authorities had manufactured a number of 'heterodox' economic shocks in trying to deal with the problem: 1986's Cruzado Plan; 1987's Bresser Plan; and, 1989's Summer Plan. These three ultimately failed attempts attempted to reduce public sector indebtedness by applying traditional measures: fixing the exchange rate; price, rent and mortgage payment freezes; wage readjustment and freezes; and, bans on indexation. All the while Brazil went through currencies with alarming rapidity - between 1986 and 1994 the country had six currencies. Brazil finally alighting on the Real in 1994, as part of a larger macroeconomic stabilization plan, having enjoyed various incarnations of the Cruzeiro and a number of Cruzados.

President Itmar Franco's appointment of Fernando Henrique Cardoso to the position of Minister of Finance, and Cardoso's subsequent introduction of the Plano Real, began to reign in an economy which was fast running out of control. [4] Cardoso worked to tame Brazil's hyperinflation, focusing on three areas: the introduction of a national equilibrium budget, a process of general indexation, and the introduction of the Real.

The Plano Real attempted to break the cycle of inflation, and inflationary expectations, by pegging the Real to the U.S. Dollar. Its positive effects are clear. Since the introduction of the Real early 1994, Brazil's inflation has broadly been contained, with the notable exception of a transitory price surge in 2002.[5] The scale of its success cannot be underestimated. World Bank data show that inflation fell from 2,287 per cent to an average of 45 per cent in 1995-96.[6] Since then, the government's policies to ensure stability have relied on an inflation targeting regime, an emphasis on fiscal discipline, and, a flexible exchange rate. As a result, inflation fell to an average 6.4 per cent between 1997 and 2010.[7]

The Rise of Lula

All the while, the threat of political instability worried the markets. This was emphasized by 2002's price surge. Concerns over a worsening economic situation in Argentina combined with what seemed to be the likely election of the left wing, and populist, Luis Inácio Lula da Silva in Brazil's 2002 presidential elections drove a rapid rise in inflation. Yet, Lula failed to live up to the worst of the market's expectations. Despite tub-thumping threats of debt default, a populist stance on the soapbox was not mirrored by his economic management. Lula's market-oriented, mostly technocrat pleasing, policies continued to build a strong Brazilian economy – driven by a continued battle to combat inflation. In addition, by maintaining his earlier emphasis on welfare for the poorest, within the broader context of 'sound money' and orthodox economic management, Lula brought stability and legitimacy to Brazil's young democracy. This legitimacy, in turn, helped to provide a degree of popular underpinning to the stability and legitimacy of the country's financial system and currency.

Brazil's successful transition of power from military dictatorship to full democracy characterized by relatively prudent economic management came at a propitious moment. As the world's economy began to heat up, particularly the demand for primary commodities to fuel and equip the rapid expansion of Brazil's BRIC cousins, the raw material blessed nation was put in prime position to benefit. The combination of inflation targeting and international serendipity bore significant fruit. Brazil's growth rates in the following decade tell this eloquently. The country was only slowed by a 0.5 per cent contraction in 2009. This was followed by an astonishing return to 7.5 per cent growth in 2010.[8]

Talking Turkey

The similarities in Turkey's political economy are noteworthy. Since World War II, Turkey has had an average of one new government every nine months.[9] This political instability was also, until recently, accompanied by sporadic economic crises. Sometimes, as in 1994 and 2001, the political and economic crises occurred in unison. Three factors fuelled this historic instability: high interest rates, inflation, and slow growth.[10] As in Brazil, until the 1980s, the state had a strong role in the main sectors of the economy. From this point on Turkey liberalized and moved away from the import substitution policies, which had characterized earlier periods of the republic's history. The period also saw the beginning of an export led growth strategy, greater trade and financial liberalisation, and the beginning of privatisation efforts, as Turkey increasingly opened itself to the international economy.

A History of Crises

The last period of reforms took place against the backdrop of a number of crises. In January 1994, Turkey was downgraded to junk by international credit ratings agencies, as the authorities mounted an unconvincing attempt to keep domestic interest rates low. As the country lapsed into another of a long stream of economic crises, which had affected it since the 1950s, international capital poured out. The downgrade, and a lack of confidence in the government's budget deficit target, caused an exchange rate collapse. Politics were played out in public, with the downgrade bookended by the resignations of two governors of the Central Bank. Some of the economic stresses came to bear on the country's overall political landscape. In 1995's general election Necmettin Erbakan's Welfare Party topped the poll with 21.8 per cent of the popular vote. This heralded the rise of a new presence on the national scale of Turkish politics. The parallels with Turkey's 2001 crisis and 2002's general election, are striking.

Latterly, Turkey's 2000-2001 crisis became a confluence between political and economic problems. A sustained period of political instability made the sustainability of the authorities exchange rate based stabilization programme seem uncertain. Again, it led to massive international financial outflows and a stock-market crash.[11] Its effects cannot be over-emphasised. The crisis had an estimated cost equal to 26.6 per cent of 2001's total GDP. At the apex of the crisis, inflation reached more than 70 per cent with interest rates topping 6,200 per cent. The Lira lost half its value almost overnight, and the International Monetary Fund (IMF) was forced to intervene.[12] It took two years for financial inflows to become positive once more.[13] As it had less than a decade earlier, economic crisis presaged political upheaval. 2002's general election saw the rise of Recep Tayyip Erdoğan's *Adalet ve Kalkınma Partisi* (AK Party) government. The AK Party has gone on to build a reputation, despite initial concerns about populism, partly predicated on the strong technocratic management of the economy. The period following the 2001 crisis has been characterized by general control over inflation – managed by a democratically elected government. By 2004 inflation had fallen into single digits for the first time in thirty years.[14]

Due to the financially constrained nature of the economy, Turkey continued to depend on international financial flows to cover for its own inadequate, domestic savings, and investment rates

As it emerged from 2001, Turkey started a process of structural reforms, partly to reduce the threat of future violent capital outflows. These reforms included improved fiscal and public financial management. Vitally, the framework macroeconomic management was redesigned. Now, an independent Central Bank is responsible for inflation targeting and the Lira is free floating. The perceptions of the Central Bank's independence have been vital in ensuring international comfort with the economy's management. It means that the goal of supporting sustainable public and external debt positions has, so far, been attained.

Experiences of earlier crises meant that authorities also looked to protect their financial sector – aware of its vital role in the negotiating the complicated path around the economy's financially constrained nature. This meant that 2008 authorities had taken measures to reduce the impact of a sudden stop in international financial flows. These included increased capital buffers, strengthened banking regulation and supervision, and more conservative banking practices.[15] The necessity of these was learnt the hard way, as the cost of collapsed banks in 2001 was around $39.3 billion. The reforms' utility can be seen in the country's relatively rapid recovery in the aftermath of 2008's crisis.

Moving On Up, But To Where?

Even factoring in the collapse in external demand, which accompanied the 2008-2009 financial crisis, Turkey's economy has continued on a more-or-less upward growth trend. Notably, at moments in 2011 it exceeded even China's. As the economy has grown, so international opinion has shifted towards increased certainty around, and improved recognition of, Turkey's newfound strengths.

The last six months of macroeconomic news from Turkey have been relatively positive. The economy grew by 8.5 per cent in 2012, but is expected to slow to 3.5 per cent in 2013. Despite this slow-down, it is now clear that authorities managed to pull deliver an economic "soft-landing." The late 2012 and early 2013 tightening of Turkey's notorious current account deficit, which by December 2012 stood at an unexpectedly low 6 per cent of GDP, meant that the item pointed to as Turkey's key macroeconomic weakness had proved less of an Achilles heel than expected. The managed slow-down, and the policies which supported it, is the key to understanding the differences in current economic conditions in Turkey and Brazil.

Credit Upgrade

This change was epitomized by Fitch Ratings' November 2012 ratings upgrade.[16] In justifying their decision to return Turkey's debt to investment grade for the first time since 1994, Fitch highlighted the country's moderate and declining government debt burden; its sound banking system; as well as what it perceived as favourable medium-term growth prospects. Vitally, the current account deficit had narrowed while inflation was falling.

It also highlighted the change in the country's political economy. Its perceptions of stability meant that Turkey was returned to a rating for financial soundness, which it hasn't held since 1994. The crisis touched on a little earlier in this paper outlined some of the reasons for the agencies' subsequent downgrade in their opinions of the Turkish economy. While it will still require upgrades from the two other main agencies, Standard & Poor's and Moody's,

BRAZIL, Brasilia: The president of Brazil, Dilma Rousseff during the signing ceremony of the first public announcement of terminals for private use, at the Planalto Palace, seat of government in Brasilia, capital of Brazil.

ESTADAO CONTEUDO / Andre Dusek

for Turkey to be included in benchmark investment grade bond indexes, the direction of travel, at least in terms of international opinion, is clear.[17] The immediate effects are apparent. The sovereign's ability to borrow will be enhanced by an associated fall in borrowing costs and yet more investment flows will be attracted to Turkey's already popular markets.

The upgrade followed a two-year period in which Ankara tussled increasingly volubly with the ratings agencies. It had been a particular point of contention for Prime Minister Erdoğan, who has presided over the decade long transformation of Turkey's economy in the decade since the AK Party came to office. He and his team have long argued that the ratings agencies have underestimated Turkey. Their argument is relatively straightforward. The last ten years have seen the economy grow at around an average of 5 per cent a year. Inflation has broadly remained under ten per cent, a far cry from the triple figures of the late 1990s.

Hot Money: Unorthodox Cooling

As Turkey's economy picked up after the financial crisis, a demand boom largely financed by external sources developed. Growth was partly driven by an import intensive, credit-dependent domestic demand boom. It was financed by foreign loans and an overvalued real exchange rate. This caused the current account deficit to grow rapidly. This trend was made more worrying by the highly volatile and international nature of the financing. By the end of 2012 external debt had risen to 15 per cent of GDP. Here is proof, were it needed, of Dani Rodrik's argument. Due to the financially constrained nature of the economy, Turkey continued to depend on international financial flows to cover for its own inadequate, domestic savings, and investment rates.

Just as in Brazil, an unholy trinity of declining global interest rates; increased liquidity as Central Banks looked to deflate away debt; and the flood of international "hot" money searching for yield provided fuel to Turkey's demand boom. What made this particularly dangerous was, and is, the short-term and transitory nature of the money – it could be withdrawn just as easily and quickly as it had arrived.[18]

Emerging economies, like Turkey and Brazil, continue to depend on international finance to cover their constraints and support investment and growth

As the economy took off in 2010 and 2011, it was driven by strong domestic demand, supported by rapid credit expansion. From late 2011 the economy's growth dynamics, as a result of deliberate policies aimed at its rebalancing, became ever more reliant on external financing and credit growth. This brought back two specters from Turkey's past: an increasing current account deficit, coupled with double-digit inflation. A significant difficulty for policy makers is that growth and the current account deficit have, over the last few years, grown hand-in-hand. This is made clear by the strong correlations between the price of oil and the current account deficit. HSBC research in 2011 illustrated that the country's total energy bill in 2010 reached $35.2 billion, or 19 per cent of total imports. On this basis, they estimated that a ten-dollar per barrel rise in the price of oil impacts the current account deficit by increasing it by 0.6 per cent of GDP. To say that this is a tricky relationship would be a significant understatement.

Turkey's exposure to "hot-money" and the threats this poses to macroeconomic stability was reflected by the Central Bank's "unorthodox" policy measures. These applied varying reserve requirements for both the Turkish Lira and foreign currency to increase maturities and raise the cost of funding. The Central Bank simultaneously widened its interest rate corridor and reduced its policy rate to discourage short-term capital inflows. With inflation down to 6.2 per cent in December 2012, only 1.2 per cent above the target rate of 5 per cent, some success in slowing credit growth could already be seen. Combined with increased international stability in energy prices and declines in food prices, inflation seemed well contained – and underlined the efficacy of the Turkish approach at that moment in time.[19]

The Central Bank's novel approach, carried out in conjunction with the Banking Regulation and Supervisory Agency, acted to slow down the growth of credit in the economy. It has, so far, successfully rebalanced the economy and supported Turkey's soft landing in late 2012. By reducing the velocity of credit growth, while encouraging a cooling off towards more sustainable levels of GDP growth, the authorities have been able to confront, so far, both the current account deficit and inflation. Despite international sentiment's initial contrarian positions on the policies, the Central Bank's high-wire act has been successful, so far.

The Future: Domestic Investment Needed

Looking forward, two interwoven issues will need to be confronted: Turkey's inadequate domestic savings rate and its current account deficit.[20] The fall in savings has been sharp. World Bank data indicate that domestic saving declined from an average of 23.5 per cent of gross national income in the 1990s to 17 percent between 2000 and 2008. It has continued this downward trend, as it fell to 12.7 per cent in 2010. This was matched by an increase in the current account deficit between 2002 and 2008. The picture is simple, foreign financing has been used to support investment demand. Concerted efforts to increase the level of domestic savings will be needed. The authorities have started to move on this, but much has yet to be done to encourage greater growth in this area.

Brazil's Rapid Return to Growth and Speedy Decline

Brazil spent the last decade feeding off high commodity prices and the successes of its reforms of the last two decades. A revitalized inflation-targeting regime allowed it to benefit from international demand for its raw produce. This is borne out by oft-repeated data. During 2004-2010, annual GDP growth averaged 4.4 per cent, compared to 1.9 per cent in the previous seven years.[21] This meant that in 2009 Brazil seemed a far better bet than Turkey, as it entered the crisis "with a much smaller external imbalance than Turkey, and as a result has experienced a much more shallow recession."[22] However, what happened afterwards has done much to change previously generous perceptions.

A Short Recession

Brazil's initial resilience to the crisis, and subsequent rapid return to growth, was astonishing. Its recession only lasted two quarters. Vitally, credibility built over the last decade ensured that Brazil's authorities could use expansionary fiscal and monetary policies, which were particularly notable during Brazil's 2010 election. The Central Bank of Brazil was able to cut its policy rate while reducing reserve requirements. A slow 2009 was quickly forgotten; growth hit 7.5 per cent in 2010.

Since then, expansion has been driven by domestic demand, fueled by expansionary fiscal policies and rapid credit growth. Foreign money flowing into Brazilian stocks and bonds accelerated. In 2007, they stood at $5 billion. By March 2011 the annualized figure was more than $50 billion.[23] With high domestic interest rates, and the extraordinarily low interest rates across the globe, the inflows seem inevitable under the current policy proscriptions. They add to the inflation risks inherent in Brazil's economy, with the scale of the flows applying upward significant pressure on the value of the Real.

Meanwhile, the strength of domestic demand and consumption increased the current account deficit. This rose from 1.5 per cent of GPD in 2009 to 2.3 percent in 2010. The financial flows that made this possible were due in no small part to the loose monetary policies of the U.S. Federal Reserve. It is feasible to argue that these developments are the inevitable result of making the economy internationally competitive. Ruchir Sharma, the head of Emerging Market Equities and Global Macro at Morgan Stanley Investment Management, argues "Hyperinflation finally came under control in 1995, but it left a problem of regular inflation behind. Brazil has battled inflation ever since by maintaining one of the highest interest rates in the emerging world. Those high rates have attracted a surge of foreign money, which is partly why the Brazilian Real is so expensive related to other currencies."[24] Despite all this, the economy began to slow. It did so dramatically in 2011, continued this trend in 2012, and seems likely to do so again in 2013.

Capital Inflows and Slowing GDP Growth

For Brazil this "hot money," together with widening current account deficit and increased private sector debt have become increasingly problematic. There are similarities with the problems Turkey has grappled with. The flood of foreign money buying up Brazilian assets has made the currency one of the most expensive in the world, with some prominent analysts now considering that the effect has been to make Brazil one of the world's most costly, overhyped economies.[25]

The Central Bank's response has been deeply orthodox. It has increased the monitoring of prudential and macro-prudential risks while tightening capital requirements to slow credit growth. Authorities have attempted to augment these measures with monetary and fiscal policy instruments to control domestic demand growth. As in Turkey, Brazil's authorities have become concerned about the dangers of overheating. Their response was initially a contractionary monetary policy. This had to be relaxed as the global economic outlook worsened.[26]

Despite government stimulus, Brazil's economy grew by only 0.9 per cent in 2012. This was its worst performance since the height of the financial crisis.

Allied with this problem are the falls in savings and investment. Savings were equal to just 14.8 per cent of GDP in 2012, down from 17.2 per cent in 2011. GDP growth is now down further from 2011's unimpressive 2.7 percent in 2011. This is not helped by the authorities consistently over-optimistic growth projections, often volubly expressed. These do little to calm the markets and much to erode the credibility carefully built over the last decade.

When Orthodoxy Just Won't Cut It

Like Turkey, Brazil has been caught in the headlights of the world's expansive monetary policies. The influx of external capital flows has placed upward pressure on the Real, and the resulting inflation has merely elicited a traditional response from Brasilia. Capital controls have been brought into action; price controls applied in an attempt to control inflation; and unwise conditions have been attached to stimulus in key sectors.[27]

The deployment of a sub-optimal policy mix has undermined the credibility of both the government and the central bank. Credibility, once lost, is hard to win back easily. Current perceptions indicate that this will be hard, as the market now sees unhinged inflation expectations; detrimental inflation dynamics; fiscal targets which are only met with arbitrary accounting exercises; official forecasts which seem to have been divorced from reality; and, a lack of acknowledgement that Brazil is dealing with partly endogenous problems.[28] Combined with this loss of credibility, Brazil's economic policies have become increasingly interventionist. When put together, the two might yet prove dangerous.

Whether Turkey's daring and relatively high risk approach will continue to be effective has yet to be seen

Belatedly, and after two years of attempting to boost growth by using lower interest rates, the authorities appear to have reached the conclusion that Brazil has a supply problem.[29] What is clear is that their approach to monetary policy has not been effective in stimulating growth in current economic circumstances. Inflation remains high and there have been two consecutive years of falling GDP growth figures. The Central Bank has held the Selic base interest rate of 7.25 per cent steady since October, arguing for caution in balancing inflation against the need to stimulate growth. With inflation apparently now the Central Bank's key concern, a level of agility in treating both upward pressure on the Real and finding policy tools to encourage sustainable growth, is going to be a hard trick for Brazil's authorities to pull off. The conservative and interventionist approach has lacked the daring (and, inevitably, the risk) of that used in Turkey. It has also lacked success.

Economic Management and the 'Trilemma'

Market sentiment is ever more strongly reflective of change. By early March, Turkey had been moved up the ranking of top picks for emerging market investors by Heckman Global Advisors.[30] Following its performance in 2011 and 2012, the country's desirability as an investment destination continues to rise. What they see is clear. Investors find the yield on Turkish debt most attractive of all. Turkish sovereign yields on the benchmark two year bonds are around 5.7 per cent, a dramatically better return than that offered by U.S. T-Bills or U.K. Gilts. Set against the backdrop of an international environment in which emerging market returns have declined in the first months of 2013, with the MSCI Emerging Markets index down 1.62 per cent year-to-date in March, indicates the dexterity with which Turkey is managing its position.[31] Brazil, by contrast and given its problems with inflation, was viewed as a "value trap."[32]

Under the circumstances, it seems that Brazil's traditional approach to policy management has not been as successful as it might have been. Its shortcomings have seen the authorities lose credibility, as well as control over inflation. It is not enough to blame the inflationary tendencies on 'Dutch Disease,' global currency wars, or, other exogenous factors. Policy makers could do worse than looking at the historical political economy underlying the choices made thus far, and see that a break with the past can be a good thing. . Extraordinary times may call for extraordinary measures. While not an entirely analogous situation, authorities in Brasilia might do well to look to Ankara's approach of the past few years.

The question for policy makers around the world will be whether they seek high-risk strategies, or continue to use conventional tactics, in attempting to cool financial flows

Why does this matter? For the past decade, the U.S. exchange rate has shaped emerging markets' investment prospects, where an artificially weak dollar, supported by loose Fed policies has greatly increased the global money supply. The significant reduction of costs for the funding for carry trades and portfolio shifts to higher-yielding bond, equity and currency markets, while boosting commodity prices, has greatly benefited emerging market exporters like Brazil.[33] With a new government in Tokyo preparing to loosen its monetary policy, and the European Central Bank likely to continue its quantitative easing by 'stealth,' the global economic environment may only become more liquid over the coming months and years.

This search for effective policy measures to apply in these conditions is made all the more pressing by The People's Bank of China's March announcement that companies and individuals sold $109 billion worth of foreign exchange and bought an equivalent amount of renminbi in January. The Financial Times reported that this was a record for a single month.[34] There are signs of significant capital inflows to China, a form of "hot money." which has caused a surge in inflation. This warning explains why Chinese authorities worked so hard in the first months of 2013 to reduce excess liquidity, and announcing that its economy was slowing.[35] If this becomes the new normal in emerging markets, for how long with Turkey's approach to dealing with the unpredictable and inflationary tendencies of short-term capital inflows continue to be viewed as unorthodox?

It seems clear the U.S. Federal Reserve sees responsibility lying with those at the receiving end of its policies. In the same speech cited earlier, Ben Bernanke later stated: "the effects of capital inflows, whatever their cause, on emerging market economies are not predetermined, but instead depend greatly on the choices made by policymakers in those economies. In some emerging markets, policymakers have chosen to systematically resist currency appreciation as a means of promoting exports and domestic growth. However, the perceived benefits of currency management inevitably come with costs, including reduced monetary independence and the consequent susceptibility to imported inflation. In other words, the perceived advantages of undervaluation and the problem of unwanted capital inflows must be understood as a package--you can't have one without the other."[36]

The warning is clear. This new environment will continue. Understanding its possible upsides, and finding adequate tools to deal with its downsides, is a key role for economic policy makers. Whether this demands an entirely new approach to managing capital inflows and inflation, or a more nuanced application of older and more established tools is not yet clear. What does seem clear is that capital controls, and other forms of traditional government intervention in the market, have not yet managed to do the work of corralling and containing the effects of quantitative easing.

Conclusion

As Dani Rodrik has made plain, the model which dominated thinking about economic growth until recently was based on the presumption of capital shortage. He has elegantly recast this argument as a three-pronged syllogism: (1) Developing nations are constrained by finance and therefore need foreign capital to grow, (2) But foreign capital can be risky if they do not pursue prudent macroeconomic policies and appropriate prudential regulation. (3) So developing countries must become ever more vigilant as they open themselves up to capital flows.[37] It is the third element this paper has attempted to shed some light on. Emerging economies, like Turkey and Brazil, continue to depend on international finance to cover their constraints and support investment and growth. For them, and others like them, it is indeed clear that vigilance will be needed.

In the remarkable conditions of global liquidity brought about since the international financial crisis, the question remains open as to how emerging markets best deal with these conditions. Whether Turkey's daring and relatively high risk approach will continue to be effective has yet to be seen – but at this moment, what is clear is that the authorities have approached this unconventional problem with unconventional tools, and have had a degree of success which some of their peers have not managed. Looking forward, Ben Bernanke's warning is clear. We may be likely to see quantitative easing to infinity and beyond. The question for policy makers around the world will be whether they seek high-risk strategies, or continue to use conventional tactics, in attempting to cool financial flows. Inducements to encourage domestic savings and investment, which reduce dependency on external capital, will be vital in the long run. Again, this will be a question of carrot and stick – will Brazil's IOF tax work - with its intended penalizing of short-term portfolio flows and nudging investors into more long-term investments - or will a more elegant solution need to be found to encourage long-term positions, and investments, in these economies?

Brazil's decade long membership of the world's most exclusive emerging market club, the BRICS, is a boon for the country

The dilemma also begs a second question. Brazil's decade long membership of the world's most exclusive emerging market club, the BRICS, is a boon for the country. Blessed with an abundance of natural resources, and what seemed ten years ago to be a suitable and sensible approach to economic management, Brazil's inexorable march to economic fortune should be inevitable. Resource poor Turkey, by comparison, was simply not as compelling. As Douglas McWilliams has recently argued, we might be tempted to look again at how emerging markets are defined – instead looking at sunrise, sunset, and, serendipity economies.[38]

Brazil's inherited bounty marks it out as a serendipity economy – bearing the right products at the right time, as much by good fortune as by planning. Turkey, by contrast, seems a sunrise economy.[39] Consistent growth now seems to be a result of careful policy choices informed in part by the country's lack of saleable goods, which can be cut out of the ground. If both of this paper's arguments are followed to their logical conclusions it seems that serendipity has its benefits, but recent events show that it may have a limit to its ultimate usefulness.

Endnotes

1. Chairman Ben S. Bernanke, a speech at the "Challenges of the Global Financial System: Risks and Governance under Evolving Globalization," a High-Level Seminar sponsored by Bank of Japan-International Monetary Fund, Tokyo, Japan, October 14, 2012, retrieved March 17th 2013, from http://www.federalreserve.gov/newsevents/speech/bernanke20121014a.htm.

2. This is GDP per capita on a purchasing power parity (PPP) basis. World Bank data, retrieved March 17th 2013, from www.worldbank.org.

3. This follows Dani Rodrik's assertion in his 2009 paper "The Turkish Economy After the Crisis" in which he argues that Turkey is, like Brazil, a finance-constrained economy. It is telling that interest rates have been quite high and at double-digit levels – at least until the recent crisis. Among emerging markets, Turkey's real interest rates are in fact second only to Brazil's." Dani Rodrik, "The Turkish Economy After The Crisis," Harvard Kennedy School, November 2009, pg. 16.

4. In fitting with the theme of political instability, President Franco was himself only appointed after the impeachment of Ferdinand Color de Mello. Color de Mello, the first directly elected President of Brazil, was impeached on corruption charges in 1992.

5. Concern over Lula's likely victory in that year's presidential elections led to capital outflows, a sharp increase in the real exchange rate, increased difficulties for Brazil in accessing international capital markets, and a rapid return to double-digit inflation.

6. World Bank: International Bank for Reconstruction and Development & International Finance Corporation: Country Partnership Strategy For The Federative Republic of Brazil For The Period FY2012-2015 (Report No. 63731-BR), pg. 2.

7. ibid, pg. 2.

8. World Bank data, retrieved March 17th 2013, from www.worldbank.org.

9. Ruchir Sharma, *Breakout Nations: In Pursuit of the Next Economic Miracles* (New York & London: W.W. Norton & Company 2012), pg. 114.

10. ibid, pg. 115.

11. Rodrik, "The Turkish Economy After The Crisis," pg. 3.

12. Sharma, *Breakout Nations: In Pursuit of the Next Economic Miracles*, pg. 115.

13. Rodrik, "The Turkish Economy After The Crisis," pg. 5.

14. Sharma, *Breakout Nations: In Pursuit of the Next Economic Miracles*, pg. 116.

15. International Monetary Fund: Turkey: Financial System Stability Assessment, September 2012 (IMF Country Report No. 12/261), pg. 4.

16. Fitch upgraded Turkey's long-term foreign currency Issuer Default Rating (IDR) to 'BBB-' from 'BB+' and the Long-term local currency IDR to 'BBB' from 'BB+', with stable outlooks on the long-term ratings.

17. It should be borne in mind that Moody's still rates Turkey one notch below investment grade, while S&P has it at two notches below investment grade.

18. Tevfik Aksoy, "Turkey 2013 Outlook: Taking Off Again With Better Balance," Morgan Stanley, January 22nd 2013, pg. 2.

19. ibid, pg. 3.

20. Steve Bryant, "Lowest Saving in 30 Years Risks Turkish Growth, World Bank Says," Bloomberg, March 12th 2012, retrieved April 9th 2013, from http://www.bloomberg.com/news/2012-03-14/lowest-saving-in-30-years-risks-turkish-growth-world-bank-says.html.

21. World Bank: International Bank for Reconstruction and Development & International Finance Corporation: Country Partnership Strategy For The Federative Republic of Brazil For The Period FY2012-2015 (Report No. 63731-BR), pg. 2.

22. Rodrik, "The Turkish Economy After The Crisis," pg. 23.

23. Sharma, *Breakout Nations: In Pursuit of the Next Economic Miracles*, pg. 59.

24. ibid, pg. 62.

25. ibid, pg. 59.

26. World Bank: International Bank for Reconstruction and Development & International Finance Corporation: Country Partnership Strategy For The Federative Republic of Brazil For The Period FY2012-2015 (Report No. 63731-BR), pg. 2.

27. Juan Lorenzo Maldonado, "Why Did Brazil Underperform its Peers in 2012? Policy," EconoMonitor, January 15[th] 2012, retrieved March 12[th] 2013, from http://www.economonitor.com/analysts/2013/01/15/why-did-brazil-underperform-its-peers-in-2012-policy/.

28. ibid.

29. Affonso Pastore, Cristina Pinotti & Marcelo Gazzano, "Brazil: Change in the Evaluations of the Central Bank", Global Source Partners, January 28[th] 2013, pg. 1.

30. Kenneth Rapoza, "What To Buy In Emerging Markets in March," Forbes, 6[th] March 2013, retrieved 15[th] March 2013, from http://www.forbes.com/sites/kenrapoza/2013/03/06/what-to-buy-in-emerging-markets-in-march/.

31. ibid.

32. ibid.

33. ibid.

34. Leslie Hook and Simon Rabinovitch, "China Warns Over Fresh Currency Tensions", Financial Times, 8[th] March 2013, retrieved 15[th] March 2013, from http://www.ft.com/intl/cms/s/0/930f90e6-87ca-11e2-b011-00144feabdc0.html#axzz2NeAhL5lK.

35. Zero Hedge, "Spot China's Hot Money Time-Bomb," Zero Hedge, 11[th] March 2013, retrieved 15[th] March 2013, from http://www.zerohedge.com/news/2013-03-11/spot-chinas-hot-money-time-bomb.

36. Bernanke, A speech at the "Challenges of the Global Financial System: Risks and Governance under Evolving Globalization," from http://www.federalreserve.gov/newsevents/speech/bernanke20121014a.htm.

37. Rodrik, "The Turkish Economy After The Crisis," pgs. 11 & 12.

38. Douglas McWilliams, "BRICs are obsolete – we need new ways of judging the global winners," CITY AM, March 20[th] 2013, retrieved March 28[th] 2013, from http://www.cityam.com/article/brics-are-obsolete-we-need-new-ways-judging-global-winners.

39. Since this paper was written in early April 2013, some developments have taken place, which are worth documenting. Firstly, Moody's upgraded Turkey to investment grade on May 16. Secondly, and more helpfully for the argument this article seeks to make, this was accompanied by a sharp drop in the average yields on Turkish sovereign dollar bonds. They fell to 3.6 per cent and, as Reuters reported, traded below Brazil's for the first time. Sujita Rao, "Update 1 – Investment grade Turkey hopes for and fears more investment", Reuters, May 17[th] 2013, retrieved May 29[th] 2013, from http://www.reuters.com/article/2013/05/17/turkey-economy-investment-idUSL6N0DY24720130517.