# Why Reading Diaz -Alejandro is Essential for Understanding Financial Crises

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***LACEA's 19th Annual Meeting***

***Carlos F. Diaz-Alejandro Lecture***

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# Outline of talk

- **A Diaz-Alejandro bibliography**
- **Brief biographical note**
- **The anatomy and sequence of a financial crisis according to Diaz-Alejandro**
- **Where does that leave Latin America now?**
  - **Lessons from the 1980s and 1990s for the 2010s**

**Please note that throughout the *italics* are Diaz-Alejandro's own words**

# Essential Bibliography


"Good-bye Financial Repression, Hello Financial Crash," *Journal of Development Economics* 19, (1985), 1-24.

"Latin American Debt: I Don't Think We are in Kansas Anymore", *Brookings Papers on Economic Activity*, (1984), Vol. 2, 335-403.

"Stories of the 1930s for the 1980s" In Pedro Aspe, et al. (eds.) *Financial Policies and the World Capital Market: The Problem of Latin American Countries*, Chicago: The University of Chicago Press for the NBER, 1983

# Other Selected Bibliography

Edmar Lisboa Bacha and Carlos F. Diaz Alejandro, "International Financial Intermediation: A Long and Tropical View," *Essays in International Finance No*. 147, Princeton University, May 1982.

Carlos F. Diaz-Alejandro, Richard N. Cooper, Rudiger Dornbusch, "Some Aspects of the 1982-83 Brazilian Payments Crisis," Brookings Papers on Economic Activity, Vol. 1983, No.2, (1983), 515-552.

Carlos F. Diaz Alejandro and Gerald K. Helleiner, "Handmaiden in Distress:World Trade in the 1980s," North-South Institute, Ottawa, Overseas Development Council, Washington DC, and Overseas Development Institute, London, 1982.

Richard A. Brecher and Carlos F. Diaz-Alejandro, "Tariffs, Foreign Capital, and Immiserizing Growth," *Journal of International Economics* Vol. 7(4), 1977, 317-322.

**Carlos F. Díaz-Alejandro** was a Yale profesor. He started there in 1961 as an assistant professor in the department of economics immediately after his graduate training at MIT. Carlos took a brief detour a few years later to the University of Minnesota, but, by 1969, he returned to Yale to become the youngest full professor ever in the economics department. In 1983, some dear friends of his doing outstanding work on subjects central to his intellectual interest lured Carlos to join them at Columbia University.

Carlos died in New York on July 1985, leaving behind not only an amazing intellectual output, but also a multitude of students, colleagues, friends and academic devotees who loved the man at least as much as his writings. We count ourselves among that group and offer him this homage a quarter of a century after his premature death.

When Carlos went to MIT in the late 1950s, it was with the wish to use that training to go back to his beloved Cuba. His application read…

*…. hopeful that sound and dynamic economic policies could do a great deal toward improving the general standard of living in my country Cuba. This fact has weighed heavily in my decision to select Economics as my career.*

*I would like to….have a general knowledge in all fields of Economics and mastery of the principles governing economic development and growth, and the governmental policies which would be appropriate to facilitate them…*

***After receiving my Ph.D. degree, I hope to find employment in the Department of Economic Research of the Cuban National Bank. Later on, I would like to formulate, or help to formulate, the policies of that institution and those of the government…1/***

**1/ Charles P. Kindleberger, "From Graduate Student to Professional Peer: An Appreciation of Carlos F. Díaz-Alejandro,"** ***Debt, Stabilization and Development*****, edited by Guillermo Calvo, Ronald Findlay, Pentti Kouri, and Jorge Braga de Macedo, (Basil Blackwell, Oxford, 1989).**

# The anatomy and sequencing of a financial crisis according to Diaz-Alejandro

## with an application to the advanced economy crisis, 2007-present

**In twenty-four pages, (these points are taken from his most cited paper, "Good-bye Financial Repression, Hello Financial Crash") Carlos provides an explanation of a costly process *"where domestic financial intermediation flourished and then collapsed."***

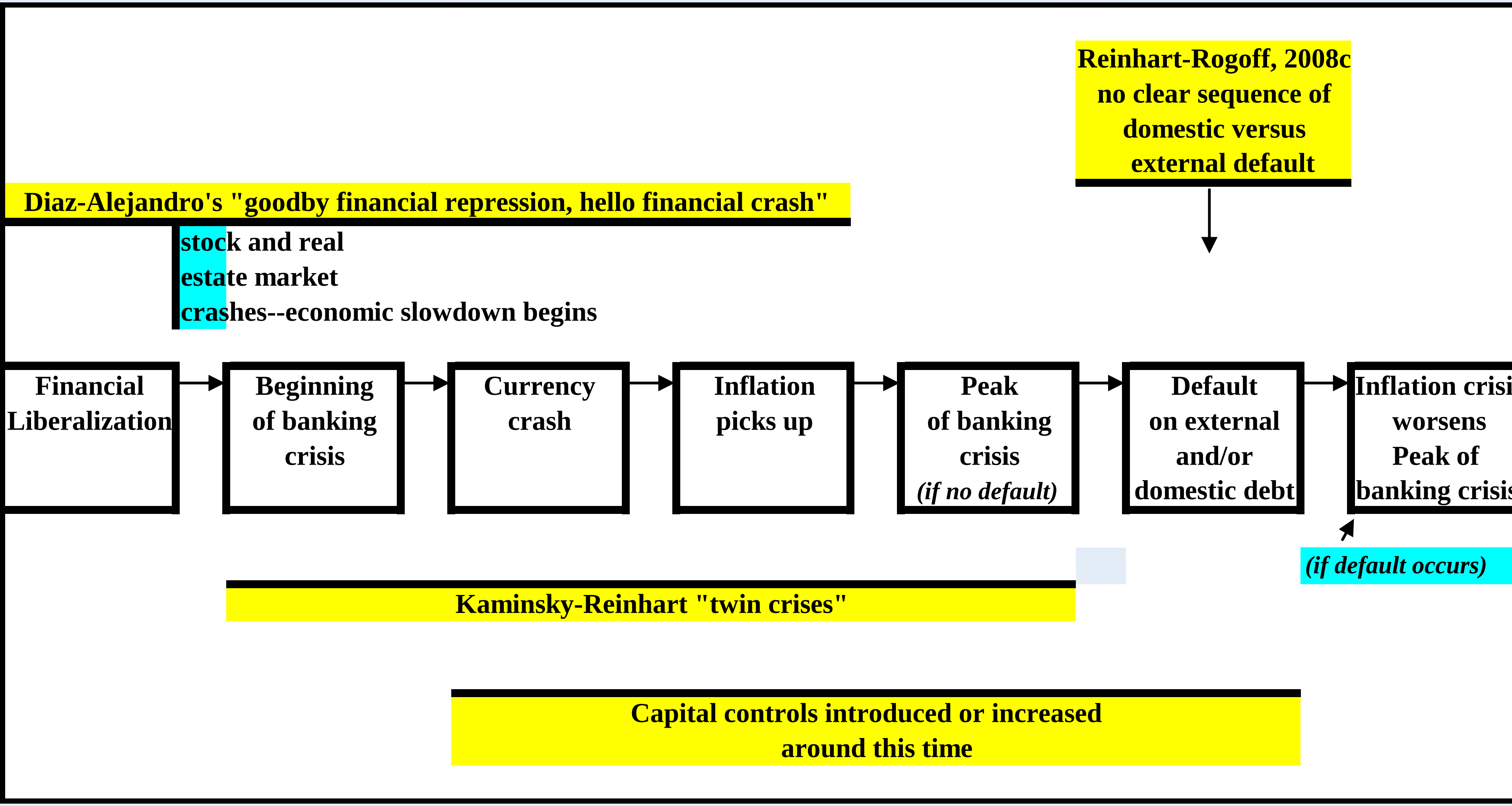
**He was discussing Chile early 1980s, but their relevance is from today's headlines.**

# Goodbye financial repression…

**This is a story, as told by Carlos F. Diaz-Alejandro in the early1980s, of how reforms and innovations in the financial industry**

***"aimed at generally seeking to free domestic capital markets from alleged government-induced distortions,… yielded domestic financial sectors characterized by widespread bankruptcies, massive government interventions…and low domestic savings."***

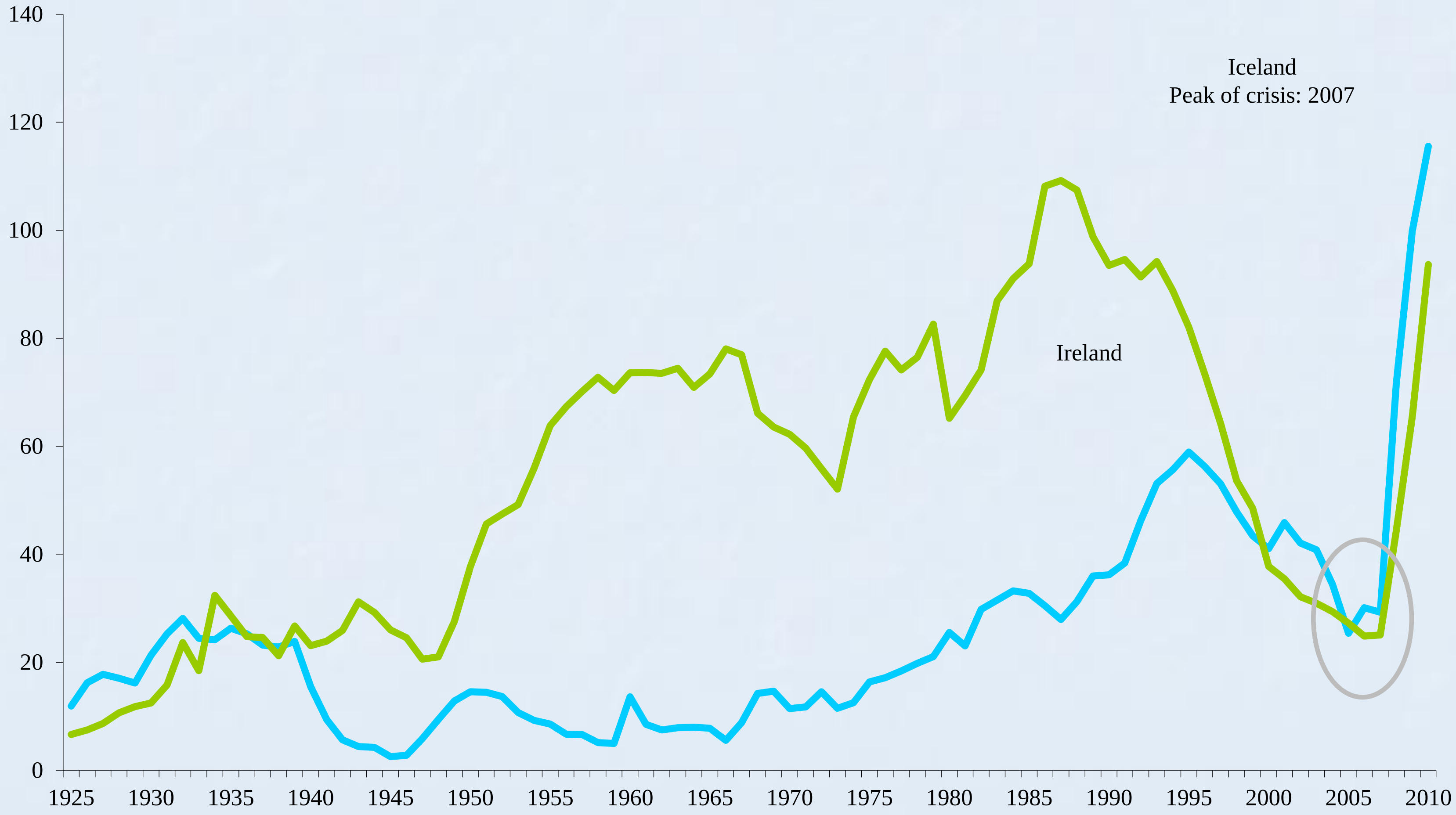
# The sequencing of crises: the big picture



**Carlos asks us to consider a country that had liberalized its domestic financial sector and was fully integrated into world capital markets.**

**"*The recorded public sector deficit was nonexistent, miniscule, or moderate; the declining importance of ostensible public debt in the national balance sheet was celebrated by some observers.*"**

# Iceland and Ireland: Government debt as a percent of GDP



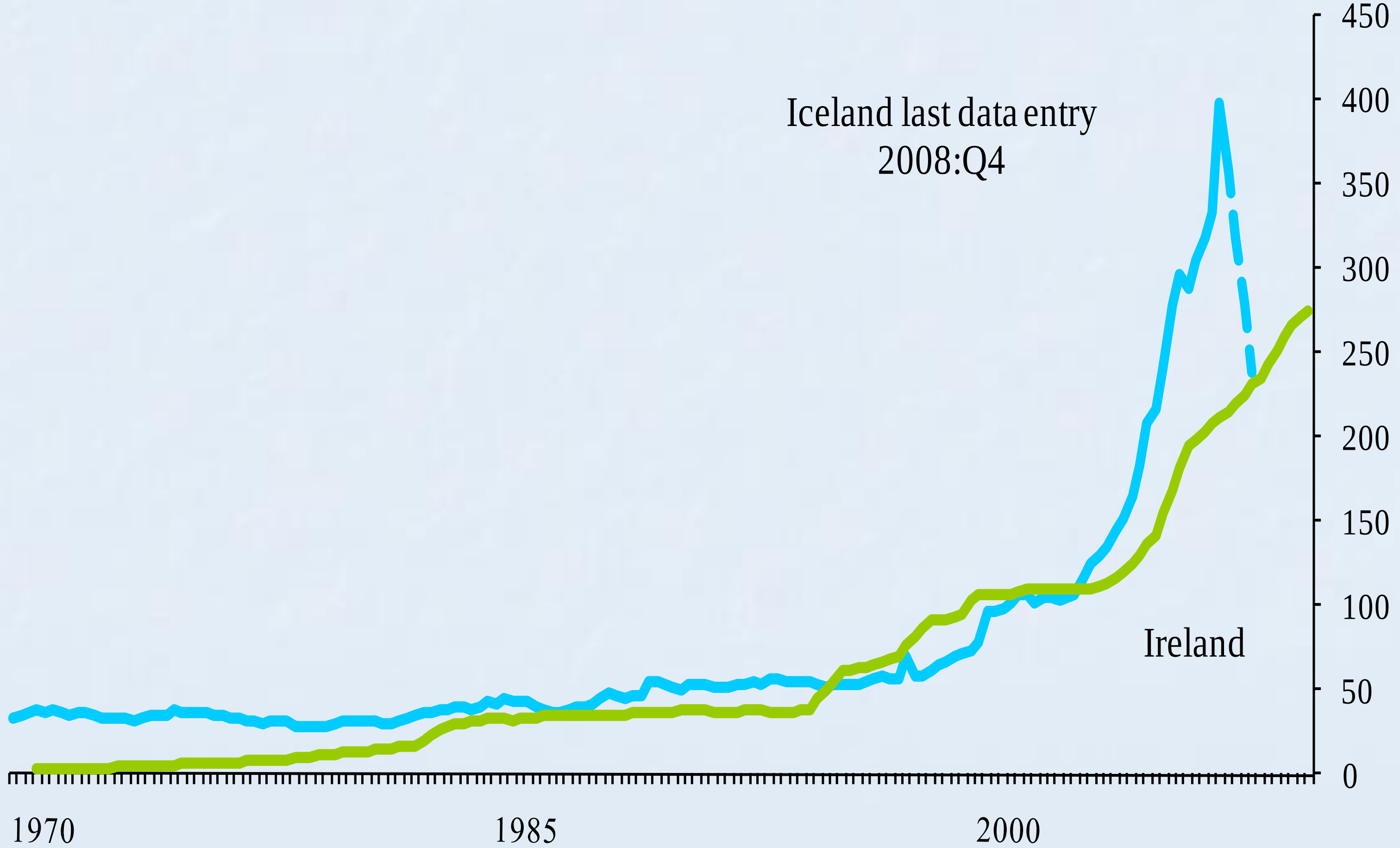
**The private sector was a different matter. Their spending persistently exceeded their income, giving rise to large current account deficits and mounting debts.**

***“Whether or not deposits are explicitly insured, the public expects governments to intervene to save most depositors from losses when financial intermediaries run into trouble. Warnings that intervention will not be forthcoming appear to be simply not believable.”***

# Lesson number 1

**We have a serious domestic moral hazard problem.**

# Iceland and Ireland: Domestic credit as a percent of GDP

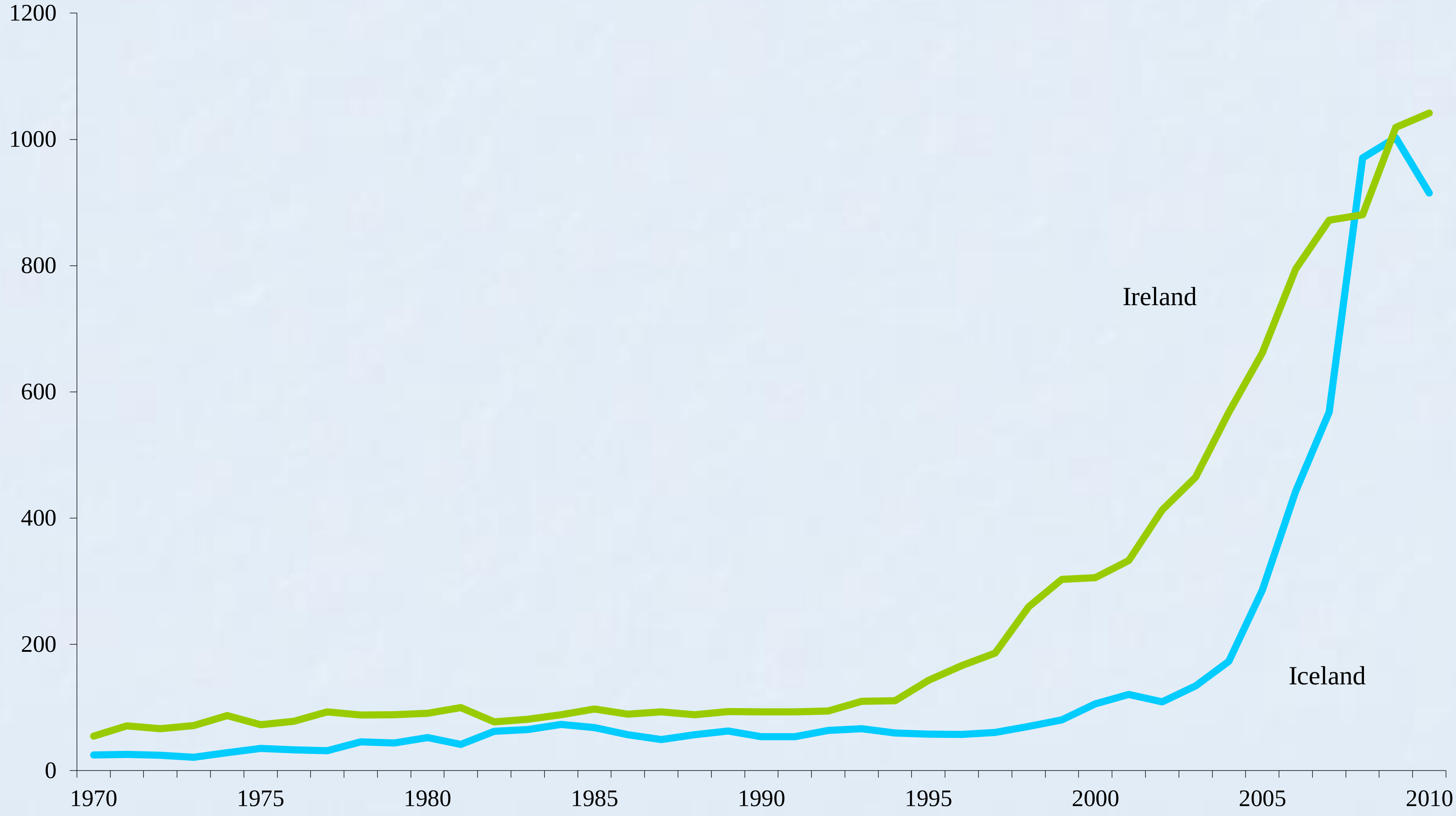


***"Foreign lenders take government announcements that it will not rescue local private creditors, especially banks, with non-guaranteed external (or domestic) liabilities even less seriously than depositors take the threat of the loss of their money."***

# Lesson number 2

**We have an even more serious external moral hazard problem.**

# Iceland and Ireland: Gross external private and public debt as a percent of GDP



***“The Central banks, either because of a misguided belief that banks are like butcher shops, or because of lack of trained personnel, neglected prudential regulations over financial intermediaries.”***

# Lesson number 3

**Central banks (and their regulatory and rating-agency colleagues) made the moral hazard problem worse.**

| Table 1. Credit Ratings on Long-term Obligations | | |
|---|---|---|
| **Moody's** | **S&P og Fitch** | **Explanation of rating** |
| *Investment grade ratings* | | |
| Aaa | AAA | Highest grade, lowest risk |
| Aa | AA | High grade, low risk |
| A | A | Above average grade, relatively low risk |
| Baa | BBB | Average grade, medium risk |
| *Speculative grade ratings* | | |
| Ba | BB | Payment likely, but uncertain |
| B | B | Currently able to pay, risk of future default |
| Caa | CCC | Poor liquidity and clear risk of default |
| Ca | CC | Very doubtful liquidity; frequent default |
| C | C | Lowest grade; extremely poor outlook for repayment |
| | D | In default |

# Iceland: Evolution of Credit Ratings: 2002-2010

| Year | Current account/GDP | External debt/GDP | Domestic credit/GDP | Moodys ratings on long-term debt | | S and P ratings on long-term debt | |
|---|---|---|---|---|---|---|---|
| | | | | Domestic | Foreign | Domestic | Foreign |
| 2002 | 1.6 | 108.8 | 104.8 | Aaa | Aaa | AA+ | A+ |
| 2006 | -25.7 | 442.7 | 304.7 | Aaa | Aaa | AA | A+ |
| 2008 | -28.3 | 970.7 | 237.8 | Baa1 | Baa1 | BBB+ | BBB- |
| 2010 | -8.0 | 914.8 | n.a. | Baa3 | Baa3 | BBB | BBB- |

**During the credit boom, real estate and equity prices soared—so did debts. Growth seemed inevitable.  However, as Carlos explains, the pity of the boom is that**

***"little effort was spent on investigating the credentials of new entrants to the ever-growing pool of lenders and borrowers…practically no inspection or supervision of bank portfolios existed…One may conjecture, however, that most depositors felt fully insured and foreign lenders felt that their loans to the private sector were guaranteed by the State."***

# Booming Housing Prices and Surging Private Debts

| Country | real house prices | domestic private debt/GDP | gross external debt/GDP | Deterioration in the current account 1997-2007/GDP |
|---|---|---|---|---|
| Iceland | 66.9 | 234.2 | 511.0 | 13.9 |
| Ireland | 114.8 | 107.5 | 407.2 | 8.7 |
| Spain | 118.5 | 95.4 | 48.9 | 9.9 |
| UK | 150.1 | 66.1 | 111.9 | 2.5 |
| US | 86.5 | 98.4 | 33.0 | 3.5 |

Notes: The debt buildups an housing price increases are calculated over 1997-2007. Numerous other European countries have also experienced either *systemic* or *borderline* crises in 2008.

***"In economies characterized by intractable market and informational imperfections, conglomerates and economic groups, even as they may correct government-induced financial repression imperfections, could exacerbate others, particularly via the creation of oligopolistic power."***

# Lesson number 4

**Financial deregulation exacerbates the "too big to fail" problem. Every small or medium-sized institution desires to become too big to fail.**

# See Dodd-Frank legislation

***"The combination of pre-announced or fixed nominal exchange rates, relatively free capital movements, and domestic and external financial systems characterized by the moral hazard and other imperfections set the stage for not only for significant microeconomic misallocation of credit, but also for macroeconomic instability, including the explosive growth of external debt."***

# Lesson number 5

**Inconsistent incentives in the financial sector trigger macroeconomic crises.**

# Hello financial crash…

# Output and crises

## *(according to October 2014 World Economic Outlook)*

| Year | Country | % change peak to trough | Number of years peak to trough | peak to recovery | Severity index | Double dip, yes=1 |
|---|---|---|---|---|---|---|
| 2008 | France | -3.8 | 2 | *9* | *12.8* | 1 |
| 2008 | Germany | -4.9 | 1 | 3 | 7.9 | 0 |
| 2008 | Greece | -23.1 | 6 | *13* | *36.1* | 0 |
| 2007 | Iceland | -12.2 | 3 | *10* | *22.2* | 0 |
| 2007 | Ireland | -12.6 | 3 | *13* | *25.6* | 1 |
| 2008 | Italy | -10.8 | 7 | *13* | *23.8* | 1 |
| 2008 | Netherlands | -5.0 | 5 | *10* | *15.0* | 1 |
| 2008 | Portugal | -5.6 | 6 | *11* | *16.6* | 1 |
| 2008 | Spain | -8.6 | 6 | *11* | *19.6* | 0 |
| 2008 | Ukraine | -14.4 | 1 | *10* | *24.4* | 1 |
| 2007 | UK | -7.1 | 5 | *10* | *17.1* | 1 |
| 2007 | US | -4.8 | 2 | 6 | 10.8 | 0 |
| Summary | Mean | -9.4 | 3.9 | 9.9 | 19.3 | |
| | Median | -7.9 | 4.0 | 10.0 | 18.4 | |
| | Standard deviation | 5.6 | 2.2 | 2.9 | 7.7 | |
| | Share of episodes with double dip | | | | | 0.58 |

Note: The italics denote any calculation in which IMF estimates for 2014- are used.

# The aftermath of crises

***"Hangover, Penance, and Purges"***

**The legacy of the severe financial crises Carlos F. Diaz-Alejandro wrote about early in the 1980s eventually became known as the "lost decade" for Latin America. As early as 1982, he had pointedly characterized the 1980s as a decade of *"Hangover, Penance, and Purges"***

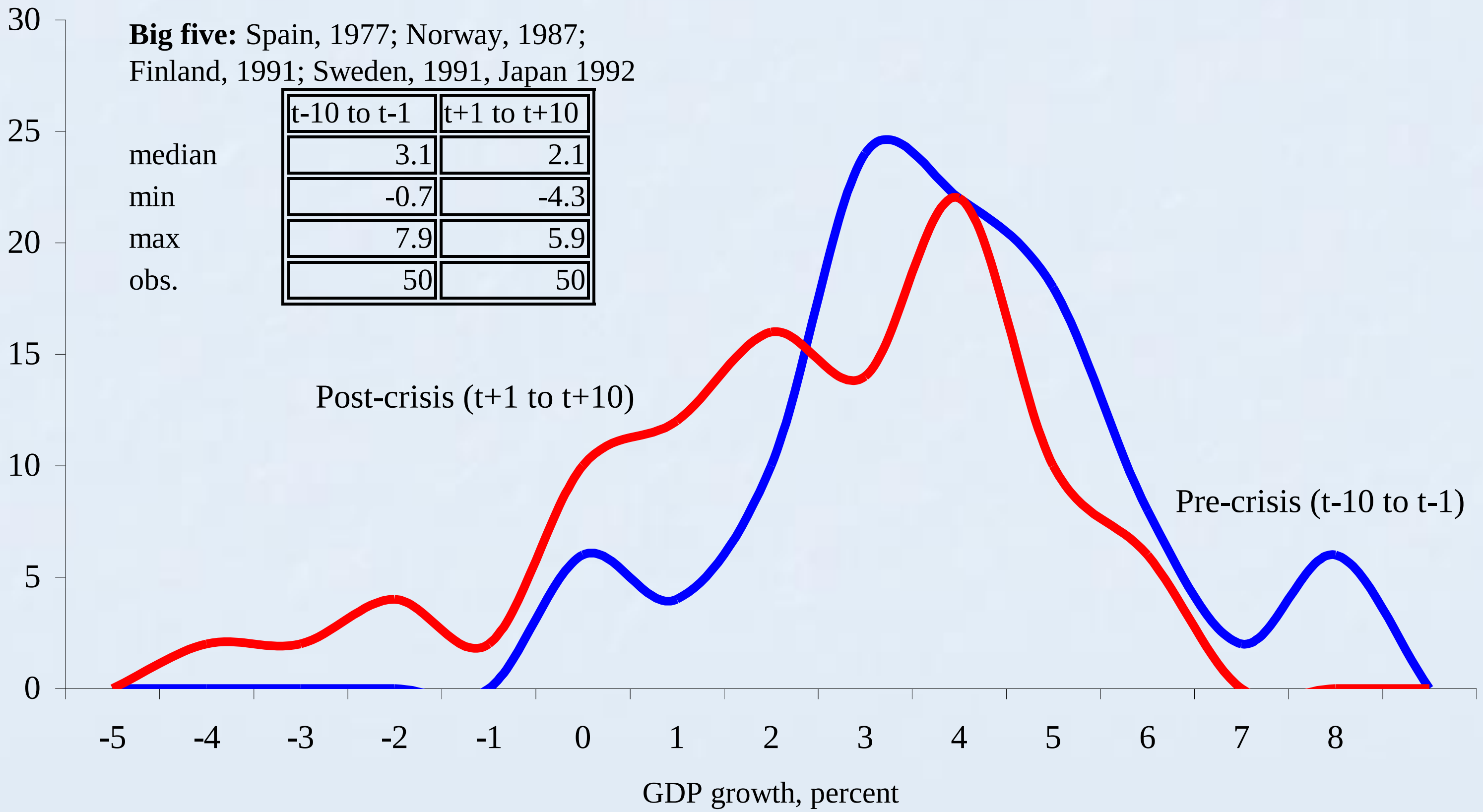
**Few observers had pinned the diagnosis of a long debt-overhang problem with lasting consequences for economic growth so accurately or so early. On the crises aftermath, he and Bacha write:**

***"The growth rates of gross national products of major semi industrialized borrowers could decline, even relative to those of 1973-1980, while pressure to expand exports and restrain imports will continue…"***

***"The outlook …remains somber and their need for concessional finance great."***

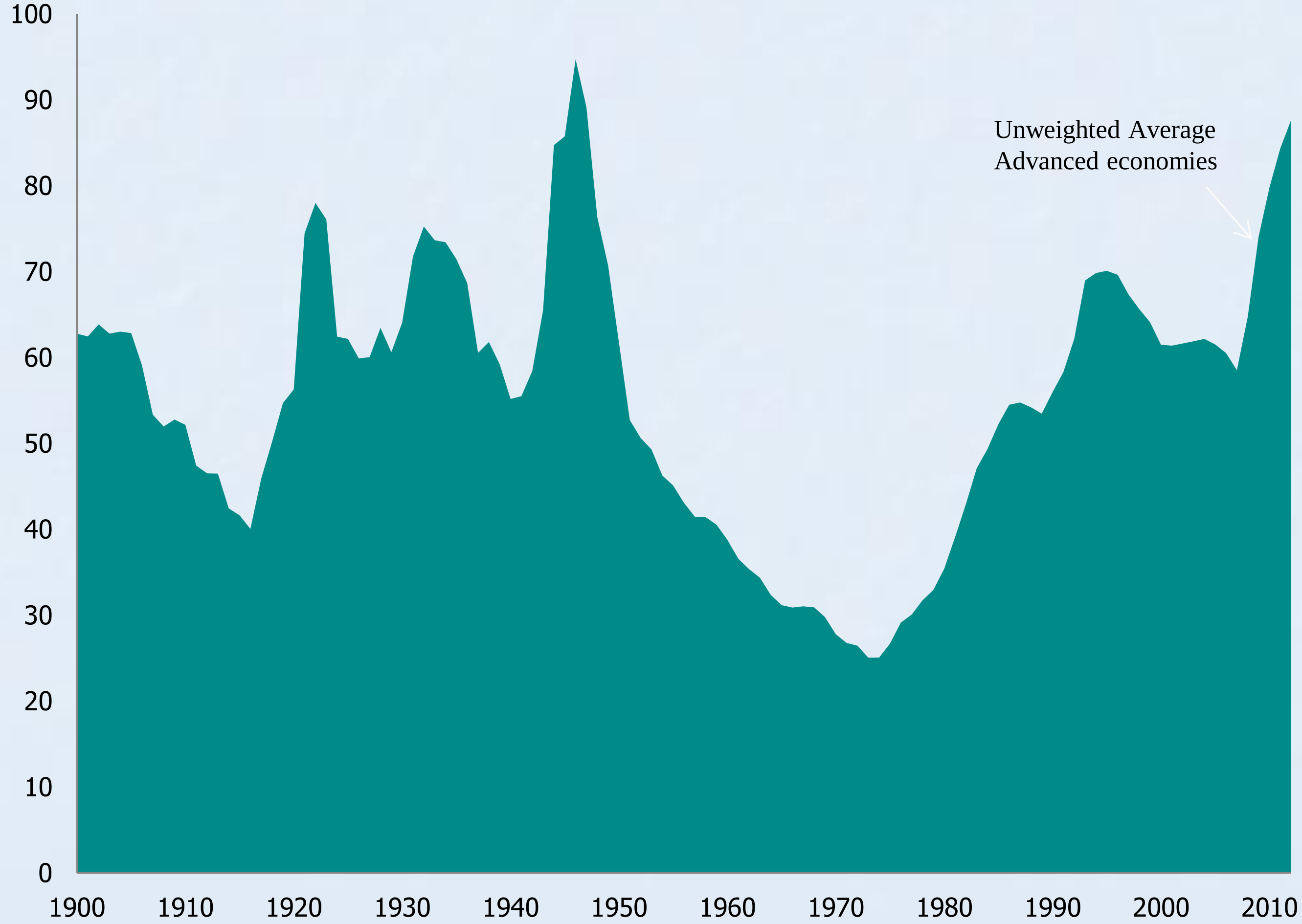
Edmar Lisboa Bacha and Carlos F. Diaz Alejandro, "International Financial Intermediation: A Long and Tropical View," *Essays in International Finance No*. 147, Princeton University, May 1982.

# Real Per Capita GDP Growth in the Decade Before and the Decade After Severe Financial Crises: Post-WWII, Advanced Economies (Reinhart and Reinhart, 2010)



# Advanced Economies' Debt: I Don't Think We are in Kansas Anymore

# Gross Central Government Debt as a Percent of GDP: Advanced and Emerging Market Economies, 1860-2013



**The temporal cycle Diaz-Alejandro described, of booming contingent debt liabilities before the financial crisis and a painful and lasting debt overhang afterwards, was also present in numerous emerging market crises since his writings in the early 1980s. Such episodes included the Mexican peso crisis of 1995, the Asian crises of 1997-1998, the Russian and Argentine defaults of 1998 and 2001, respectively.**

# Where does that leave Latin America now. Where is it in this boom-bust cycle?

## Lessons from the 1980 and 1990s for the 2010s

# By early 2013,
# in major emerging markets (LATAM inclusive)

- Current account deficits  had reappeared
- As did credit booms
- And currency overvaluation
- Growth had begun to slow
- Inflation had resurfaced as a concern

**And then came the announcement of QE tapering…**

# Since that May 2013 tapering announcement, other global factors have deteriorated

(i) commodity prices have declined sharply;
(ii) China's slowdown has intensified;
and (iii) global investors have turned turned to advanced economies equity markets in increasing numbers.
Downgrades are a matter of time…

**Even remembering that Latin America is historically a debt intolerant, chronic-inflation region, the indicators for end-2014 do not match (in magnitude) the usual vulnerabilities associated with the onset of past financial crises.**
**Yet, the bonanza decade of 2003-2013 is over--we not in Kansas anymore.**

# Concluding remarks

- **While Diaz-Alejandro wrote primarily about Latin America, the boom-bust pattern he so insightfully captured is universal .**
- **Carlos' contributions spanned many aspects of exchange rate policy (including currency wars), capital controls, trade and development. It is impossible to do justice to all of these here.**