# Interview

# Guillermo Calvo

***Editor's Note:*** *This is an abbreviated version of RF's conversation with Guillermo Calvo. For the full interview, go to our Web site: www.richmondfed.org*

**Why are some countries rich and others poor? It's perhaps the most important question in all of economics. Although many economists have tried to answer it and much progress has been made, there are still many issues that are unclear. Latin America provides a good case study. While a few countries, such as Chile, have experienced steady rates of economic growth for many years, the region as a whole still lags well behind the developed world in standards of living. Moreover, other countries have continued to suffer large financial shocks, which have introduced volatility in their economic and political institutions.**

**Guillermo Calvo has spent much of his career looking at problems facing developing countries, first as an academic and later as a policymaker. Calvo, who formerly held faculty positions at Columbia University and the University of Pennsylvania, now teaches at the University of Maryland and has written several influential papers on a wide range of topics in macroeconomics. From 1988 to 1994, he was a senior adviser in the research department at the International Monetary Fund (IMF). During his time at the IMF, he visited several countries of the former Soviet bloc, examining what could be done to help ease their transition to more market-oriented systems. Since 2001, Calvo, a native of Argentina, has served as chief economist at the Inter-American Development Bank (IDB), where his focus has largely been on Latin America.**

**In addition to his teaching and policymaking responsibilities, Calvo is president of the International Economic Association.**

**Aaron Steelman interviewed Calvo at the IDB on May 31, 2006.**

PHOTOGRAPHY: LISA HELFERT

**RF: This is a very broad question, but I think it will help lay a foundation for the rest of the discussion. How do developing economies differ from developed economies? Are there some attributes of the latter that are typically lacking in the former?**

**Calvo:** You could make a very long list of differences, but the ones that I think are most important and that have captured my attention have to do with the financial sector. There is often market incompleteness, which means that many countries have to borrow in terms of foreign exchange denominated bonds. There is also imperfection with domestic capital markets. In particular, there is often poor protection of credit, which makes people suspicious that there will be a devaluation or confiscation. That can lead to bank runs. So these two things seem to play a central role in developing countries.

Now, one might wonder whether the institutions are so different from developed countries or whether the shocks are different, because the relative price changes are much wider? If the United States were subject to those kind of shocks, perhaps there would be the same type of political pressure that we see in developing countries, and that would affect the structure of institutions. It's very difficult to tell.

**RF: You have argued that there is no one correct choice of exchange rate regimes for developing countries. Could you please discuss why that choice should depend, at least in part, on the characteristics of a country's economy?**

**Calvo:** Consider heavily dollarized economies. It's very difficult to have a floating exchange rate because balance sheets are mismatched in terms of currency denomination. Let's take the example of Bolivia. Eighty percent of deposits in the banking sector are denominated in dollars. Those loans go mostly to the private sector, denominated in dollars, and therefore if you were to devalue all of a sudden, you would have a financial crisis. So I think the financial characteristics of an economy play a large role in determining its exchange rate policy.

Now, in general, markets are seriously incomplete in developing countries. You have structures that are not very reliable and you have poorly functioning futures markets. That makes it difficult for the policymaker. It's very risky to float. As a consequence, developing countries, whether they like it or not, tend to peg. I'm not saying that pegging is optimal, but it's a system that, at least in the short run, does not interfere very much with the working of the economy and, thus, it becomes appealing to the policymaker.

There are exceptions to this as you noted in the question. Some developing countries have adopted floating exchange rates with some success. But this is because they have already developed the appropriate financial institutions.

**RF: How important is the choice of an exchange rate regime relative to other macroeconomic policy choices?**

**Calvo:** My answer may sound a bit paradoxical. On the one hand, as I have said, the choice of exchange rate policies is heavily dependent on institutions; it is not much of an *independent* policy variable. On the other hand, it is a very critical variable. For countries to grow, at least for developing countries, exports are key. It's very difficult to find an example where exports are not the driving force. The exchange rate can be thought as of a *bridge* between the domestic and international economy. Exports have to go over that bridge, and if exchange rates are highly volatile and noncredible, coupled with incomplete futures markets, the life of the exporter can be very difficult. That will have negative effects on trade and, consequently, on growth.

**RF: The import-substitution model was quite popular in Latin America in the 1960s and 1970s. Why do you think that was the case?**

**Calvo:** It catered to the domestic producers and it also promised to lessen income inequality, which is a big problem in Latin America. So it was popular for those reasons. The period in which those policies were implemented also happened to be a period of relatively high growth for the region. So if you just look at the numbers and don't do any deep analysis, you may reach the conclusion that high growth was a result of import substitution.

I think many analysts may overestimate the policy changes occurring in Latin America. I don't see the region, in general, as veering off course.

By the early 1980s, opinion changed and the conventional wisdom said that the model was exhausted. I'm not so sure that was the case. The region is very sensitive to external credit conditions, and during the early 1980s interest rates were going through the roof. So this led to some very serious problems in Latin America. But the simple-minded analysis concluded that the model was exhausted, just as the simple-minded analysis today says that the "Washington Consensus" is exhausted because it, too, has experienced some problems. Our theory is that there is a strong parallel between the two. While the import-substitution model is not a system that I like, it may be unfair to say that it simply had run its course and failed. It was certainly vulnerable to shocks, to be sure, but any system is vulnerable to shocks.

**RF: You mentioned that income distribution is a problem in Latin America. Could you please elaborate on that? For instance, is it slowing economic growth in the region?**

**Calvo:** The World Bank has done work that shows some evidence of a link between inequality and slower economic growth. I can imagine the mechanism: Inequality causes political tension, which causes politicians to pursue policies that cater to the poor by taxing capital, which induces capital flight, which lowers growth. Eventually, the situation gets so bad that even left-of-center governments change policies and adopt a more market-oriented approach. That works for a while — you get increased growth but income distribution deteriorates again. That's the story and it seems to fit the facts. If it's true, then it's a real trap. It's not clear how you get out of it.

**RF: How can policymakers in developing countries effectively signal that they are committed to economic reform?**

**Calvo:** I don't think that there is a formula for that. I think certain devices are useful, such as an independent central bank. But that doesn't mean it's going to be a fail-safe solution because, in the final analysis, it can still be subject to political pressure if the economy becomes very bad. International agreements, such as the Free Trade Area of the Americas (FTAA), can also be useful. They can help establish credibility. But, again, the success of such agreements depends on the political support that you can conjure up at home, both in adopting them and then complying with them.

**RF: What is your opinion of central banks in developing countries adopting inflation targets?**

**Calvo:** When developing countries adopt an inflation target it's usually because there is a lack of credibility. So they are forced to stick to a system that is very rigid. That has some benefits, but it also makes it quite difficult to deal with shocks and, unfortunately, developing countries can experience quite crippling shocks. For instance, let's say there is a financial shock and you need to rescue the banking sector. The intense focus on controlling inflation may make that very difficult. So an inflation target could push the central bank toward pursuing policies that are counterproductive and ultimately unsustainable from a political point of view. That's why I cannot be too excited about inflation targets in developing countries.

I should say that I'm also not a big supporter of the United States adopting an inflation target. There have been cases, such as the period immediately following the stock market crash of 1987 and the collapse of Long Term Capital Management in 1998, where the Fed pursued policies that were good for the economy but that would have been difficult to implement had it been committed to a rigid inflation target.

**RF: How would you rate Latin America's efforts at greater trade integration and openness?**

**Calvo:** The 1990s was a period of trade liberalization. It's questionable whether that is sustainable. I am not particularly optimistic. My hope was that something like the FTAA would be ratified. Unfortunately, many countries seem to have given up on the FTAA and instead are pursuing bilateral trade agreements with the United States. That's not very tidy. One of the benefits of something like the FTAA would be to open up regional trade. There is not much trade going on between Latin American countries now. So there are some real opportunities that could be exploited even if trade with the United States did not increase substantially. And, in that context, it would be very useful to have a currency union.

Also, it goes beyond just trade. Latin America is a low savings region, and in order to grow you need investment. So if you are low savers, you need to attract foreign capital. That requires creating an attractive environment. I think the FTAA would have helped move the region in that direction.

**RF: You mentioned that a currency union would help intra-regional trade. What's your opinion of Latin America adopting a currency union more generally?**

**Calvo:** The jury is still out on how it has worked in Europe. We don't know what is going to happen with Italy or Portugal, for example, where officials have been lax in their enforcement of rules established by the European Commission. I have been a fan of currency unions for some time, but my enthusiasm for them has cooled off recently. I am beginning to see many more potential difficulties with them now.

A currency union requires commitment among the policymakers in the member countries. In a region that has typically had a lot of political instability, politicians are naturally inclined to give high priority to domestic issues. They want to make sure that they are popular at home so that their governments do not come under pressure from competing factions or are toppled. This makes it difficult for many of them to credibly commit to the type of policies that are required by a currency union. For instance, many will be unlikely to hit the fiscal targets if that means they will risk domestic unpopularity.

So I think it is a bit premature for Latin America to adopt a currency union. But this doesn't mean that the region shouldn't begin taking steps toward that goal. For instance, Europe did not adopt its currency union overnight. It took many years, indeed decades, to establish how the system was going to work and then to implement it.

**RF: Many South American countries seem to be undergoing an ideological shift. A number of leaders have gained power running on an anti-Washington platform, arguing that their countries should resist the type of "neoliberal" policies favored by many in the develop-**

## Guillermo Calvo

**➤ Present Position**

Chief Economist of the Inter-American Development Bank and Distinguished University Professor of Economics at the University of Maryland

**➤ Previous Faculty Appointments**

University of Pennsylvania (1986-1990) and Columbia University (1973-1986)

**➤ Education**

Ph.D., Yale University (1974)

**➤ Selected Publications**

Author or co-author of dozens of papers in such journals as the *American Economic Review*, *Journal of Political Economy*, *Quarterly Journal of Economics*, *Journal of Monetary Economics*, and *Journal of Macroeconomics*

**➤ Awards and Offices**

President, International Economic Association; Fellow, American Academy of Arts and Sciences; Fellow, Econometric Society; Research Associate, National Bureau of Economic Research

**ment community. How widespread is this sentiment? And how large of an obstacle does it pose for economic growth and stability in the region?**

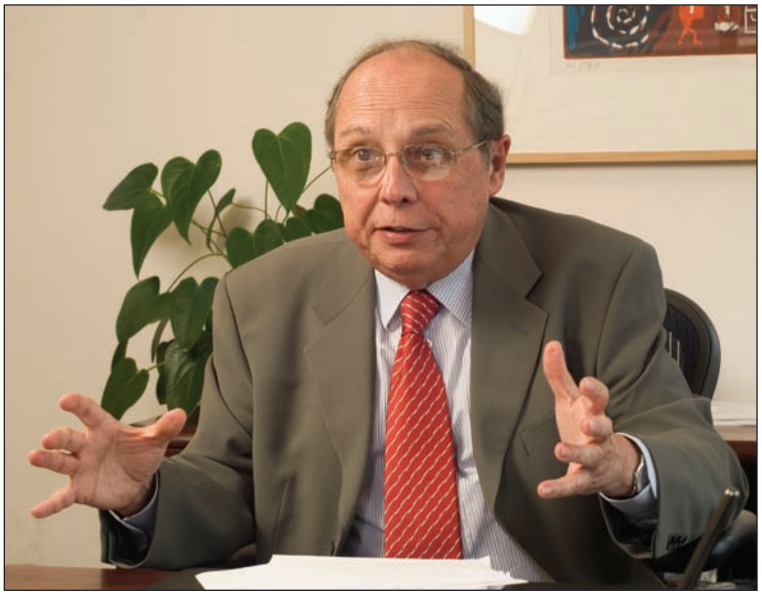
**Calvo:** I would say that it is more talk than action, at least at the macro level. For instance, in Brazil, President Lula said that he would not repay international loans, but now he is making those payments, and implemented a fiscal program that is even tighter than the one agreed with the IMF. There are some exceptions. And in some countries, it is too early to tell whether the rhetoric we have heard will translate to big policy changes. But the majority of countries are generally pursuing sound macroeconomic policies, and I don't anticipate that changing.

Now, it is true that there is a lot of talk in Latin America about the "Washington Consensus" not working, and those voices are joined by some prominent economists here in the United States. My opinion is that the "Washington Consensus" is really a misnomer. It is, for the most part, the "Latin American Consensus" also. Most people agree that the decalogue of policy proposals that are closely associated with it are reasonable and generally should be followed. But it's an incomplete list. For example, it does not adequately address how to reform the financial sector. We need to work on those problems, but that doesn't mean the decalogue is itself bad or counterproductive.

Also, I think it is important to mention the spread of democracy during this period and the role it played. In many parts of Latin America, democracy was a relatively foreign concept. Then all of a sudden, the world opens up, democracies are established, and politicians start making promises to a populace that doesn't understand democratic politics and which takes those promises at face value. So when the decalogue was proposed, some political leaders both at home and abroad perhaps oversold what it would mean for the region. When those things didn't happen — indeed, when there were severe financial crises — the populace became skeptical of liberalization. Unfortunately, it also led to skepticism about democracy. The public associated democracy with economic liberalization — and, in their minds, those things brought instability and financial trouble. That's not how things actually worked, but the timing of events led them to believe it was true.

So I don't want to downplay the opposition that does exist to the "Washington Consensus." But, as I said before, I think that many analysts in the United States may overestimate the policy changes that are occurring in Latin America right now. I don't see the region, in general, as veering off course.

**RF: How do you account for some rather dramatic differences in economic performance within the region? For instance, countries like Chile have been relatively stable and grown relatively quickly, while some of its neighbors have experienced significant and persistent problems.**



**Calvo:** Actually, we have a paper comparing Chile with Argentina and how they responded to the crisis of 1998. Chile suffered from that crisis, but the implications for Chile were very different than they were for Argentina. In Argentina, the system shut down almost completely. In Chile, the growth rate went from about 6 percent to zero, but then it bounced back. One of the major reasons has to do with differences in financial systems and institutions. Chile wasn't dollarized, while Argentina was and that caused a whole host of problems.

As for the broader question of Chile's relative success in the years leading up to the 1998 crisis and following it, I think there are a number of factors at work. Chile, perhaps more than the rest of the countries of South America, liberalized its trade policies and generally pursued market-oriented reforms in the 1980s. On balance, these reforms were beneficial to the economy. Also, Chile experienced high rates of productivity growth. We are still uncertain about all the causes of this productivity spurt — some of it can probably be attributed to domestic policies, some of it to positive shocks, such as exogenous technological improvement — but whatever the causes, it's clear that it helped improve growth rates.

**RF: Chile has a long history of American-trained economists advising the government. How common is that in other Latin American countries?**

**Calvo:** I would say that is now commonplace. The one exception may be Argentina, where many of the American-trained economists have left the government. Also, the economists who are active often have quite important roles in the policymaking process in Latin America, much more so than in the United States. In addition, I think it is more common for Latin American politicians to cross party lines in seeking out economists for government positions.

**RF: What is your opinion of Hernando de Soto's *The Other Path*? What lessons can policymakers in Latin America take from that book?**

**Calvo:** The main lesson is that regulations must be simplified as much as possible in order to encourage the development of the formal sector and, thus, most likely enhance the pace of technical progress. However, I am skeptical that a major overhaul of government regulations will have a major effect in the short or medium term. The reason is that the informal sector strongly relies on tax evasion and, unless you implement a major tax moratorium — accompanied by substantially lowered tax rates —firms are likely not to move to the formal sector, even if all the red tape is eliminated. Moreover, a moratorium is likely to have detrimental moral hazard implications.

**RF: Roughly 15 years after the fall of the Soviet bloc, what have we learned about the transition from centrally planned to market economies? For instance, is there an optimal way to sequence reforms?**

**Calvo:** Optimal sequencing of reforms is a very complex issue which transcends economics. My view is that it is essential for politicians to get strong popular support. This enhances the credibility of reforms. Without credibility, even well-designed and good policy reforms may turn out to be counterproductive. This makes it difficult to extrapolate reforms in the Soviet bloc to other regions, for instance, like China. A sudden dismantling of state-owned firms in China, following the Soviet bloc pattern, would seriously impair growth and social cohesion in China.

**RF: Debt forgiveness has gotten a lot of attention recently. What is your opinion?**

**Calvo:** I think it raises real problems. It is one thing for the developed world to make transfers to poor countries. If they want to do that, fine. But it's quite another for those countries to make loans to poor countries and then when those countries get in trouble because of bad policies, simply forgive the debt. In those cases, you are simply pretending that you are lending money and, in the process, you are allowing policymakers to behave in a way that is not good for them. It's bad for the country that is making the loan and it's bad for the country that is receiving it. The moral hazard issues here are quite severe and I don't think they have been dealt with adequately.

**RF: Could you comment on the "global savings glut" hypothesis and its implications for the path of the U.S. current account?**

**Calvo:** In general, I am sympathetic to that argument. I think it fits the fact well. Now what could be causing it? It's possible that it could be a consequence of some of the crises we had in the 1990s. In particular, those crises might have induced Asian countries to save more, giving them the ability to finance spending in countries like the United States. Could this situation be stable? I think it could be. I think we could go along in this way for quite a while without there being a global crisis. My concern is that if there were a hiccup in the financial markets, it would not be the United States that would be most severely hurt, as some have argued. Rather, I fear that emerging markets would be hit hard. In the eyes of most investors, the United States, despite its current account deficit, is still a very stable, attractive place to put their money. If there were trouble, I think they would turn to the United States as a haven.

**RF: How has your academic work helped you as a policy adviser?**

**Calvo:** I think it has been very useful. The analysis we have to do is often very complex and there will be many things that you will not understand fully. But I have gone back time and again to basic macroeconomic principles to develop a framework for looking at the policy questions I encounter. Also, the work that sprang up from the rational expectations revolution has helped me think about problems regarding credibility. Even if I don't take the rational expectations stories verbatim, they provide a very simple but powerful way of understanding how people think about the future and how to structure policy responses. You might not get every detail right, but at least you will be working within a reasonable framework and set of parameters. In contrast, if you do not have a strong grasp of theory, I think you will eventually find yourself adrift.

**RF: How would you compare your position now with the Inter-American Development Bank to your previous job at the International Monetary Fund?**

**Calvo:** The two institutions are very different. For instance, the IMF has a much larger staff of macroeconomists, and the politics of the institution were much more difficult to navigate. Also, the events that occurred while I was at the IMF were unique. I was there when the Soviet Union was falling apart. This gave me a chance to travel to Eastern Europe and witness the problems they were facing firsthand. In academia, you are always trying to push your work to the frontiers of the field, but when I was at the IMF I had to get back to basics and deal with very simple but hard questions. For instance, what is the demand for money when prices are not well-defined because of prior across-the-board price controls as in the former Soviet Union? Those type of issues can really focus your mind. That said, for a number of reasons, it was hard to influence the direction of the IMF. Eventually, they did absorb some of the advice that I gave. So the experience was ultimately mutually beneficial, but it was also very tricky.

The IDB focuses on a broader set of questions. It deals with a lot of microeconomic questions — welfare programs, poverty, and so on — while the IMF was much more interested in purely monetary issues. Also, from a personal perspective, the number of macroeconomists is much smaller and, as a result, I have a much greater ability to influence the Bank's approach to macro issues. **RF**