

## Introduction to Part I

The chapters in this part were written while my collaborators and I worked at the IMF; Leo was visiting the Research Department, while Carmen and I were full-time staff there. These chapters carry a straightforward message, namely, that Latin American economies are highly sensitive to news from the U.S. economy. My intuition about the existence of a significant linkage with the U.S. economy was inspired by a trip around several Latin American countries in 1992. At that time capital flow to EMs was running at full steam, bringing about accumulation of international reserves and output expansion—all good news. The capital inflow phenomenon was not well understood, however, and observers came up with idiosyncratic explanations that, given the phenomenon's relatively recent origin, could not be subjected to serious empirical testing.

When empirical evidence is shaky, explanations have a tendency to become self-serving. Thus, policymakers and multilateral financial institutions interpreted these facts as reflecting the success of the Brady Plan, and that several countries in the region had embraced the path of economic reform. However, I did not find this argument fully convincing, as many countries were undergoing a similar experience even though their reform efforts varied greatly in some cases.

On my return to Washington, Carmen, Leo, and I sat down to discuss this puzzling similarity of outcome despite the divergence of objective conditions. It soon became obvious to us that, if there were common factors, they must lie outside the region, and the natural candidate was the U.S. economy. The papers in this part show that we were on the right track, as empirical tests confirm that U.S. variables explain a large portion of regional variance.

I will let the papers speak for themselves, and rather say a few words on how these papers were received at the IMF. I believe I would

not be exaggerating if I said that the reception was cold and, if anything, unsympathetic. This took us by surprise because we thought the papers were full of useful insights. For example, they showed that EMs could be vulnerable to crisis even though they followed traditional Fund advice. At the time we were especially concerned about a possible sharp rise in U.S. interest rates, and one of our key findings was that U.S. interest rates were important in the determination of capital flows to Latin America—increasing when interest rates were low, and vice versa. Thus, our research suggested the possibility of a sharp capital flow reversal (which later materialized in the Tequila crisis when the Fed finally raised interest rates by about 300 basis points in 1994)—a shock that both the IMF and EMs should prepare themselves to confront. Could anyone think of a better use of research time?

We were, of course, very naïve. As pointed out in the Introduction to this book, old ideas die hard. In this case, it is clear why. New ideas could put at risk the credibility of policymakers and multilateral institutions. What if residents realized that the region's incipient success was in great part due to sheer luck? Would the IMF risk its influence and partnership with the region's policymakers by openly accepting the results of an empirical study that, quite possibly, would be rejected by the next nerd who hit a computer?

Understandable as it is, it always strikes me how little empirical evidence is required to keep old ideas and conventions on their lofty pedestals. Keynes's genius always comes to mind in this respect: "Worldly wisdom teaches that it is better for reputation to fail conventionally, than to succeed unconventionally" (Keynes [1961], chapter 12). The main lesson that I extract from this is that there exists a great distance from discovery to application, even in economics. My feeling is that most of us occupy extreme points of the spectrum: either we work on discovery, or we work on applications. The road between these two points is home for a small band of adventurers who run the risk of being dismissed by the other two groups as outsiders, or worse. Fortunately, this market imperfection has been internalized by some multilateral financial institutions, like the IDB, where research on those desolate points in-between is encouraged.

## References

Keynes, John M. 1961. *The General Theory of Employment, Interest and Money*. New York: Macmillan & Co.