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Introduction

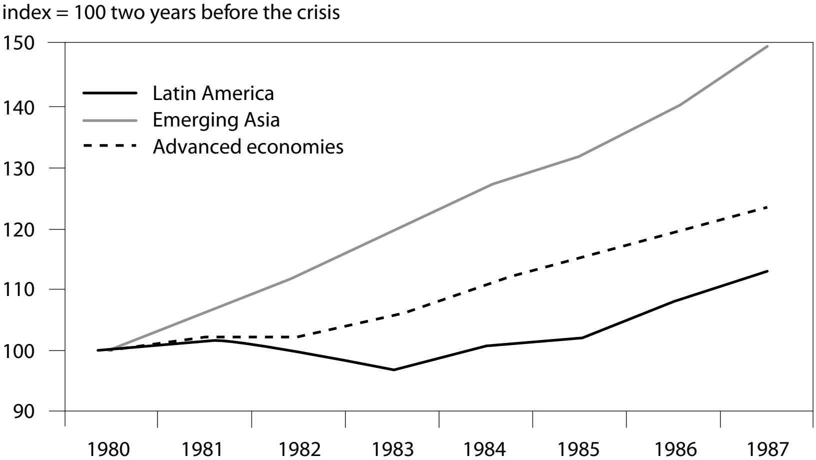
Latin America's robust economic performance in the wake of the global financial crisis of 2008–09—the worst crisis since the Great Depression—is unprecedented. Other global crises during the postwar period caused significant downturns in most emerging-market economies, including those in Latin America, which generally took the largest hit. While Latin American and other emerging-market economies around the world suffered during the recent crisis, and although some endured sizable contractions in 2009, overall, they have been surprisingly resilient: The damage was limited, and their recoveries have been very strong. Even against the relative strength of other emerging-market economies, Latin America's performance has been surprisingly robust. It has performed better than during other recent crises that affected all economies in the region, notably the Latin American debt crisis of the 1980s and the 1997–98 Asian financial crisis. Growth in the region has almost paralleled the success of emerging Asia and has outstripped that of the advanced economies (figure 1.1).

In this book I examine the factors underlying Latin America's impressive economic performance during the global financial crisis. The focus is on the region's seven largest economies, which are referred to as the LA-7 and account for more than 90 percent of the region's output: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.[1] These are the only countries

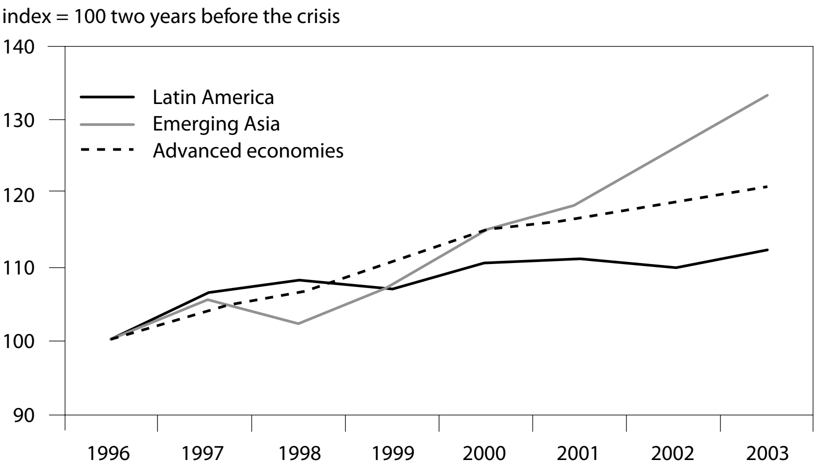
1. The data used here are from the International Monetary Fund's *World Economic Outlook* (WEO) database. The WEO tracks data for the Latin American and Caribbean (LAC) region, which includes 32 countries—the LA-7 and the 25 other countries in the WEO's LAC region: Antigua and Barbuda, the Bahamas, Barbados, Belize, Bolivia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Paraguay, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, and Uruguay.

Figure 1.1 GDP during debt crisis, Asian crisis, and global financial crisis: Latin America, emerging Asia, and advanced economies

a. The debt crisis



b. The Asian crisis



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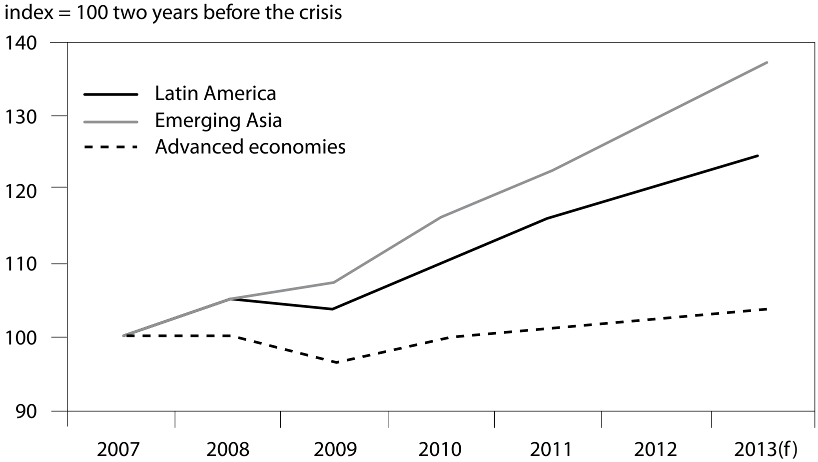
with GDP of over $100 billion. Most of my discussion is concentrated on this group of countries, since it allows more focus and is the most relevant from a global point of view. These countries have also been the poster children of previous crises, high inflation, financial crises, and macroeconomic mismanagement. All these countries have faced serious economic problems of varying degrees and at different periods.

The book reviews recent regional and country-specific experiences, describes the main features of these economies' macroeconomic and financial

Figure 1.1 GDP during debt crisis, Asian crisis, and global financial crisis: Latin America, emerging Asia, and advanced economies *(continued)*

c. The global financial crisis



f = forecast

Note: Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela; emerging Asia: China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand; advanced economies: 41 countries as defined by the International Monetary Fund.

Source: IMF (2013a).

policies, explores why the region fared so much better during this crisis than during previous crises, and extracts lessons for how best to preserve stability and promote sustained growth.

The analysis here shows that Latin America's strong economic performance in the wake of the crisis is the result of good macroeconomic and financial policies, which allowed for significant monetary and fiscal expansion and a resilient financial system. It is also the result of good international conditions. Specifically, the terms of trade—the ratio of export prices to import prices—have been very favorable for Latin America since the mid-2000s, and overall global financial conditions have been positive for emerging markets as a whole. This contrasts with the Latin American debt crisis and the Asian financial crisis, when terms of trade declined and external conditions deteriorated for the region.

The relative importance of good policies versus good luck is different for the various countries of the region because the ultimate effects of external conditions largely depend on domestic policies. Potential vulnerabilities such as a sudden stop in capital inflows, a disruption of international trade or financial flows, or fluctuations in commodity prices, can be mitigated by sound domestic policies.

Brazil, Chile, Colombia, Mexico, and Peru have significantly strengthened their macroeconomic, financial, and regulatory management and have become more financially integrated into the global economy, all of which improved their resilience during the crisis. This was not true of Argentina and Venezuela. Both, as well as the other countries, benefited from high commodity prices (soybeans for Argentina and oil for Venezuela), which enabled them to perform well before and during the crisis and to implement expansionary policies. But both countries have high inflation rates, lack an independent monetary policy, and are hampered by rigid exchange rate regimes, and these policy weaknesses have recently begun to bite, specifically through the foreign exchange markets, producing significant black-market premiums and massive reserve losses that threaten their stability and growth.

High commodity prices are the result of good economic performance in emerging markets, in particular the impressive growth in China. Things would have been different if the decline in commodity prices observed in late 2008 had persisted. However, good macroeconomic policies still could have alleviated the effects of bad external conditions if they had persisted. Experience shows that good macroeconomic management and strong financial systems can significantly mitigate a deterioration in the external environment. Chile offers an example. Copper is quite important in the Chilean economy and in 2012 represented 12 percent of GDP and 54 percent of exports. Hence, it is one of the most exposed countries to the commodity cycle. Good policies helped Chile to grow moderately in the early 2000s, when real copper prices were lower than at any other time since the Great Depression, and to avoid an unsustainable boom in the face of the record-high copper prices of recent years. Chile's dependence on copper price fluctuations has declined over time, despite the importance of copper in economic activity and exports.

Recent macroeconomic reform and favorable external conditions may have helped the region's performance in the wake of the crisis, but additional reforms will be necessary to improve these economies' potential output and spur sustainable growth over the long term.

The risks to the region linger from the global financial crisis. Advanced economies have not fully recovered from the crisis and face serious problems, including lackluster growth, high unemployment, incomplete financial reforms, and, in the euro area, a need to bolster economic and monetary union. At the same time, the advanced economies have only limited policy space to address these problems through traditional approaches such as expansionary fiscal policies. Several euro area member countries have faced sovereign debt crises, which intensified in mid-2011 and have been only partly resolved by intervention by the European Union, the European Central Bank (ECB), and the International Monetary Fund (IMF)—the so-called troika behind the recent bailouts. A number of EU banks remain weak, and bank deleveraging may further weaken growth. Japan, the United Kingdom, and the United States continue their efforts to bolster growth by keeping interest rates near the zero lower bound through the use of unconventional monetary policy. In contrast, activity in most emerging-market economies has already reached full capacity. In fact, many of these economies have recently faced challenges associated with relatively strong growth that may threaten their economic and financial stability, in particular, strong currencies and large capital inflows. With such risks still prevalent, securing long-term growth and financial stability is an important policy concern for Latin America.

Latin America from a Global Perspective

Table 1.1 provides a snapshot of current economic data for the LA-7, which account for more than 90 percent of the region's GDP. These countries all have a long tradition of poor economic performance. Throughout the postwar period until the 1980s or 1990s, depending on the country,[2] they were characterized by a number of factors that hampered growth: weak institutions, high inflation, unsustainable fiscal policies, exchange rate rigidities, high inequality, and low openness to trade (De Gregorio and Lee 2004).[3]

To different degrees and at different periods, all of these countries have faced serious economic problems. The debt crisis that began in 1982 had its origins in the adjustment in the United States to high inflation following the oil shocks of the 1970s, which induced the Federal Reserve to sharply tighten monetary policy. Latin American governments owed high levels of external debt to US banks, and the steep rise in US interest rates made the debt burden unsustainable. The Mexican government defaulted on its debt in August 1982, which set off a regional crisis. The crisis also owed much to macroeconomic mismanagement. For example, Chile had huge financial end external imbalances that led to a massive devaluation and the abandonment if its fixed exchange rate regime in June 1982. This initiated a deep economic and financial crisis, which would have taken place regardless of the Fed monetary policy adjustment, although effects would have been less dramatic without the negative external shock.

The abundance of international capital since the early 1990s and the lessons learned from the mismanagement before the debt crisis provided the impetus for reform. The success of Chile, in particular in the context of the return to democracy, was also an example in the region to push for reforms.

The 1980s were a lost decade for Latin America, with a sharp decline in relative income during the first half of the decade. In 1985 GDP had recovered to its precrisis levels, but advanced economies and Asia had GDP growth of 15 and 30 percent, respectively, above their 1980 levels.

2. Reforms in different countries have come at different times. For example, in Chile, the early reformer, the opening up of the economy and the liberalization of domestic prices took place in the 1970s, while inflation stabilization came only in the 1990s.

3. Weak institutions are key to understanding the stagnation in Latin America. See the persuasive account of Acemoglu and Robinson (2012).

Table 1.1 Basic indicators for the seven largest Latin American countries, 2012

Country	GDP (billions of US dollars)	GDP per capita: US dollars	GDP per capita: PPP US dollars	Share of Latin American GDP (percent)	Population (millions)
Argentina	475	11,576	18,112	8.2	41
Brazil	2,396	12,079	11,875	41.6	198
Chile	268	15,410	18,419	4.7	17
Colombia	366	7,855	10,792	6.3	47
Mexico	1,177	10,247	15,312	20.4	115
Peru	199	6,530	10,719	3.5	30
Venezuela	382	12,956	13,616	6.6	30

PPP = purchasing power parity

Source: IMF (2012d).

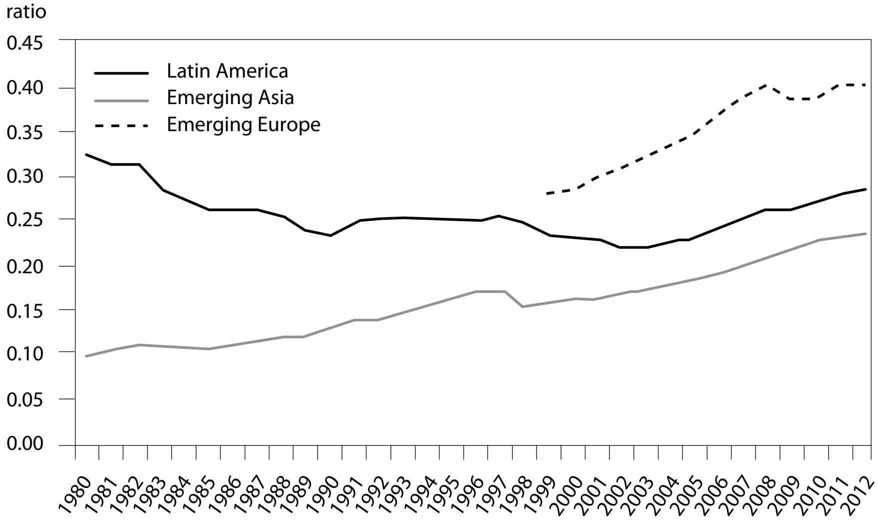
Certainly macroeconomic mismanagement led to crisis and slow growth, and mistakes could have been avoided. However, most of the macroeconomic reforms were undertaken in the 1990s, and benefits came almost a decade later. There is always trial and error; ex post we obviously have a better understanding of what went wrong. Nevertheless, not only has good performance been the result of current policies but also a path has been built over time by learning from mistakes.

Indeed, the first five, out of ten, recommendations of the so-called Washington Consensus, quite unfairly discredited as being unable to promote growth, refer to broad macroeconomic principles, in particular geared to sound fiscal policies and competitive exchange rate (Williamson 1990).[4] The latter was a response to artificially overvalued currencies that were central to economic malaise in the region. Of course, the recommendations are insufficient, so the list is quite incomplete. The region is in a development stage where new challenges to foster economic progress have to be addressed. Indeed, issues such as poverty alleviation and social inclusion should be a top priority and were not in the Washington Consensus list. Despite being incomplete, most recommendations of the Washington Consensus have been followed and have paid off, in particular opening up of the economy and consolidating macroeconomic stability.

The reforms of the late 1980s and early 1990s did produce stronger growth, but the pace of growth was not fast enough to make up for lost ground and, despite positive growth, the 1990s were a period of continued income stagna-

4. See also the recent review and revision in Fischer (2012).

Figure 1.2 Per capita GDP of Latin America, emerging Asia, and emerging Europe as a percent of US per capita GDP, 1980–2012



Note: Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela; emerging Asia: China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand; emerging Europe: Czech Republic, Hungary, Latvia, Lithuania, Poland, and Romania.

Source: IMF (2013a).

tion for the region in relation to both other emerging-market and advanced economies.

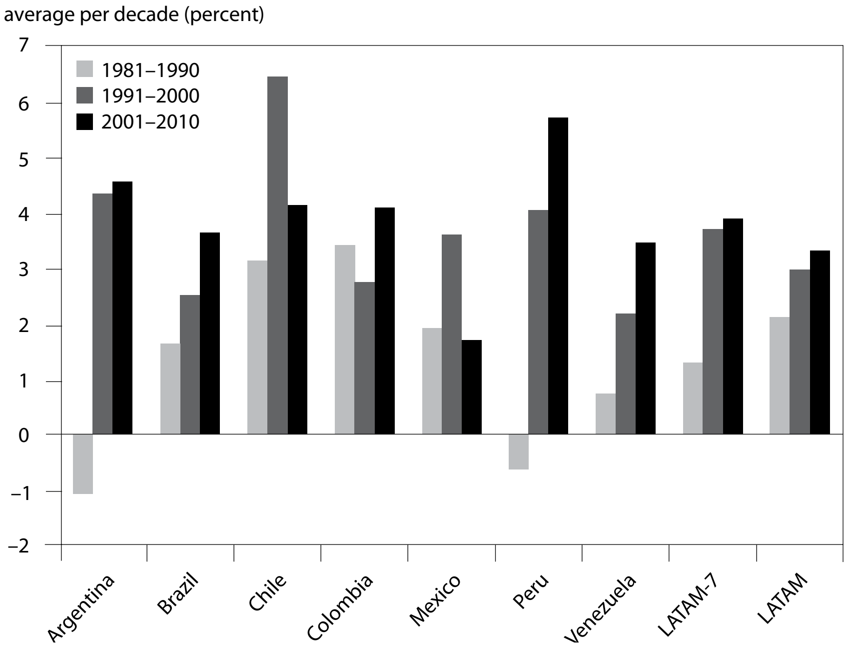
Figure 1.2 shows that growth, on average, tracked growth rates in the United States, until the slowdown attendant to the Asian financial crisis of 1997–98 and early 2000s. However, it is important to separate out the cyclical growth patterns to identify the long-term results of the reforms. Figure 1.3 shows average growth by decade since the 1980s. Chile, the earliest reformer, enjoyed its highest growth during the 1990s. In the other countries, most of the macroeconomic reforms occurred during the 1990s—including granting independence to central banks, consolidating fiscal policy, taking the first steps toward exchange rate flexibility, and other structural reforms—and these countries enjoyed the benefits almost a decade later.[5]

Figure 1.4 shows the growth experiences of the LA-7 in more detail by showing GDP per capita by country compared with the United States.[6] Chile

5. See Edwards (2010) for further discussion of macroeconomic progress during the 1990s and early 2000s.

6. Caution must be taken in comparing annual GDP per capita with that of the United States because these data are very sensitive to exchange rate fluctuations.

Figure 1.3 Growth in Latin America, 1981–2010



Note: The figures are simple annual averages across decades. The figure for the seven Latin American countries (LATAM-7) is the simple average and for Latin America (LATAM) is the weighted average from the IMF's *World Economic Outlook*.

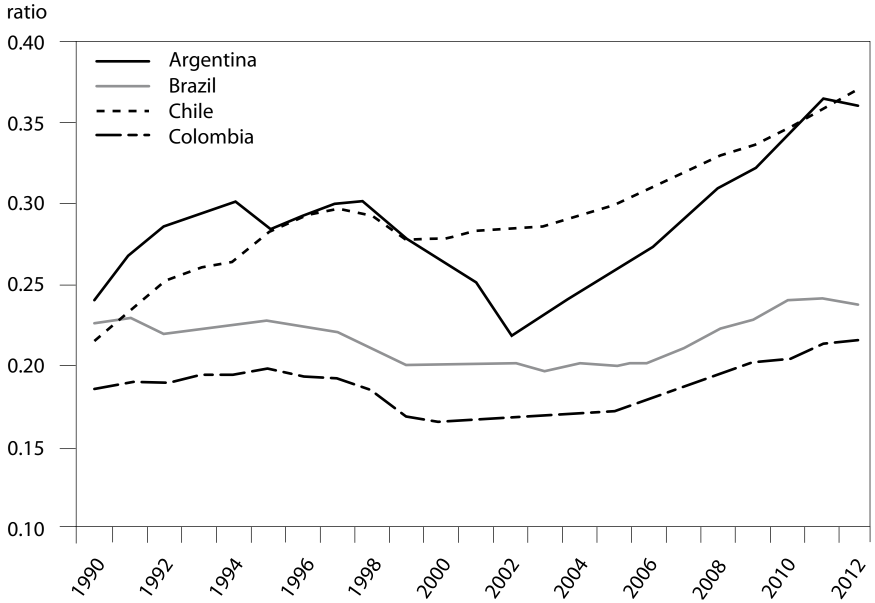
Source: IMF (2012d).

and Peru have made important income gains, while Mexico's income per capita has remained relatively stable relative to income in the United States since 1994, after the so-called Tequila crisis. Income in Venezuela declined on a relative basis until 2004, when oil prices started to rise. Argentina experienced a sharp fall in income with the convertibility crisis of 2001–02 but has experienced a significant recovery since then.[7] Income in Brazil and Colombia started to grow faster than in the United States after a slight decline during the early 2000s. In 1990, the richest among the LA-7 were Mexico and Venezuela, but by 2012, they had been overtaken by Argentina and Chile. Argentina and Venezuela experienced the most rapid growth during the commodity price boom from 2004 until 2008. These countries are examples of the benefits of good luck in weathering the recent crisis, but they also demonstrate the

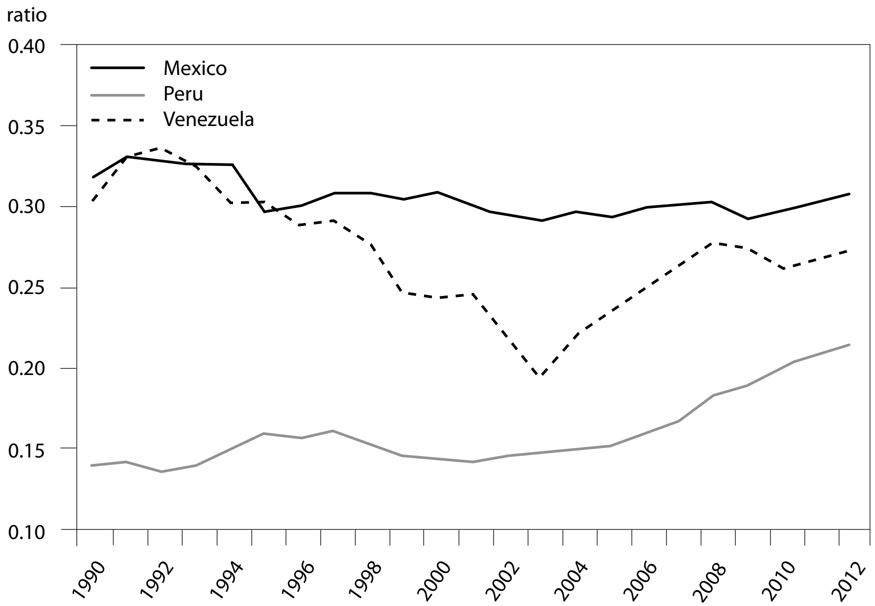
7. Argentina's official statistics have been considered unreliable since about 2007. In fact, the IMF has called on Argentina to adopt remedial measures to address data quality, particularly for inflation figures. Official estimates put inflation at about 10 percent, but others estimate it at around 25 percent. Similarly, current GDP estimates could be overvalued by about 15 percent.

Figure 1.4 Per capita GDP of Latin American countries as percent of US per capita GDP, 1990–2012

a. Argentina, Brazil, Chile, and Colombia



b. Mexico, Peru, and Venezuela



Source: IMF (2013a).

perils of being too dependent on external conditions, as discussed in detail in chapter 2.

More recent reform measures, some of which were adopted after the Asian crisis, created the policy space that helped the region respond to the global financial crisis. These reforms, mostly on the macroeconomic front, have stabilized inflation and consolidated public finances. One of the key early reforms, around 1990, was to grant independence to and mandate accountability by the central banks. To various degrees, central banks have been tasked with controlling inflation and have not been allowed to finance government budget deficits. The central banks in Brazil, Chile, Colombia, Mexico, and Peru adopted flexible inflation targets and, in an environment of low inflation, this permitted them to respond aggressively to the deterioration of the global economy by loosening monetary policy (e.g., lowering policy rates). In terms of fiscal policy, better policy has prevailed, which took advantage of the good external conditions. Most countries have run prudent fiscal policies, with limited budget deficits and in several cases surpluses as a result of the commodity price boom. However, less progress has been made on fiscal institutions, not only in the region but in emerging markets in general, with the exception of Chile with the application of a fiscal rule founded on solid economic principles.

There is a long history of populist experiments in Latin America to address the serious economic inequality and low growth that have characterized the region. By populist policies I mean policies oriented to solve many of the serious inequality problems, by means of fiscally unsustainable measures and widespread distortions.[8] These distortions did not efficiently tackle the social problems, although intentions may have been commendable. In other cases, populist policies end up giving special privileges to interest groups, which are not the right targets from a social point of view, on the one hand, and hinder economic growth on the other.

There was a resurgence of populism in the region during the 1980s, with leaders such as Raúl Alfonsín in Argentina, José Sarney in Brazil, and Alan García in Peru, and a renewed wave during the early 2000s, with the emergence of Hugo Chávez in Venezuela and Néstor Kirchner in Argentina. The region is not free from populism; the road ahead should decisively promote social progress in a sustainable way and ensure that these policies are not detrimental to long-term economic growth and macroeconomic stability.[9]

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8. Massive trade protection, price controls, and widespread subsidies have characterized these episodes.

9. Dornbusch and Edwards (1991) is the classical reference for the macroeconomics of populism in Latin America.

Latin America Compared with Other Emerging-Market Economies

Figure 1.2 shows the disparate growth performances of selected Asian, Latin American, and European emerging-market economies, and the experience of these three groups highlights some of the factors that explain Latin America's recent resilience.[10] The countries in each group are the following:

- Latin America: LA-7 (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela). These countries accounted for 91 percent of the LAC region's economy and 8 percent of world GDP in 2012.
- Emerging Asia: China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand. These countries accounted for 19 percent of world GDP in 2012, and 7 percent when China is excluded.
- Emerging Europe: Czech Republic, Hungary, Latvia, Lithuania, Poland, and Romania. These countries accounted for only 2 percent of global GDP in 2012.

The question of weighting the sample of Latin American countries is quite important. If the average is weighted by the GDP of each country, the evidence for Latin America comes mostly from Brazil and Mexico, obscuring the rest of the countries. In contrast, if all 32 Latin American and Caribbean countries are equally weighted, then Brazil and Mexico are each only 1/32 of the average, which clearly minimizes their impact. A good compromise is to take a few countries and apply the same weight to all of them. This is what I will do with the seven Latin American countries I study in this book.

The Asian countries included here experienced persistent growth since the early 1980s, which was only briefly interrupted during the Asian crisis. GDP per capita was 10 percent of US GDP per capita in 1980 and had grown to 23 percent in 2012. In 1980 the LA-7 had GDP per capita of 32 percent of the US level but only 29 percent in 2012, a decline that was more marked during the debt crisis and during the late 1990s and early 2000s. Growth recovered during the second half of the 2000s.[11] Growth in the included emerging European countries was significant after the adoption of the euro but has stalled since the start of the global financial crisis in 2008. This group of countries appears to have initially experienced overheating and unsustainable growth—performance not too different from that of Latin America during the debt crisis of the 1980s.

10. GDP per capita is calculated as the simple average across the selected countries in each region. This does not provide an indication of the relative importance of each region from a global perspective, but it does provide a better comparison of the average performance of each region.

11. Arithmetically, in per capita terms Latin America grew 31 percent more than the United States between 2002 and 2012.

Was This Crisis Different for Latin America?

In the past, global crises have had very significant negative effects in Latin America. The recent crisis stands in stark contrast, which can be seen by comparing the economic performance of the group of Asian emerging-market economies discussed above, the LA-7, and the advanced economies during three recent international crises: the debt crisis of the 1980s, the Asian crisis of 1997–98, and the recent global financial crisis (see figure 1.1).[12] The level of GDP for each region is set equal to 100 two years before the start of each crisis (1980, 1996, and 2007).[13]

The debt crisis hit Latin America particularly hard. If the recession in the United States in the late 1970s were considered a flu, the effects on Latin America were more like pneumonia. The region's economies were ill equipped to deal with the slowdown in the United States and in global trade or with the tightening of US monetary policy and the rise in interest rates in 1981. High levels of external debt, wide current account deficits, large fiscal deficits in some cases, poorly regulated financial markets, and general macroeconomic mismanagement led to a sharp contraction when US capital stopped flowing into the region. Exchange rate regimes had been semirigid before the crisis, but once the rigidity was abandoned, the region's currencies experienced significant devaluations. By 1987, the region's GDP was only 10 percent higher than in 1980 and GDP per capita remained stagnant. Meanwhile, Asian GDP had grown by 50 percent and advanced economies' GDP by 23 percent.

It is not surprising that Latin America performed poorly during the debt crisis, which was centered in the region. But when Asian countries were the epicenter of the crisis that spread through all emerging-market economies in 1997–98, their subsequent recovery was also much stronger than that of the Latin American economies. In 2003, five years after the crisis, GDP in Asia was more than 30 percent higher than the precrisis level, lower than the 50 percent increase in the five years after the debt crisis but still remarkable. Latin America, in contrast, stagnated. The initial decline was greater in Asia, but over the medium term, Latin America performed as poorly as after the debt crisis despite the fact that the initial contraction was less severe.

One reason is that the problems in Latin America were due not only to the Asian crisis but also to serious economic mismanagement. There was a convertibility crisis in Argentina in 2001, a currency crisis in Brazil in 1999, and a banking crisis in Colombia in 1999. The other countries in the region were un-

12. All data come from the WEO database, and "advanced economies" include those defined as such in this database, which weights by size. For Latin American and Asian countries, the average growth rate is calculated for each year and used to construct the index. The WEO definition contains 41 countries in the advanced economies group. Korea and the Czech Republic are classified as advanced economies, but they are kept in the Asian and emerging Europe samples here, respectively.

13. I assume the year of the largest decline in GDP to be the year the crisis started. The index is constructed using simple average growth rates.

able to implement vigorous expansionary policies to engineer a rapid recovery. Indeed, Latin American economies had become used to pursuing procyclical macroeconomic policies, to a large extent because of their reluctance to adopt flexible exchange rates—"fear of floating"—which led them to tighten monetary policy and reduce access to international financial markets, which further impeded fiscal expansion. These issues are discussed in more depth in subsequent chapters.

The recent crisis was different for Latin America—quite different. Four years after the crisis, Latin America's GDP is expected to be about 25 percent higher than the precrisis level, twice the growth achieved five years after the other two crises. Latin America's recovery still lags Asia's, although it is similar if China and India are excluded from the Asian group.

Saying that this time is different, especially when risks are still on the horizon, could be interpreted as an exaggeration. As Reinhart and Rogoff (2009) document, all crises are similar and go through similar phases. Indeed the global financial crisis had a strong credit boom, a softening of the financial conditions, supervisory negligence, and all the ingredients needed to cause a financial collapse. Nothing of this is new in Latin America. The recurrent financial crises in the region are quite similar to the recent one in the advanced world. Sometimes it was of fiscal origin, other times it was private. Regardless of the source, the crises were deep. The global crisis has not ended, therefore, we cannot say the story is over for Latin America, but the resilience has been astonishing. This time has been different, so far.

What Explains Latin America's Resilience?

The remainder of this book examines the factors underlying the strong performance of Latin America in the wake of the global financial crisis and identifies some important challenges and risks that lie ahead. In short, Latin America was resilient because of good macroeconomic policies, strong financial systems, and a bit of luck.[14]

1. Improved macroeconomic policy frameworks and good initial conditions generated enough policy space to allow the implementation of strong monetary and fiscal stimulus. The adoption of flexible inflation targeting regimes helped improve the success of monetary policy.
2. A cornerstone of the improved macroeconomic framework is exchange rate flexibility. Although several countries have used a combination of exchange rate intervention and capital controls to mitigate the appreciation of their currencies, for the most part and, more important, at crucial times, exchange rates have been allowed to float and thereby to act as shock absorbers.

14. Paraphrasing Rudiger Dornbusch's book, *Keys to Prosperity: Free Markets, Sound Money and a Bit of Luck* (Dornbusch 2000).

3. Strong, well-regulated, and fairly simple financial systems prevented exchange rate depreciations from causing a financial collapse. The strength of the financial systems meant that lending could resume as soon as conditions improved. A well-regulated financial system, with an appropriate macroeconomic framework, has been key to avoiding the perils of capital inflows.
4. High levels of international reserves played an important role in deterring attacks on the region's currencies. The reserves also provided a cushion to buffer the effects of any shortages of foreign financing.
5. It was a bit of good luck that most Latin American countries, which are exporters of primary commodities, enjoyed very good terms of trade: Commodity prices boomed during the second half of the 2000s and bounced back to very high levels after the sharp decline experienced during the crisis.

Overview of the Book

The chapters in this book examine each of these factors and identify some of the associated challenges that will need to be overcome in order to solidify the region's resilience, ensure sustainable growth for the long term, and tackle inequality to broaden the spread of prosperity.

Chapter 2 sets the stage by reviewing the favorable international environment for Latin America before the start of the global financial crisis, particularly the evolution of terms of trade. The benefits of terms of trade improvements were not equal for all countries in the region and were particularly strong for Argentina, Chile, Peru, and Venezuela. Moreover, Mexico and some countries in Central America suffered an important negative external shock from the expansion of manufacturing in China. The chapter reviews how improved fiscal and monetary policy positioned various countries to take advantage of good luck, overcome external shocks, and pursue expansionary policies during the crisis. The chapter examines the role of flexible inflation targets in monetary policy and the adoption by some countries of countercyclical fiscal policies, which helped to mitigate the effects of the external shocks.

Chapter 3 examines two very important factors underlying Latin America's recent success: flexible exchange rates and accumulation of international reserves. Most Latin American economies have overcome their traditional fear of floating. The extent of floating varies from country to country, and there has been foreign exchange rate intervention to build up reserves and avoid excessive appreciation of currencies. But these countries did not stubbornly defend an unrealistic value for the currencies, as in many previous episodes. The chapter reviews how anchoring inflation rates and strengthening their financial resilience has allowed these countries to overcome fear of floating, as large fluctuations of exchange rates have muted effects on financial stability and limited pass-through to inflation.

These economies also built up significant international reserve holdings before the crisis. Their use of these reserves during the crisis was limited, but they acted as a deterrent to currency speculation and sudden stops of foreign credit.

Chapter 4 discusses how improved financial systems and a focus on financial stability helped prevent serious disruptions during the crisis. The chapter reviews the origins of the financial crisis and how Latin America's cautious approach to financial innovation helped the region escape financial problems and avoid the credit booms that occurred in the advanced economies and emerging Europe. The chapter also discusses the role of new macroprudential tools in ensuring financial stability and the interactions between such tools and monetary policy.

A very important source of financial risk in emerging markets is capital flows, discussed in chapter 5. During the early 1990s, net capital inflows to emerging markets financed a widening of current account deficits. This was not the case in the years before the crisis, when most emerging-market economies had current account surpluses. Instead, these economies used inflows to accumulate reserves. The type of inflows to Latin America has changed as well, and this has reduced the attendant volatility and financial risks. Before the debt crisis, most flows to Latin America were in the form of bank credit, but the composition has been changing and now includes more foreign direct investment. Latin America has also become more financially integrated into the global economy, which made it more resilient. Despite a sharp decline in bank cross-border credit at the peak of the crisis, capital flows quickly resumed. Chapter 5 also examines the issue of how best to manage capital inflows to improve financial stability, an important question in emerging markets. The chapter explores the benefits and risks of exchange rate intervention or the use of capital controls. It argues that exchange rate intervention must be exceptional and preferably undertaken on a rule based on avoiding "intervention addiction," which ends up introducing inefficient rigidities.

Chapter 6 summarizes the main findings of the analysis in the book and some further challenges to fostering growth and prosperity in Latin America. These include the quality of institutions, high levels of inequality, and the need to promote social integration.