The Mexican Crisis of 1994-95

Background: An economy that had suffered recurrent exchange rate crises and debt default (in the early 80's). Going back to capital markets, hoping to increase trade, attract large inflows of foreign investment and grow faster.

The role of the exchange rate: Mexico sees stability of the (nominal) exchange rate a requirement to provide reassurance to foreign investors. A system of fixed (nominal) exchange rates is the solution adopted. From November 1991 the Peso was “fixed” to the US dollar within a band that was slowly depreciating (less than 5% per year). In October 1992 the band allowed for a slightly faster depreciation. In January 1993 a new Peso was introduced and remained stable (around 3.1 Pesos per USD) for most of 1993.

The early success: After the debt crisis of the early 1980s Mexico remained isolated from the world capital markets until the end of the decade. Then, in the years 1990-93 Mexico received $91 billion of net capital flows (about 20% of the total capital flows to developing countries). $61 billion took the form of portfolio investment. Interest rates declined to reach a low of about 9% in early 1994. The economy boomed during these years.

Inflation: Despite the efforts from the Central Bank to bring inflation down to levels similar to the US, inflation remained higher than US levels even during the period of stability of the nominal exchange rate.

The real exchange rate: A stable nominal exchange rate combined with high inflation meant an appreciating currency in real terms during the 1990-94 period.
**Imbalances:** As growth was strong (partly fueled by the capital inflows), the current account imbalance was getting bigger every year requiring additional capital inflows. Strong growth kept inflation high and therefore the real exchange rate kept appreciating leading to a loss of “competitiveness” and hurting the current account.

These imbalances in the case of an emerging market are risky because changes in the confidence of foreign investors can produce a fast reversal of capital flows and a crisis.

**Political turmoil and the international environment:** In addition to imbalances getting bigger we have in 1994:

1. Internal political turmoil as there is a peasant uprising in Chiapas as well as the assassination of leading presidential candidate (risk premium increases)

2. A change in international conditions as the Federal Reserve raised U.S. interest rates several times during 1994 to prevent U.S. inflation.
Questions:

1. Given the imbalances that are accumulating in the economy, how should the government (fiscal policy) and the central bank (monetary policy) react to them?
2. Once the level of confidence starts declining, what should the central bank do to ensure that the exchange rate remains fixed?
3. Is there a limit to what the central bank can do to defend a currency?
4. What are the lessons from a currency crisis such as this one?