

## Abstract

In the first quarter of 1995 Mexico found itself in the grip of an intense financial panic. Foreign investors fled Mexico despite very high interest rates on Mexican securities, an undervalued currency, and financial indicators that pointed to long-term solvency. The fundamental conditions of the Mexican economy cannot account for the extent of the crisis. In particular, the crisis was not the result of irresponsible fiscal behavior. It was largely due to unexpected shocks that occurred in 1994, and the inadequate policy response to those shocks. In the aftermath of the March assassination of presidential candidate Colosio the exchange rate experienced a nominal devaluation of around 10 percent and interest rates increased by 7 percentage points. However, capital outflows continued. The policy response to this was to maintain the exchange rate rule, and to prevent further increases in interest rates. The Government prevented interest rates from going up by expanding domestic credit and by converting short-term peso-denominated government liabilities (*Cetes*) falling due into dollar-denominated bonds (*Tesobonos*). A fall in international reserves and an increase in short-term dollar-denominated debt resulted. The government simply ended up illiquid, and therefore financially vulnerable. Illiquidity exposed Mexico to a **self-fulfilling** panic.