

The Mexican Peso Crisis: Sudden Death or Death Foretold?*

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April 1996

Abstract

We argue that allowing for the possibility of a self-fulfilling panic helps understand several features of the recent Mexican crisis. Self-fulfilling expectations became decisive in generating a panic only after the government ran down gross reserves and ran up short-term dollar debt. We present a simple model to explain how and why multiple equilibria can occur for some levels of reserves or debt, but not for others. Lastly, we argue that the imperfect credibility of Mexican exchange rate policy made it advisable to follow more contractionary fiscal and monetary policies in 1994. Our model formalizes the reasons why this is so. *JEL Classification Numbers E52, E58, F31, F32, O23, O54. Key words: fixed exchange rates, capital movements, currency crises.*

*We thank the Center for International Affairs at Harvard University and the C.V. Starr Center for Applied Economics at NYU for financial support, and Gerardo Esquivel for excellent research assistance. All errors are our own.

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