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MEXICAN CURRENCY CRISIS: OVERVIEW AND LESSONS

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Abstract

Economic theory did not encounter specific definition about currency crisis that is acceptable as universal. However, when we think about currency crisis the first thing we recall is a massive escape of investors from the currency for which they fear will depreciate thus affecting that this devaluation to really happen at a more financial repressive dimension than usual. In such a situation currency loses its stability and confidence, and if there are no sufficient international reserves then this can result in serious financial crisis. The aim of the paper is underling the utilization of theoretical knowledge about currency crises and focusing on the evaluation of existing theoretical models, over the last fifteen years, which were developed different theoretical models of currency crises in order to explain disruptions in the financial system or collapse of the exchange rate. Also, here we determinate the reasons and implications of a currency crisis, as the crucial role of the foreign exchange reserve for a country and behavior of investor in such a circumstances.

Key words: currency crisis, models, generations, Mexico.

1. Introduction

Economic losses caused by the currency crisis are spending the fiscal costs of restructuring the financial sector, a fall in economic activity, a distortion in distributable income, a decline in credibility (IMF, 1998) emphasize the importance of crisis prevention and the use of all available tools that can help in early identification of the financial weaknesses of the crisis crises system. For this reason, some kind of

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systems could identify the vulnerability indicators or predict a currency crisis in order to take on time true measures to avoid the crisis.

Utilizing theoretical knowledge about currency crises and focusing on the evaluation of existing theoretical models, over the last fifteen years, simultaneously were developed different theoretical models of currency crises in order to explain disruptions in the financial system or collapse of the exchange rate. Because different models (different "generations" of models) identify different factors as the cause of the crisis, and in practice some countries have significant deviations from the "generational" variants of the currency model, the advantage of empirical studies from the point of view of each country is obvious.

2. Literature review

2.1. Theoretical models of currency crisis

The theory for currency crisis distinguishes several types of crises. In the literature on the currency crisis, three generations can be distinguished for explanation of currency reasons. The first generation ("speculative attack models") appeared as an attempt to explain the currency crises in Mexico (1973-1982) and Argentina (1978-1981) (Agenor et al.,1991; Garber,1994).

The models of this generation point out to an inadequate macroeconomic policy as the main reason for a currency crisis. Second generation models ("exit clause models") are designed to include the significance of speculative attacks in Europe and Mexico in the 1990s, emphasizing the self-fulfilling features of the currency crisis and the emergence of multiple balances. The third generation highlights the consequences of the moral hazard in the banking system and the effect of infection as a key determinant of the currency crisis and explains the currency crisis in South Asia. There are also several models related to individual needs in crisis situations that are an alternative explanation for the causes of the currency crisis outside conventional "generation directions".

2.1.1. First generation of currency crisis

The first formal model of the currency crisis is presented by Krugman (1979) which gives a basic intuitive insight into the first-generation currency crisis model. Krugman argues that the currency crisis is

1. The economic reforms of the late 1980s, designed to limit the often uncontrolled inflation in the country, began to crack as the economy weakened.
2. The credentials of Mexico's presidential candidate in March 1994 prompted the sale of the currency.
3. The Central bank had about \$28 billion in foreign exchange reserves, which were expected to keep the peso stable. In less than a year, the reserves are gone.
4. The Central bank began to convert the short-term debt, denominated in pesos, into dollar-denominated bonds. This conversion resulted in a decrease in foreign exchange reserves and an increase in debt.
5. The self-fulfillment of the crisis resulted when investors fear default debt on the part of the government.

When the government finally decided to devalue the currency in December 1994, the biggest mistakes were made. It does not devalue the currency in a sufficiently large amount, which showed that while pegging policy was still followed, it showed a lack of interest in taking the necessary painful steps. This led foreign investors to undermine the exchange rate of the peso dramatically lower, which ultimately forced the government to increase the domestic interest rate close to 80%. This was a huge "toll" for Mexico's GDP, which also declined. The crisis was finally mitigated by an urgent loan emergency loan from the USA.

According this - lesson ... when there is a possibility of facing a currency crisis, the Central Bank in economies with a fixed exchange rate may try to keep the fixed exchange rate by "eating" the foreign exchange reserves of the country, or to allow foreign exchange course to fluctuate.

4. Crucial role of foreign exchange reserves

When a devaluation is expected on the market, downward pressure on the currency can only be settled (neutralized) by increasing the interest rate.

In order to increase the rate, the Central Bank must reduce the money supply, which in turn will cause an increase in demand for the currency. The bank can do this by selling foreign reserves to create an outflow of capital. When a bank sells part of its foreign exchange reserves, it receives a payment in the form of a domestic currency, which keeps it outside the turnover as a means. Also, the reliance on the exchange rate can not last forever, both in terms of the reduction of foreign reserves, as well as economic and political factors, such as the increase in unemployment. Devaluing the currency through an increase in the fixed exchange rate results in domestic goods being cheaper than foreign, which increases demand for workers and increases the output. In the short run, devaluation also raises interest rates, which must be settled by the Central Bank by increasing the money supply and increasing foreign reserves.

As it is mentioned above, earlier the suspension of the fixed exchange rate can "eat" through the foreign exchange reserves of the country quickly, and devaluing the currency can bring back the reserves.

5. Behavior of investors

If the market expects the Central Bank to devalue the currency - which will increase the exchange rate, the possibility of stimulating foreign exchange reserves by increasing the aggregate offer was not realized.

Instead, the Central Bank must use its reserves to reduce the money supply, which in turn increases the domestic interest rate.

If the confidence in the stability of the economy with the investors is diluted, then they will try to bring their money out of the country. This is still called an outflow of capital. When investors sell their domestic currency-denominated investments, they convert these investments into foreign currency. This causes a worsening of the exchange rate, resulting in the escape of the currency, which may even be impossible for the country to finance its capital expenditures.

6. Concluding remarks: Reasons and implications

The prediction when a country enters a currency crisis involves an analysis of various i.e. complex ranges of variables. There are several common factors that relate to recent crises:

1. The countries borrowed a lot (current account deficits)
2. the value of the currency is rapidly increasing
3. the insecurity associated with the Government's activities makes the investors nervous.

The high level of public debt increases the cost of defending the exchange rate, but increases the dangers of speculative attacks. A high unemployment rate leads to difficulty in defending the exchange rate with a higher interest rate. The fact that the government will not tolerate a high unemployment rate may lead to currency depreciation (Lestano and Jacobs, 2007).

When the expectations for the devaluation embedded in the nominal interest rate, the greater the interest cost of the debt will lead to an increase in the cost of maintaining the exchange rate. Speculative attacks can occur even when the currency is overvalued.

The overvalued currency causes current account deficits, and in some cases deflationary pressure that leads the monetary authority to assess that the cost of defending the exchange rate is greater than the benefits.

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