

Latin American Currency Crises

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Abstract

This study aims to provide a detailed explanation and a comparative analysis of the currency crises experienced by Argentina, Brazil and Mexico, which constitute the major traumatic economic events in the history of the Latin American region. Despite the fact that the main causes and the triggering factors of these crises were similar, the evolution, the policy responses as well as the impact and the outcome of the crises differed significantly across the three countries. Understanding the nature and the dynamics of these significant crises is crucial in order to be able to evaluate the economic outlook of emerging economies in international financial markets, which is critical for the stability of the global financial system.

Keywords: Currency Crises, Latin American Economies, Emerging Markets

Introduction

Latin America has historically been one of the most volatile regions for currency and financial crises. Latin American currency and financial crises have historically been driven by a combination of heavy external borrowing, overvalued fixed exchange rates, sudden shifts in global interest rates and domestic fiscal imbalances. Rather than isolated events, these crises generally occurred in sweeping regional waves. The structural roots of vulnerability were external debt accumulation, fixed exchange rate regimes and external shocks. Throughout the 1970s, international commercial banks recycled petrodollars into heavy loans to Latin American governments, causing external debt to skyrocket. Most countries artificially pegged their currencies to the US dollar to control inflation and ease imports, which eventually eroded foreign exchange reserves as currencies became heavily overvalued. High dependency on commodity exports and vulnerability to shifts in US monetary policy meant that any tightening by the US Federal Reserve immediately exacerbated debt-servicing costs. Following the turbulent decades of the late 20th century, most Latin American central banks transitioned from rigid fixed pegs to flexible exchange rate regimes and adopted inflation-targeting frameworks. Additionally, Latin American countries built substantial foreign exchange reserves and reduced dollar-denominated domestic liabilities, significantly lowering their vulnerability to sudden shifts in global financial conditions. This study provides a detailed explanation and a comparative analysis of the currency crises experienced by Argentina, Brazil and Mexico, which constitute the major traumatic economic events in the history of the Latin American region.

Literature Review

The academic literature on currency crises has traditionally been categorized into three generations of economic models, each of which reflects the shifting dynamics of global financial systems and subsequent historic market collapses.

Papers in first-generation models explain crises driven by unviable domestic macroeconomic policies such

as expanding a government fiscal deficit while attempting to maintain a fixed exchange rate pegged to a foreign currency. Krugman (1979) provides the foundations of currency crisis theory. The author illustrates how an expansionary monetary policy systematically drains a central bank's foreign exchange reserves, making a speculative attack mathematically inevitable before reserves hit zero. Flood and Garber (1984) simplify and formalize Krugman's 1979 model. A continuous-time framework is introduced in this study in order to precisely calculate the exact "shadow exchange rate" and pinpoint the precise timing of a speculative currency attack.

Prompted by the 1992–1993 European Exchange Rate Mechanism (ERM) crisis, the second-generation models recognize that a crisis can occur even in economies with stable underlying fundamentals if market sentiment turns negative. Obstfeld (1994) focuses on government trade-offs such as maintaining a currency peg vs. lowering interest rates to combat domestic unemployment. The study proves that self-fulfilling speculative expectations can shift an economy into a crisis equilibrium that would have otherwise been avoided. In a follow-up paper, Obstfeld (1996) explores how a government's lack of absolute commitment to defending its exchange rate allows investor panic to trigger structural collapses, even without fiscal deficits.

The third-generation models developed following the 1997 Asian Financial Crisis shift focus toward banking sectors, excessive corporate debt, moral hazard, and currency mismatches on balance sheets. Krugman (1998) argues that the Asian crisis was less about fiscal policy or self-fulfilling panics, and more about structural moral hazard. Implicit government guarantees led to asset price bubbles and reckless lending practices by financial intermediaries. In another study, Kaminsky and Reinhart (1999) empirically document the deep, systemic correlation between banking crises and currency crises. The authors demonstrate how a weakening financial sector predates and amplifies currency collapses. In a study focusing on an economy with credit constraints, Aghion et al. (2001) connect sticky nominal prices and credit limits to macro-shocks. The study models how a sudden drop in currency values expands foreign debt obligations for domestic firms, crippling their investment capabilities and plunging the wider economy into a deeper crisis loop. Kaminsky et al. (1998) introduce the 'signals approach' to evaluate macroeconomic red flags such as real exchange rate overvaluation, equity prices, and exports to build an early forecasting blueprint for impending currency shocks. Glick and Rose (1999) demonstrate empirically that currency crises spread rapidly to geographic neighbors because of deeply integrated, mutual international trade links rather than global macroeconomic similarities.

The literature focusing on Latin American currency crises has been extensive. Sachs (1985) examines why Latin American countries like Argentina, Brazil, and Mexico struggled to cope with severe debt and currency crises while East Asian nations managed to avoid them. The study emphasizes the role of trade policy, overvalued real exchange rates, and structural fiscal management. Kilby and Clague (1990) analyze the macroeconomic aftermath of the 1982 Mexican default and the subsequent structural adjustments. The authors provide a detailed explanation of how 'inflation-stabilization' programs often led to severe currency devaluations. Sachs et al. (1995) offer an enlightening discussion of the Mexican Peso Crisis. The authors argue that the vulnerability was caused by a dangerous combination of overvalued real exchange rates and a high volume of short-term dollar-indexed debt rather than a simple fiscal deficit. Calvo et al. (1996) explore the regional contagious effect of the Mexican crisis, specifically focusing on how capital flight rapidly infected Argentina and Brazil due to sudden shifts in foreign investor sentiment, regardless of local fundamentals. In a later study, Mussa (2002) provides a definitive analysis of why Argentina's strict 1-to-1 currency peg collapsed. The study highlights the fatal contradiction between an

inflexible nominal exchange rate and an unsustainable, deficit-driven domestic fiscal policy. Calvo et al. (2004) introduce and formalize the concept of a “sudden stop” in capital inflows. The paper uses Argentina's 2001 disaster to demonstrate how a sudden halt in foreign lending forces a massive real depreciation, destroying balance sheets that rely heavily on foreign-currency debt.

Frenkel and Rapetti (2012) evaluate two distinct historic waves of Latin American crises; namely, the 1980s and the 1990s/early 2000s. The authors demonstrate how unregulated domestic financial liberalization paired with rigid fixed exchange rates predictably leads to balance-of-payments destabilization. Gourinchas et al. (2001) compare international lending behavior over 40 years and prove that while lending booms are a standard feature of development, they affect Latin America with much higher volatility. The study shows that a Latin American lending boom massively exacerbates vulnerability to real currency appreciation, reserves depletion, and sudden balance-of-payments crises. Cavallo and Fernandez-Arias (2008) measure the regional exposure of Latin America to external currency shocks. The paper points out that despite macroeconomic improvements, Latin American economies remain structurally vulnerable due to a slow transition in portfolio composition and inadequate international reserve accumulation compared to other emerging markets. Last but not least, Van den Berg et al. (2012) investigate the predictive capabilities of an early warning system applied to Argentina, Brazil, and Mexico. The paper highlights a critical limitation in traditional models, which successfully link past Latin American currency collapses to commodity crashes and banking sector fragility while entirely failing to predict the sudden currency crises of late 2008 following the global liquidity squeeze.

Latin American Currency Crises: Cases of Argentina, Brazil and Mexico

This section provides detailed explanation of the currency crises experienced by Argentina, Brazil and Mexico as well as a comparative analysis of the key aspects of the crises such as causes and consequences. The 2001 Argentine Convertibility Crash is remembered as one of the most severe self-inflicted economic disasters in modern history. It resulted in a dramatic “triple crisis”—the simultaneous collapse of Argentina's currency regime, its banking system, and its ability to pay back its sovereign debt. The core of the tragedy lies in an economic policy that worked brilliantly to cure one disease, hyperinflation, but left the patient completely paralyzed when external conditions shifted.

In the late 1980s, Argentina was ravaged by hyperinflation that peaked at over 3,000%. Out of options, Economy Minister Domingo Cavallo introduced the *Convertibility Plan* in 1991. According to the plan, the Argentine peso was legally pegged by the law to the US dollar at a strict 1:1 ratio. Every single peso in circulation had to be backed by a US dollar sitting in the central bank's vaults. The initial reaction of the economy was a success story. The psychological shock worked wonders. Inflation plummeted almost overnight, foreign investment poured in, and during the early 1990s, Argentina enjoyed booming economic growth. Argentines could travel the world, buy cheap imported goods, and take out mortgages in dollars. However, there was a major flaw of the 1:1 peg. Argentina essentially signed away its monetary sovereignty. Because the central bank could only print pesos if it had matching US dollars, it lost the ability to act as a lender of last resort or adjust interest rates to counter domestic economic shocks. Argentina's economy became bound to the fortunes of the United States.

By the late 1990s, three external forces broke the system's back. The first one was *the super-dollar*. The US economy was booming, pushing the value of the US dollar steadily upward. Because the peso was tied to it, Argentine exports became incredibly expensive globally. The second factor was the Brazilian devaluation in 1999. Brazil, Argentina's largest neighbor and trading partner, abandoned its own currency

peg in 1999, causing the Brazilian Real to drop sharply. Suddenly, Argentine products were vastly uncompetitive compared to Brazilian goods. Finally, the third external force was the heavy borrowing in international financial markets. Unable to print money to fund government spending, Argentina covered its persistent budget deficits by borrowing heavily in international markets, in US dollars.

By 2001, Argentina had been trapped in a painful recession for three years. Unemployment was soaring, and tax revenues were evaporating. Investors realized the math simply did not add up anymore. Desperate to maintain international trust, the government pledged a "Zero Deficit" policy, aggressively cutting the salaries of civil servants and pensioners by 13%. This triggered massive domestic protests but failed to restore market confidence. Through the end of 2001, sensing the 1:1 peg is about to snap, panicking citizens began frantically withdrawing their deposits from banks and converting them directly into US dollars to hoard at home or ship abroad. With the banking system on the verge of total collapse, the government froze all bank accounts. The infamous "Corralito" restricted cash withdrawals to \$250 a week, completely strangling a cash-reliant domestic economy. As a result, violent protests and looting erupted across Buenos Aires. President Fernando de la Rúa declared a state of emergency. As protesters marched on the presidential palace, de la Rúa resigned and fled the roof in a helicopter.

In the period to follow, a rapidly shifting series of interim presidents took power. President Adolfo Rodríguez Saá officially declared default on \$95 billion of foreign debt, the largest sovereign default in history up to that point. In 2002, the new president, Eduardo Duhalde, officially repealed the Convertibility Law. The peg was broken, the peso started to float and it immediately lost nearly 70% of its value, vaporizing the life savings of millions.

The size and the cost of the collapse were staggering. By mid-2002, the poverty rate in Argentina shot past 50% and unemployment cleared 20%. Because many local debts, contracts and mortgages had been written in dollars, the government attempted a forced conversion called "pesification". Dollar savings accounts were forcibly converted into pesos at artificial rates, while banks were left heavily damaged. The 2001 crash left deep scars on the Argentine psyche. It created a permanent distrust of the domestic banking system as well as a systemic cultural preference for hoarding physical US dollars and kicked off decades of cyclical inflation and sovereign debt battles that the country still navigates today.

The 1999 Brazilian Real Crisis is an incredibly interesting case study due to the fact that, unlike the catastrophic collapses seen in Mexico in 1994 or Argentina in 2001, Brazil managed to "fail upward." While the initial currency devaluation was painful, the policy adjustments Brazil made during the eye of the storm laid the macroeconomic foundation for its massive economic boom in the 2000s. In order to be able to understand the crisis, one needs to look at what came right before it. In the early 1990s, Brazil was suffering from near-fictional levels of hyperinflation, peaking at an astronomical 2,400% in 1993. In 1994, Finance Minister (and later President) Fernando Henrique Cardoso launched the "Plano Real". According to the plan, a new currency, the *Brazilian Real (BRL)*, was introduced and anchored to the US dollar using a "crawling peg" band. The plan worked miraculously to tame inflation. However, just like Mexico and Argentina, anchoring the currency to the dollar came with an expensive side effect: the Real became highly overvalued, exports shrank, and Brazil became heavily dependent on hot, short-term foreign capital to cover its deficits.

By 1997 and 1998, Brazil hadn't done anything inherently wrong domestically to trigger a crisis. Instead, it became a victim of international "contagion". As a result of the 1997 Asian Financial Crisis, international investors panicked and began pulling money out of emerging markets globally. In addition, the 1998 Russian Debt Default sent shockwaves through Wall Street. Foreign hedge funds and institutional

investors faced massive losses in Russia and rushed to liquidate their assets in other emerging markets to raise cash. Brazil was the next logical target. Investors looked at Brazil's large fiscal deficit and overvalued currency and decided it was not worth the risk. A massive wave of capital flight began. The Brazilian central bank tried desperately to protect the Real. It raised domestic interest rates to a staggering 45% to convince investors to keep their money in the country, and it burned through tens of billions of dollars in foreign currency reserves. It was an unsustainable bleeding edge. In January 1999, the governor of Minas Gerais (Brazil's second-largest state) declared a 90-day moratorium on paying back its debt to the federal government. Investors interpreted this as a sign that Brazil's fiscal house is collapsing. As capital flight hit a fever pitch, Central Bank Governor Gustavo Franco resigned. The government attempted a controlled 8% widening of the currency trading band. Investors saw weakness and attacked the currency harder. As a result, having lost over \$30 billion in foreign reserves in just a few months, the central bank admitted defeat. It completely abandoned the peg and allowed the Real to float freely.

Immediately after the float, the Real plunged dramatically, losing more than 40% of its value against the dollar in a matter of weeks. Everyone expected Brazil to follow the catastrophic path of Mexico in 1994—skyrocketing hyperinflation, default, and a deep depression. However, that did not happen. Brazil pivoted brilliantly by introducing the "Macroeconomic Tripod", which still forms the basis of Brazilian economic policy today. The new policy was based on inflation targeting, floating exchange rate and fiscal responsibility. Instead of pinning the *currency* to a dollar, the Central Bank focused entirely on targeting a specific *inflation rate*, using interest rates to keep prices under control. The market would decide what the Real was worth, acting as a shock absorber for the economy. The government passed strict laws capping public spending and forcing states to maintain primary budget surpluses. Consequently, the devalued Real made Brazilian agricultural and industrial exports incredibly cheap on the global market. Combined with a massive global commodity boom in the early 2000s, Brazil quickly transformed its trade deficits into massive surpluses, completely recovering from the crisis by 2000 and embarking on one of its strongest growth eras in history.

Last but not least, the 1994 Tequila Crisis experienced by Mexico was a watershed moment in modern international finance. It was the world's first "fickle capital" crisis of the globalization era, showing how fast billions of dollars can vanish when international investors get spooked. In order to understand how it fell apart so quickly, one needs to look at the economic vulnerabilities built into Mexico's system, followed by the political shocks that acted as the match. Before a single dollar fled in 1994, several underlying economic imbalances left Mexico highly vulnerable. The first one was the overvalued Peso peg. To curb the hyperinflation of the 1980s, Mexico pinned the peso to the US dollar using a managed "crawling peg", allowing tiny, predictable daily devaluations. While it successfully crushed inflation, Mexico's domestic inflation remained slightly higher than that of the US. Over time, this caused the peso to become heavily overvalued, making Mexican exports expensive and imports artificially cheap. The second structural cause of the crisis was the massive current account deficit. Because imports were cheap, Mexicans bought massive amounts of foreign goods. By 1994, Mexico's current account deficit peaked at nearly 7% of GDP. Mexico was essentially living beyond its means, relying entirely on foreign investment inflows to balance the books.

As investors grew anxious about Mexico's stability later in the year, they stopped buying standard peso-denominated debt. Desperate to keep capital from leaving, the Mexican government began issuing short-term bonds called *tesobonos*. These were bought in pesos but indexed to the US dollar. This meant if the peso was devalued, Mexico's national debt load would instantly explode. Another factor causing the crisis

was the US interest rate hike that started at the beginning of 1994. Federal Reserve began steadily raising interest rates to head off inflation. Suddenly, foreign investors could get safer, higher returns in the US, making risky emerging markets like Mexico far less attractive.

The Mexican crisis unfolded through a series of escalating political and economic shocks over the course of a single year. On January, the 1st, 1994, the Zapatista Uprising broke out simultaneously as the North American Free Trade Agreement (NAFTA) went into effect. The Zapatista National Liberation Army (EZLN) launched an armed rebellion in Chiapas. Foreign investors were rattled by the sudden political instability. On March, the 23rd, 1994, Luis Donaldo Colosio, the leading presidential candidate for the ruling PRI party, was assassinated at a campaign rally. This triggered immense political panic. Capital flight began in earnest, forcing the Bank of Mexico to burn through billions of dollars in foreign reserves to protect the fixed peso rate. During the following period from April to November, 1994, the government chose not to raise interest rates or let the peso drop in order to prevent a deep recession before the upcoming presidential election. Instead, the government swapped trillions of pesos of maturing debt into dollar-linked *tesobonos*, hoping the panic would blow over.

In December, 1994, the newly inaugurated President, Ernesto Zedillo, realized that foreign reserves had dwindled to a critically low \$6 billion. The government announced a 15% devaluation of the peso's fixed band. The controlled 15% devaluation backfired completely. Realizing Mexico could not defend its currency, investors panicked and rushed for the exits. Left with zero choices, the central bank abandoned the peg entirely and let the peso float. The currency instantly crashed. By early 1995, the peso had lost roughly 50% of its value against the dollar. Because Mexico's *tesobonos* debt was pegged to the dollar, the country was suddenly facing imminent insolvency—it literally did not have the dollars to pay off its short-term bonds.

The panic spread instantly to other emerging markets in Latin America and Asia, which is the phenomenon known as the "Tequila Effect". Investors blindly pulled money out of any country with a fixed exchange rate or current account deficit. In order to prevent a total collapse of the international financial system, US President Bill Clinton bypassed a hesitant Congress and orchestrated a \$50 billion international bailout package alongside the IMF. Mexico used the funds to pay off the *tesobonos*, stabilized its financial sector, and eventually repaid the US loan ahead of schedule—but the domestic toll was immense, plunging Mexico into a severe, painful recession that took years to recover from.

From a comparative perspective, the most striking contrast is between Brazil and Argentina. When the speculative attacks hit Brazil in 1999, the government fought for a few weeks, recognized it was burning through too many reserves, and simply let the currency float. The Real depreciated, but the system bent without breaking. Argentina, however, had turned its 1:1 peg into a sacred legal pillar through the Convertibility Law. Because changing the law required an act of Congress, the peg was entirely brittle. It could not bend, so when it finally broke under the pressure of a three-year recession, it shattered the entire constitutional and financial framework of the country.

Argentina, Brazil and Mexico followed different strategies also with respect to management of debt and balance of payments. Mexico converted its peso debt into dollar-indexed *tesobonos*. When the peso fell, its debt obligations instantly doubled. Argentina went a step further by allowing its domestic banking system to dollarize. Regular citizens had mortgages, car loans, and bank savings denominated in US dollars. When the peso plummeted, citizens' wages were paid in depreciated pesos, but their debts remained in dollars, instantly bankrupting millions of households. Brazil, by contrast, held most of its

public debt in local currency, Real. When the Real depreciated, the government's domestic debt did not automatically multiply in value the way Mexico's and Argentina's did.

Finally, how these countries responded *after* the crash made all the difference. Mexico relied on a massive geopolitical lifeline—the US government could not afford a collapsed state on its southern border right after signing NAFTA, forcing a historic financial rescue. Brazil did not rely purely on a bailout; it completely rewrote its economic playbook by introducing the Macroeconomic Tripod (inflation targeting, floating exchange rates, and fiscal discipline). This structural shift turned a currency disaster into an opportunity, allowing Brazil to catch the massive global commodity wave of the 2000s and experience legendary growth. Argentina, left to default and isolated from international credit, spent the next two decades trapped in a cycle of litigation with creditors and systemic inflation.

Conclusion

Currency crises in Latin American economies have had large macroeconomic, financial and political consequences, especially in the form of weaker growth, output losses and disrupted policy credibility. The crises have not only affected the Latin American countries, but also other developing countries and emerging economies across the globe through contagion. The crises experienced by Argentina, Brazil and Mexico were not entirely isolated failures. Instead, they represent different cases of the same phenomenon experienced by emerging markets: the painful process of fragile and vulnerable emerging markets transitioning into a globalized financial system. While the underlying vulnerabilities were quite similar, the choices made by each government during the panic led to radically different economic outcomes.

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