

# THE 1994 PESO CRISIS: OVERVALUATION OR OVERREACTION

A prediction and analysis of the peso price during the 1994 Mexican Financial

Crisis: was the market valuation correct

by

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Crisis: was the market valuation correct

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## Abstract

The understanding of financial market crashes evolves over time. First Economists were confident that the 2008 Global Financial Crisis was caused purely by a housing bubble, then it became clearer that systemic problems in the US financial system caused a much bigger crisis than a housing bubble would justify. With financial crises in smaller economies, often this evolution of understanding takes more time – if it is ever reached. And this paper will shed light on whether the prevailing opinions on the 1994 Mexican Peso Crisis are accurate. Here the opinions of peso overvaluation during this period will be challenged, and by using economic theory of what underlying factors determine the price of a currency, I will create a prediction of the peso price between 1991 and 1999 as its underlying determinates would reflect. This prediction then will be compared to the actual price of the peso and from there the gap between the predicted and actual price will determine what overvaluation or undervaluation occurred and to what extent. The results show that although the overvaluation before the crisis, as predicted by economists, was present, it was much overstated and concludes that this overvaluation wasn't a justifiable cause of the crisis or a significant explanation to why the Mexican Economy was destined for financial collapse.

## Introduction

Mexico currently ranks as the 12<sup>th</sup> largest economy by GDP. Dominated by industry and service sectors, it is also the 12<sup>th</sup> largest producer of crude oil. In addition, Mexico is the second largest trade partner of the U.S. with 15.4% of US exports and 14.2% of US imports. Despite these erstwhile strengths, the Mexican peso suffered a calamitous collapse in 1994, leading to unemployment, contraction, and bankruptcy. That this occurred on the heels of what appeared to be a period of growth and increasing stability added to the pain. And much like the USA crises of 2007-8, the impact went beyond Mexico and caused direct and indirect consequences for the world's economy.

But was the sudden reversal of fortunes justified? Up until 1994, the Mexican peso traded at 2.5 pesos to the dollar. By March 1995, it was 6.7 and by September 1998 it was 10.5. While many observers believed that the peso was overvalued, this does not mean that the magnitude of the correction was legitimate. The goal of this paper is to examine that question. To do this, I will predict a base value for the peso, compare that to the actual values leading up to the crisis, and show whether or not the post-crisis exchange rate truly reflected the story told by the Mexican and US fundamentals. I will conclude that while it does appear that the peso was overvalued pre-1994, this was minor and in no way justified the degree of collapse that followed. In short, financial market participants overreacted.

The paper will proceed with a background of the history leading up to the crisis, an explanation of the economic theories used, an introduction to the empirical model used and an explanation of the results of the empirical model.

## History Background

On the 1<sup>st</sup> of December 1994 the 61<sup>st</sup> President of Mexico, Ernesto Zedillo, was inaugurated. He inherited a Mexican economy with a booming asset market, an economy ripe with foreign investment, and an increasing sentiment that Mexico was emerging as an impressive modernizing economy. In 1995, however, GDP dropped 5.9%, the peso was less than half its earlier value, and the stock market had plummeted. The start of this sudden shift was President Zedillo's announcement that the pegged peso was to be devalued by around 15% against the dollar to fight the mounting inflation – something he had earlier said he would not do.

Often this action was/is critiqued as the cause that started the Mexican Financial Crisis of the 90s, where President Zedillo led his country into ruin. Although the correlation is clear that before the devaluation the Mexican economy seemed fine and after the devaluation a disaster occurred leading to an economic downturn not experienced by Mexico in decades, the Mexican economy was not in the amazing position that it seemed. Many of the Neo-Liberal policies that had created this economic 'boom' led to a financial fragility that would inevitably see the Mexican Economy bust. As James M. Cypher states, the crisis was not just a "A result of monetary policy errors relating to the exchange rate, nor is it limited to a sectoral crisis in finance", rather, it was a result of many nuanced factors including: Neo-Liberalization, implicit guarantees, over confident agents and extreme growth seeking firms (Cypher 454 1996).

In the 1980s Mexico decided to shift away from their government control approach into an ultra laissez-fair position. They did this through a series of Neo-Liberal reforms aimed at modernizing the Mexican economy and increasing growth, they believed the Neo-Liberal

belief that decreased regulations and privatization immensely increased the efficiency of the economy thus increasing the growth rate as the economy performs better. The re-privatization of the banking sector was a major part of this neo-liberalization where President Salinas from 1991-1992 “rapidly sold the 18 banks that had been nationalized in 1982” (Cypher 453 1996). This was coupled with policies of deregulation such as decreasing capital reserve requirements of banks and a lack of regulation of capital outflows. Mexico saw the financial sector as its key to modernization and growth, their pro finance agenda led to finance and real estate’s share of GDP rise from 8.6% to 14.9%. Furthermore, Mexico saw bank profits grow from: “\$1.3 billion in 1991 to \$1.9 billion in 1992, to \$2.7 billion in 1993...” this drastic growth rate led Cypher to state that “Bank profits were so high in relation to the return on equity found elsewhere that there can be little doubt that the financial sector was draining on the industrial sector of the Mexican economy of its ability to expand its productive base” (Cypher 455 1996). All these policies prioritized profit and growth over all else, and naturally that agenda led to a higher concentration of riskier investments in the economy, as more and more agents wanted to be exposed to the large upsides that the new Mexican economy was introducing.

Furthermore, Colin Danby argues that “the neoliberal reform[s] had the perverse effect of strengthening implicit state insurance against exchange-rate losses by large firms” (Danby 582 2002). Because of the adamancy of the government not devaluing the peso and their encouragement for high growth banks now saw themselves as not being exposed to the dangers of peso-devaluation. Banks also gained the ability to take in state-guaranteed deposits to make high risk loans, an idea in line with accelerating the economy from a medium to high growth regime. Ultimately, the speed at which Mexican banks became financial unstable was largely caused by an increased access of agents to external sources of

capital, [raising] the pace at which liabilities could be accumulated by the private sector” (Crus, Amann, Walters 720 2005), and the reinforced idea that the banks need not worry about the riskiness of their investments.

This scenario created by the Mexican government saw signs of instability become evident in the financial sector as the high risk – high reward agenda took root. Cypher lays out the situation:

*“Behind the facade of official accolades and self-congratulations, however, the data revealed a banking system permeated by high-risk finance methods of the most fragile type. Bank lending soared—the six largest banks (which controlled 70 percent of the commercial bank loans) increased their lending by 230 percent in the six-year period from 1988 to 1993, with the most rapid growth coming in the 1990s. Profits for these banks, meanwhile, increased 137 percent in the same period [Giron 1994, 1072]. Foreign borrowing was a favored stratagem of the banks, creating external debts that rose from \$9 billion in 1989 to \$23 billion in 1993 and to an amount estimated between \$25 billion and \$38 billion in 1995 [OECD 1995, 20; Gonzalez 1995. I, 451. By late 1994, the OECD estimated that one third of the loans extended by the Mexican banks were in foreign currencies and that 25 percent of these loans were to businesses and individuals who had no income in foreign currencies” (Cypher 455 1996)*

Furthermore, the evident of recession started to the local markers, bank credit to the private sector saw a 400% increase, with most being consumer credit. The signs that the financial sector was being stretched beyond its capacity was evident, and the evidence of a prevailing hubris in the agents transparent.

The rest Mexican economy was not growing with their expanding financial sector, the rest of the economy started slowing down while the financial sector soured. While banks enjoyed incredible growth the real GDP from 1983-1994 only grew by 1.6% annually (a number significantly below Mexico's population growth rate), down from an approximately 6% average annual growth rate between 1940-1980. Moreover, the top 10% of income earners expanded their share of the population income to 38.2% from 32.8%, meaning that in this small real GDP growth the bottom 90% of earners enjoyed little to none of the growth. The industry sector's share of the GDP fell to 20% of the economy in 1993 from 22% in 1980, export performance declined by 15% from 1991-1994, and wages failed to increase with inflation.

The reason why none of these factors seemed even occur to Mexican officials was a series of misinformation, overconfidence, and arrogance. The government elite believed that the Mexican economy was on the brink of modernization and used many enabling myths to convince themselves and other that the economy was not in danger. The Government officials believed that the high growth rates that they were seeing were completely sustainable and were ignorant of or wishfully avoiding the dangers that the financial sector was getting itself into. This is most effectively seen in the statement by, the Secretary of the Treasury, Dr. Pedro Aspe's statement in December of 1994:

*"The Mexican financial sector has confronted the challenge of modernization and it has consolidated its presence within Mexico's economic strategy in order to respond to current global circumstances, which demand a competitive integration within the international economy, as well as improved efficiency and balance in all financial activities. The financial system of today is imbued with both characteristics and*

*instruments which will promote a growing savings level and channel foreign financial flows to the most productive and efficient use for the benefit of society.” (New York Times 1994)*

Ultimately Mexico’s desire to be a modernized nation, overoptimism of their strength, and ignoring of economic fragility; led them to pursue a high growth agenda that led to a much higher risk financial sector now making up a larger part of the economy, economic stagnation from other sectors as investment is concentrated on finance, and a much larger recession than they out to have had given their devaluing of the peso.

## Crisis in Mexico

There are many complex theories regarding why financial crises occur in general and how specific cases happened. These range from explanations of large-scale collapses such as the Great Depression and the Great Recession, to smaller events like those in less developed economies. As the latter inevitably have less data, the theories sometimes become even more complicated and less definitive. Economic crises are broadly explained by a section of the economy, or multiple sectors, deviating from what market fundamentals suggest they should be. The factors that have been targeted have ranged from an outside shock causing a sensitive economy to collapse to a poor government decision leading to poor economic performance or any amount of large-scale mispricing by either psychological factors or poor market decision making. All these can independently cause varying levels of disruption in the economy.

In Mexico's case, the discussion in the previous section suggests that there was overpricing in the asset market, poor market and government decision making, and a multitude of psychological factors that led to the crisis. The specific manner in which they contributed requires a theory by which to understand the causal linkages. I will accomplish that here, beginning with a definition of financial crisis and then building a model that shows how various factors can create tensions that may lead to a collapse.

Financial crises are seen as sudden widespread catastrophic systematic events, that have far reaching economic consequences. John Maynard Keynes and later economists emphasized that crises are often driven by underlying factors, and "the forces that create them are integral parts of capitalism" (Harvey 62 2009). A crisis may start in one sector of the economy (such as currency collapse or the bankruptcy of financial intermediaries) but can spread to other sectors, triggering widespread economic turmoil. The interconnections among

these sectors cause the crisis to escalate in severity as different sectors react to the initial disruptions. There are not a result of outside shocks but are the result of the development of increasingly optimistic forecasts coupled with economic situations that do not justify these expectations. Then when a shock hits the market, for the crisis to materialize, the agents affected have to react to their incorrect expectations in a way that has negative consequences to the economy.

The beauty of the asset market is that market agents, me, you, and asset manager John, can buy stakes in companies from around the world without meeting the owners of the company, stepping foot in the area, and being able to buy and sell (at will... mostly). This allows investors to become part of the upside of public domestic and foreign companies, without being constrained by geography, language or direct market experience. The danger is that there are now thousands to millions of investors that are all buying and selling stock in a company based on what they perceive the value of the company is. This can lead to great financial gains by savvy investors, but also lead to a significant difference between the asset value and the value of the underlying that the asset represents.

The question is why investors perceive the value of an asset as different than the underlying, and why do these investors that make these 'incorrect' assessments not get driven out of the market when the underlying asset is undoubtedly not worth the buying price? This is due to the expectations that agents have for the asset, that the asset itself is not just worth the underlying value of the present but the value that it can have in the future. This can be explained like an investor buying an autobody shop in the Dallas Fort Worth area. The investor would look at the shop, see the value of the underlying asset by the prices of the tools, the materials in the building, and the value of the land price etc; he would likely most look at the earnings of the shop and this would largely be the basis of what the return he perceives he could get from the purchase. Therefore, the investor in theory shouldn't buy the

shop if the price of the purchase wouldn't be repaid by the earnings in an agreeable amount of time, or be recouped by what he can sell the underlying assets for. However, the investor might still purchase the property because of factors that do not feature in the underlying and he might not be punished/wrong for it. The investor may look at the location of DFW and see the city is growing in population and wealth and thus believe future earnings could grow, or the investor might see other lots for sale next to the autobody shop and see expansion opportunities that would benefit the company, the investor also might even see that this plot is perfect for another business and scrap the whole shop to build a more profitable business like a Walmart. All these things are not part of the price of the underlying but are what the investor sees as potential future value and thus would pay more for the property than the underlying value of the assets. This is Expectations Theory and is why in the stock market there are companies trading at a value significantly higher than their earnings. What Expectations Theory tells us is that assets are constantly going to deviate in the market without changes in the underlying and market agents are going to act on these expectations. In markets with significant market access the price of an asset will often change based on consensus expectations by most of the agents, this means that assets generally can stay at values significantly different than the underlying value for long periods of time as agents are buying and selling the asset base on this consensus.

This, however, is not something that is limited to valuation of companies, stocks and purchases of smaller assets, but can be applied to a country as a whole. As when agents believe a country is going to economically grow they will invest in assets in that country, which will drive the price of those assets up, leading to more people believing that the country will expand because of a 'booming stock market' or sectors of the economy having increased investment. This can cause a feedback loop of agents perceiving a higher and

higher value of the assets in an economy, often increasing at a greater rate than the underlying is (like the GDP).

A prevalent consequence is the domestic currency value of a country increasing faster than the economy is expanding. As the currency value of an economy increases due to the sum of the asset values in a country, which as discussed is effected by market expectations. When the expectations of an economy's future growth/strength drop, the asset values will drop, and the currency value will drop as well. In a case where there is a significant difference between the asset value and the value of the underlying this drop might lead to a run on the assets as agents realize the asset value should be significantly lower.

In Mexico the story was similar with a key difference, the peso was pegged to the dollar and consequently expectations by market agents didn't change as quickly or significantly as would have been expected. When a currency, like the peso, is pegged this value change won't be realized in the actual currency value but will still affect the perceived free-market currency value. In this case there is a gap in the pegged currency value and what the free-market currency value would be, and if this gap is large then agents will either buy the underpriced currency or sell the overpriced currency. The currency value can still be corrected as the government can react and reset the pegged rate, so the gap is smaller and market agents won't feel as if the market is as overpriced or underpriced as before. However, the problem for Mexico was still there, after the positive feedback loop boosting the domestic asset value and boosting the price of domestic currency there is less pressure on the government to change the pegged rate as the gap is small to what the asset values suggest the currency value should be. And market agents may continue to trust the pegged currency value, and thus even when the gap to market-currency value gets larger and larger the domestic asset value can be kept high based on a value purely decided by the government.

What other economists have suggested that could've cause the Mexican Crisis is the problem that has led many countries into a pressure point of economic instability and eventually recession. Due to Mexico's extreme deregulation of the financial sector, coupling with an over-confident banking sector. This is a theory that many have applied to the Great Recession of 2008, where billions of dollars were made by complicated and convoluted CDOs that had insufficient regulation on evaluating the risk of the CDO. This can be particularly dangerous in a 'booming' economy that causes everyone to be making money and therefore not realizing their mistaken valuing of risk, thus when the speculative investment does fail and everyone realizing their mistake, total trust in the system fails and panic ensues as billions of dollars seem to vanish. Financial deregulation has been a topic debated in the USA for decades, and there are great arguments for deregulation of many sectors of the economy. It is one of the biggest propositions of Milton Friedman who said that "the government solution to a problem is usually as bad as the problem" (Goodreads). And the reasoning is clear, the market can better decide what is the most efficient thing to do with their money than the government can. This will lead to a more efficient allocation of capital across the economy as investment is dispersed across the economy and companies and individuals can receive capital to grow their production more effectively.

However, the danger of ultra Laissez-Fair/Neo-Liberal reforms can make, is that as every market agents is out to make money for themselves, many of them can act with short-term returns as their main focus. This leads to multiple problems, such as an excess of market volatility. As in Mexico, when there is a lack of regulation of capital outflows, once a market downturn is perceived a run on the market can happen leading to net capital inflows significantly decreasing. Another problem that the Neo-Liberal reforms often produce, is that reasoning for the reforms introduction is often because of a government desire to expand their country's banking sector, and thus the government often makes implicit guarantees to the

banking sector to allow banks to act more freely with a growth mindset. In this scenario bank will often disregard risk for an increased return, leading them to take on riskier and riskier positions with impunity. This means that the banks are exposing themselves to a scenario where many of their invested positions fail. Thus, their returns will fall and people will take their investments out of the banking sector as they know it isn't a solid investment. However, this isn't necessarily a big problem, banks often make different returns based on the business cycle and a multitude of factors. The problems occur when the return on investment in the banking sector is significantly higher than other parts of the economy, so investment floods to the banks and away from other sectors. This not only hurts other sectors growth but inflates the scale of the banks, and creates the problem that one bank failing can cause an immense effect economy and also the other banks who people will now trust less. Furthermore, the banks growth mindset will cause them to take on a significant amount of debt, much of it foreign debt, to fund further risky investments. These two scenarios lead to a significantly inflated problem where the amount of the economy effected by bank defaults being much larger, and the ease at which these banks can fail by defaulting on their significant amount of loans much quicker. Ultimately banks have been the causes of many recessions in the US and around the world, but quick dramatic financial liberalization can push banks into a riskier and riskier situation that they otherwise might not have been in.

## Empirical Model

As suggested in the introduction, the goal of this paper is to measure the degree of possible overvaluation pre-crisis and test for the possibility of overreaction on the part of market participants thereafter.

First, I will test for the determinants of the peso-dollar rate getting them from economic theory used in other papers about currency values. These are: the Mexico-USA CPI, Mexico-USA GDP, Mexico-USA trade balance, Mexico-USA interest rate difference, all stated in rate of change. These will be tested according to data collected from 2000-2023 to see how well they correlate with the peso price. These Mexico fundamentals are compared to US fundamentals as the peso price is best seen as a representation of how many pesos is worth a dollar. The correlation of these determinants is then used to create a prediction of the peso price for 2000-2023. The prediction of the peso price can then be compared to the actual peso price to see whether these determinants are accurate predictors.

If this prediction is accurate, I will predict the peso price between 1991-1999 using the same determinants. This prediction then will be compared to the actual peso price between 1991-1999 and give insight to whether the peso was overvalued or undervalued and what the size of the deviation was.

Running the testing between 2000-2023 is useful as the peso price was not pegged during this period, as well as it being far enough removed from the crises that the market should have ample time to correct its valuation. This means the actual peso price will be determined by market valuation, thus I can compare the prediction created in the 2000-2025 data to what a market price would be.

## Base Regression Results

In this section I will be finding the equation used for the prediction of the peso price stated in the previous section. The results of this regression will show how each of the variables relates (numerically) to the peso value, thus creating an equation that uses the values of the variables plus the multiplier given by the regression. I will then use this equation to create a prediction of the peso price from 2000-2023. This equation is expected to show that each of the variables are significantly correlated to the currency price, and that the equation can be used to predict the price of the peso accurately.

As this equation shows the relationship between the fundamentals and the peso value I can thus apply the data of the fundamentals between 1991-1999 to the equation and create a prediction of the peso value for this time period.

Running the regression that was previously mentioned from 2000-2025 lead to these results.

Source	SS	df	MS	Number of obs	=	96
Model	828.471664	4	207.117916	F(4, 91)	=	13.49
Residual	1397.62792	91	15.3585486	Prob > F	=	0.0000
Total	2226.09958	95	23.4326272	R-squared	=	0.3722
				Adj R-squared	=	0.3446
				Root MSE	=	3.919

peso	Coefficient	Std. err.	t	P> t	[95% conf. interval]
cpi	.7665072	.2744841	2.79	0.006	.2212783 1.311736
gdp	-.3348582	.1665065	-2.01	0.047	-.6656028 -.0041135
intdiff	-.112106	.2117638	-0.53	0.598	-.5327489 .3085368
trade	-.0147246	.0072324	-2.04	0.045	-.0290909 -.0003583
_cons	2.324169	1.204762	1.93	0.057	-.0689427 4.717282

Fortunately, most of the variables were significant, as expected, with the exception of the interest rate difference. Even though the  $R^2$  is not very large the overall fit was in the range of

what others find in similar studies. The best representation of how well the equation did in its prediction is seen in the visual representation below.

Figure 1: Predicted versus actual Peso Level 1991-1999

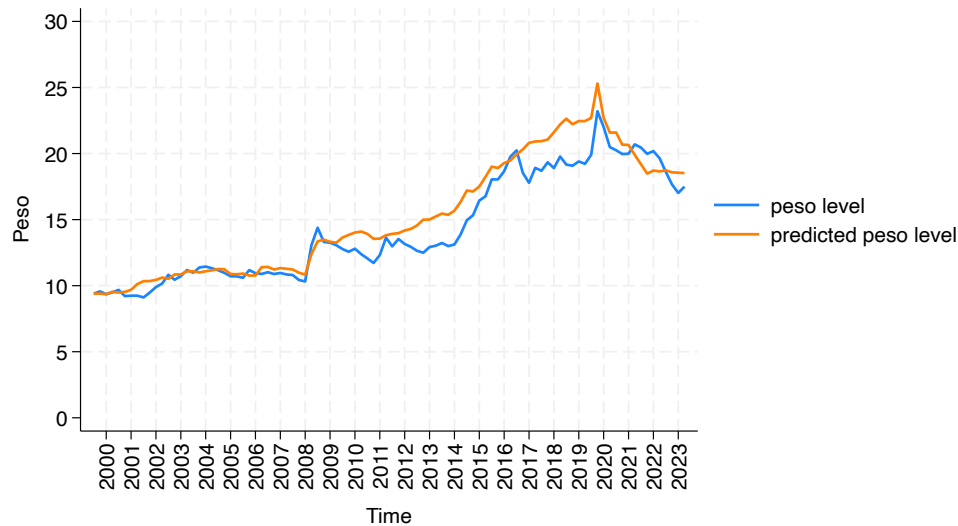
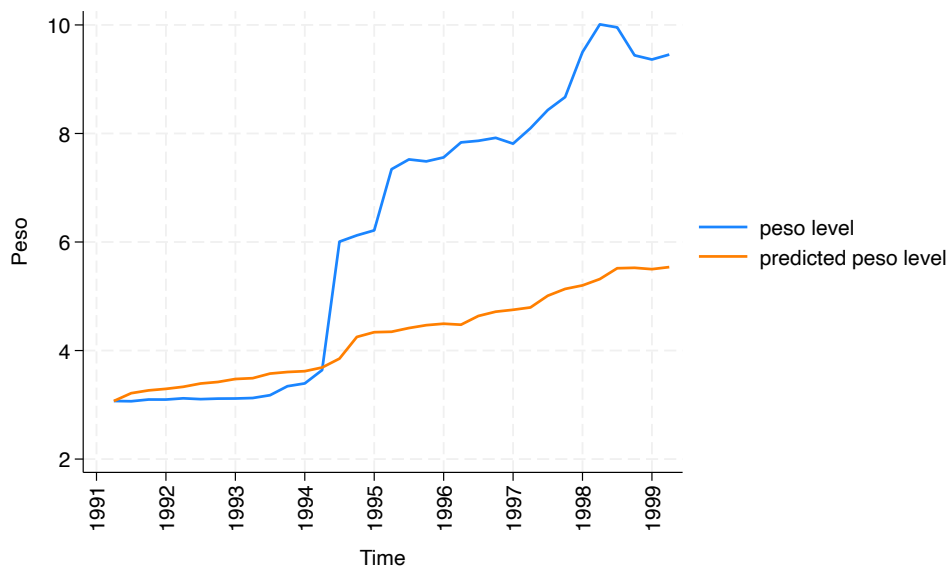


Figure 1 offers visual evidence of the relevance of the estimates. This graph clearly shows that the model was able to follow the peso level pretty closely even with only the 4 variables used. The predicted peso level was able to accurately follow the trends of the actual peso level and thus give a good idea of how the peso moved over time. This then gives me confidence that the estimates – based on underlying fundamental factors – will give a solid appraisal for what peso values should be, regardless of any possible financial market over or under valuations or reactions.

## Results explained

Now that the equation for the prediction is set, we can apply the parameters found to the period of 1991-1999. This will be done by using the equation from the 2000s graph:  $\text{peso} = 0.7665072(\text{CPI}) - 0.3348582(\text{GDP}) - 0.112106(\text{Intdiff}) - 0.0147246(\text{trade}) + 2.324169(\text{constant})$ . With this equation I will use the value of the peso in 1991 quarter 1 and then apply the equation to it over time to get all the values that my model predicts the peso to be. This then will be applied to a graph with the actual peso level and the graph will show what I predict the gap between the peso level and what the market peso value would've been before the 1994 crash and after.

Figure 2: Predicted Peso Level vs Peso Level 1991-1999



What is clear is that the economists were right in their predictions that the peso was overvalued leading up to the crisis (shown by the blue line being below the orange). The peso shows a period of overvaluation while it was pegged up until 1994, however it does not seem

to be as significant of a gap as many of the market agents would have predicted. Although this gap would put pressure on the Mexican government and would make investors be less inclined to the peso, it isn't as significant as expected. Furthermore, an assumption that I had going into this study was that the peso would continue to be more and more overvalued over time, shown by a gap in between the predicted peso price and the actual price, leading a point where the gap was too large and a breaking point was reached and the government had to devalue. This, however, doesn't seem to be the case. The graph shows that although the gap between the peso and the free-market price peso did get slightly larger it didn't get significantly larger and reach an obvious point of significant overvaluation. Leading to the question whether the peso overvaluation was unsolvable and if the government handled the situation better than the crises might not have been triggered.

However, another interesting finding is the significant under valuation of the peso after the Mexican Financial crisis in 1994, shown by the very large gap between the predicted level and peso level after 1994. It is known that often there are overreactions in the market especially after a crises but the significance of the gap is unusual, with the peso level vs predicted level gap reaching points of a 5 peso to dollar difference, significantly more than any predicted overvaluation before 1994. Furthermore, during time of overreactions it is common for the market to correct itself overtime due to market agents realizing that the discrepancy is there and then fixing there price estimates. However, in the graph the overvaluation sustains itself for the six years shown and doesn't show much significant correction at all to reach a more realistic level. This gap exemplifies the difficulty of predicting currency prices, as this sustained undervaluation of the peso would demonstrate that after the crash when the peso is un-pegged and thus is determined by a free-market price agents are still using expectations to value the price of the peso otherwise the gap would be significantly smaller.

An interesting conclusion could be drawn that the sentiment of the economists acted much like expectations of market agents. They posited that the peso was overvalued because of it being pegged, because of signs that this overvaluation was effecting the economy, by boosting asset prices higher than expected and through observations that the peso was becoming less attractive for purchase at the price it was at. However, this reasoning and the peso being overvalued for a long period of time might've mislead economists and market agents to believe that the peso was more overvalued than previously thought. This situation from 1994-1999 was evidentially not corrected by market agents and doesn't seem to be corrected by economists either. Through this period market agents are acting on expectations the same as they were before 1994 but just in the opposite direction, here the undervaluation could be that the agents expectations were based off of a distrust of the Peso/Mexican government and therefore an unwillingness to price the peso at an accurate value determined by the underlying value of the peso.

## Conclusion

While this paper showed that the sentiment of the economists and other market observers was true, that the value of the peso was overpriced in the period it was pegged to the dollar, it shows that the significance of this problem was overstated. This suggests that the problem that led to the Mexican Financial Crisis likely was not caused by the overvaluation of the peso but by other theories previously mentioned. Suggesting further that the shock of devaluing the Peso by President Ernesto Zedillo might not have caused a market crash if it was handled better, possibly by being more open to warn the market that it may occur. Furthermore, although the overreaction is in line with economic theory the significance of the overreaction is unexpected and the period in which this overreaction is sustained suggests that the market doesn't always correct valuation errors in free-market situations. In fact, the findings show that although expectations are the cause of incorrect valuation, the market will not always learn from its mistakes and, even in the event of a crash exposing these incorrect expectations, agents will go back to misvaluing the peso or other market products based on expectations: even if this misvaluing is in the form of under-pricing.

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