Financial Crises in Emerging Markets: The Lessons from 1995

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In this paper we examine closely the financial events following the Mexican peso devaluation to uncover new lessons about the nature of financial crises. We explore the question of why, during 1995, some emerging markets were hit by financial crises while others were not. To this end, we ask whether there are some fundamentals that help explain the variation in financial crises across countries or whether the variation just reflects contagion. We present a simple model identifying three factors that determine whether a country is more vulnerable to suffer a financial crisis: a high real exchange rate appreciation, a recent lending boom, and low reserves. We find that for a set of 20 emerging markets, differences in these fundamentals go far in explaining why during 1995 some emerging markets were hit by financial crises while others were not. We also find that alternative hypotheses that have been put forth to explain such crises often do not seem to be supported by the data, such as high current account deficits, excessive capital inflows and loose fiscal policies.

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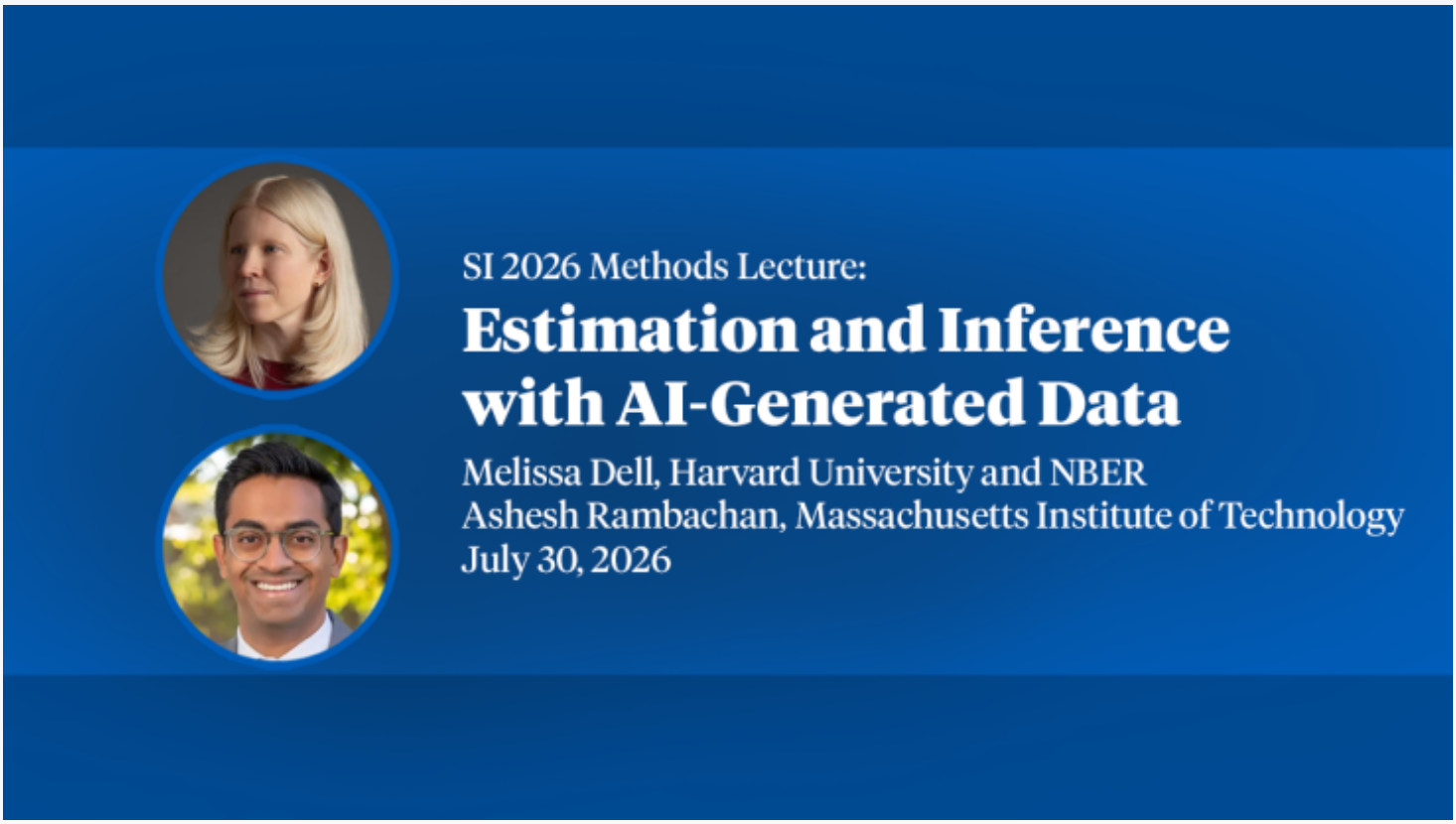


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