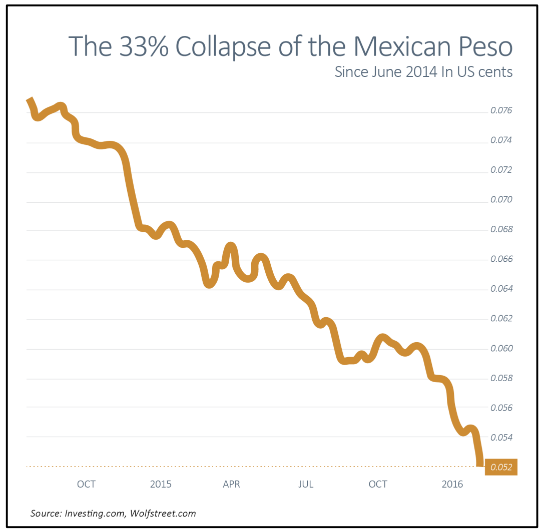
Entrada Group

whitepaper

Entrada Group
www.entradagroup.com
Ph: +1.210.828.8300
Doug Donahue
VP, Business Development

For Foreign Manufacturers in Mexico, Peso Devaluation Brings Both Advantages and Challenges



Ever since Mexico's Peso crisis of 1994, the value of the Peso against the US Dollar has been sliding. Throughout this period, intermittent rallies have repeatedly been followed by continuing devaluation. For manufacturers considering establishing Mexico production, the long-term trend presents competitive advantages over other countries.

The Mexican Monetary Authority is one of the most bullish emerging-market central banks around the world. Toward the end of 2016, The Authority tightened interest rates by 225 Basis Points for the last 12 months in order to prop up the Peso and, furthermore, to prevent concerns about runaway inflation due to depreciation.[1]

It's important for manufacturers that are considering setting up Mexico operations to be aware of the fact that the Peso's fluctuations bring operational concerns and complications that no manufacturer should ignore. To consider how the value of the Peso might change in the years ahead, relative to the US Dollar, it's important to understand the major forces driving the devaluation.

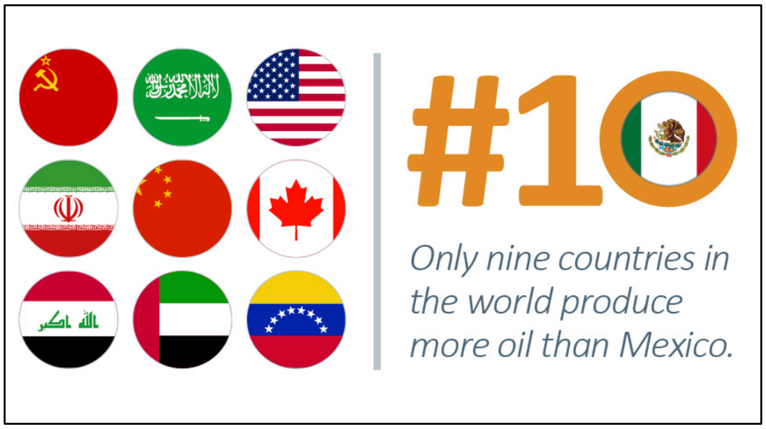
Understanding the Long Decline

The relative global strength of the US Dollar, which has long been viewed as a "safe haven" currency, has played a central role in the ongoing devaluation of the Mexican Peso. At the same time, additional pressures such as inflation and the recent Brexit situation have also contributed to the Peso approaching a longtime low. And that was before the 2016 US election.

Donald Trump's victory was followed by the Peso plunging as much as 13.4 percent against the US Dollar on November 9. Mexico's currency eventually rebounded to a net 9.2 percent loss on that day, but it was still the Peso's worst single day since 1994.

[1] https://www.dailyfx.com/forex/market_alert/2016/12/15/After-Fed-Hikes-Banxico-Meets-with-Pressure-to-Protect-Mexican-Peso.html

While these factors are undeniable, the most consistently significant for the Peso's valuation has been the price of oil. Oil exports have been a mainstay of Mexico's economy for just more than a century. Although government dependence on Pemex, the state-owned, heavily taxed petroleum company, has eased in the last few years, the monopoly still provides approximately 20 percent of all of Mexico's tax revenues. And markets still react very strongly when oil prices decline.[2]



When those prices started to climb in the mid-2000s, and then surged in the late-2000s, the effect on the Peso became increasingly clear. Since the Great Recession, the correlation between oil and the Peso has been particularly strong.

"When oil goes up, the Peso goes up," economist Joe Atikian tells Entrada Group's Doug Donahue, in an interview for Entrada Group's offshore manufacturing podcast series. "When oil goes down, the Peso goes down. And that relationship is very, very tight. The recent plunge in oil… has had a big effect on the weakening Peso."

A Clear Edge, with Caveats

The persistent devaluation of the Peso has given Mexico a longstanding competitive advantage in attracting manufacturers looking to reduce production costs, particularly for those selling finished goods to the United States. The fact that the decline has been relatively gradual—without too many wild swings in value—has further bolstered manufacturers' confidence about the prospect of producing in Mexico.

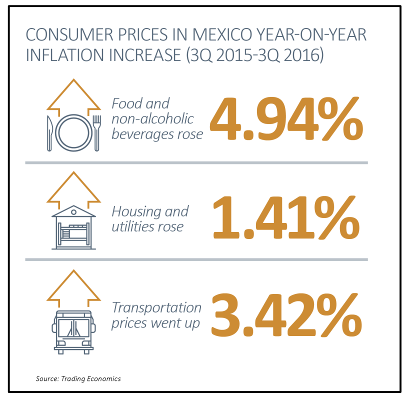
As Atikian explains, "the Peso has been sliding, but it's also been relatively stable. It doesn't really lurch back and forth like… the Canadian Dollar. People just don't have the confidence to invest [in Canada], because they don't know what's going to happen to the price of labor and the price of the [Canadian] Dollar."

The benefits of the Peso devaluation aren't as wide-ranging as some manufacturers might hope, however. Atikian says the advantage applies mostly within North America, and that the ongoing devaluation hasn't sparked a real competitive edge against Japan and its Yen, for example. "Every time the Yen got stronger," he explains, "Japan got stronger as an industrial economy, becoming a world power in science and automation. Mexico hasn't become a world leader on those fronts yet."

[2] http://www.reuters.com/article/mexico-economy-imf-idUSL2N1561KL

At the same time, the Peso's devaluation has helped Mexico to better compete against China in becoming an attractive manufacturing hub. As the Mexican Peso devalued against the US Dollar, the Chinese Yuan strengthened. This resulted in a more cost-effective environment for manufacturing suppliers to produce in Mexico.

This competitive benefit predominately materialized in labor costs. While huge growth in demand for labor in the manufacturing sector has driven up wages in China's factories in recent years, Mexico's wages have remained much more attractive than China's. In addition, China has to deal with the affects of its "one-child" policy that created its graying and stifled labor pool. In contrast, Mexico's labor force is young and growing. In terms of technical skills, Mexico ranks eighth globally in generating nearly 114,000 annual graduates in the fields of engineering, manufacturing and construction. Additionally, 39% of computing graduates in Mexico are female, the second-highest of any OECD (Organization for Economic Co-operation and Development) nation aside from Ireland.[3]



It is also important to note that production savings in Mexico may be more limited than many manufacturers assume. Those expecting lower costs throughout every facet of their operations in Mexico may be disappointed to find that the majority of the savings come almost exclusively from lower labor costs.

Other costs such as construction, utilities and telecommunications are often at a premium in Mexico because such infrastructure elements are financed in US Dollars. Because Mexico is an emerging market, the cost of financing in Dollars is much higher than it would be in the United States or Europe, adding to a supplier's overall infrastructure cost. It's important for manufacturers contemplating a Mexico footprint to look beyond the workforce and consider the all operation costs they will incur.

Another key factor is the location of every link along the supply chain. For many manufacturers in Mexico, devaluation cuts both ways—increasing the cost of any required parts from the United States or Europe, for instance. This is one of the main reasons that OEMs and Tier Ones producing in Mexico strive to source products from quality, local suppliers that are manufacturing nearby in the country. In doing so, they can cut costs drastically by reducing turnaround time from order to delivery—such as the landed cost of imports—lowering freight costs, and improving speed to market and customer service.

Although Mexico's overall level of inflation remains contained within the 2 to 4 percent target band set by the Central Bank, policymakers are growing increasingly concerned that consumer prices will accelerate in 2017, and have warned that the "great achievement" of curbing inflation throughout a decade must not be sacrificed.[4]

[3] http://www.oecd.org/gender/data/percentageoftertiaryqualificationsawardedtowomenbyfieldofeducation.htm

[4] https://www.dailyfx.com/forex/market_alert/2016/12/15/After-Fed-Hikes-Banxico-Meets-with-Pressure-to-Protect-Mexican-Peso.html

It's Complicated

Other scenarios also diminish the advantages a devalued Peso can bring, raising additional concerns. Producers that sell in Pesos in Mexico's domestic market and consolidate their earnings in another currency can lose out. The manufacturers that bear the greatest risk are those that borrow in US Dollars, make their income in Mexican Pesos and have to repay their loans in Dollars. Additionally, some clients of manufacturers may expect to share in the devaluation edge, in the form of discounts.

Jonathan Fogg, Chief Financial Officer of Pacific Insight Electronics Corp. (an Entrada Group client based in Fresnillo, Zacatecas, that supplies to the automotive, heavy truck and marine sectors), says that the Peso's recent slide "has temporarily increased our competitive position. But if the devaluation continues for a prolonged period, we anticipate price pressures from our primary customers." For many manufacturers, the extent of the advantage gained from devaluation depends heavily on the specific terms of their purchasing contracts.

Considerations can become even more complex for other manufacturers. For those that deal with parts and assemblies that go back and forth across the border, for example, the movement of the Peso can provide hedging opportunities.

Some companies are willing to take on the attendant currency risk, either because they think they can play the market well or because their global exposure to other currencies minimizes the danger. Such an approach should be undertaken only with great caution, however.

Looking Ahead

Caution is also at the heart of Atikian's message for manufacturers. Prior to the US election, he warned against assuming that the Peso's devaluation will continue, especially given the strong correlation with oil prices. "I wouldn't think that the weakening of the Peso could be sustainable for a long time," he says. Atikian estimates that a substantial but realistic rise in oil prices, "could bring about a 10, 20, 30 percent change in the exchange rate. It's a huge factor. I wouldn't take it too lightly, in other words."

In addition to examining the affect future oil prices may have on the Peso, changes to international trade policies may also contribute to further devaluation. Tariffs imposed by the new US administration, in particular, could further drive down the value of the Mexican Peso, resulting ultimately in Mexico continuing to remain competitive as a manufacturing location on the global stage. Tariffs also have the potential, however, of creating havoc in the Mexican domestic economy, which could lead to political strife in Mexico as well as increased immigration to the United States and the rest of world.

Fogg says that while his company doesn't specifically plan for Peso appreciation, the management team does keep a vigilant eye on the market, since any substantial rise would compress revenue margins for its facility in Fresnillo, Zacatecas.

Building some optimism for the strength of the Peso into any Mexico production plan is one simple way for manufacturers to protect against a potential rise. But that kind of prudence should also inform every aspect of a firm's approach to Mexico, from whether and how to establish operations, to the details of purchasing contracts and beyond.

Impact on Employees Cost of Living

Some manufacturers in Mexico are treating devaluation savings as an opportunity to enhance compensation and mitigate high employee turnover that has been a persistent challenge. For workers struggling to make ends meet, the uncertain value of the Peso makes it difficult to plan for even the near future.

Mexicans, especially young people who want to purchase US goods, are particularly upset about the steep depreciation. The costs of items such as electronics and clothing have increased considerably as the Peso continues to decline.

Ms. Sanchez for example, who works for Electrex (a maker of wire harnesses and cables at Entrada Group's Fresnillo, Zacatecas campus) says the fluctuating power of her paychecks has forced her to closely monitor the cost of groceries and other essentials. "I go by what I'm making. I wait for my paycheck and see how it will go from there," she says.

Ms. Sanchez grew up and worked in the United States before returning to her native Mexico. She recently received a promotion and salary increase that, combined with money she receives from her US-based relatives, enables her to slightly adjust her spending habits. "The increase definitely helped, but I still watch how and where I spend my money," she says. Because of the continued Peso devaluation, the widening exchange rate against the US Dollar still means it is nearly twice as expensive for her to buy US goods.

Having had professional experience in both the United States and Mexico, Ms. Sanchez recognizes the benefit of working for an American-based company. She sees the growth potential a company like Electrex can afford her in Mexico—assuming US companies will continue to operate manufacturing facilities in the country—contributing to a bright future.

This is because in such an environment, even modest pay increases like what Ms. Sanchez has gotten can have a major impact on the quality of life for employees—and on the way they view their employer and their work. Ms. Sanchez recently noted that due to her series of incremental pay increases: "I saw the change, and I thought, 'I want to stick around.' And here I am." "Now," she says, "I think it's my time."

AVERAGE COST OF LIVING COMPARISON:
MEXICO VS. UNITED STATES

	MEXICO USD	UNITED STATES USD
Meal, Inexpensive Restaurant	$4.16	$12.09
Domestic Beer (0.5 liter bottle)	$0.87	$2.05
Cappuccino	$1.66	$3.86
Milk (3.8 liters)	$2.80	$3.37
Gasoline (3.8 liters)	$2.57	$2.24
Basic Utilities (Electricity, Heating, Water, Garbage)	$34.92	$147.36
Average Monthly Disposable Salary (Net After Tax)	$491.90	$2,893.09

Source: Numbeo
Mexico data (December 2016) based on 19175 entries in the past 18 months from 1458 different contributors from all major cities in the country.
United States data (December 2016) based on 179079 entries in the past 18 months from 19571 different contributors from all major cities in the country.