Podcast Transcript: Doug Donahue and Joe Atikian, Economist and Author, "Industrial Shift: The Structure of the New World Economy"

Doug Donahue: Joe, again, thank you for being here today. Can you begin by outlining the peso devaluation effects on the Mexican and US economy?

Joe Atikian: Okay, yeah, thanks for having me as well Doug. On the peso, the first thing I'd like to say about that, is that there's been a lot of action on it lately, but I want people to keep in mind that it's been a really long-term slide for the peso. So if you look at a chart, let's say going to back to 1995, soon after they changed it to the new peso. It's pretty much had short periods of stability, and then it's devalued, and it's happened again and again and again. So it's been sliding since the mid-nineties. Having said that, I think generally you should look at three aspects that the devaluation would entail. So that would be investments, purchasing decisions, and then recurring transactions. So investment, for example, I think with a devaluating peso, it's pretty straightforward stuff. A weaker peso generally means that Mexico would invest less into the United States. So currently Mexico does invest in the US, and of course it goes the other way as well. But proportionally, it's interesting, Mexico invests more into the US than the US does into Mexico. So US foreign direct investment would be straightforwardly less, as the peso weakens. The other way around, US investment into Mexico, it's a bit more complicated. Because you'd think that a weaker peso should just encourage more US investment in Mexico. Things are cheaper to buy, so investments and assets are in the same sort of position. But the thing is that US firms cans also choose to invest in Canada, you know, and staying within the NAFTA zone. So Canada becomes another factor in the location of investments, so that's just something to keep in mind. The Canadian dollar fluctuates a lot, so that can be a deciding factor on where investment goes in some cases. So similar to the investment side, the purchasing side.. similar kind of rationale applies to that. So let's say if somebody wants to decide on where they're going to make a future production, a weaker peso should basically encourage more firms to engage with Mexican producers. So the thing is, I think that the with the current change in the peso, with the current weakening, there's probably a limited scope for effect here. Because people are already seeing Mexico as a low-cost supplier compared to Canada. So it doesn't seem like another one or two points in the peso weakening is going to make a big huge difference. It just sort of reinforces the same trend. And then I think we should also keep in mind that.. exports to Mexico from the US support about a million jobs in the US, so it is kind of a big deal, it is pretty important to have US exports into Mexico. So you can see the effects of a long-term slide in the peso are pretty wide economically. I hope that answers the kind of.

Doug: It does; it gives a good outline. As we were talking offline, there's all sorts of different factors that go into a currency's fluctuation. But from your perspective, what do you believe the major cause is of Mexico's peso devaluation?

Joe: Well yeah, okay, I'd say you're definitely right on that. There's a lot of moving parts, as we talked about before, that affect the foreign exchange rates. People also talk about inflation, Mexican inflation and US interest rate hikes. I think all that stuff is overblown, I'd just like to throw out my comment there. I think there's probably-- okay, I'll say two things that I'd like to mention about oil-- sorry <laughs>, about the peso, and one of them is oil, in fact. So in the '90s, most of the way through the '90s, oil was pretty cheap, and we know that Mexico is a big producer. But oil was pretty cheap, so it didn't have a strong effect on the peso. But then oil starts climbing in the mid-2000s, and then it really surged in the late 2000s, and I think it started to push the peso around quite a bit. And the interesting thing is, if you look at a correlation between oil and the peso, that correlation got really strong in.. let's say the last six years, so after the Great Recession. The correlation between a.. rising oil and rising peso is very strong. So when oil goes up, the peso goes up, oil goes down, the peso goes down. And that relationship is very, very tight. So it does look like the recent plunge in oil, like after the recession, I think that had a big effect on the weakening peso. And being here in Canada, I can say that we have a similar situation here. When the oil went down after the recession, Canada got hit really hard because we're also a big oil producer. So I think oil's a really big one. The second factor that I'd like to mention is the strength of the US dollar in general. So it's globally seen as-- the US dollar I mean, is globally taken to be a safe haven currency. So we know that Europe is having a really hard time in banking right now, and they have a lot of economic concerns. Italy's going through a really tough patch with their banking right now. So the US dollar is kind of a safe haven for the world, and it's strengthened against a lot of different currencies, so that includes the peso. So the peso could just be also getting swept up in the global sentiment about safety. So those are the.. I think the two long- term factors that we should probably focus on. Oil and the relative US global strength.

Doug: So obviously at first glance, everybody's going to say this gives Mexico a competitive advantage worldwide. Are you in agreement with that? And how would it manifest itself? And I guess the third part of that, is it sustainable?

Joe: Yeah. So I think that's true. I think the peso devaluation has increased Mexico's competitive advantage. And I think the long-term decline of the peso, so again, as I said, from the '90s it's been pretty much weakening the whole time, gives confidence to firms that want to move into Mexico. It doesn't really jag back and forth as much as, let's say, the Canadian dollar has. So if, for example, you look at automakers from all three globally producing regions, North America, Europe and Japan, they've all moved into Mexico. So you can say that the peso has had an advantage for Mexico. And you can see it here in Canada too. Because there's a lot of complaining in Canada that our auto production growth has pretty much been decimated by the peso, and the low cost of labor in Mexico. So the competitiveness within the NAFTA sector is definitely a strong suit for Mexico. We keep hearing about aerospace being one of the next manufacturing sectors in line, to move into Mexico in a bigger way. But on the other hand, you have to say that the peso is just one factor. And investment in other sectors, like telecommunications and oil extraction, for example, those are not so much tied to the peso. But investment in those fields has been weak, because government regulation allows monopolies to persist for years or for decades in those areas. So it's not so much the currency and the whole economy, it's depending on more like what the government regulations allow.

Doug: I would even strengthen your point there based on our history. When we go through doing cost models for manufacturers who are potentially going to set up in Mexico, the only savings there is, is really on the cost of labor because of the devaluations. All other cost, even Mexico cost, such as telecommunications, infrastructure, infrastructure being buildings, is more expensive in Mexico than in the United States or Canada.

Joe: Yeah, that's really interesting. I mean it goes to show that maybe the popular perception of weak currencies, is maybe not on the right mark. Because there's so much-- so many other factors at play there.
Doug: Yeah. Joe: I guess that's what you're seeing there too, right?

Doug: Absolutely, absolutely.

Joe: I'd like to reinforce again though, the peso has been sliding, but it's also been relatively stable. It doesn't really lurch back and forth like the Canadian dollar's been kind of terrible, because people just don't have the confidence to invest here. Because they don't know what's going to happen to the price of labor and the price of the dollar.

Doug: I think that's interesting, and it leads into the next question. We're talking about this devaluation as a competitive advantage for Mexico, but I've got to imagine there are some disadvantages to the international manufacturer with this type of devaluation. And you alluded to one, if it's going back and forth it's hard to project. Can you think of any other ones? Especially against the dollar or the euro?

Joe: Yeah, for sure. Let's say for individual firms who are thinking about setting up somewhere, a weaker peso can hurt exports to Mexico by making them more expensive. And in this case I think maybe you have a lot more information on this than I do, but I've heard some estimates that show that cars that are made in Mexico, for example, use up to-- half of their parts come from the United States. So those parts that are made in the US and sent to Mexico become more expensive. So the peso weakening cuts both ways, in other words. And then there's firms that sell in pesos, and consolidate their earnings let's say in another currency, whether it's euros or United States dollars, they can also lose out. And I think the other one that you can see as a disadvantage, is that someone who borrows within Mexico, borrows in pesos, but let's say they're dollar-denominated bonds or loans that they take out. So if they borrow in pesos and then have to repay in dollars, those kinds of holdings can get hurt as well. So having said that, again, there's always a flipside to everything. So the other thing that happens with, let's say parts that go back and forth across the border, parts and assemblies, the movement in the peso allows you to take on what you would call a "natural hedge." So if you use Mexican goods in your manufactures, when you sell those parts back in US dollars into Mexico, then it reduces the price of your exports. So it really depends on how a company sets up their purchasing contracts, what their purchasing terms are. So it can cut back and forth, it's not necessarily one way or the other.

Doug: That's a very interesting point. A lot does depend upon the contracts. Again, with our client base, some of their clients want to receive part of the peso devaluation in discounts. So it all depends on the contract and how it's set up, as to how much advantage you can get. So I think it's interesting that you raise this.

Joe: Yeah. And some firms actually want to take on the currency risk. They think they can play those markets better, or maybe they have more global exposure to other currencies and they run their currency risk as baskets, instead of as individual currencies. So it depends a lot on the particular situation. And I would say for someone moving into Mexico to you know, you really have to carefully consider what your position is globally.

Doug: Joe, you've alluded to it a little bit but I want to dive into this a little deeper. When I'm working with my clients, and we're discussing the devaluation and trying to project cost moving forward, they are all thrilled with the devaluation. But I sort of have been advising them that when the price of oil goes up, or even stabilizes, there could be an appreciation of the peso against the dollar. I'm not an expert, and I say there "could be," and I don't try to be. I'd like to get your opinions, your thoughts on what could happen, in a little more depth, if the price of oil goes up or begins to increase in the barrel cost.

Joe: I would start by saying, how much is oil a part of the Mexican economy? And we know that it has been a significant part for decades. I mean I guess Mexico produces something like.. I don't know what it is, but two or three millions barrels a day, or something around there. So if you look at, let's say the magnitude of the shifts in oil prices over the last several years, a 10-dollar change in the barrel price is completely within the realm of recent experience. And in fact we've had a run-up of 50 dollars, 70 dollars, and then a loss of 50 dollars. So the price of oil is a huge-- I think it's a huge risk on both the upside and the downside. So let's say for example, if oil was recently-- I think it peaked at 140 before the recession, or during the recession, and then so. Let's say we're at around 50 dollars today. Could it go back up to 100 dollars? I mean it seems easy that it could go back that high. So if you look at the-- okay, so we tied the oil price back into the correlation that we were talking about before. The peso and the price of a barrel of oil are correlated by about point nine, which is a very, very strong correlation. So if the oil price let's say goes up by 100 dollars, it could drag the peso up by-- okay, I'm not going to make a prediction here. But let's say it could knock five pesos off the exchange rate, or seven pesos or something like that. So that's around 30 percent, it could be.. okay, so you call it 10, 20, 30 percent change in the exchange rate. It's a huge factor. So I wouldn't take it too lightly, in other words. I wouldn't think that the weakening peso could hold on, and could be sustainable for a long time. Although it has been, it has been-- as I said before, it has been weakening gradually over the years. But I think it could now, with the stronger correlation with the barrel of oil, it's a big impact on the Mexican economy and it could be a big impact on the peso.

Doug: Joe, does Mexico have any advantage here against the yen, for example, or other currencies when discussing currency devaluations?

Joe: Doug, I think that's a really interesting question. Because for myself I've been watching the yen and the impact on the North American economy for a long time. Because I used to be in the auto industry directly. So I think the thing about Japan that's really interesting, is that they seem to have developed a long-term strategy to deal with the fluctuations in the yen. And they've surprised us continuously over the years. That even-- every time the yen got stronger, which happened several times, and it got stronger by quite a lot, Japan dealt with it. And everything in the economy improved, and their products improved, and their business practices improved, and they had radical automation, partly in response to the stronger yen. So every time it happened-- every time the yen got stronger, I think Japan got stronger as an industrial economy. So I think the comparison there is that.. I don't think Mexico has become famous for those kinds of factors. Like, seeking perfection in their product, or becoming a world power in science and automation and that sort of thing. It's not that Mexico doesn't do that, it's just that they haven't really become a world leader on that front yet. So I would say that alone.. the currency advantage, I don't think gives an advantage over places like Japan -- or economies like Japan. That would be my-- I'd sort of sum it up that way. It's beneficial, the devaluation of the peso is beneficial to Mexico, but I don't think it's a huge advantage over Japan and the yen.

Doug: So it's a very interesting comment. Because if you look at the Germans, they also went to automation, more efficiencies as at the time the mark became stronger, and then later the euro. So that's a very interesting observation. Well Joe, I really appreciate your time, and we appreciate you joining us on these podcasts.

Joe: Hey thanks, I enjoy it myself, so I appreciate the chance to participate again. Thanks again, Doug.