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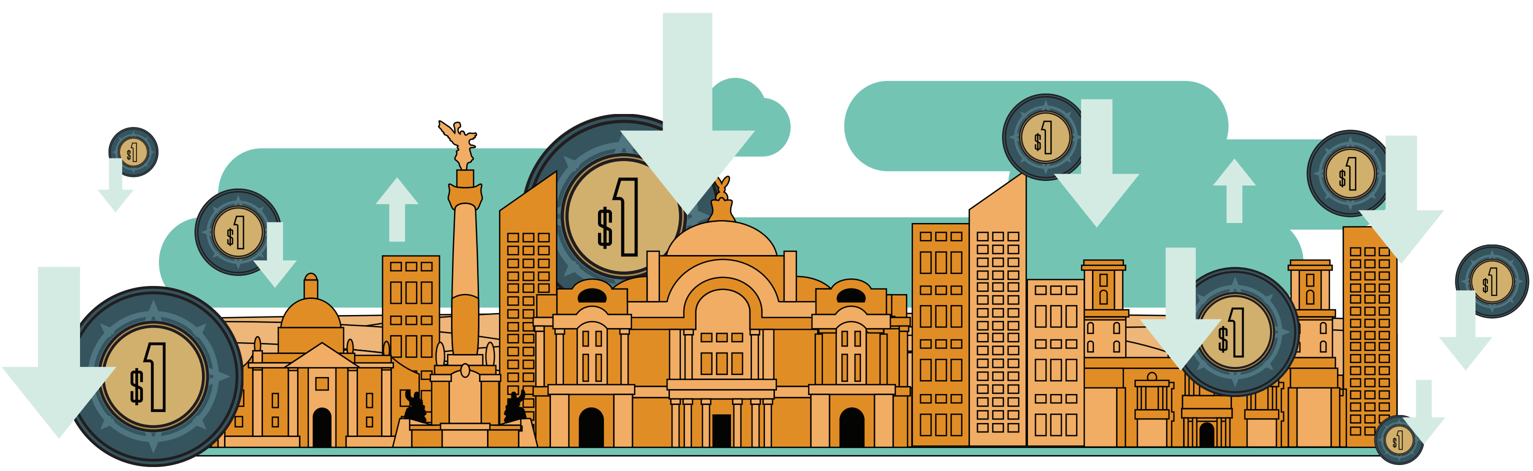
WHITEPAPER

For International Manufacturers in Mexico, A Consistently Weakening Peso is Still a Competitive Advantage, For Now

Mexico's currency crisis struck in 1994, and ever since then the value of the Peso against the US Dollar has been sliding consistently. There have been peaks and valleys during this nearly 25-year period – Trump's election in late 2016 resulted in a significantly higher drop than usual, followed by a modest rally that has since stabilized, for example – but a consistent devaluation has been the norm, for the most part.

For manufacturers considering establishing Mexico production, the long-term trend presents competitive advantages over other countries. At the same time, there are some important caveats to be mindful of.



Mexico's 1994 currency crisis was a signature event that became one of the first international financial crises ignited by capital flight. As calamitous as Mexico's currency crisis was, including a near-default by the Mexican government and a $50 billion U.S. bailout, the country was able to adapt and overcome by implementing a free-floating exchange rate and de-pegging its currency to the US Dollar. This is one of the key factors that has resulted in the long, steady weakening of the Peso.

It's important for manufacturers that are considering setting up Mexico operations to be aware of the fact that Peso fluctuations bring advantages as well as 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 historical forces driving the devaluation.

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Peso Down 56% Against US Dollar Since 2014[1]

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 steady, ongoing devaluation of the Mexican Peso. At the same time, additional pressures such as inflation and Brexit 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.

Since then, the Peso has rebounded slightly against the US Dollar, with the August 2018 announcement that NAFTA would be renegotiated (and rebranded as USMCA) resulting in an overall stabilizing effect on the currency. As of this writing, the final details of USMCA are still being hashed out, with the pact awaiting approval by the U.S., Mexico and Canada. But those final details are unlikely to have a significant impact on the future value of the Peso against the US Dollar. Year to date, the Peso is one of the best-performing currencies against the US Dollar in 2018, having gained back over 4 percent so far.[2]

[1] "US Dollar Peso Exchange Rate (USD MXN) – Historical Chart," Macrotrends, November 2018

[2] "Charm Offensive by Mexico's AMLO Sends Peso on a Relief Rally," Bloomberg, July 6, 2018

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WEIGHING POLITICAL FACTORS

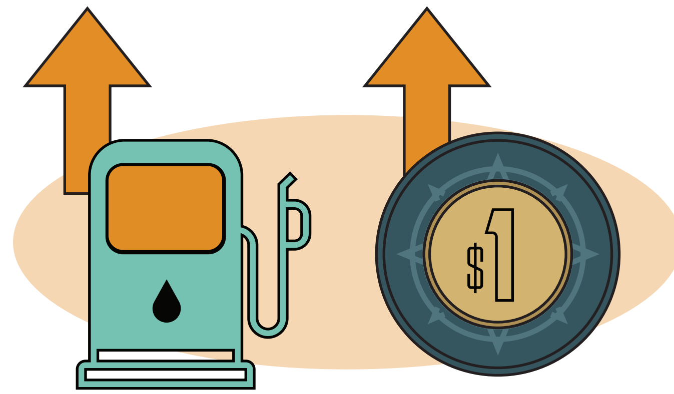
It's important to keep in mind that while political rhetoric, fiery quotes and tweets may garner a lot of headlines and media coverage, it's unlikely that either the Trump administration or the administration of Mexico's new President Andrés Manuel López Obrador (better known as AMLO) will do much to significantly affect the Peso/US Dollar exchange rate.

Despite all of Trump's threats to build a wall and remake NAFTA into a better deal for the US, Mexico's Peso remains near historical lows against the US Dollar and, as such, represents a huge competitive advantage for international manufacturers in Mexico.

For AMLO's part, since being elected in the summer of 2018, his administration has been doing and saying all the right things to calm investor anxiety about any potential policy changes. His Finance minister reassured investors that the country's 2019 budget will remain under control and that the independence of Mexico's central bank will be respected. If current actions are any indication, there is little concern of AMLO implementing an extreme measure such as taking the Peso out of circulation as a free-floating currency or tying its value to the US Dollar.[3]

Only ten countries in the world produce more oil than Mexico.

Source: CIA World Factbook, 2017 estimates



Oil Remains a Key Component

Trade policy and political aspects notwithstanding, the most consistently significant factor 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.[4]

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."

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> **Joe Atikian**
> Economist (in interview for Entrada Group's offshore manufacturing podcast series)

[3] Ibid.

[4] "Markets exaggerate Mexico's oil price dependence, which hits peso-IMF," Reuters, January 2016

Peso Remains 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 product 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."

The Peso's devaluation, however, 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 have increased wages in China's factories in recent years, Mexico's wages have remained much more attractive than China's, because Mexico's currency has continued to devalue, while China's Yuan has increased in value. In addition, China has to deal with the effects of its 'one-child' policy that created its graying and stifled labor pool. In contrast, Mexico's labor force is young and growing.

For technical skills, it ranks as the eighth-best nation worldwide, with nearly 114,000 annual graduates in the fields of engineering, manufacturing and construction—the highest of any OECD (Organization for Economic Co-operation and Development) nation aside from the U.S., Japan and South Korea.[5]

It is also important to note that production savings in Mexico may be more limited in scope 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 full range of costs their operation 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 1s 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.

Inflation is a perennial concern of Mexico's central bank, with particular focus on international energy prices as a pressure point. For the coming year, economists have predicted Mexico's inflation rate to hover around 5 percent, with the Bank of Mexico cautioning that it may need to raise interest rates to counter inflation persistently above that threshold.[6]

[5] "World Economic Forum 2015/UNESCO Institute for Statistics"

[6] "Mexico central bank chief concerned higher energy prices could fan inflation," Reuters, October 2018

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 are in the greatest risk are the ones 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.

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. He warns against assuming that the devaluation will continue forever, 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. One undefined issue that could greatly decrease the value of the Mexican Peso would be if the Trump administration were to add significant tariffs to products entering the United States from Mexico. In such a case, the market conditions would force the Peso to further devalue, in order to ensure that Mexico remains competitive. This has the potential 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.

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.

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Impact on Employee 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 receives money from her US-based relatives, and recently, she got a promotion that came with an increased salary, enabling 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, helping her have a more fruitful life.

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.

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	USA USD
Meal, Inexpensive Restaurant	$4.87	$14.00
Domestic Beer (.5 liters)	$0.88	$2.01
Basket of Goods (bread, milk, rice, eggs)	$5.98	$9.57
One-way Ticket (Local Transport)	$0.39	$2.25
Gasoline (3.8 liters)	$3.41	$2.70
Basic utilities (electricity, heating, water, garbage)	$35.30	$149.83
Average monthly salary (net after tax)	$463.51	$3,031.15

Source: Numbeo
Prices in United States: These data are based on 214,736 entries in the past 18 months from 23,673 different contributors. Last update: December 2018. Our data for each country are based on all entries from all cities in that country.

Prices in Mexico: These data are based on 23333 entries in the past 18 months from 2028 different contributors. Last update: December 2018. Our data for each country are based on all entries from all cities in that country.

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About Entrada Group

Entrada Group guides manufacturers in establishing and running their own cost-effective Mexico operations, enhancing their global competitiveness. Our manufacturing platform reduces risk and supports long-term growth, giving small- and medium-sized foreign companies a production footprint in Mexico, and empowering them to anticipate needs and deliver solutions to their clients, in an accelerated way. On behalf of the manufacturer, Entrada Group assists with the strategic, legal and practical requirements of setting up operations in Mexico, and also provides ongoing production support (General & Administrative) services. This leaves producers free to focus fully on their key competency: manufacturing great products.