FIGHT OR FIGHT: AN ASSESSMENT OF CURRENT BUSINESS OPPORTUNITIES FOLLOWING MEXICO'S PESO DEVALUATION

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Last December's announcement of the Mexican peso devaluation caught the financial world by surprise instigating a wave of skepticism as to Mexico's economic stability. Foreign investors quickly pulled out of the Mexican stock market and many U.S. companies put a hold on their Mexican operations. In a matter of weeks, Mexico was transformed from the darling child of Latin America to its financial pariah. In the weeks that followed, other Latin American countries quickly tried to distance themselves from Mexico in an effort to avoid the "Tequila effect" (Mexico has a bad binge, and the whole continent got a hangover). Considering this series of events, this article will address the future effects of the devaluation and the opportunities it has created.

EFFECTS OF THE PESO DEVALUATION

Although international financial investors suffered important losses following the December 20th peso devaluation, the financial repercussions will be felt longer and harder by Mexico. Mexicans have suffered job losses since December, as foreign companies have interrupted, curtailed or ceased their operations in Mexico and local manufacturers shut down manufacturing plants. U.S. auto makers have shifted their production focus from the Mexican market to the export market and industry analysts predict that overall auto sales this year in Mexico will drop a staggering 40% percent from 1994.[1] The consumption of U.S. consumer goods has also fallen dramatically and Mexican banks have basically been transferred from lending to collection institutions.[2]

The Mexican economic crisis has also had a ripple effect in the United States. U.S. exports to Mexico have diminished as U.S. exporters' goods have suddenly become more expensive. In 1994, Mexico was the third largest foreign market for U.S. goods after Canada and Japan. The U.S. will therefore loose a large percentage of its export market and suffer bilateral trade and job losses as a result.[3]

But behind this economic crisis hides a brighter picture. As gloomy as it may look now, in the long-run this peso devaluation will offer some positive effects for Mexico's economy and for U.S. companies. The higher demand for Mexican goods will increase Mexico's currency reserves and undoubtedly foster long-term growth. As for U.S. companies, they will benefit from this devaluation as a cheaper peso offers many new opportunities. The following are illustrations of some of these opportunities.

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1 El Financiero, "Right Place, Right Time," Jan. 16-22, 1995, p. 7.
El Financiero, "Post-Devolution Outlook Mixed for Auto," Jan. 9-15, 1995, p. 1.

2 El Financiero, "Border Retailers Report Drop in Sales," Jan. 16-22, 1995. p. 11.
El Financiero, "Pay Day, Someday," March 20-26, 1995, p. 10.

3 U.S./Latin Trade, "Free Fall in Mexico," Feb. 1995, p. 27.

1. Manufacturing: In the average manufacturing operation, twenty percent or more of the expense of manufacturing a product is the cost of labor. Lower wages therefore increases the profit potential for international corporations. The peso devaluation has reduced labor wages by a staggering 40-50% in most sectors. Hourly wages have plummeted from an average U.S. $2.00 to $1 lower, less than half the average manufacturing wage in Taipei (Taiwan).[4] The first beneficiaries of this windfall are U.S. and Japanese companies that have already established manufacturing plants in Mexico, most of them along the U.S.- Mexico border. It is therefore the perfect time to set up manufacturing plants in Mexico through the "maquiladora" program (where a U.S. company may import, in-bond and duty-free, all supplies to produce goods in Mexico, after which those products are re-exported to the world). Currently more than 2,000 companies have maquiladora operations, including, for example, Sony, Johnson & Johnson, General Electric, and General Motors.

2. Mining Industry: Peso dominated costs and mineral prices set in $U.S., and which are constantly rising in international markets, make the mining industry another great sector to invest in. Foreign companies now have access to Mexico's great mineral resources as Mexican law was recently modified to allow overseas participation in mining. As a result, U.S. companies can now buy concessions to explore and develop Mexican minerals. There are opportunities in

4 Mexico Trade and Law Reporter, Study finds NAFTA has a marginal impact on U.S. employee relocations, April 1st, 1995, Vol.5, #4.

silver (Mexico is the world's largest silver producer), gold, copper, iron and zinc. Mexico, although well-explored, remains under-explored. According to SEMIP (Mexican Secretariat of Energy, Mines and State-Owned Industry) only 20 percent of Mexico's subsoil has seriously been explored, and modern concepts and modern exploration technology have yet to be applied in Mexico.[5]

3. Banking Industry: Because of dramatically higher interest rates, rising unemployment and a growing number of business contractions and bankruptcies, Mexico's banking system is under tremendous stress. Many households and companies are unable to make their loan payments on time in the face of falling incomes and rising interest costs. Before the collapse, past due loans were approaching 10% of total loans in the banking system. Today that figure is close to 20% and two large banks have failed so far in 1995. It appears that many banks will have difficulty this year retaining enough funds to meet the government's capital requirement of 80% of assets.

The opening of the Mexican financial system to foreign banks could therefore not have happened at a better time as the economic crisis triggered by the peso devaluation left most of the Mexican banks with massive liquidity problems. Although Mexico's finance officials have put forth a new plan to recapitalize Mexico's ailing banking system, such measures won't be sufficient to meet Mexico's growing financial needs.

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5 El Financiero, "Right Place, Right Time," Jan. 16-22, 1995, p. 7.

Mexican banks are presently leading the search for foreign equity partners. Banco Bilbao Vizcaya of Spain, last June, became the first foreign bank to acquire a majority shareholding in a Mexican financial group when it took control of Probursa, a small bank burdened with a large portfolio of bad debts.

4. Agricultural Sector: Mexico has about one-fifth as much cropland as the United States but three times as many farmers: 67 million acres of cropland versus 328 million; and 6 million farmers versus 2 million. Land values have been greatly reduced in Mexico following December's Peso devaluation and the Mexican "daily" farm wages of $4-8 (roughly the equivalent to U.S. "hourly" farm wages) have plummeted as well. In December 1991, Mexico modified its constitutional prohibitions restricting the use of agricultural land so as to promote large operations, foreign investment and the resulting economies of scale. Therefore, Mexico's agricultural sector is poised to become an export oriented business, which creates a series of opportunities for U.S. agribusiness. The U.S. agribusiness operations in Mexico have already expanded since the beginning of the 1990's and is expected to grow even more so now.

With Mexico's cheap land and cheap labor as a result of the peso devaluation, Mexico can offer some very low-cost horticultural products on the markets today. Trading companies will want their share of the market as Mexican farmers will need great assistance in exporting their horticultural products.

5. Telecommunications: TELMEX's (Telefonos de Mexico) monopoly on long distance telephone service expires on January 1st 1997. U.S. small and large telephone companies will finally have access to Mexico's domestic long distance market. Potential competitors are already forging ahead with plans. Mexico City, Guadalajara and Monterrey offer the most promising local markets. In mid-April, the Mexican government announced it would not charge licensing fees for foreigners entering the Mexican telephone market. (Such fees were speculated to be as high as $150 million per company.)

In addition to the long distance market, there will be many opportunities for foreigners in Mexico's telecommunications infrastructure, which is in dire need of a face lift. Mexico suffers from low density of lines (about nine for every 100 people), those few phone lines need to be modernized very soon and the demand for new telecommunication services (voice mail, cellular phones) keeps increasing.[6]

Oil industry: PEMEX (Petroleos Mexicano), Mexico's state-owned oil company, is currently the world's third largest oil and gas producer, but despite rumors PEMEX will not be privatized in the upcoming months as Mexican President Zedillo will stand by Mexico's long-standing policy of protecting the state-owned

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6 U.S./Latin Trade, "Call Waiting," Jun. 1995, p. 22-24.
Mexico Business, "Dial C for Competition," Jul./Aug. 1994, p. 43.

energy giant, thus guarantying economic sovereignty. Furthermore, the oil industry is expected to be the motor of Mexico's economic recovery.[7]

In order to modernize its operations, and as an alternative to privatization, PEMEX now offers concessions or subcontracting in exploration, production and distribution activities to foreign companies.[8] The Mexican government has recently adopted new legislation allowing for private investment in the transportation, storage and distribution of natural gas. Foreign companies will be permitted 100% ownership in these operations as recently approved by Mexico's Foreign Investment Board.

Conclusion: For companies that are looking to Mexico for the long term, the devaluation has created a unique window of investment opportunity which may not be seen again for years.

Surprisingly enough, Mexico has already shown signs of recovery. Trade flows have reversed since December. Non-oil exports are up 30% from 1994; imports are down 2%. According to BANAMEX (the National Bank of Mexico), Mexico's exports will grow 19.6% and imports will shrink 13.6% this year. BANAMEX predicts that oil exports will represent the most significant increase, followed by agricultural and manufactured products.

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7 Mexico Business, "Recovery or Ruin," May 1995, p. 41.

8 Id., "Modernizing PEMEX," p. 13.

Foreign direct investment in Mexico jumped during the first two months of 1995 to $3.722 billion, up from $916 million during the same period last year, according to the Mexican Commerce Ministry (the direct investment figures may be misleading because of a lag between when a company expresses its intent to invest and when it actually does so.) Manufacturing investment rose to $899.1 million during the first 2 months of 1995, up from $311 million for the same period last year, while service sector investment rose to $2.283 billion, up from 1994's level of $363 million.

The peso has staged a comeback, rising 15 percent in April from a low 7.5 to the dollar to 5.865 per dollar. Since March the peso has risen steadily, helping Mexican stock prices.[9]

An old chinese expression defines a crisis as a dangerous opportunity. Although Mexico's investment horizon has been darkened by the retreat of portfolio investors, Mexico offers unique and attractive opportunities for those capable or savvy to short term problems. In this investment climate, foreign investors who are looking to establish operations in Mexico find themselves in a buyers' market. Many Mexican firms have been damaged by the devaluation and are in dire need of foreign capital and know how in order to survive. The devaluation, while severely damaging the prospects of the domestic market in the near term, has served to

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9 The Wall Street Journal, "Battered Peso Stages Surprising Rebound," Tuesday, April 25, 1995.

substantially lower the potential cost of new investments, acquisitions and mergers in Mexico.