The Lessons Of Mexico Vs. Europe

Mexico's Depreciating Currency And Stable Interest Rates Have Done It Well

Many of Europe's problems come into better focus if, as I suggested most recently in [Revisiting the Cost of Being Europe](), the Eurozone is viewed as seventeen different countries that fixed all of their exchange rates against one another. As a country can fix an exchange rate or its short-term interest rates, but not both, the currency union is characterized by widely fluctuating interest rate.

Now let's take our neighbor to the south. For much of its history, Mexico tried to preserve its peso exchange rate via higher short-term interest rates; it generally failed after a point only to watch the MXN collapse and short-term interest rates surge in a vain attempt to keep capital in the country.

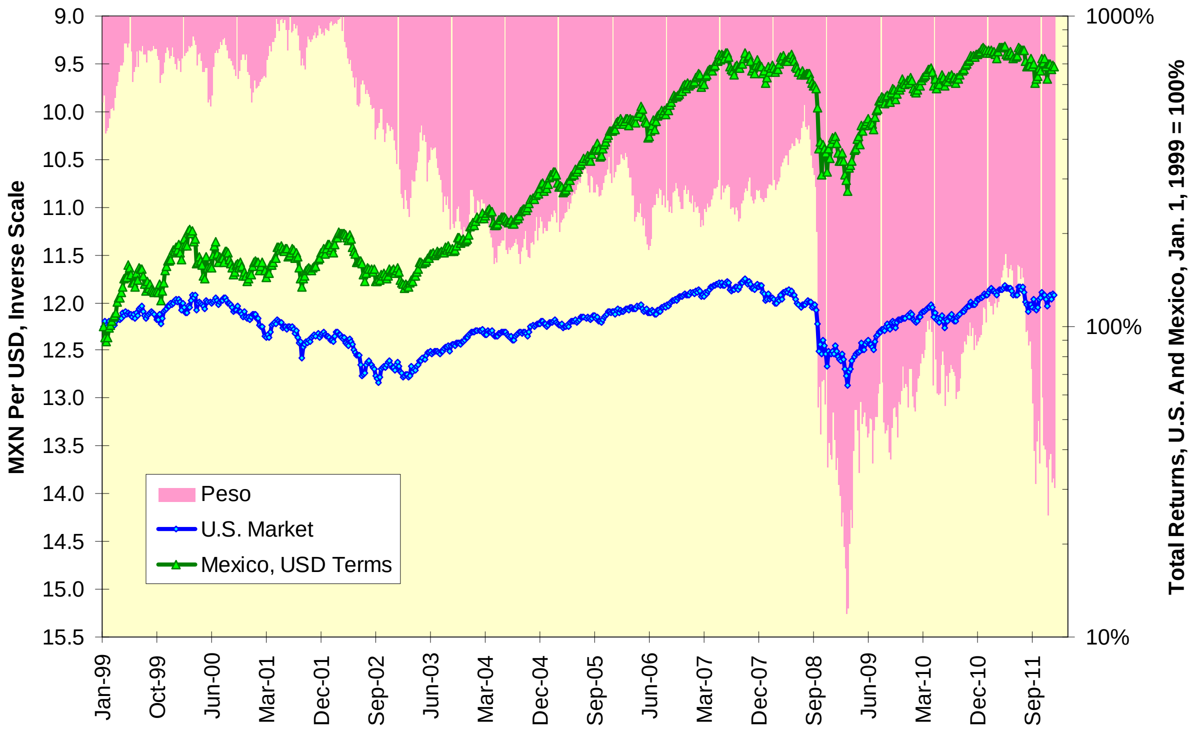
Mexico took a different approach within its free-trade zone. It allowed the MXN to depreciate and resisted the temptation to raise short-term interest rates. The interest rate gap between three-month MXN and USD has been stable for almost two and one-half years and has remained so through both a sharp rally in the peso between March 2009 and August 2011 and the subsequent decline.

Interest Rate Gap Stable

The August 2011 turnaround, highlighted on the chart above, is no accident. This is the date when our beloved Federal Reserve announced to the world it would keep short-term interest rates near 0% into 2013. Several major emerging markets, all of which had been on the receiving end of the dollar carry trade, faced the prospects of an American QE3-style policy flooding their economies with cheap cash and creating both asset bubbles and higher inflationary pressures. I will address India's approach in a later column.

Suffice to say, had Mexico raised domestic interest rates, the carry trade cash would have created problems. Instead, it kept its rates under control and allowed the peso to decline. In keeping with my oft-stated principle equity markets do not care whether a currency is "strong" or "weak" but only whether it is valued fairly, Mexican stocks held their own vis-à-vis their American counterparts.

Mexican Relative Performance Remains High



The combination of a weaker peso and a more stable U.S. economy helped remittances rise in 2011 over 2010 levels. Mexico exports labor, a euphemism, and imports capital from their earnings to support domestic consumption; remittances actually are Mexico's second-largest source of foreign exchange.

Here is where the comparison to Europe becomes obvious: A Mexican worker receiving dollars and buying pesos can do something a Spanish or Portuguese worker in Germany cannot do, and that is swap a strong currency for a weaker one. If the weaker countries of the Eurozone export labor, those workers cannot turn around and buy ever-larger quantities of pesetas or escudos; no, they are buying a singly valued euro.

As long as the common currency remains with us, weaker Eurozone members will lose their mobile labor force to stronger ones and suffer a net welfare loss. This is really a damning argument against the euro. The sad part is getting from here to there will involve a number of adjustment shocks, and that, too, is a euphemism.