

# MEXICO'S NEW FOREIGN INVESTMENT CLIMATE

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## I. INTRODUCTION

For the past six years in Mexico, industrialization has been the major source of economic growth. With monumental efforts, a wide and diversified infrastructure was created. That infrastructure, along with vast natural resources and access to an increasingly better trained and better educated human capital helped to achieve an integrated and efficient industrial sector. Nevertheless, the industrial sector has been plagued by a variety of problems: low levels of integration in the production process, inefficiency, low productivity, excessive regulation, and a lack of international competitiveness. But for these problems, Mexico enjoys an enormous potential over other countries at the same stage of development.

Along with the debt crisis of the early 1980s, increasing inflationary pressure produced high levels of investor uncertainty. This uncertainty caused low rates of growth in the overall economy and the retention of obsolete technology in the industrial sector, as well as low wage income throughout the general population. Since the beginning of President Carlos Salinas de Gortari's administration, several strong measures were implemented to correct the problem. These measures, which were outlined in the National Development Program for 1989-1994 and in the National Program for Industrial Modernization and Foreign Trade for 1990-1994, were long term programs aimed at getting to the root of the problem. The programs are designed to create the proper conditions for pursuit of normal growth levels in the Mexican economy and thereby increase the wealth and welfare of the entire Mexican population. This article will show that the basic requirements needed to strengthen Mexican industry and enhance its ability to compete in the international market place have already been implemented.

## II. BACKGROUND

To fulfill basic national needs, different governments throughout

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Mexican history have applied various economic strategies and policies. The first economic model utilized in Mexico had its roots in colonial times and achieved its peak during the government of Porfirio Diaz (1880-1910). This model relied on exportation of primary goods to generate growth. It was an outward-oriented model in which government adopted a passive role and the economy developed under free market forces. This model was abandoned in 1929 because of two factors: (1) The creation of the National Revolutionary Party, which marked the end of a period of social and political instability; and (2) the great World Depression.

From 1929 to 1939, the objectives of economic policy were to reconstruct the Mexican economy and to expand the domestic market. To fulfill these objectives, a greater participation of government was needed to create basic infrastructure, develop fiscal and financial systems, eliminate foreign control of strategic sectors, and promote the agricultural sector of the economy.

After World War II, the industrial sector significantly grew as a result of these policies. The policies were based on the substitution of imports and on fiscal and financial incentives. In addition, the government built an important industrial infrastructure: highways, airports, seaports, networks for the distribution of energy, etc. The state played an active role in productive activities through public enterprises and through the creation of educational institutions and centers for scientific research.

During the 1950s and 1960s, Mexico adopted a model of import substitution, which was generally successful. The model permitted the development of various industrial branches and the production of intermediate and capital goods. As a result, industry's proportion of gross national product increased considerably. Industry became one of the major sources of employment and deeply transformed the social and economic environment of the country.

In 1970, problems began to arise. Because protectionist policies had been prolonged, monopolistic structures developed and consequently Mexican products became less competitive. The fiscal and financial schemes that the government implemented in 1970 to stimulate productivity and the adoption of new technologies failed. With their scientific and theoretical orientation, research in the academic centers failed to create necessary links to Mexican industry, which reinforced Mexico's lack of technological development.

A new industrial policy was the proposed solution to these problems. However, the redefinition of policy was delayed as a result of the oil boom in the early 1980s, which greatly increased national income

and permitted the tolerance of low levels of productivity in other industries. In 1982, the oil boom ended and correction of Mexico's industrial problems became an imperative. Overall strategy for the industrial sector was redefined. Its new objectives included: the establishment of a more competitive framework for the Mexican economy, the improvement of productivity for local industries, and an increase in the competitiveness of non-oil exports. The Mexican government decreased protectionist measures, developed a more flexible framework for foreign investment, sold non-strategic public enterprises to the private sector, and ended fiscal and financial concessions for industry.

By strengthening its own industrial sector, Mexico can increase the flow of Mexican products into international markets, which will ultimately lead to higher rates of economic growth. Furthermore, in 1989, Mexico eliminated excessive governmental regulations and controls on foreign investment, and implemented a new program for the simplification of regulations for foreign investment and technology transfers.

### III. THE NEW MODEL OF INDUSTRIALIZATION

To increase rates of productivity in the industrial sector and to achieve higher levels of economic development and social welfare, a clearer contour of the economic horizon was needed. All sectors of the economy agreed with these goals and a plan was implemented to stop the inflationary process. Rapid increases in prices misled the public, created disincentives for long term productive investments, and produced an unhealthy financial speculation. What Mexico desperately needed was macroeconomic stability. In order to achieve inflation rates similar to those in the international environment, and thus to begin an economic recovery, several steps were required. Public finances needed correction, the economy needed opening, and an agreement between the industrial and social sectors was needed to reduce the recessionary effect of stabilization.

First, the Mexican government has been making great efforts towards correcting the public finances. In 1983, the primary *deficit* was 7.5 percent of the Gross National Product. In 1988, this situation reverted to a primary *surplus* of 7.5 percent. There has never been a similar achievement in any other stabilization plan in the contemporary world.

Second, since 1988, the Mexican economy has become one of the most open economies in the world, after decades of being one of the most closed. In 1983, all imports were subject to prior permits, while the maximum import tax could be as high as 100 percent. Beginning in 1988, only 6 percent of all imports were subject to permits, while the maximum import tariff was reduced to twenty percent. As a result, non-oil exports

rose from four billion dollars in 1983 to approximately fifteen billion dollars in 1988. Like the countries of the southeast Pacific region, Mexico has significantly increased its exports.

Finally, due to the Solidarity Economic Pact and the Pact for Growth and Stability, the annual inflation rate of approximately 180 percent at the end of 1987 decreased to less than twenty percent in 1989. The efforts made by all sectors of the economy are evident. The agreements made among the economic sectors continue to produce real and positive results as planned.

#### IV. THE NEED FOR A NEW INDUSTRIAL POLICY

The world is undergoing a new stage of development due to globalization in both production and trade. All decisions for production and commercialization must consider factors that go beyond local markets. Production processes are often a link of a world scale production chain. In this new context, Mexico needs to develop a strategy of industrial promotion and foreign trade, which takes into account its comparative advantages. This strategy must also aim at eliminating problems and inefficiencies that still exist in the industrial sector. Among the most important problems are the following: insufficient levels of investment; low rates of employment, excessive regulations, scarce technological development, inadequate standards, regional over-concentration and inadequate infrastructure, obstacles to microindustry, insufficient integration between in-bond industry and the rest of the economy, insufficient access of Mexican products to international markets, insufficient development of forms of foreign trade, inconsistent degrees of trade protection for inputs and final products, and obstacles and practices that inhibit foreign trade. Additionally, reduced investment levels have resulted from a reduction in aggregate demand, uncertainty about the cost of capital, scarcity of funds, unclear rules for the foreign investor and an insufficient promotion of investment alternatives, both for the national and foreign investor. From 1981 to 1988, foreign investment as a percentage of Mexico's GNP fell from fifteen to twelve percent. Even though Mexico's economy has recovered significantly since 1987, the rate of employment is still low, primarily because of a seventeen percent decrease in the number of persons employed in the manufacturing industry from 1981 to 1987. Excessive regulation of economic activities has brought about inadequate production scales, inefficient allocation of resources, monophonic and oligopolic structures, and geographic over-concentration of industry with an accompanying misuse of regional comparative advantages.

Protection against international competition and financial instability caused insufficient technological development. Mexican enterprises

spend less than one percent of sales receipts on technological research, while enterprises in other countries reinvest between five and fifteen percent of their sales. Hence, there are many obstacles to overcome: lack of industrial integration, research and development centers, lack of information about available technology, inefficient allocation of financial and fiscal funds available to enterprises, insufficient training and development of qualified human resources, and, generally, a lack of recognition of industrial property rights.

The system of standards and practices needs to be revised in order to avoid excessive requirements and to be consistent with Mexico's open economy. There is a great deal of bureaucratic "red tape" in the form of requirements and permits needed to use and sell domestic products. This results in high production costs and causes great distributive inequities. These in turn lead to inadequate quality control, which ultimately affects consumers adversely.

Mexico's industrialization requires a new infrastructure to allow for balanced regional growth, development of industry and foreign trade. To solve this problem, it is essential to address Mexico's inadequate rail and port facilities, scarcity of water, insufficient loading and storage facilities, and lack of industrial parks. In addition, a new infrastructure would help end industrial concentration which has created a great deal of pollution.

Any solution to Mexican industry's problems must also consider the difficulties that micro, small, and medium size industries face. In general terms, these enterprises lack negotiation capacity and organization. They have inadequate technology, scarcity of qualified labor, sparse marketing of their products, insufficient capacity to compete in the foreign markets, inability to obtain financial resources, and excessive regulation involving their operations.

The *maquiladora* industry also has many difficulties that need to be corrected. First, there is little integration with the rest of the Mexican economy. This can be seen by the fact that only 1.7 percent of this sector's production inputs is Mexican made. High concentration of *maquiladoras* near some border cities has resulted in infrastructure scarcity problems and high labor rotation. Besides, foreign investment in this sector is not diversified. Only a few economic activities are involved in the in-bond industry. Foreign trade problems are also a result of the import tariff system, high distribution costs, excessive bureaucratic procedures and the high storage costs. The competitiveness of domestic industry located along the border has decreased, when compared with the foreign and *maquiladora* industries, because of high import taxes on inputs. The existence of non-tariff trade barriers and the creation of world

trade blocks have inhibited the access of Mexican products to foreign markets. Therefore, it is necessary to develop Mexican enterprises that specialize in foreign trade. Even though there have been some advances, there are still multiple levels of protection for inputs and final products. It is necessary to eliminate these as well as other distortions.

#### V. WHAT IS THE NEW INDUSTRIAL POLICY ABOUT?

The government has become an active promoter of economic activity. The national industrial policy aims at reaching these four objectives:

1. Enable the national industry to grow via a strong, competitive export sector.
2. Create balanced industrial development with the adequate use of regional resources.
3. Promote and defend Mexico's foreign trade interests.
4. Increase the number of productive jobs as well as the social welfare level.

The achievement of these objectives will permit a healthy and continuous growth of industry. Moreover, it will induce the industrial exploitation of comparative advantages and specialization on highly competitive international products. Along the same line, it will allow for industrial development consistent with resource availability and environmental equilibrium. The new industrial policy promotes industrial and foreign trade modernization, creating a higher standard of living for all Mexicans. It should generate a more efficient economic dynamism.

Mexico's industrial modernization rest on five basic strategies:

1. Internationalization of Mexican industry.
2. Upgrading productivity levels through technological development and promotion of the philosophy of higher quality.
3. Deregulation of economic activities.
4. Export promotion.
5. Domestic market growth and strengthening.

Under the first strategy, industry will be globalized. Mexican businessmen will have to become export oriented to be able to better perform and compete in the world economy. In addition, promotion of foreign investment and consolidation of the economic stabilization program will be key elements in the modernization process because they generate effects such as specialized production, upgraded scale economies, and adoption of adequate technology.

The second strategy will allow firms to choose the right technology. This will supply an efficient link between Mexican industry and technological institutions and research centers. In this way, research will be firmly directed to the solution of specific problems enabling industry to

innovate rapidly. This will increase the ability of firms to satisfy variable consumer demands. Additionally, technology must balance with the ecological environment.

The third strategy establishes the deregulation of all economic activities. A simplified and more transparent regulatory framework will allow for more competitive markets, enhance exports, induce growth in productivity and private investment, and lead to medium and long range programs based on principles of productivity and efficiency .

The fourth strategy is export promotion. It will generate efficient allocation of resources as well as create an internationally competitive industry. To stimulate export enterprises, to carry out foreign trade negotiations, and to enhance the growth of the *maquiladora* and border industries, stronger coordination is needed among the social, private, and public sectors.

The fifth strategy is to strengthen the domestic market. The primary goal is to achieve a high correlation between industrial growth and consumer welfare. The more profitable and dynamic industrial sectors will lead the current modernization process. Firms and individuals are to be actively involved in the design and execution of the industrial modernization programs. Already, medium range plans are being developed for the computer, pharmaceutical, and automotive industries.

To promote modernization and consolidation in the auto industry, two Decrees were issued by the Federal Government on December 11, 1989: The Decree for Modernization of the Automotive Industry and the Decree for the Modernization of the Transportation Vehicle Manufacturing Industry. The following objectives were established under the first decree:

1. To adapt the automotive industrial policy to the new industrial policy based on economic deregulation and the more open economy.
2. To reach an efficient production scale and to integrate the industry into the international markets.
3. To use adequate technologies enhancing international competitiveness.
4. To build domestic, border, and export markets with competitive price and quality strategies.
5. To produce inexpensive vehicles for popular consumption.
6. To renew the automotive stock and to reduce environmental pollution levels.
7. To enhance the already competitive and efficient automotive component industry.

The following measures have been taken to achieve these objectives:

1. New vehicles may be imported by firms of the terminal industry which have a positive balance of payments, from the model year 1991 and thereafter.
2. Through more extensive use of parts and components from domestic manufacturers of automotive components, the terminal industry must generate thirty-six percent added value.
3. Several restrictions will be eliminated, such as the production permit of the Commerce and Industry Secretariat, the level of domestic integration, the limited variety of models that can be produced, the obligatory components in production, the limitations for setting up new terminal enterprises and the prohibition of the production of eight cylinder engines.
4. Any person will be allowed to import a new car if the domestic price of the same vehicle is higher than the international price.

With this Decree, the Mexican automotive industry will effectively enter the international market. It will also use adequate technologies thereby achieving international competitiveness. In the same way, the new policy will raise consumers' welfare facilitating the supply of better cars at lower prices. For the economy, it means expansion of exports, employment, and production.

The transportation manufacturing industry is considered vitally important to the development of all of the other industrial sectors. The goal of the new Decree is to renew and increase the vehicle stock as well as to assure affordable transportation costs while controlling environmental pollution levels. The Decree provides for the gradual import of 16,000 pound trucks, with the restriction that annual imports cannot exceed the value of the vehicles and components produced in Mexico for each firm in each year. Special vehicles can be imported beginning on January 1, 1990 and integral buses beginning January 1, 1991. The Decree eliminates various outdated import requirements such as those prescribing the level of national integration, obligatory components, majority Mexican capital, or graphic speed controls. The Mexican industry is scheduled to produce at competitive international prices in 1991 for cab trucks and in 1992 for heavy trucks. Beginning in 1992, Mexican enterprises will be able to produce gasoline trucks with safety and emission controls. The industry will be able to upgrade truck quality and reduce prices to international levels, enabling it to compete more successfully in foreign markets.

As for the pharmaceutical industry, a program has been established to gradually remove items from the permit requirement. The program must first review the import regulatory framework to prevent dumping

practices. Then it must contribute to any anti-inflation efforts. Sanitation requirements will also have to be applied equally to both domestic and imported pharmaceutical products.

In the case of the computer industry, there is an agreement between the industry and the Commerce and Industry Secretariat to start a program of modernization beginning on March 15, 1990. The main feature of this program is that it eliminates import permits and will give preferential treatment to imports according to a formula based on net exports, domestic added value, investment in domestic assets and expenses in technological research and development. As for the technological development strategy, the new regulations (Control and Register of Technology Transfer, and Use and Exploitation of Patents and Brand Names) direct the registry's activities for the promotion of technology in accordance with the new domestic and international economic policy. This will enhance technological modernization, promote the international competitiveness of industry and give more certainty to firms' decisions in this field.

The other guidelines established in the new policy will improve trade liberalization and more effectively promote both national and foreign investment. They also revise the regulatory framework to eliminate bottlenecks and obsolete regulations.

To keep the current dynamism of the in-bond industry going and to encourage higher rates of employment, a new Decree was published on December 22, 1989. The Decree for Promotion of the *Maquiladora* Industry responds to the present development needs of the industry. The principal objectives of the Decree are:

1. To achieve a growth rate of over ten percent in employment and number of enterprises.
2. To raise the level of domestic integration in this industry.
3. To create new areas of development.
4. To promote programs for the generation of more technologically advanced production processes.
5. To promote the establishment of in-bond industry service firms.
6. To expand the *maquiladora* activities.

These objectives will be accomplished through the elimination of the biannual renewal requirement for *maquiladora* programs. *Maquiladora* firms are no longer required to obtain authorization for computers and equipment, telecommunication equipment, trailers, containers, and temporary imports. The requirements in the sale of products in the domestic market will be simplified and customs processing will be streamlined.

Along with these measures, several actions are being taken to

strengthen the in-bond industry, such as identification of areas with a proper infrastructure for possible relocation, financial aid, labor training, and promotion of private participation in infrastructure development. All activities will be sustained with a view towards promoting both foreign trade and the development of Mexican industry. Through use of these broad based social agreements, Mexico will securely travel the path towards modernization, inserting itself with an ever growing presence into the new world economy.