

Universidad del Salvador
Facultad de Ciencias Económicas y Empresariales
Licenciatura en Gerenciamiento Económico Intercultural



Trabajo Final de Grado

**What Makes a Country Attractive to Foreign
Direct Investment? – The case of Mexico**

Autor: Simon Moser

Profesor Tutor: Pablo Tassara

What Makes a Country Attractive to Foreign Direct Investment? – The case of Mexico

Abstract

Foreign Direct Investment (FDI) was a key factors in shaping world's economy over the last couple of decades. During this period, it grew faster than trade and was considered vehicle of increasing integration of the world economy.

In the late 19th and early 20th century, foreign investors were attracted to Mexico due to its richness in commodities, especially in the mining and oil sector and thus, were pursuing resource seeking FDI. To transport the raw materials and to be able to set up operations, the foreign companies had to install communication and electricity systems as well as a functioning transport infrastructure.

In the mid 20th century until the late 1970s, the Mexican economic policy was characterised by protectionism and import substitution. Thus, the political stability and the economic policies, like fixed exchange rates, gave a greater planning reliability to foreign investors, which might be an explanation for the growing amounts of FDI. Moreover, the receiving sector portfolio, more and more shifted to the manufacturing sector, in particular the automotive and chemical industry. The likeliest explanations for these shift are a highly competitive human capital/cheap labour ratio and Mexico's location between the North- and Central-/South American continents. Hence, there has been a shift in the motives for FDI. Even though the foreign investors are still seeking resources, the main resource they are looking for now, is cheap and qualified labour, instead of natural resources.

The unstable economic environment in the 1980s, with high external debt, excessive inflation rates of up to 140% and an overvalued Mexican Peso, lead to capital flight and a sovereign default.

The liberalisation and privatisation processes, combined with a fiscal stabilisation process from the late, which started in 1987, lured fresh foreign capital to Mexico. Moreover, the free trade agreements, especially the NAFTA agreement from 1994, made Mexico highly

interesting to foreign investors, who now also saw Mexico as an attractive target for market seeking FDI, as goods, which were produced in Mexico, now could be sold tariff free to many destinations, especially in North- and Latin America. Another reason for the upwards trend might have been a favourable corporate tax rate and a variety of tax loopholes. All those factors resulted in high FDI growth rates, averaging 30.5% between 1988 – 1993. The negative effect of political instability on FDI could be seen in the mid 1990s, when rebellions and political murder unsettled investors. The effects of the current political and social instability and insecurity, coming from the drug cartels, which are gaining power and influence, have yet to be assessed by literature.

Since the late 1990s, FDI is, even though still to the greatest part invested in the manufacturing sector, gaining more importance in the ICT, (financial-) services and energy sector. The stable growth rates in the past years and Mexico's market size, as Latin America's second largest economy and largest exporter, might be reasons for that. Moreover, the discovery of new oil and gas deposits in the Gulf of Mexico, as well as favourable natural conditions for renewable energies, attract new FDI to Mexico's energy sector.

From 1980 – 2004, Mexico almost constantly performed over the world average in terms of FDI as a share of GDP. Reasons are especially high-quality human capital combined with low wages, considerable natural resource deposits, an outstanding number of free trade agreements and a favourable location between the North- and Latin American market. Political- and economic instability might be assessed as negative factors, however, those conditions were mostly common in developing countries worldwide.

The reasons, why since 2004, Mexico has almost constantly performed below average, are harder to assess. Reasons might be a relatively high political risk which Mexico gets attested by the Worldbank. Other reasons might be a high bureaucratic burden, a volatile economic stability, a transport infrastructure, which gives room for improvement, high energy costs and omnipresent problems with corruption. The partial privatization of the state owned enterprises CFE and PEMEX from 2013 might improve the situation, which yet has to be assessed by literature.

Contents

1. Introduction.....	1
2. Theory and Literature Review Section.....	1
2.1 Definition of FDI.....	1
2.2 FDI Flows over Time.....	2
2.3 The Main FDI Theories.....	4
2.3.1 Vernon’s Product Life-Cycle Theory.....	5
2.3.2 The Influence of Exchange Rates on International Trade.....	5
2.3.3 Hymer’s Internalization Theory.....	6
2.3.4 Dunning’s Eclectic Paradigm.....	6
2.4 Forms of FDI.....	7
2.4.1 Greenfield Projects.....	7
2.4.2 Joint Ventures.....	7
2.4.3 Strategic Alliances.....	7
2.4.4 Horizontal, Vertical and Conglomerate FDI.....	8
2.5 Motives for FDI.....	8
2.5.1 Resource Seeking.....	8
2.5.2 Market Seeking.....	9
2.5.3 Efficiency Seeking.....	9
2.5.4 Further Motives.....	9
2.6 FDI’s Effect on the Economic Growth of the Recipient Economy.....	10
2.7 What are a Country’s Main Determinants to Attract FDI?.....	11
2.7.1 Economy.....	12
2.7.1.1 GDP and Market Size.....	12
2.7.1.2 Market Growth.....	13
2.7.1.3 Free Trade and Trade Agreements.....	13
2.7.1.4 Economic Stability.....	14
2.7.1.5 Local Financial Markets.....	14
2.7.1.6 Taxes.....	15
2.7.2 Political and Legal System.....	15

2.7.2.1 Political and Legal Stability.....	15
2.7.2.2 Privatization.....	16
2.7.2.3 Corruption.....	17
2.7.2.4 Bureaucracy.....	18
2.7.3 Resources.....	19
2.7.3.1 Natural Resources.....	19
2.7.3.2 Infrastructure.....	20
2.7.4 Concluding Remarks.....	22
3. Country Analysis – The Case of Mexico.....	22
3.1 Economic History.....	23
3.2 Economy.....	26
3.2.1 GDP, Market Size and Growth.....	26
3.2.2 Free Trade and Trade Agreements.....	28
3.2.3 Economic Stability.....	29
3.2.4 Local Financial Markets.....	31
3.2.5 Taxes.....	32
3.2.6 Summary.....	32
3.3 Political and Legal System.....	33
3.3.1 Political and Legal Stability.....	33
3.3.2 Privatizations.....	35
3.3.3 Corruption.....	36
3.3.4 Summary.....	36
3.4 Resources.....	37
3.4.1 Natural Resources.....	37
3.4.2 Infrastructure.....	38
3.4.3 Summary.....	42
3.5 FDI in Mexico – The Numbers.....	42
3.6 Summary and Linkage of Findings.....	51
4. Conclusion and Policy Recommendations.....	53
5. Bibliography	54

List of Figures

Figure 1: Foreign direct investment: Inward and outward flows and stock, annual, 1970-2010.....	3
Figure 2: Mexico's Inflation Rate, 1976 – 1990.....	24
Figure 3: Mexico's GDP growth (annual %), 1980 – 2010.....	25
Figure 4: Mexico's GDP per capita (USD), 1980 – 2010.....	27
Figure 5: Distribution of GDP across economic sectors as a share of GDP in Mexico, 2005 – 2015.....	28
Figure 6: Inflation in Mexico, 1980 – 2010.....	30
Figure 7: Development of the Mexican Peso against the USD, 1990 – 2010.....	30
Figure 8: Tax on corporate profits as a share of GDP (in %), 2000- 2015.....	32
Figure 9: Worldwide Governance Indicator Mexico, 1996 – 2010.....	35
Figure 10: Investment into the exploration of new deposits in Mexico in million USD, 2002 – 2012.....	37
Figure 11: ICT as a share of GDP in Mexico, 2005 – 2013.....	39
Figure 12: FDI into the ICT sector in Mexico, 2000 – 2013.....	39
Figure 13: Sources of energy supply in Mexico, 2014.....	40
Figure 14: FDI by receiving sectors, 1940 – 1970.....	43
Figure 15: FDI by receiving sectors, 1989 – 1994.....	45
Figure 16: FDI by receiving sectors, 1994 – 1998.....	46
Figure 17: Net FDI inflows into Mexico in USD, 1980 – 2015.....	47
Figure 18: Net FDI inflows into Mexico as a share of GDP, 1980 – 2015.....	47
Figure 19: Net FDI inflows as a share of GDP worldwide, 1980 – 2015.....	48
Figure 20: FDI by receiving sectors, 2000 – 2012.....	49
Figure 21: Accumulated FDI in Mexico by country of origin, 2000 – 2012.....	51