



AMERICAN CHAMBER  
MEXICO

## **Foreign Direct Investment in Mexico: Is your Investment Safe?**

*deserve your dream*

*-Octavio Paz-*

# Foreign Direct Investment in Mexico: Is Your Investment Safe?

## Executive Summary

The Mexican government is engaged in a vital effort to disrupt and dismantle drug cartels. The military has been called in, local police are being reorganized, retrained and purged of corrupt elements, and changes have been made to streamline criminal trials. The result has been an unprecedented number of arrests, extraditions, prosecutions and large-scale seizures of drugs, weapons, cash and assets. These efforts have also led to increased violence as criminal gangs confront government forces and battle among each other for control of key territory.

These events have been widely publicized on both sides of the U.S.-Mexico border. The media coverage, however, often fails to provide sufficient context. **AMERICAN CHAMBER OF COMMERCE OF MEXICO (AMCHAM)** is aware that the perceptions of Mexico as a place to live, work and do business are very often at odds with the reality.

Although the number of armed confrontations has increased markedly since the government's enforcement efforts were implemented three years ago, the widely-reported death toll is confined to a relatively small region of the country. Moreover, the vast majority of the victims are either drug traffickers or the officials trying to stop them. While the risk of being a victim of random drug-related shooting is minimal, it must be acknowledged that crime does have an impact on business in Mexico. As reported by our members in the 2010 Security Survey, the areas most affected include employee security, executive protection and transportation of goods.

As **AMCHAM** members will readily attest, Mexico offers tremendous investment opportunities. Since joining NAFTA, Mexico has developed a stable market economy, now the eighth largest in the world, and enjoys a solid record of macro-economic success. The middle class is now the largest socio-economic group in the country. In addition, China's low wage advantage has all but disappeared while transportation costs have soared. As a result, Mexico with its myriad of free trade agreements, is perfectly positioned to serve as an export platform for manufacturers. In 2010 alone, a number of foreign companies have announced investment plans involving hundreds of millions of dollars to create or expand productive capacity in Mexico or to serve the burgeoning middle class.

Mexico is a strategic economic partner of the U.S. **AMERICAN CHAMBER/MEXICO** is committed to working with Mexico in its efforts to reduce crime, to create more and better economic opportunities for its citizens, to improve transparency and the rule of law, and to promote greater integration between our two nations.

# I. Introduction

AMERICAN CHAMBER/MEXICO believes that while the recent spate of insecurity has put a cloud over Mexico's business climate, Mexico remains an excellent choice for investors: the country has a strong and growing internal market, offers a competitive manufacturing environment with excellent geographic location and has solid macro-economic fundamentals.

On May 19th, 2010, in the company of Mexican President Felipe Calderón, U.S. President Barack Obama quoted renowned Mexican author and Nobel laureate Octavio Paz who wrote that “**you must deserve your dream.**” It is not enough to dream of a prosperous and democratic country unburdened by poverty, illiteracy, delinquency and corruption. Tough choices have to be made and strong measures must be taken to turn those dreams into reality. From the 2000 elections marking Mexico's full membership in the club of democratic nations to the courageous battle now being fought against organized crime, the Mexican people deserve their dream.

## II. Pulling Out of the Global Recession

### A. An Economy Bouncing Back

**The global financial crisis hit Mexico especially hard.** Over 85% of the country's exports are destined for the U.S. As credit dried up and consumer confidence eroded, the U.S. market for automobiles, home appliances and electronic goods collapsed. At the same time, Mexico saw its oil revenues decline significantly as global prices plunged. When the U.S. building boom went bust, many Mexican immigrants found themselves out of work and unable to send money home. Finally, the A-H1N1 (swine) flu pandemic erupted with Mexico at the epicenter. Business and tourist travel dropped sharply as a result creating a large hole in Mexico's tourism revenues representing 12.6% of the country's GDP.

In the end, the Mexican economy shrank by 6.5% in 2009. Since then, the economy has bounced back. **GDP is expected to grow by 3.9% in 2010** and unemployment, currently at 6.1%, is expected to decline to 5.9%.

Mexico's most recent economic difficulties were not of its own doing. Unlike the U.S. and Europe, Mexican financial institutions did not engage in reckless lending practices. To the contrary, **the Mexican banking system is very sound.** In fact, Mexico has been a model of economic stability since at least the early 1990's. And with an average per capita income of over \$7,800 USD, Mexico is considered a relatively wealthy country by World Bank standards.

### Key Economic Indicators for Mexico

	1999	2009a
Population (millions)	99	111
Nominal GDP (US\$ billions) b	520	875
GDP, PPPc Basis (US\$ billions)	969	1,611
Per Capita GDP (US\$)	5,277	7,870
Per Capita GDP in \$PPPs	9,825	14,480
Total Merchandise Exports (US\$ billions)	136	230
Exports as % of GDP	28%	26%
Total Merchandise Imports (US\$ billions)	142	234
Imports as % of GDP	30%	29%
Public Dept/GDP	44%	39%

Source: Compiled by U.S. Congressional Research Service, based on data from Economist Intelligence United (EIU) database.

Notes:

a. Some figures for 2009 are estimates

b. Nominal GDP is calculated by EIU based on figures from World Bank and World Development Indicators.

c. PPP refers to purchasing power parity, which reflects the purchasing power of foreign currencies in U.S. dollars

Indeed, **Mexico has run a responsible macroeconomic policy** for the last several years. The country has more free trade agreements than any other country in the world. Moreover, **Mexico more than halved its import tariff** average rate (from 11% to 5%) to the rest of the world. Inflation was brought down to U.S. levels and its accumulated foreign reserves have helped Mexico weather this economic downturn. At the same time, the flexible exchange rate has helped stabilize the peso. All of this was accomplished while also transitioning to a representative democracy after 70 years of single-party rule. Not many countries could have accomplished such a feat.

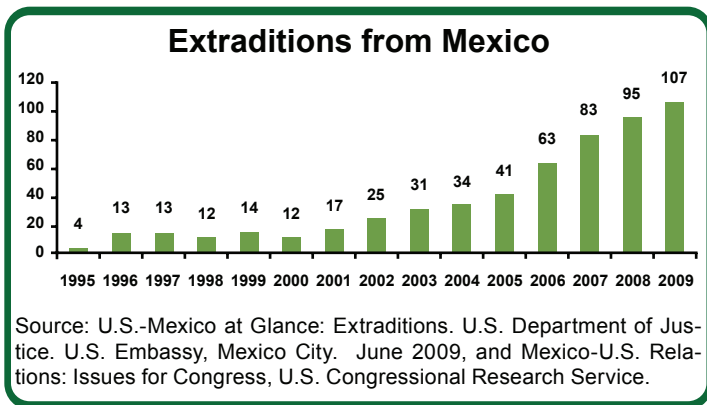
There are a number of reasons to be positive about the **prospects for economic growth and stability in Mexico.** First, Mexico enjoys enormous benefits owing to its proximity to the United States. Geography will become even more pronounced as manufacturers

move away from outsourcing and embrace near sourcing, while China continues to lose its once considerable cost advantage. Second, **NAFTA offers legal protection to U.S. investors** in Mexico that operates independently from the domestic legal system. Third, Mexico has a young, hardworking and well trained labor force; in fact, according to Engineering Trends, Mexico graduates more engineers per capita than Brazil, China and even the U.S. Fourth, Mexico and the U.S. enjoy strong cultural and business linkages.

Finally, the Mexican government has implemented a number of initiatives designed to enhance Mexico's competitive position. The National Infrastructure Program will upgrade the country's railroads, highways, energy sector and ports. Antitrust legislation will reduce the power of long-standing monopolies and Mexico will continue down the path of greater transparency and more effective legal regimes including the protection of intellectual property rights.

#### B. A Change in Law Enforcement Policy

Shortly after taking office, **president Calderón announced a policy shift toward drug trafficking** from one of tacit acquiescence to one of **disruption and elimination**. The government has deployed thousands of troops and federal agents to interdict drug shipments flowing north and cash and weapons coming south, and to arrest, prosecute, convict and extradite those involved in drug trafficking and money laundering.



The reaction from the drug cartels has perhaps been more aggressive than anyone anticipated. In addition, the drug cartels have been battling each other

for control of the most lucrative trade routes into the U.S. The increase in the death toll and the number of clashes between government forces and the cartels has dominated the headlines. Unfortunately, news reports rarely provide the depth and context necessary to put these activities in perspective as they impact daily activities, business operations, and particularly, as they relate to foreign investment in Mexico.

## IV. The Outlook for Foreign Direct Investment in Mexico

### A. Investment in Mexico

Nothing speaks louder and more directly to the international business community's confidence in Mexico than the spate of recent investment decisions by multinational companies. In the first few months of 2010 alone, millions of dollars in foreign direct investment commitments have been announced. It is projected that **FDI for 2010 will total \$19 to \$22 billion** which would be on par with 2006 levels.

	2006	2007	2008	2009	2010p	2011p
Direct	19.3	27.3	23.1	11.4	19-22	18-21
Portfolio	6.4	8.5	2.4	7.6	5-15	3-16

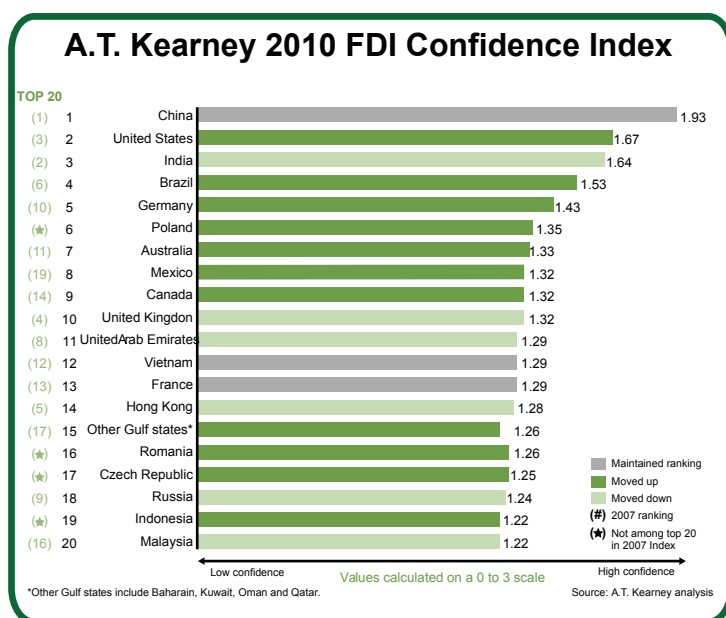
Source: Charting the Economy – 2nd Quarter 2010 – AMERICAN CHAMBER/MEXICO

Walmart—the leading retail chain in Mexico—recently announced plans to invest \$1 billion to open 300 new stores throughout the country in 2010. Retailers such as Lowes and Best Buy have just begun operations in the country where The Home Depot has been very successful for the last several years. These and other investments reflect a core belief in the stability of Mexico and the growth and purchasing power of the Mexican middle class.

In the manufacturing sector, the list of projects is extensive including Nissan's plans to invest \$600 million in a new assembly plant for the new Micra; the Chrysler/Fiat investment of \$550 million; Procter & Gamble's decision to build a \$250 million razor blade plant in Guanajuato; and the new \$445 million Freightliner truck plant in Saltillo, to name just a few.

Ciudad Juárez is an excellent example of Mexico's strengths. If there is a ground zero for the drug violence in Mexico, Ciudad Juárez is surely it. Yet every day thousands of engineers and managers drive across the border from El Paso to work at plants owned by such companies as Delphi, Johnson Controls and Emerson Electric. According to Randy E. Wilcox, president for the Americas for Otis Elevator: "Not only are we not going anywhere, but more and more of our key suppliers are in Mexico... It's the hub of our supply chain for North America."

Financial commitments on this scale simply would not be made if the global business community did not have the **utmost confidence in the stability of Mexican society, the ability of the Mexican government and its institutions to deal with security issues and the other challenges Mexico is now addressing.**



According to the *Mexico Competitiveness Report 2009* published by the World Economic Forum and Harvard University: "In the last decade or so, Mexico has made impressive progress toward achieving macroeconomic stability and liberalizing and opening its economy, leaving behind a recent past of recurring financial crises linked to changes in the administrations, oil price volatility and fiscal excesses, among other factors, and establishing a solid foundation for sustainable long-term economic growth." Rosalind Wilson, president of the Canadian Chamber of Commerce, echoed these sentiments last year: "The strength of the Mexican economic system makes the country a favorite destination for Canadian investment."

## *The Near-Sourcing Trend and Advanced Manufacturing in Mexico*

Much of the growing interest in Mexico can be attributed to the global near-sourcing trend. There has been a shift in off-shore production strategies from one that focuses heavily on low labor costs to one that puts more emphasis on geographic proximity.

The **near-sourcing (or near-shoring) trend** is the result of a number of factors, but is attributable primarily to the rising cost of freight which is expected to remain high into the foreseeable future. Low-cost fuel made transportation costs negligible and for many years allowed manufacturers to locate operations in the lowest-wage countries. But as fuel prices rose from 15% of a carrier's operating costs to 40%, the dynamics changed. CIBC World Markets reported that the transportation cost of Asian imports to the United States is roughly the same as imposing a 9% tariff. Consequently, companies are re-evaluating the cost-benefit calculations of their outsourcing policies and finding that staying closer to home is often the right decision.

This trend clearly favors Mexico. The ability to **move goods from Mexico to the U.S. in a matter of days by rail or truck**, versus a matter of weeks from Asian ports, is a tremendous advantage for many types of manufacturers. In addition, the ability to communicate and do business in the same time zone is often of vital importance. Unlike their counterparts in Asia, Mexican managers can communicate with U.S. headquarters and often resolve issues in the same day.

According to a quarterly report from AMR Research—a consulting firm from Boston—buyers will increase their near-shore sourcing and manufacturing activities by a ratio of 5 to 1. The report goes on to state that: "**Mexico is the preferred near-shoring destination**, with 84% of the respondents choosing it as a place for sourcing or manufacturing, followed by Canada at 55% and Brazil at 49%."

Mexico is very committed to free trade. Besides NAFTA, the country has trade agreements with many other countries including Japan, the European Union and various Latin American countries with which the U.S. has no free trade agreement. As a result, qualifying products made in Mexico can be exported to these countries under preferential tariff rates.

With over 100 million predominantly young residents, Mexico's domestic market is also large and growing. Annual automobile sales in Mexico almost doubled from 1999 to 2008. And demand for durable consumer goods is expected to increase as young people start families and purchase homes. Whirlpool, for example, is currently experiencing a boom in domestic refrigerator sales.

### C. Labor Cost Realignment

Mexico is also benefitting from rising labor costs in China. For over a decade, China has seen double digit GDP growth and rising productivity, which have increased labor costs in real terms. Inevitably, higher wages must be offered to attract Chinese workers. Honda and other manufacturers have recently been forced to raise salaries to deal with labor problems caused largely by the increasingly high cost of living in China. In addition, **the Chinese currency is appreciating against the dollar**. Despite a 20% increase to date, many leading economists believe the Chinese currency remains seriously under-valued. In some industrial sectors, Mexico is already the lower cost alternative.

#### Cost to produce an aluminum auto part

	2005	2008
China	\$17	\$25
Mexico	\$18	\$20
U.S.	\$24	\$29

Source: Business Week, Alix Partners

In contrast, as a result of the integration of the U.S. and Mexican economies, most economists expect the peso-dollar value to remain very stable. Signs of these linkages became apparent this year. Shortly after the economic crisis, there was a global flight to the dollar as the safe haven currency which briefly drove the peso-dollar exchange to nearly 16 to 1. Since then the peso has stabilized and returned to a rate approaching 12 to 1 as of the date of this report.

### D. The Focus on Infrastructure Improvements

Infrastructure continues to be Mexico's Achilles heel, however, the situation is about to change. The government has launched a **massive \$141 billion five-year National Infrastructure Project (NIP)** to bring Mexico to the world's top 20 in terms of infrastructure development. In the near term, these projects will also create thousands of new jobs. There are over 300 individual projects included within the NIP relating to a variety of industrial sectors including energy, environment, transportation, telecommunications, security and tourism.

In terms of transportation, the investment, both public and private, will be channeled into ports, highways, border crossings, railroads and airports. More than 20,000 km of highways and rural roads are slated for improvement and modernization. The NIP also includes highway maintenance programs designed such that 90% of existing roads and highways will soon meet international standards. The rail system will be expanded by almost 1,500 km. Pacific and Gulf Coast ports, including Manzanillo, Lázaro Cárdenas and Veracruz will undergo major expansion projects to increase capacity for containers as well as bulk materials and roll-on/roll-off cargo. In addition, at least three new airports will be built and existing terminals will be expanded

The importance of infrastructure development cannot be over-stated. The ability to move products among NAFTA countries and beyond in an efficient and cost-effective manner is of vital importance to Mexico's competitive position. AMERICAN CHAMBER/MEXICO is heavily involved in efforts to improve transportation and logistics especially as it relates to streamlining customs and inspection procedures at border crossings.

### E. Labor Force Availability, Quality and Affinity

According to a recent study by the Boston Consulting Group (BCG), a number of foreign companies are already enjoying the advantages offered by Mexico, especially in connection with advanced manufacturing activities. One of the key reasons has to do with the Mexican labor market.

First, as mentioned above, Mexican labor costs are approaching parity with Chinese labor rates according to the same BCG study. By the end of 2010, it is expected that **average wages in Mexico will be at 120% of Chinese labor costs, down from 200% in 2008**. With the continued appreciation of the Yuan, Mexico will become the lower labor cost country. Second, the labor pool is large and young. **Over half of the Mexican population is under the age of 35**.

Third, there is an abundance of managers with an excellent command of English, many having been educated in the U.S. With 15 years of experience under NAFTA, Mexican managers have become very familiar with U.S. business and management practices. Moreover, **most of Mexico is in the Central Time Zone**. Consequently, the time difference with the U.S., if there is one at all, is negligible. In contrast, the time zone change with China is 12 hours making same-day communications very inconvenient. The ability to have face-to-face meetings is also greatly facilitated. There are direct five-hour flights from New York to Mexico City, making it closer than Los Angeles.

Finally, **Mexicans have a Western point of view on cultural matters** very similar to the U.S. The values and interests of Mexicans—family, religion, personal growth, sports, etc.—track very closely with those of most of their northern neighbors. These similarities help foster a spirit of trust and cooperation which leads to stronger and lasting business relationships.

#### *F. Investment Protection under NAFTA*

One of the most innovative features of NAFTA is the creation of a dispute resolution system designed to protect foreign investors. Country risk is a key concern for most foreign investors especially in countries with still maturing domestic legal systems.

An entire chapter was included in NAFTA specifically to deal with the traditional problems arising under international law when a private foreign investor has a claim against the host government. If a government, at any level, takes actions or refuses to act when required to do so and, as a result, the value of an investment is impaired, the foreign investor may seek a resolution using a private arbitration process. These arbitration panels have already been used by investors

to obtain compensation for losses caused by various regulatory decisions that have impaired foreign investments.

#### *G. Reform Agenda Supported by AMERICAN CHAMBER/MEXICO*

Economic growth, prosperity and job opportunities are critical to Mexico's efforts to reduce crime. While progress has been made, Mexico is working on a number of initiatives to enhance competitiveness and spur economic growth.

Especially as it relates to foreign direct investment, the protection of intellectual property rights is critical. Mexico has taken **aggressive steps to protect intellectual property** in addition to the protection contained in NAFTA. While much remains to be done, the Mexican government understands the relationship between IP protection and foreign direct investment, and will continue to move aggressively to provide it. Apart from protecting foreign IP, Mexico is becoming a creator of intellectual property and, therefore, has a vested interest in making sure that it is protected.

Mexico is also attempting to reform its tax code to broaden the tax base and reduce its dependence on oil revenues which currently represent over a third of the federal budget. The Mexican private sector is pushing hard for changes in employment laws to make the labor market more flexible and dynamic which would lead to more job opportunities especially for lower skilled and younger workers. The government, supported by various NGO's, is also working to improve the public education system. Mexico already enjoys a high literacy rate, but more advanced skills will be needed to fill positions in increasingly sophisticated manufacturing processes and the growing services sector.

The status quo always has its defenders and these proposed reforms have met with resistance. However, the recent global economic crisis may actually serve as a wake-up call to government officials concerning the need to enhance competitiveness. AMERICAN CHAMBER/MEXICO will continue to support reform efforts designed to improve Mexico's overall business environment, enhance the country's competitiveness, and that will generate economic growth and jobs.



# AMERICAN CHAMBER MEXICO

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## **For a better business environment**

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