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Political and Macroeconomic Determinants of Foreign Direct Investment in Mexico

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Abstract

This study deals with the way in which macro-economic conditions, political and economic stability, and economic incentives influence FDI flows to Mexico. Specifically, the model examines the effect of Salinas' policy initiatives on FDI in Mexico.

About the author : *Yuet Wei Wan, a 1993 graduate who double-majored in mathematics and economics received the designation Research Honors for this paper, which was an offshoot of her senior research project. She described her research projects as being "a lot of fun," with her Econometrics class having prepared her for such projects. Yuet Wei now works as an investment banking analyst for CS First Boston at Chicago. She cites communication skills, discipline and the ability to handle responsibility (all of which she greatly enhanced at Wesleyan) as being big assets at work. She plans on getting a Masters in Business Administration after a few years of work experience.*

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## Yuet-Wei Wan

I. INTRODUCTION

Over the last decade, Mexico's economy has been undergoing a series of exciting changes. In 1983, Mexico was still a highly inward-oriented economy with a government that was outspoken in its criticism of multinational cooperations. Today, Mexico ranks among the most outwardly-oriented developing economies of the world (Nunez p. 7). The present administration, under the leadership of President Salinas, has implemented significant changes aimed at liberalizing Mexico's policy towards foreign direct investment (FDI). The changes in Mexico's policy have been largely in response to the 1982 debt crisis and deteriorating economic conditions. This study deals with the way in which macro-economic conditions, political and economic stability[1], and policy incentives influence FDI flows to Mexico. Specifically, the model examines the effect of Salinas' policy initiatives on FDI in Mexico.

Research in this area is meaningful for many reasons. First, being the world's fifteenth largest economy, Mexico is clearly an important member of today's global economy. Over the last few decades, Mexico's economy has been experiencing impressive growth rates. In 1975, Mexico's real gross domestic product (GDP) grew by 5.7%.

In the early 1980s, real growth rates were between 8% and 9%. In 1982 however, the real growth rate plunged to an alarming 4%. In recent years, the growth rate has been between 1.87% in 1987 and 3.98% in 1990. Some of the slowdown in GDP growth rates can be attributed to the debt crisis in 1982. Mexico also has its share of economic problems. Many of the recent economic reforms, including the change in Mexico's policies towards FDI, have been in response to the sudden slowdown. Nevertheless, Mexico's

economy has still been doing relatively well. As such, it is hardly surprising that Mexico is among the largest recipients of FDI from the industrialized nations. Over the period from 1955-1982, Mexico received over $13.44 billion in FDI (Nunez p. 17).

Graph 1 : FDI vs GROWTH
Mexico, 1971-1990
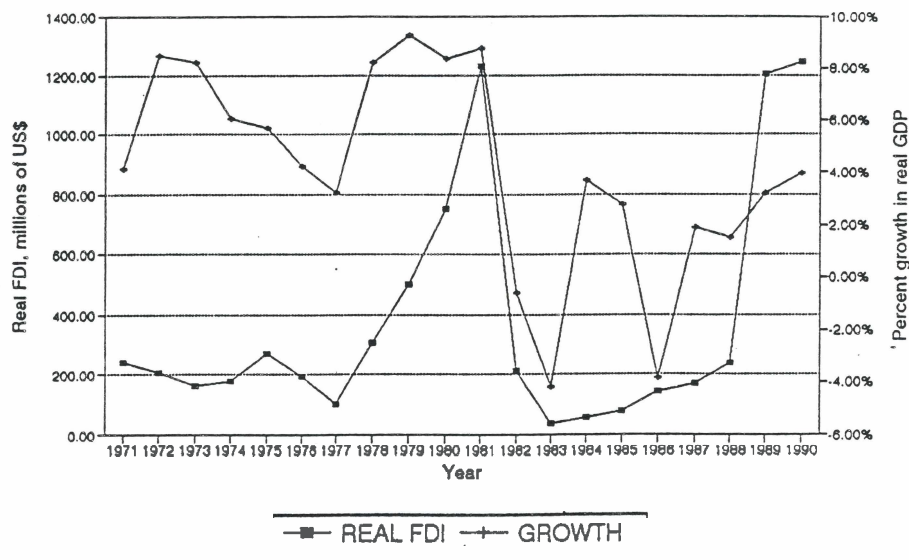
From the above graph, it is reasonably clear that there is a positive relationship between growth and FDI. This supports the findings of this study.

FDI flows to Mexico are expected to continue to grow rapidly over the next decade. Part of this is due to the North American Free Trade Agreement (NAFTA) between the United States, Canada and Mexico. Among these three nations, Mexico has the comparative advantage in low-skill, labor intensive production. Under the auspices of NAFTA, multinational enterprises can set up cost efficient production facilities in Mexico and have access to the vast US and Canadian markets as well.

The decision to engage in FDI is a long and deliberate process. It is a decision that involves a long term commitment of the multinational corporation's time, effort and resources. There are many factors that need to be taken into consideration. Not all of these factors are economic in nature. In fact, one of the primary considerations is political risk. Clearly, a nation that is likely to experience a coup is not a viable location for FDI. As such, any model that does not attempt to model political and economic stability would be incomplete.

This study incorporates the effects of government policy on FDI. The current stance of Mexico's policy makers on this issue cannot be more different than it was two decades ago, when the "Law for the promotion of Mexican Investment and Regulation of Foreign Investment" of 1973 was passed. This piece of legislation

severely restricted foreign ownership rights in Mexico. Since his election in 1988, President Salinas has implemented various policies aimed, specifically at attracting foreign capital. In a recent interview with <u>Forbes</u>, Salinas states " We know we have to be competitive [in tax rates] on an international level if we are to compete for capital, which in the Nineties will be the key question for economic success or failure" (p. 64). Among other things, Mexico does not tax capital gains. Given this radical about-face in policies towards FDI, Mexico is the ideal candidate for this study of the effect of the government's policy stance on FDI flows.

II. Literature Review

There exists a vast body of literature that pertains to the FDI decision process. Over twenty years ago, Stephen Hymer pioneered work in this area with his seminal thesis on FDI and multinational enterprises. Since then, research in this area has taken off in many directions. Today, literature on FDI and the multinational corporation crosses disciplines. Substantial work on this subject can be found among the literature on international economics, international business, and finance.

Most of the existing research concentrates heavily on the micro-economic considerations behind an individual firm's decision to invest abroad. Although these studies are not directly related to my research, they provide the micro-economic foundation upon which I can build my macro-economic model. My base model was put together under the guidance of Dr. Jian Hai Lin from the International Monetary Fund. He has conducted a similar study on Malaysia and Singapore. Dr. Lin discovered that in Malaysia, a sophisticated and relatively low cost labor force is of primary importance in attracting FDI. In his study, the impact of government policy incentives on FDI in Malaysia seemed to play a minimal role. In Singapore however, Dr. Lin discovered that FDI flows are positively related to incentives and inversely related to relative labor costs and inflation rates (p. 44).

My literature search was conducted in three stages. First, I looked for past theoretical and empirical work that supports the inclusion of the variables in my base model. Then, I researched past work on political risk assessment. Concurrently, I also looked for research related to the effects of government policy incentives on FDI flows.

According to Dr. Lin, the growth rate of the market, relative labor costs, net exports, government debt, and inflation are important determinants of FDI. In the literature, there is much support for the importance of the growth rate of the market. Daniels and Radebaugh point out that one of the primary motives for investing abroad is to gain market access (p. 194). Dr. Lin found that the growth rate of the market (GDP growth) is a key variable in explaining FDI in Singapore and Malaysia (p. 59). In theory, the multinational corporation (MNC) need not set up a

plant inside a country in order to gain access to its market. The MNC can also gain market access by licensing and exporting. However, there are other real world considerations that often render these options unrealistic. An important example is transportation costs. For some products, the cost of transportation makes it impractical to export the good over any great distance. Other factors include trade barriers and consumers' preference for domestically produced goods (Daniels and Radebaugh, p. 195-197).

Daniels and Radebaugh identify production costs as another important determinant of FDI. The realities of competing in a global marketplace make it necessary for MNCs to seek out the most cost efficient sources of raw materials and factors of production (p. 194). An empirical study by Cushman on the effects of real wages and labor productivity on FDI failed to support the theory that real wages are an important determinant of FDI in the US. Richard Caves argues that the decision to undertake FDI is a function of the cost of home production relative to the cost of foreign production. Since global financial markets are very integrated, capital has become very mobile. It is not so with labor. As such, the country with a comparative advantage in low cost labor will be a net recipient of foreign capital (Caves, p. 21).

In the literature, there is disagreement over the effect of the trade balance on FDI. The political risk assessment literature identifies the trade balance as an indicator of a country's political and economic stability. Persistently high trade deficits can result in the restriction of foreign exchange transfers. This inhibits the ability of the MNC to repatriate its profits. The government may also attempt to reduce imports by devaluing the local currency or by restricting imports of certain goods. MNCs often depend on external sources for their inputs to production. As such, a devaluation of the local currency increases production costs as intermediate goods become more expensive. Similarly, import restrictions raise production costs or impede production. In this sense, a high trade deficit discourages FDI (Bunn and Mustafaoglu, p. 1565-66).

It is also argued that a high trade deficit weakens the country's currency. On the one hand, this makes it more expensive for MNCs to import intermediate goods. On the other hand a weaker currency should stimulate demand for the country's exports, stimulate production and consequently, raise income and improve the population's purchasing power (Madura, p. 484). As such, the MNC will be able to sell more of its products both within the country and export more to the rest of the world. In this sense, a high trade deficit may be appealing to foreign investors. Clearly, the literature does not tell us whether a high trade deficit should be considered an indication of economic stability or economic instability.

Another important indicator of economic stability is the external debt level. This is very closely related to the trade deficit in that a sustained trade deficit year after year

contributes to the external debt level. The external debt figure includes government and private debt. A high government debt level discourages FDI. This is especially true if the government is an important customer of the MNC in that a large debt may curtail the purchasing power of the government and hence harm the profitability of the MNC (Madura p. 484). High private debt levels are also harmful in that they contribute to the overall level of external debt. A high external debt level does not inspire confidence in investors in that there is a higher risk of the country defaulting on its external obligations. This does not help the country's economy or the MNC's profitability. This was exactly the case with Mexico in the 1982 debt crisis. Mexico's high external debt (refer to Graph 2) level can be linked to the plunge in the real GDP growth rate (refer to Graph 1) and the decrease in FDI to Mexico.

GRAPH 2 : FDI vs. DEBT
Mexico, 1971-1990

REAL FDI   DEBT
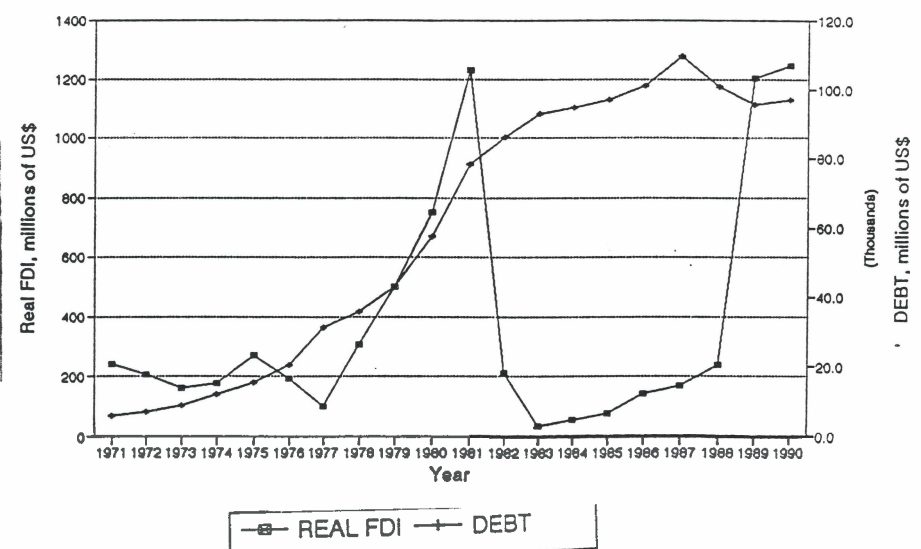
The graph suggests that the relationship between external debt and FDI is somewhat ambiguous. From 1975-1981, the appears to be a positive relationship. The opposite is true for all other years. Model A supports the positive relationship. DEBT is probably not a good proxy for stability.

Finally, inflation is significant because inflation affects the purchasing power of consumers and as a result, consumer demand for the MNC's products (Madura p. 482). Nunez points out that inflation also pushes up the costs of production and may eat into the profits that an MNC hopes to repatriate (p. 31). Dr Lin also found that inflation is a key explanatory variable of FDI in Malaysia and Singapore (p. 59).

III. The Base Model

The first step in this study is to estimate the base model. The base model uses macro-economic variables to explain FDI into Mexico. It does not include the government policy variable. The

base model is important because the final model can then be compared with it. The comparison may yield some insights as to the effects of the government policy variable on FDI. The base model also gives an initial indication of how well the final model can be expected to explain FDI in Mexico.

FDI in Mexico is hypothesized to be a function of real GDP growth, relative labor costs, net exports, government deficit and inflation :

FDI = f(GROWTH, INF, LABOR_US/MEX, NET_EXP, DEBT)

The empirical model is as follows :

FDI = a + b * GROWTH + c * INF + d * LABOR_US/MEX + e * NET_EXP + f * DEBT + error

Table 1 describes the variables. The data are time series from 1971-1990. Where applicable, all variables are measured in real terms. Data for unit labor costs for both the US and Mexico are not available for 1989 and 1990. As such, OLS regressions of US unit labor cost and Mexico's unit labor cost as functions of time were run. The data for 1989 and 1990 are extrapolated from the results of the regression[2].

TABLE 1 : DEFINITION OF VARIABLES		
VARIABLE	TYPE	DEFINITION
FDI	Dependent	Mexico's total real foreign direct investment
GROWTH	Macro-economic	% annual growth in Mexico's GDP
INF	Macro-economic	Inflation rate calculated from GDP deflator
LABOR_US/MEX	Labor cost	Relative unit labor cost, US/Mexico
LABOR	Labor cost	Mexico's unit labor cost
NET_EXP	Stability	Mexico's real net exports
DEBT	Stability	Mexico's external debt - government and private
SALINAS	Policy	Policy variable - dummy - 1 Salinas is President - 0 otherwise
Note : Where applicable, all variables are in millions of constant US$.		

IV. Base Model - Hypothesis

1) Real GDP growth (GROWTH) is expected to have a positive impact on FDI. This is because a high growth rate will attract MNCs that are seeking to expand into new and growing markets.

2) Inflation (INF) discourages FDI in that it increases the cost of production and eats into the profits that a MNC may hope to repatriate. A high inflation rate also slows the real GDP growth rate and erodes the purchasing power of Mexican consumers.

3) Relative labor cost (LABOR_US/MEX) is expected to have a positive impact on FDI. MNCs that have already decided to invest in this region are presumably hoping to gain access to one or more of the markets in this region (i.e. the United States, Canada and Mexico). These MNCs have the option of locating their production facilities in the United States, Canada, or Mexico. In making this decision, relative unit labor costs clearly is an important consideration. Production costs in the United States and Canada are not significantly different. Since the United States is the largest source of FDI in Mexico, I chose to compare its (rather than Canada's) unit labor cost with Mexico's. This is also more consistent with the Caves' theory that "domestic" (United States) vs foreign production costs are important. Even if the FDI is from outside the United States (such as the European Community), United States/Mexico labor costs are the relevant costs to be considered because MNCs that choose to locate in this region compare production costs in the US (or Canada) with production costs in Mexico. As LABOR_US/MEX increases, Mexico's labor costs are becoming relatively cheaper, thus increasing FDI.

4) LABOR is an alternative measure of production cost. The LABOR variable takes only Mexico's productivity adjusted labor costs into account. As Mexico's labor cost increases, FDI should decrease.

5) The expected sign of Net Exports (NET_EXP) is uncertain. On the one hand, continued high trade deficits can result in restrictions on foreign exchange transfers. This inhibits the ability of the MNC to repatriate profits. The government may also attempt to reduce imports by devaluing the local currency or by restricting the imports of intermediate goods that the MNC depends on. This discourages FDI. Also a trade deficit results in a lower exchange rate. Although this makes imports of intermediate goods more expensive, it also makes the country's exports more competitive in world markets. Foreign investors often find this aspect of a lower exchange rate appealing. As such, the ultimate effect of a high trade deficit is ambiguous.

6) External debt (DEBT) is expected to be negatively related to FDI. A large debt level increases the probability of default. This is an indication of the economic and political

instability and as such, should discourage FDI.

V. Base Model - Results

   The empirical model was regressed using Ordinary Least Squares (OLS). Two separate models are regressed. Model A uses includes all variables discussed in the hypotheses section except LABOR. This is because LABOR and LABOR_US/MEX are alternative measures of production costs. As such, they are used interchangeably. The data are time series, from 1970-1990. All data have been extracted from the World Bank's _World Tables 1992_. The results are summarized in Table 2.

TABLE 2 : OLS REGRESSION ANALYSIS

DEPENDENT VARIABLE : FDI

INDEPENDENT VARIABLES	EXPECTED SIGN	MODEL A	MODEL B
GROWTH	+	2955.511 (1.6096)	2170.306 (1.0047)
INF	-	-650.279 (2.4695)	-417.126 (1.6414)
LABOR_US/MEX	+	425.279 (1.1241)	
LABOR	-		-732.583 (3.3223)
NET_EXP	+/-	-0.265 (2.7061)	-0.36 (3.3042)
DEBT	-	0.006 (1.6086)	
SALINAS	+		
CONSTANT		-221.407	1328.379
R-SQR		0.787	0.675
ADJ R-SQR		0.710	0.588

   First, Model A is discussed. Besides LABOR_US/MEX, all of the variables are significant. The GROWTH variable has the largest coefficient. It is also significant at the alpha = .10 level. As hypothesized, the GDP growth rate is important in explaining FDI to Mexico. The pattern of FDI and GROWTH in Graph 1 supports this result. The INF variable is also statistically significant and turned out as predicted.

The NET_EXP variable turned out to be negative. This supports the theory that a high trade deficit is an indication of economic instability. Evidently, MNCs weigh the risk of devaluation, foreign exchange restrictions and import restrictions more heavily than the advantages associated with exporting from a country with a more competitive exchange rate.

Only the relative labor cost variable (LABOR_US/MEX) is not significant at the alpha = .10 level. This may be because in recent years, while the US is still the largest investor in Mexico, significant portions of its FDI have been coming from other parts of the world as well. This may cause the results to be somewhat distorted. From Graph 3, it appears that until the late 70s, there was a positive relationship between FDI and LABOR_US/MEX. The relationship seems to break down after that.

Graph 3 : FDI vs LABOR_US/MEX
Mexico, 1971-1990
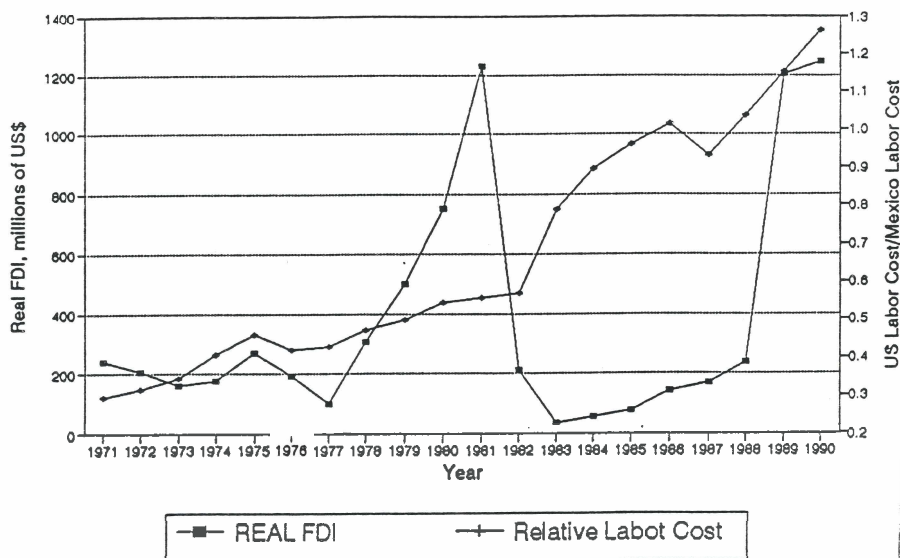
The data do not suggest a strong positive relationship between relative labor costs and FDI. From 1982, the positive relationship seems to break down. This indicates that a comparison of labor costs between the US and Mexico may not be appropriate.

The sign for the external debt variable (DEBT) did not turn out as expected. However, the size of the coefficient is also small. I suspect that net exports (NET_EXP) and external debt (DEBT) are closely related. I had intended that they proxy the same thing - stability. As such, it may be more appropriate to leave DEBT[3] out of the equation. The regression explains 71.0286% of FDI flows to Mexico.

Model B is a variation of Model A. LABOR is used instead of LABOR_US/MEX. Based on the results of MODEL A, the DEBT variable is dropped. LABOR turned out to be negative and significant at

the alpha = .01 level[4]. The GROWTH variable is insignificant. All other variables turned out as expected and are statistically significant.

Observe that all of the variables in the Model A and Model B are purely macro-economic and stability variables. It is clear from the hypotheses that there are sound economic reasons for including these variables into the model. These economic variables do a fairly good job explaining FDI flows to Mexico. However, from the literature search, it is clear that we must also take policy incentives and political factors into account in order to get a more complete picture of what is really going on.

Graph 4 : FDI vs LABOR
Mexico, 1971-1988
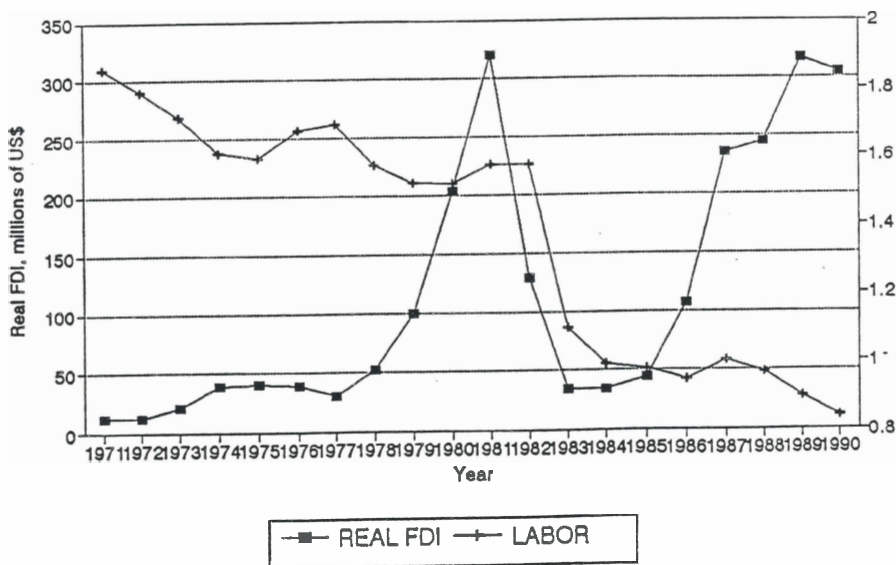
It is quite obvious that there is an inverse relationship between FDI and unit labor costs. This is a reasonably good proxy for the importance of production costs.

VI. Model Including Policy Variable

Dornbusch claims that currently, one of Mexico's critical policy issues is "how to generate confidence in the economy" (p. 313). This captures the essence of what the Salinas administration is trying to do. The only way Salinas can achieve his economic goals is to instill confidence in both domestic and foreign investors that economic and political conditions in Mexico guarantee a stable flow of returns on their investments.

In order to achieve this goal, the Salinas administration has, among other things, offered more competitive tax rates to MNCs. Mexico has also, in recent years, relaxed its foreign ownership restrictions. The recent North American Free Trade Agreement (NAFTA) between the United States, Canada and Mexico has also stimulated a lot of confidence in Mexico. I needed to come up with a variable that reflects these changes and captures the effects of the return of investor confidence in Mexico.

The expanded empirical model is essentially the same as Model B. The only difference is that a new variable, SALINAS is included into the equation. Various approaches to modeling policy incentives were considered. Initially, I had considered using tax rates on MNCs and foreign ownership restrictions. However, I had trouble obtaining data for these measures. Upon consultation with Dr. Dornbusch, it was confirmed that most of these data simply are not available. Dr. Dornbusch suggested that a dummy variable for the years Salinas has been in power will probably capture most of the effects that I am trying to model. After all, what I am basically trying to measure is expectations.

The SALINAS variable is a dummy variable consisting of 1 for the years Salinas has been president (1989 and 1990) and 0 for all the other years. Salinas was inaugurated in August, 1988. However, the "Salinas effect" is expected to be lagged for two reasons. Firstly, the changes the Salinas administration has brought about did not occur overnight. These things take time. Secondly, it also takes time for MNCs to gather information regarding these reforms. A lot of time and resources are involved before an MNC can react to the changes implemented by the Salinas administration. A few MNCs may even want to wait for awhile before they have confidence in the ability of the new government to carry out these changes. As such, the SALINAS variable has 1s for 1989 and 1990. Clearly, the SALINAS variable is expected to have a positive impact on FDI.

The expanded empirical model is estimated as follows :
FDI = a + b * GROWTH + c * LABOR + d * NET_EXP + e * INF +
      f * SALINAS + error.

Table 1 summarizes the definition of variables. All previous hypotheses apply. The new variable, SALINAS is expected to be positively related to FDI. The SALINAS variable represents the return of investor confidence in Mexico brought on by all the new policy incentives implemented by Salinas.

VII. Expanded Model - Results

Table 3 summarizes the results of the OLS regression for the expanded model. The results of the Model A and Model B are also tabulated for comparison. The models are described as follows:

TABLE 3 : OLS REGRESSION ANALYSIS				
DEPENDENT VARIABLE : FDI				
INDEPENDENT VARIABLES	EXPECTED SIGN	MODEL A	MODEL B	MODEL C
GROWTH	+	2955.511 (1.6096)	2170.306 (1.0047)	2970.515 (1.7644)
INF		-650.279 (2.4695)	-417.126 (1.6414)	162.941 (0.6226)
LABOR_US/MEX	+	425.279 (1.1241)		
LABOR			-732.583 (3.3223)	-28.401 (0.1038)
NET_EXP	+/-	-0.265 (2.7061)	-0.36 (3.3042)	-0.293 (3.3975)
DEBT		0.006 (1.6086)		
SALINAS	+			830.836 (3.3467)
CONSTANT		-221.407	1328.379	29.379
R-SQR		0.787	0.675	0.819
ADJ R-SQR		0.710	0.588	0.755

MODEL A - Base model.
MODEL B - Revised base model. Excludes DEBT and uses LABOR instead of LABOR_US/MEX.
MODEL C - MODEL B + SALINAS variable or the expanded model.

In model C, all the signs turned out as expected. Everything except inflation (INF) and unit labor cost (LABOR) is statistically significant at the alpha = .10 level. The SALINAS variable is statistically significant even at the alpha = .01 level. Its coefficient is also large. This suggests that Salinas has managed to do a lot for investor confidence in Mexico. In fact, the Salinas effect has been so large that apparently it has swamped even the effect of Mexico's low unit labor cost (LABOR). The LABOR variable was statistically significant in Model B but in Model C, it is not significant. By and large Salinas' policies appear to have been successful. If reliable data were available,

it would be interesting to examine the impact of specific studies.

The fact that the inflation variable (INF) is statistically insignificant in the expanded model (Model C) can be explained by the inclusion of the SALINAS variable. This is because both variables measure expectations. As such, the SALINAS variable must have picked up most of the variation caused by expectations.

The fact that GDP growth rates switched from being insignificant (MODEL B) to significant (MODEL C) indicates that the GROWTH variable performs much better in conjunction with the SALINAS variable. There may be some multicollinearity[5].

Model C has an adjusted r-square of 0.754. Model B's adjusted r-square is .587. This tells us that purely economic factors cannot completely explain FDI in Mexico. Clearly, policy incentives and investor confidence in Mexico's political and economic stability should not be overlooked.

VIII. CONCLUSION

The results of my research suggests that the determinants of FDI in Mexico are both economic and political. Investor confidence in the political and economic stability of the country is an important factor. Often, there is no clearly defined distinction between a "political variable" and an "economic variable". The two are too inter-related in too many ways. As such, the Salinas administration has the unenviable task of getting both the politics and economics right in order to attract FDI. At this stage, it appears as though their policies are having a measurable impact on their ability to attract FDI.

I believe that one of the main reasons Salinas has been so successful is that he has managed to structure a very attractive incentive package for foreign investors. Salinas has managed to get the message across that Mexico is an attractive place to invest. A promising avenue of future research would be an assessment of the effects of specific policies on FDI. Unfortunately, the data for such a study are not available. Hopefully, as research in this area receives more attention, reliable and comprehensive data sources will become available.

A shortcoming of this study is that it fails to capture a more long-term perspective of the recent developments in Mexico on FDI patterns in Mexico. Of particular interest would be an evaluation of the overall impact of NAFTA on FDI in Mexico. Since the agreement has only recently been signed and will not fully take effect for a number of years, such a study cannot be undertaken for a few years yet. The Mexican - United States - Canadian free trade zone promises to be one of the most dynamic and exciting economic regions in the world. It is also potentially a rich source of valuable economic research, particularly in the area of FDI.

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ENDNOTES

1. Political and economic stability are very closely related. Even in industrialized countries like the US, whether a president is successfully re-elected for a second term depends on the economy's performance. In less developed nations, economic hardship can bring about political unrest. Political instability also hampers economic growth. As such, the terms "political stability" and "economic stability" will often be used interchangeably.

2. The regression results are as follows :
   $L\_US = -49.604 + 0.0255*Year$ Adjusted R-square = .958
   $L\_Mex = 112.564 - 0.0561*Year$ Adjusted R-square = .828
   where L_US is unit labor cost for the and L_Mex is unit labor cost for Mexico.

3. Refer to Graph 2 for the graphical relationship between FDI and DEBT.

4. Refer to Graph 4.

5. Since the multicollinearity -- if it exists, is not a serious problem here, no attempt has been made to deal with it.

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