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# STRATEGIC INVESTMENT IN MANUFACTURING: HOW TO MAKE IT

TRENDS

Challenges to foreign direct investment in Mexico

Legislative liaison

Consejo Nacional
de la Industria Maquiladora
y Manufacturera de Exportación

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# THE RAPID RETURN ON INVESTMENT **AS A MEXICAN ADVANTAGE**

***Luis Manuel Hernandez, president of the National Council of the Maquiladora and Manufacturing Export Industry (INDEX), pointed out that the country has the opportunity to recover investments in a short period of time***

**Mexico City, July 2, 2021 -** Among the attractions that the country offers to domestic and foreign investors is the return of investments in a shorter period of time compared to other places. This was stated by Luis Manuel Hernandez, president of the National Council of the Maquiladora and Manufacturing Export Industry (INDEX).

During his participation in the conversation "USMCA, engine of economic growth", organized by the Ministry of Economy within the framework of the 1st anniversary of that treaty, he highlighted that any company that wants to open its operations in the region has a return on investment of between 12 and 14%. This means that companies that invest here recover their investment in 5 or 6 years, while in Asia the return can take 12 years. On the other hand, in European countries the return can be 8%. He also stated that this message needs to be conveyed more so that investors know the speed with which they can have a return on their investment compared to other latitudes.

A year after the implementation of the USMCA, he said that the manufacturing sector has to understand its role and participate strongly in the implementation and strengthening of the treaty. He also mentioned that the key words for the future of the USMCA are collaboration and compliance. Among some notable figures, Luis Manuel Hernandez mentioned that the North American region concentrates 16.5% of the world's population and 18% of the world economy's GDP. He also mentioned that at least 32% of the goods consumed in the United States are produced in Mexico.

The national president of INDEX referred to the growing number of jobs generated by the manufacturing sector, which as of last April totaled 170,000. He also highlighted the fact that 80 manufacturing companies have opened despite the pandemic.

Tatiana Clouthier, Secretary of Economy (SE); Carlos Salazar, president of the Business Coordinating Council (CCE); Francisco Cervantes, president of the Confederation of Industrial Chambers (CONCAMIN) and Humberto Jasso, vice-president of Foreign Trade of the National Agricultural Council (CNA) participated during the discussion.


# STRATEGIC INVESTMENT IN MANUFACTURING: **HOW TO MAKE IT**

*Without investment there is no growth, and in the last two decades the Mexican economy has seen a reduction in it. The manufacturing industry has followed this pattern, which has gradually made it more unproductive. How can this be reversed?*

**INTERDISCIPLINARY PUBLIC RESEARCH TEAM[1]**

On average, in the last thirty-eight years the country has grown 2.2 % annually[2]. Economists agree that for Mexico this growth is low. This is a problem that goes beyond the confinement in 2020, electoral changes and the economic crisis of 2008. Why have trade liberalization, market flexibilization and the "demographic bonus" not yielded the expected results? While there is a wide range of competing answers, they all agree on one point: **not enough resources have been invested on the right fronts.** *Investment* is the key.

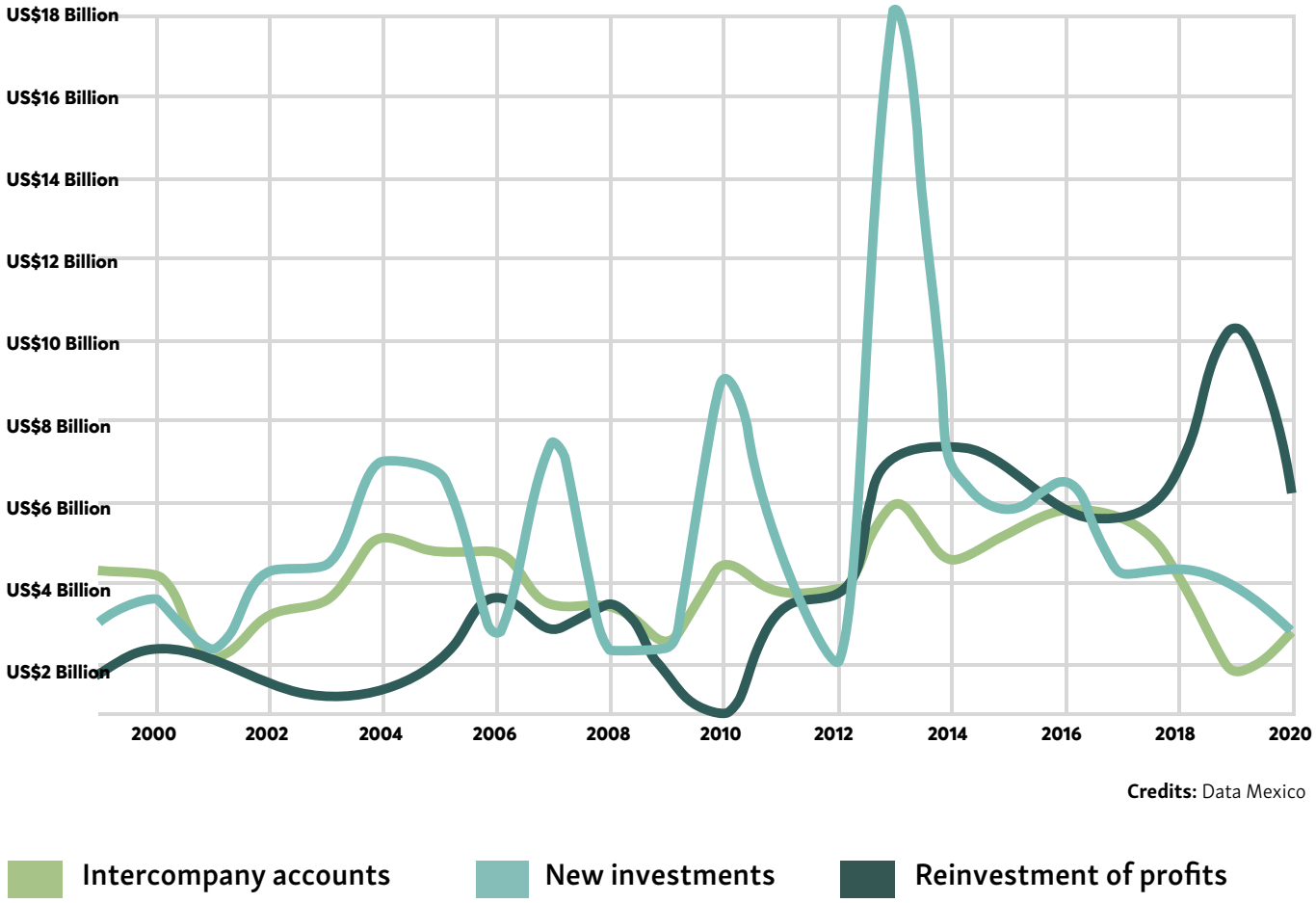
**In the case of Mexican manufacturing, one of the most important forms of investment is in "physical capital" or gross fixed investment, that is, investment in long-lived assets used to produce goods and services.** It is the purchase of equipment, physical structures and intellectual property made by companies to produce more in less time and grow in global markets. It sounds like a simple process, but it is not: to do it properly, they must ensure that the rate at which they increase physical capital is faster than its depreciation. Machinery, software and warehouses age. Material tends to degrade and investing in it means renewing it; only then can companies remain competitive. The same is true for national economies. For the productivity of a country's physical capital to increase, investment must be higher than the rate of depreciation[3]. *How can this be achieved in the current context?*

1 Meet the members of our team on the last page.
2 Anuar Sucar Diaz Ceballos, **Debates sobre la productividad en Mexico,** Nexos, Mexico, 2020. Available here.
3 Lida R. Weinstock, **Introduction to U.S. Economy: Business Investment**, Congressional Research Service, U.S., 2021.

# THE ESSENCE
# OF THE ISSUE

Investment in physical capital is a critical issue for export manufacturing. Our industry is one of the industries that invests the most in this type of goods, notably via Foreign Direct Investment (FDI). In 2020, FDI in manufacturing industries was $US 11.8 billion, that is, a little more than 40% of what the entire Mexican economy received for this concept in that year[4]. And in the last 20 years, from January 1999 to December 2020, the total invested was $US 293 billion. It is worth looking at the behavior of this amount. $US 115 billion (39%) were allocated to new investments; $US 90 billion (30%) to "intercompany accounts", that is, transactions between companies belonging to the same corporate group; and $US 88.4 billion (29%) to reinvestment of profits that were not distributed as dividends (see Graph 1).

**Graph 1. Annual FDI Flows in Manufacturing Industries by Type of Investment, 1999-2020.**




4 Annual FDI flows in manufacturing industries, Data México. Information by Secretaria de Economia Available here.
Own estimates.

In Graph 1 we also observe something intriguing: although new investments are proportionally higher than the rest of the investments, they do not represent more than half of the total.
Thus, much of what is invested in manufacturing via FDI does not result in more physical capital, which is what can generate more growth for both the sector and the country. Moreover, there has been a downward trend for this type of investment over the last six years, while profit reinvestment has increased. This may mean that fewer new players have entered the sector, that the pace of investment in new projects has slowed, and that only established companies have tended to increase their capital. If this is the case, it could reflect a deterioration in internal competition in the sector, although other hypotheses are feasible.

Let us remember that, in the long term, the greater a nation's stock of physical capital, the greater its productive capacity, which generates more goods and services. This also brings with it new jobs, higher incomes and, presumably, a better quality of life for the entire population. Thus, without adequate investment in physical capital, both manufacturing and general economic activity are headed for obsolescence.
**Along with human capital and technological development, investment in physical capital is what drives economic growth, even more so than the fluctuations in supply and demand seen in business cycles, crises and recessions.**
A thriving economy invests well, even when the horizon looks cloudy, as it was during the 2008 crisis and during the brief contraction caused by the spread of SARS-CoV-2.

Another point of alarm, in addition to the decrease in investment, is that it is increasingly unproductive. At the national level, the productivity of the factors of production[5] has decreased steadily over the last 20 years - the average rate for the total economy between 1991 and 2019 is -0.34 - and we observe a similar behavior in the United States, our largest trading partner. In the same period, the annual growth rate of the manufacturing industry is also negative (-0.33)[6]. Why has this happened in Mexico? There are local and global hypotheses. Let's start with the former: the Mexican economy "is essentially made up of a myriad of small, low-productivity economic units"[7]. **In our country, 95% of the economic units have less than ten employees and most of them are engaged in retail trade and food and beverage preparation services[8].** It may sound exaggerated, but we have a country of taquerias, grocery stores, restaurants and shoe stores: necessary businesses, but which produce and grow very little. Many of these, moreover, remain informal. The debate as to why this has happened is still ongoing. Some groups argue that the liberalization reforms are still incomplete and need to be deepened: "to stimulate economic competition, promote the accumulation of human capital, eliminate relative price distortions, reduce transaction costs and strengthen the rule of law" [9]. Others point to the current social protection structure as a cause, since it indirectly taxes formal work and subsidizes informal work (for more details see Santiago Levy (2010, 2018)[10]), which makes it more attractive to remain in activities that are not very productive. On the other hand, the global responses can be condensed into three. The first is that the current productive slowdown is a consequence of the incorporation of new information technologies, which made firms more productive in the 1990s but, once fully

5 The productivity of the factors of production or total factor productivity is the difference between the growth rate of production and the weighted rate of increase of the factors (labor, capital, etc.).
6 Total factor productivity, INEGI, Mexico, 2021. Available here.
7 Anuar Sucar Diaz Ceballos, **Debates sobre la productividad en Mexico,** Nexos, México, 2020. Available here.
8 Ibid.
9 Ibid.
10 Santiago Levy, **Good Intentions, bad outcomes,** Brookings Institution Press, 2010 and **Esfuerzos mal recompensados: la elusiva busqueda de la prosperidad en Mexico**, Banco Interamericano de Desarrollo, 2018.

adopted, output growth returned to its previous levels. The second is that new technologies, such as smartphones, increase productivity less than the technologies of the past, such as the combustion engine. The third answer is that we are still living with the consequences of the 2008 financial crisis, which reduced companies' investments in research and development, inhibiting the emergence of new technologies.

**Of course, the causes may be a combination of the above hypotheses. If we want the Mexican manufacturing industry to expand, this scenario must be addressed. The first step is to recognize it.**

**The bottom line:** Without investment in physical capital, the economy cannot grow in the long term. This investment must be accompanied by conditions that ensure large-scale productivity. As a country, we are stagnating on both fronts.

# TRENDS

If we want to grow economically, it is necessary to invest more and better, both domestically and in the manufacturing industry. These are the trends to keep in mind:

- ***Gross fixed investment.*** Investment in construction, machinery and equipment in Mexico has seen meager growth since 2013, with a decrease in 2020. If we break it down in more detail, the bulk of investment continues to be in machinery and equipment, mostly imported. This type of investment does not create as many jobs as investment in more labor-intensive areas, such as construction.

- ***Foreign direct investment.*** Recent data are encouraging, but they represent only a rebound in a trend that has remained stable. During the first quarter of 2021, FDI amounted to 11.864 billion dollars, its highest level since 1999. Most of this investment is in manufacturing and is destined for reinvestment of profits. It is not so much about creating new projects as it is about maintaining established capital, i.e., it is a figure that seeks to contain depreciation.

Will investments grow this year? Partially yes, as a consequence of the economic reactivation. Three additional economic factors should be kept in mind: the speed with which vaccination is carried out, which will allow the economy to reopen; the policies implemented by the newly elected governments, especially the role of governors in states with high manufacturing activity; and the effects of the USMCA dispute settlement panels, already in force and operating.

11 INEGI. Consult the data in this link.

# ENTRY POINTS
# FOR PUBLIC DISCUSSION

How to stimulate investment? Any public discussion must necessarily include the following elements:

1. ***Improve general economic conditions.*** Investment increases along with the demand for products. The higher the demand, the more companies will seek to increase their productivity to meet it and will invest in new capital. When, on the other hand, demand contracts, investment is cut back, as we saw in the 2008 crisis and in the early days of the COVID-19 pandemic.

2. ***Improve business expectations and confidence.*** This element is more elusive and has to do with business expectations. Since these are subjective, often emotional, interpretations, they are more unpredictable and difficult to address through targeted public policies. Owners may believe that demand for their products will decline for a myriad of reasons, including confidence in government, the arrival of new industries and changes in consumer behavior. Even so, it is something that should be considered of great weight, especially in the management of official communication.

3. ***Long-term interest rates.*** Given that most business owners turn to banks to finance new investments and that the interest rates on such loans go hand in hand with the rate set by the central bank, this element is the responsibility of BANXICO. When BANXICO lowers the interest rate, it stimulates investment; the opposite happens when it raises the interest rate, i.e., borrowing becomes more expensive. Investment is also related to savings in the economy. When there is more savings, there is more money available to lend and, therefore, the interest rate decreases.

Given the various diagnoses of the causes of economic stagnation, public policy recommendations differ. Suffice it to say that investment and total factor productivity must be increased. To do so, the above mentioned variables must be taken into account, while strengthening the rule of law, changing social security schemes, labor market regulation and the tax system. At what pace? Which one to prioritize? This is the relevant discussion.

# UPDATES

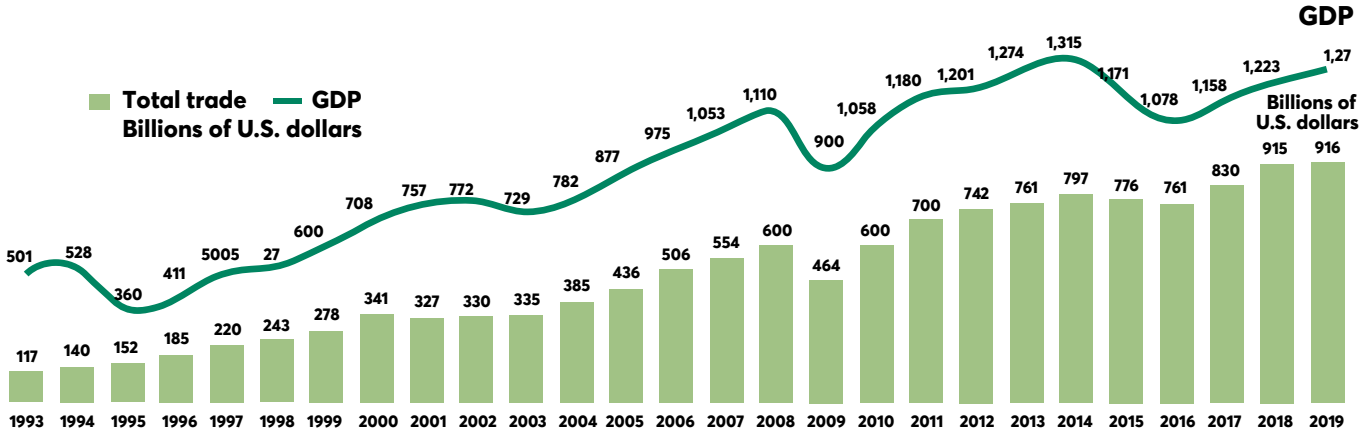
# CHALLENGES TO FOREIGN **INVESTMENT IN MEXICO**

**By Israel Morales**
Director of the International Agreements and Treaties Committee, index Nacional.

*There are great challenges to increase the pace of foreign direct investment in Mexico. The solutions go hand in hand with the IMMEX program and the institutional framework.*

Since NAFTA was signed, two factors have grown proportionally in Mexico's economy: manufacturing exports and foreign direct investment (FDI) in the sector. The correlation between these two indicators is undeniable. The export industry represented by the IMMEX program companies is responsible for the exponential growth of Mexican manufacturing exports over the last 25 years (Graph 1).

**Graph 1. Trade liberalization and its effect on Mexican manufacturing.**




Trade liberalization has impacted Mexico's trade and GDP growth. At the end of 2020, Mexico had 6 Economic Complementation Agreements and 13 Free Trade Agreements, linking 50 countries. IMMEX companies contribute 80% of this trade exchange.
**Source:** Banco de Mexico, International Monetary Fund and World Trade Organization.

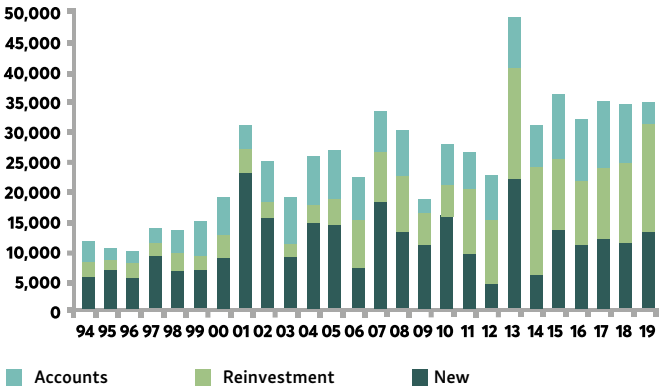
This would not have been possible without the investment U.S. companies and other countries have made in Mexico, with the installation of world-class factories and manufacturing plants, especially in manufacturing with high technological sophistication (aeronautics, electronics, automotive and transportation, medical, specialized machinery and equipment, etc.). But the path of foreign direct investment in our country has not been an easy one, as it has faced all kinds of challenges:

**1. Global economic context.**
Financial crises, such as the one in 2008 and the recent pandemic in 2020, have thrown off foreign investment indicators around the world. Mexico has been no exception.

**2. Political decisions of strategic business partners.** The decisions of major players in geopolitics also directly influence the flow of foreign investment. A recent example is when the Trump administration threatened to cancel NAFTA if its requests were not granted, which caused a slowdown in foreign direct investment between 2016 and 2020 by North American investors (as shown in Graph 2).

**3. Internal policies for IMMEX companies.**
Since 2012, the regulatory policy of the IMMEX program has established a series of additional rules, such as the establishment of sensitive sectors (steel, textile-clothing etc.), and other restrictions. The imposition of VAT, in 2015, on temporary imports made by IMMEX companies had an uncertainty effect that changed the inertia of investment in Mexico. These heavy administrative burdens resulted in a slowdown of FDI from 2014 onwards. Currently, although Mexico signed the USMCA with commitments to openness, there are some sensitive issues, such as energy, that could impact foreign investment in the same way.

**Graph 2. FDI flows to Mexico by type of investment, 1994-2019 (millions of dollars).**




The pace of investment has decreased since 2014.
**Source:** Mexico's Central Bank and the Mexican Ministry of Economy.

**How can we recover the dynamism of foreign and domestic investment in export manufacturing?**

**The first thing** to do is to plan, create the conditions and promote public policies that foster a business-friendly environment, provide certainty, and promote investment. We must avoid the uncertainty generated by administrative burdens, extra costs in the country, public policies and laws that discourage foreign investment in Mexico.

**The second** is to communicate, to do the marketing, to promote the capabilities, the offer, the competitive and comparative advantages of Mexico, the attributes and advantages of its workers, the world-class quality, the response time, the best landed costs (delivery costs) compared to other regions, etc.

**The third** is to remove internal obstacles that inhibit investment, such as laws, regulations and administrative burdens that confuse the investor. It is also important to combat insecurity with the effective intervention of state force and the application of the rule of law. Finally, obstacles can be removed by improving road, port and technological infrastructure.

Broadly speaking, we must align the vision of all government agencies that attract investment and consider the national private sector as a strategic ally. We must ensure that the attraction of FDI is not only expanded to subsidiaries of global corporations, but that it is also applied to projects in which there are national co-investments with MSMEs. Such a development can ensure accompanied and sustainable growth. Since 1994, Mexico showed the world that it was ready for an open economy, but there is still much to be done in terms of attracting Foreign Direct Investment. All in all, Mexico is attractive and full of investment possibilities.

# LEGISLATIVE LIAISON

Information provided by **Grupo Estrategia Politica**

## Pending constitutional reforms

Recently, the President of the Republic announced that he will present three constitutional reforms in the near future. The first one on electoral matters, the second one on the integrated national electricity network and the third one to transfer the National Guard to SEDENA's commands. However, the approval of such initiatives is at stake, since the electoral results of June 6 in the House of Representatives were not favorable for Morena.

The majority group, as well as its legislative allies (PT and PVEM), lost the ability to reform the Constitution on their own in the Chamber of Deputies, so they will have to negotiate with the opposition for its approval.

It is evident that the opposition block formed by PAN, PRI and PRD will not support the first two reforms proposed by the President. However, with respect to the reform of the National Guard, there are precedents in the Senate that PAN and PRI legislators have supported the transfer of command to SEDENA.

In view of the uncertainty of the positions of the opposition bloc regarding these issues, the possibility that Morena may call for an extraordinary period in the next few days to approve such amendments has not been ruled out. This in order to take advantage of the fact that in this legislature it still has the necessary votes to do it.

## Priority agenda of the Senate of the Republic

Before the beginning of the LXV Legislature in September of this year, the Senate of the Republic announced its Priority Agenda for the next three years.

The document contains various proposals and follow-ups on legislative projects of the various parliamentary groups, among which the following stand out:

- Electoral constitutional reform.
- Constitutional reform of the integrated national electricity grid.
- Reform to the General Law for the Prevention and Integral Management of Waste, regarding solid waste management.
- Reforms to various laws to regulate commerce in electronic platforms.
- Issuance of the General Law of Circular Economy.
- Issuance of the General Law of Humanities, Sciences, Technologies and Innovation.
- Issuance of a new Mobility and Road Safety Law.
- Issuance of the Law to Guarantee the Right to Water.

## Economic recovery

One of the biggest challenges for the current administration is to reactivate the national economy. As part of the strategy to achieve this, the President of Mexico recently announced the change in the head of the Ministry of Finance and Public Credit, who will now be Rogelio Ramirez de la O, as well as the appointment of Arturo Herrera as head of Banco de Mexico. These appointments will have to be ratified by the Chamber of Deputies and the Senate, respectively.

Although Ramirez de la O has never been a high-level public official, international markets and private industry have reacted favorably to his appointment because he has been an economic advisor to private industry throughout his career. Another of the federal government's actions to reactivate the national economy is the reopen-

ing of the border with the United States, which is why a vaccination plan is being implemented for the entire remaining population in the 38 border municipalities. This strategy is being implemented by SEDENA, SEMAR, SSPC and SRE.

## Towards the 2022 economic package

From September to November of this year, the activities of the Chamber of Deputies will be focused on analyzing, discussing and approving the economic package for 2022. Unlike the last three years, in which Morena held a qualified majority to approve it, this year will be different. Negotiations are expected to be more extensive and become a bargaining chip to push opposition projects.

Likewise, various officials of the federal public administration have given mixed signals regarding the economic package. President Lopez Obrador and the current Secretary of Finance and Public Credit have stated that there will be no increase in rates or taxes by 2022. On the other hand, the head of the SAT, Raquel Buenrostro, stated that the government's tax collection will increase by 200 billion pesos compared to 2021; a fact that is almost impossible if rates or taxes are not updated.

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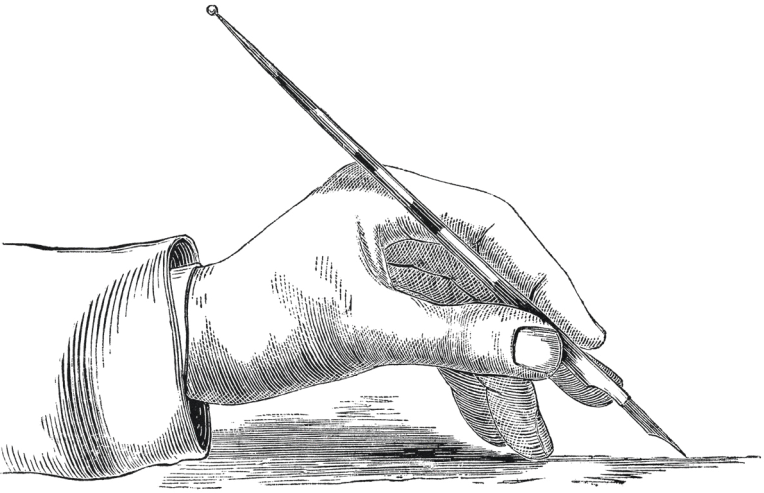
This publication is produced by a committed, multidisciplinary team. Our goal is to take the economic, political and social knowledge of the manufacturing industry to the next level.

By disseminating our findings, we seek to raise the level of public debate. Share and comment freely, let's start the dialogue.



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