The FTA and direct foreign investment from non-member countries

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DIRECT FOREIGN INVESTMENT (DFI) in the United States has grown rapidly over the last decade. In 1980 it was reported as being 83,046 million dollars, while in the last nine years it had risen to 400,817 million (Survey of Current Business, 1990).

This unusual increase in direct foreign investment in the U.S. can be explained mainly by two factors. First of all, locating production plants in U.S. territory makes it possible to enter the U.S. market in better conditions and/or evade customs restrictions. Secondly, it enables producers to avoid possible future protectionist measures.

As Mexico is about to enter into a free trade agreement with the United States and Canada this subject is of relevance for our country because, as the trade border is gradually done away with, we may be able to attract part of this foreign investment here, as the objective of achieving a share in the American market may then be possible from installations located in Mexico.

This article attempts to give a preliminary opinion as to the likelihood of this. With this aim in mind, I shall first analyze Mexico's strategic position once the free trade agreement is set up. Secondly, I shall speak of the role that rules of origin will play in attracting DFI and, finally, I shall talk about the alternatives for U.S. and Canadian capital, and that of other countries cooperating with Mexico.

The globalization of economic processes is the concrete result of the great capacity that the industrial corporations have developed for scattering their production activities over a wide geographical area. Just a few years ago, location possibilities were limited basically to one's own national territory. Now the choices for locating production units may cover the whole world. There may be several countries where one and the same production process could be located and, of course, several options within each of them.

Direct Foreign Investment (DFI) in the U.S. has grown rapidly over the last decade. Its relevance for Mexico, on the eve of the Free Trade Agreement with the U.S. and Canada, is that part of this investment capital might be lured south; money that can help Mexican business establish itself in the American market from installations on either side of the border.

The freedom to locate production processes or fragments of them in the best possible place according to their requirements in labor or any other production factor is the result of technological progress in transport, in information systems and in the development of the industrial organization's administrative capacities.

Technological and administrative development, which have given a freedom never before known to set up production plants makes it possible to

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use the location of plants and processes not only to bring down costs, but also as a purely strategic tool. That is, to achieve objetives that are not necessarily linked to considerations of the production process itself.

Direct foreign investment makes it possible to reduce frictions caused by deficits in trade balances, to negotiate with particular interest groups in each country, to avoid customs barriers, or simply to take advantage of the artificial differences that national borders promote.

During the years of protectionism in Mexico, investments were made by large industrial corporations which -as they could not export to Mexico from their traditional locations- were obliged by tariff regulations to produce these same goods within the country. Although this process was based on conditions peculiar to Mexico and to the period when these investment took place, we can now see a similar movement in direct foreign investment in the newly forming economic blocs.

Direct investment on the part of countries which are not members of the blocs has started to increase. In the case of Europe, developed countries outside this bloc -due to the possible intransigence of trade policies- have begun to make direct investments in the EC countries. The United States, Japan and Canada, among others, have set up their "beachheads" on the old continent, hoping thereby to have a share in the strengthening of the inter-European market and avoid being excluded from it in the future.

Now, with the Free Trade Agreement between Mexico, the United States and Canada, there may well be a similar movement of capital. The question is: Where will the new investments choose to locate?

In order to answer this question, it is necessary to take into account that industrial investments are not for fully integrated work processes, as was the case at the stage of worldwide expansion of capital. Industries now fragment their production processes, locating them wherever they find the best conditions for each one of the fragments. This location logic suggests that foreign investments seeking to obtain a share in the market developing in North America will probably decide to install complementary production processes in more than one country.

That is to say, we may expect simultaneous and complementary investments in Mexico, Canada and the United States or in any combination of the three. This will be the case for new investments. However, it is also logical to expect some readjustments among foreign investments already operating in Canada and the United States.

One of the expected effects of the FTA is a reorganization of production processes at the territorial level, as there will be more space open to investment decisions. In other words, we can expect transfers of production processes to any of the three member countries.

However, as the trade border between Mexico and the northern market gradually disappears, Mexico will have large comparative advantages for attracting investment from other countries, as well as from Canada and the United States. For example, the low cost of labor, the development of medium-sized cities offering a wide range of possible locations, and the proximity to the United States and Canada.

Furthermore, one can clearly see how foreign investment from non-member countries reacted rapidly when there were partial reductions in the "trade border" between Mexico and the United States (proof of this is to be seen in the "maquiladora" program). A prominent example of this rapid reaction has been Japanese investment in Mexico's northern border area[1]; investments that, by locating in Mexico, capitalize both on the cost of labor and the fact that the "maquiladora's" output is considered as being "Mexican" for accounting purposes[2].

On many occasions and in different forums and media, various groups have spoken out against Japanese plants in Mexico, objecting to the fact that their production is destined for the American market. It is pointed out that the Japanese evade taxes, or that in this way they are enabled to cope with possible restrictions in the future. There is also the concern of "organized labor and some manufactures in the United States who fear being displaced by Japanese firms based in Mexico (Sekely, p. 3)."

With such antecedents, it is sure that the participation of other countries in a program intended for American firms will lead to more discussion in the FTA negotiations on rules of origin, whose main objective is to restrict and regulate other countries' share in the benefits brought about by the reduction in obstacles to commerce within the free trade area.

Investments on the part of non-member countries, by locating in

[1] Japanese investment in "maquiladora" plants has increased very rapidly. In 1988, there were 50 Japanese plants of this type (JETRO-Mexico 1990). In relative terms, the Japanese share in the "maquiladora" industry is limited, only 3.3% of the total number of plants. However, it is outstanding for the amount of investment per worker, and the size of the plants (see González-Aréchiga, 1988).

[2] The aim of the large Japanese corporations' investments on the northern border is to penetrate the U.S. market, taking advantage of the better tariff conditions. "Setting up in Mexican territory enables them to have access to the U.S. market in better conditions, since in spite of the little value added generated in the "maquiladora" plant, because of the fact that they are made -or rather assembled, in this case- in Mexico, the products enter the USA as Mexican exports (SDU), 4.IV.87)."

Mexico, seek and will continue to seek, primarily, access to the U.S. market. However, in order to qualify in the FTA they must comply with the regulations that such an agreement will set up for other countries.

The rules of origin are the conditions that decide whether an article produced in a particular country of the three taking part in the agreement should be considered as a national product. It is likely that both on this subject and on others, the clauses already approved in the bilateral agreement between the United States and Canada will be retained. Rules of origin established in that agreement consist basically of the following concepts:

First of all, any product leaving the territory of either of the contracting parties will be considered as national "if it has been *transformed* in the territory of one or both parties, in such a way that it undergoes a change of classification or, if this is not the case, is included within the clauses authorizing goods that do not change their classification (United States-Canada Free-Trade Agreement, Implementation Act of 1988 Sec. 202, IB)."

On the other hand, "an article will not be considered as originating in the territory of one of the parties (under the above terms), if it has only undergone packaging or mixing operations (except for processes contemplated in the agreement itself) (*op. cit.* Sec. 202, 2A, B, C).

"In the case of articles that undergo no change in classification during the process located in the territory of one of the parties, it will be considered that they have been transformed in the territory of one party and will be treated as a product originating in the territory of one of the parties if:

The value of the materials originating in the territory of one or both parties, that are used in the production of goods in the territory of one or both parties, constitutes no less than *50% of the value of the goods* when they are exported to the territory of one of the parties (*op. cit.* Sec. 202, 3B)."

These restrictions make it clear that operations of the "maquiladora -type", with a high content of foreign (non-Canadian or non-American) inputs and production processes that are merely assembly, are excluded from the benefits of the agreement unless they can demonstrate a high degree of input on the part of the economies of the countries signing the FTA, in which case their products are not subject to the heavier duties now in force.

At first glance, the rules of origin appear to be an obstacle to attracting direct foreign investment to Mexico, as they might discourage investors who seek an "easy" -duty-free- bridge to the U.S. market. With the approval of the fast track, differing opinions have appeared in the Mexican press with regard to the FTA, in particular warnings of the negative impact of the rules of origin for Mexico.

It has been categorically pointed out that if these rules are applied "it would practically shut the door to the possibility that has been talked of a good deal in the last few months, of foreign investment pouring into Mexico to set up 'maquiladora' plants alongside the largest market in the world and in the paradise of cheap labor (Chavarría, 1991)."

On the contrary, in my opinion the rule of origin not only does not eliminate Mexico's comparative advantage (as the rules apply in the three countries) but, in addition, it might be used to help achieve the objetives that have always been pursued through foreign investment. That is, transfer of technology, training of labor, integration into the national economy, etc.

In spite of the fact that this subject will have to be handled very carefully in the negotiations, thinking that the rules of origin are only a tool to benefit Canada and the United States is equivalent to imagining the only possible role for Mexico as that of the "biggest 'maquiladora' in the world."

The certificate of origin may, and must, become a strategic tool for getting the greatest benefits from DFI. This will only be so if Mexican entrepreneurs and the government assume a definite position in which joint participation is sought in new investment projects. It must be admitted that Mexican industry's

With regard to foreign investment, regulations were thoroughly revised and simplified in mid-1989. In activities that today amount to nearly 60% of GDP, investors from other countries can start up businesses with capital of up to 100 million dollars without requiring any kind of authorization from the Government. Full foreign ownership is allowed in activities representing an additional 14% of GDP, subject to a review and authorization process that cannot take more than 45 working days. Minority participation is allowed in activities that generate a further 7% of GDP, and the rest is reserved either to Mexican nationals or the Government. In the near future it is expected that these current regulations will become Constitutional law, thus assuring permanence in the flows of foreign direct investment.

Source: MEXICO: AN ECONOMY ON THE MOVE, Department of Economic Studies, BANAMEX (Banco Nacional de México).

lack of integration with the "maquiladora-type" industry is largely explained by the passivity of Mexican entrepreneurs.

In Sekely's words, "One powerful explanation for this situation [the lack of strong linkages with Mexican suppliers] that is often overlooked is that entrepreneurs in the heartland of Mexico remain largely indifferent to the fact that, in the midst of a nationwide recession, there is an industrial boom on Mexico's northern border."

The free trade agreement on the horizon and all the new conditions stemming from it will require -if we are to take full advantage of it- a radical change in the Mexican entreprenuers' way of doing business. Without this far-reaching change, the benefits of the FTA will flee to more dynamic economic areas.

Thus we must seek and experiment with models of operation that have not been used in Mexico as much as they should. One must not lose track of the fact that the globalization of the world economy remains in a stage of experimentation, finding alternative means of cooperation between the different industrial corporations.

For example, the so-called "joint ventures or cooperative agreements between companies which provide relatively cheap means for the competitors to gain access to technology and penetrate key markets."

Other types of cooperation that would enable other countries to share in the North American free trade area have been clearly set out by the Mexican-German Chamber of Commerce and Industry. In addition to the already described model, it proposes, among others, "Cooperation Projects" that consist of drawing up agreements between firms in which the foreign party is only a technological, not a financial, partner. The foreign company would further the transfer of technology, provide production installations and also draw up a long-term cooperation agreement that includes licenses, training and transfers of technical knowledge (Von Othegraven, 1991)."

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This is merely one example of the possibilities that exist for setting up cooperation projects between countries outside the FTA and Mexico. We have much to gain from them, not only with regard to the creation of jobs, but also the transfer of technology, the incorporation of Mexican inputs, training of labor at all levels, and the assimilation of more aggressive business techniques.

That it is so obvious should not make us overlook the fact that this type of cooperation ought to be put into practice mainly with Canadian and American partners. In spite of all we have already said, Canada and the USA will also benefit from other countries' direct investment in Mexico. First of all, because it will certainly generate new investments in their countries and, to the extent that Mexico's economy grows, there will be increasingly large benefits to be reaped by their economies too.