5. Political Risk and FDI in Mexico
5.1 Politics in Mexico
5.1.1 Stylized Facts of Mexican Political History

After independence from Spain in 1821 Mexico experienced long periods of political instability, civil wars and quickly changing governments caused by the struggle for power that was unfolding between liberals and conservatives. Moreover, Mexico experienced the invasion of the country by the United States followed by a loss of large territories as Texas, Alta California and New Mexico. Under the liberal rule of Benito Juárez from 1859 to 1872 that was based on the Constitution of 1857 important changes were implemented as for example the abolition of preferential treatments for members of the military and the church as well as the obligation of the church to sell its large possessions of land. As a reaction to this liberal policy Mexican conservatives eagerly tried to convince European powers of the necessity to provide aid for restoring their power. When Mexico asked for a two years moratorium on its external debt, the French government decided to invade Mexico in order to enforce its claims forcing Juárez to exile in the north of Mexico. After the successful invasion the French enthroned Maximilian of Habsburg who should later be executed by the eventually victorious liberals. This long period of political turmoil ended when Porfirio Díaz established his authoritarian government in 1877. Although de jure a democratic republic based on the constitution of 1857, the rule of Díaz was characterized by his personal dominance in all sectors of government. He used appointments to reward supporters and left a national administration with a high fraction of military officers and businessmen. This technique which was generously applied produced corruption in all levels of political life and enhanced the political culture that public office was rather a reward to be taken advantage of than a public responsibility. Díaz reversed the cautious process of decentralization that was begun under Juárez by concentrating power in the hands of the national government. To further strengthen the federal government Díaz engaged in largely expanding the national bureaucracy. The power of the judicial and the legislative branch were decreased making them subordinate to the presidency and public elections were merely held to anew the loyalty of the Mexican people to the regime of the dictator. Opposition was suppressed by imprisonment, threats and violence while the press was subject to censorship. Typically lower social groups, and in particular indians that were believed to be racially inferior and an obstacle to national development, were the victims of the most violent oppressions. As power was largely concentrated in the hands of Díaz, his successors inherited an institutionally weak political system that lacked legitimacy and an extremely large, corrupt state apparatus as well as a society with severe inequalities. This inequality, the oppressive and racist nature of the regime that largely ignored the interests of workers and peasants as well as the favoritism towards foreigners and foreign corporations led to the outbreak of the Mexican revolution in 1910. The revolution of 1910-20 marks the beginning of modern Mexican political history with the revolutionary

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1 See Córdova Vianello (1994).
constitution of 1917 still being in effect. Although the 1917 constitution draws very much on its predecessor from 1857, it additionally establishes revolutionary principles concerning the separation of church and state, labor regulation and rules that were aimed at reducing the foreign domination of the Mexican economy.³

The Mexican revolution again implied long years of political instability with quickly changing governments, large numbers of deaths in the population and a severe economic crisis. Although the military phase of the revolution ended around 1920, the time until 1940 was characterized by political instabilities and occasional violent societal conflicts. In an initiative of president Calles, who ruled from 1924-1928 but dominated political life during the so-called maximato for six more years the Partido Nacional Revolucionario (PNR) was founded in 1929. Calles designed a ruling party with corporatist structure which could channel the different ideological positions in the revolutionary movement to avoid the outbreak of further violence. This party that should later change its name to Partido de la Revolución Mexicana (PRM) in 1938 and then to Partido de la Revolución Institucional (PRI) in 1946 should remain in power until the year 2000 when Vincente Fox became the first Mexican president that was not a member of the former governmental party. The renaming of the party in 1938 by president Cárdenas was accompanied by an reorganization of the party in corporatist lines with separate sectors being created for labor, the peasantry, the military, and middle class groups.⁴ If the initial goal of this reform was to provide a framework for the expression of popular demands, the system soon became an instrument of political control and electoral manipulation. In exchange for granting political and economic benefits to sector leaders the party could ensure its power. The change of the official party's name in PRI in 1946 signaled a turn away from the revolutionary upheavals of the Cárdenas years in favor of political stability and economic development.⁵ Hence, the response of the Mexican leaders to the enduring political instabilities and the massive devastation of the revolution was as CHAND writes

"to create a highly centralized political system with an extremely powerful president and a dominant state-sponsored political party, whose function was to garner support for the revolutionary elite and ensure that social demands were channeled through the confines of the official party, where they were more easily controlled."⁶

Although the Mexican constitution proclaims the separation of powers and a system of checks and balances that allows for a control of the executive branch, the reality was characterized by a president ruling without any

³ The constitutional rules are further explored in the paragraphs on the branches of government. Paragraph 5.2.2.1.1 discusses the economic implications of the 1917 constitution for FDI.
effective control of the legislative branch or the judiciary.\textsuperscript{7} This particular organization of the PRI implied that a clear distinction between the party and the state was no longer possible. The status as "official" party ensured the party's superiority vis-a-vis the opposition parties in terms of media presence, financial resources and government patronage. PRI candidates for public offices were not democratically elected but chosen by an intimate inner circle of the party usually led by the president. This political practice of handpicking candidates was also applied for presidential candidates. The so-called \textit{dedazo} meant that the current president chooses the next PRI candidate to run for the presidency. Considering the dominant role of the PRI in Mexican politics picking the presidential candidate was equivalent to choosing the next president of Mexico.\textsuperscript{8} If, despite of their superiority in every respect, PRI candidates failed at the polls, the regime took advantage of electoral fraud to ensure the victory of its candidate. Although violent repression has never been used systematically, the government occasionally resorted to coercive measures to suppress dissident movements.\textsuperscript{9} During the 80s the PRI cautiously initiated reforms that should finally foster democracy and strengthen the opposition.\textsuperscript{10} This process of democratization was in part initiated by the party itself but also a reaction to the popular demands for more democracy in Mexico. A starting point for massive public protests was the gubernatorial election in the state of Chihuahua in 1986 that was characterized by massive irregularities. This fraudulent election provoked a wave of protests among the Mexican population including many civil organizations and the Catholic church that threatened to suspend service if the elections were not annulled. Protest continued after the fraudulent presidential election of 1988 where the popular PRI dissident Cuautémoc Cárdenas and the PAN candidate Manuel Clouthier challenged the PRI candidate Carlos Salinas de Gortari. Although there is some evidence that Cárdenas won the election, Salinas was announced winner and took the presidency.\textsuperscript{11} Repeated experiences of electoral fraud and growing discontent with the regime finally obliged the PRI to enact electoral reforms that strengthened the role of the opposition and culminated in the election of the PAN candidate Fox in 2000.\textsuperscript{12} The problem of electoral fraud

\textsuperscript{7} See Penner (1999) p. 39-47. For a more detailed analysis of the president's, the legislatives' and the judiciary's role in Mexican politics see paragraph 5.1.2.2, 5.1.2.3 and paragraph 5.1.2.4 respectively. As Pritzl (1997) points out an inefficient separation of powers is a characteristic of many Latin American countries. See Pritzl (1997) p.64-80.

\textsuperscript{8} The PRI stopped this practice in 1999 under the rule of president Zedillo when for the first time in the history of the PRI an open presidential primary was held that eventually chose Francisco Labatista as the PRI candidate for the presidential race in 2000. See Camp (2003). Despite of this move towards democratization it is argued that the primary was in fact a disguised "dedazo" because of the privileges Zedillo's candidate Labatista enjoyed. See Langston (2002) p.80.

\textsuperscript{9} The most prominent example are the student massacre that took place in 1968 where hundreds of protesting students were shot on the Tlatelolco square in Mexico City and the violent repression of student protests in Corpus Christi in 1971. But there are several other examples for violent repression. See Philip (1992).

\textsuperscript{10} Semo (1996) gives an overview over the initiating phase of the democratization process.


\textsuperscript{12} For a short overview of the electoral reforms see Swan/Martorelli/Molinar (1998).
was tackled by the creation of the Instituto Federal Electoral (IFE) to supervise the electoral process, the financing of parties and competitive access to the media.\textsuperscript{13} The growing importance of opposition parties in congress and on the regional level slowly established a system of checks and balances that helped constrain the power of the federal government and to break the dominance of the PRI.\textsuperscript{14} Consequently, from the late 80s onward Mexico changed from being an authoritarian one-party state to becoming a multiparty democracy with a competitive electoral process. Moreover, the extremely powerful position of the presidency was opposed by a stronger congress and a more independent judiciary which are now posing limits to the executive branch of the Mexican government.\textsuperscript{15}

5.1.2 The Current Political System in Mexico
5.1.2.1 Overview
This paragraph describes the main characteristics and institutions of the current Mexican political system. Due to its high complexity the description will be limited to mechanisms that are important for the analysis of political risks emerging from its institutional characteristics.\textsuperscript{16} Before the different branches of the system are reviewed in greater detail this paragraph offers a brief overview of important characteristics of Mexican politics. Mexico, the official name of which is the United Mexican States, is a federal republic of 31 states and one federal district with the states being divided into 2394 municipalities. The capital and seat of government is Mexico City which is also the cultural and economic center of the country. De jure Mexico is a presidential democracy with many similarities to that of the United States. It is based on a constitution that was passed during the Mexican revolution in 1917 which divides power between an executive branch, a legislative branch, the judiciary and the federal states. The executive branch of federal government is represented by the president of the republic who is publicly elected for a six year term and a cabinet of 19 agencies. The legislative branch consists of a bicameral congress that is divided into a 128-member Senate and a 500-member Chamber of Deputies. Senate elections are held every six years. Chamber of Deputies elections are held every three years. On the state level governors, town councils and mayors are directly elected by the population. The judiciary has local, state and national levels the last comprising a court of appeals and a supreme court that may overrule legislation that violates the constitution. The main parties of the political spectrum are the former state party PRI (Institutional Revolutionary Party), the conservative National Action Party (PAN) and the leftist Democratic Revolutionary Party (PRD) with 51 seats. Smaller fractions are the Labor Party (PT) and the Ecologist Green

\textsuperscript{13} For a detailed description of the IFE and its role in ensuring fair elections see Prud'home (1998).
\textsuperscript{16} Camp (2003) and Castro Rea et al. (1999) offer an excellent initial overview over the Mexican political system.
Party of Mexico (PVEM). The seat distribution in the Senate is still characterized by a majority of the PRI with 60 seats followed by the PAN, PRD and PVEM with 46, 15 and 5 seats respectively. A general principle of the Mexican political system is the principle of no reelection to any political position in the Mexican government including all seats in the federal and state legislatures. Although there was a lot of progress in this matter during the last years, the press and media remain partly controlled. For a long time the federal government retained direct control over the press through its monopoly of newsprint. In the second half of the 90s the ability to control government advertising remained. Too critical media or press coverage of political events may therefore be sanctioned with the withdrawal of government advertisement contracts. Inherited from the interventionist past the federal government still operates public enterprises in economic sectors like petroleum, petrochemicals, electricity, communications, transportation, and agriculture.

"La silla presidencial está embrujada: cualquier persona buena que se sienta en ella se convierte en mala"
Emiliano Zapata

5.1.2.2 The Executive Branch of Government

One of the keys to understanding Mexican politics is the role of the national presidency because since independence all of Mexico's political systems have been based on presidentialism. This means that the executive power lies in the hand of the president who is publicly elected for a six year term or sexenio without the possibility of being reelected. Despite of similarities with the US system the powers of the Mexican president went far beyond those that are found in other presidential democracies. In fact, the dominant role of the president is not a consequence of his constitutional powers but of a combination of de facto structures in Mexican politics. Many scholars refer to the presidency as an institution with "meta-constitutional" powers. Therefore, the de facto rules of Mexican government differ to a large extent from the de jure rules of the Mexican constitution which establishes a strict division of power. A close look on historical presidential governments reveals that since the official party PRI was founded in 1929 the Mexican president has been the dominant force in national politics. Before the reforms enacted by the administrations of Zedillo and Fox the position of the president in Mexico could

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17 This constitutional principle is a revolutionary heritage caused by the dictatorship of Porfirio Diaz who ruled the country from 1877 to 1911.
18 See PRS Group (2003). The change of government in 2000 limited the possibility of the PRI to influence the press.
19 For a history of Mexican presidentialism see Córdova Vianello (1994).
20 The principle of no re-election has not been violated during the last years. See Philip (1992).
21 See Sutherland (1999). The author does not enter here the controversial discussion of the political science literature if presidential governments are generally inferior to parliamentary democracies. For an overview of the discussion see Mainwaring/Shugart (1997). For a detailed criticism of presidential democracies see Linz/Valenzuela (1994).
22 See Weldon (1997) for a detailed analysis of the factors that enable these meta-constitutional powers.
23 See Penner (1999).
be compared to that of “an absolute monarch for six years”. Article 71 of the 1917 constitution enables the president to initiate legislation which comprises the right to initiate amendments of the constitution. Article 72 states that the president can veto legislation and only be overturned by a two-thirds vote of congress. In addition the president had the right to nominate ministers, the judiciary, high rank officials and important party leaders, to name the mayor of Mexico City and to remove state governors and congress members from office. Between 1946 and 1996 presidents removed 67 governors and during the Salinas administration 17 publicly elected governors resigned “voluntarily” and were replaced by members of the presidents inner circle. Thus, in spite of the federalist system established by the constitution Mexican politics are in fact highly centralized. In addition to his legislative powers the Mexican president may issue regulations that serve as guidelines for the interpretation of existing legislation. The president may nominate and remove all members of his cabinet, as well as name diplomatic officers, military officers of a certain rank and supreme court judges with the latter necessitating the approval of senate. Moreover, before Zedillo presidents made use of the so-called dedazo to name their successor. Although the constitution does not provide the president with extraordinary decree powers, he was granted the right to regulate domestic and foreign commerce including taxes, tariffs and subsidies on his own account as well as to intervene in monetary policy.

However, more than the constitutional powers of the president, his partisan powers, that is, his ability to control congress and his own party, are responsible for the large extent of his power. It is highly probable that the powerful position of the head of state erodes when he faces a congress dominated by opposition parties. In fact, an important reason for the strength of the presidency in Mexico was the fact that the disciplined PRI dominated congress and approved nearly all presidential bills without amendments.

25 The mayor of Mexico City is now publicly elected.
29 Currently, the Bank of Mexico is an independent organization. Since 1994 the NAFTA treaty also limits the presidential power in the design of economic policy. In the case of invasions and severe disturbances of internal peace the president gains extraordinary decree powers. The extraordinary powers of the presidency in economic policy relied on a constitutional amendment that has been passed under the rule of president Miguel Alemán. See Carbonell y Sánchez (1994).
30 The experiences of president Fox who faces a congress that is dominated by opposition parties show that the power of the president is now effectively constrained by the legislative branch as several presidential bills have not been passed.
31 See Weldon (1997). As Philip states: “The PRI was not designed to represent the views of an articulate membership, but to reward conformity and control elections; all efforts to reform the PRI by turning it into a members’ party have been successfully resisted. Philip (1992) p.165. For a more detailed analysis of the role of congress see paragraph 5.1.2.3.
simple formality. To illustrate the latter point table 5.1 depicts the bill success rate of the Mexican president for two different legislative periods.

Table 5.1: Bill Success Rate of the Mexican Presidency

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<tr>
<td>Bills Presented</td>
<td>274</td>
<td>677</td>
</tr>
<tr>
<td>Executive Success Rate</td>
<td>99%</td>
<td>90%</td>
</tr>
</tbody>
</table>


The presidential control of congress and the minor role of opposition parties implied that the president was even able to change the constitution with high discretionary power. Since its establishment in 1917 the constitution has been changed more than 350 times according to the current political and societal necessities. These constitutional amendments have been used to implement government policy or to further strengthen the power of the executive. The presidential gain in power by the lacking control of congress over bills is enforced by the lacking control of the judiciary. The weakness of the other branches of government implied that the Mexican president played the decisive role for all political decisions including economic policy. The joint responsibility of the presidential office for such diverse matters as fiscal policy, national health, ecological norms, national education, social policies and the national economic strategy made the president the veritable geometric center of the political system.

Another important factor that influences Mexican presidential politics is the camarilla-system. A camarilla is a group of political actors who share political interests and rely on one another to improve their chances in political leadership. The Mexican political system is permeated by these clientelistic relationships that have been formed over long periods of time and are based on personal loyalty. A camarilla leader who ascends in an organization places the members of his group in other influential positions. As the Mexican political system does not permit a re-election of the president the supreme patron and his camarilla are removed every six years and replaced by the new presidents group. One immediate consequence of this system of personal loyalties is that the responsiveness and accountability of officials is greatly diminished. Moreover, it is an important source of political discontinuity. A recent study reveals that 80% of top office holders are replaced every 12 years and 90% every 18 years. At the end of each administration nearly one third of top-level

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32 See Rubio et al. (1994) p.25. This extraordinary power was exercised until 1988 when the PRI lost the necessary two-thirds majority in congress. See Sutherland (1999).

33 See Penner (1999).

34 See paragraph 5.1.2.4.

35 See Bolaños Guerra (1994).

players drop out of political life. So every six years 18,000 publicly elected posts and 25,000 designated posts are changed. 37

The reforms of Zedillo and Fox as well as the loss of the PRI majority in congress marks the end of unchecked presidential rule. It remains to be seen how the role of the president will be changing subject to these alternate conditions. In any case the analysis of the president's position in Mexican politics shows that before the recent reforms the executive power was hardly limited or controlled by any other governmental branch. 38 This lack of checks and balances often led to arbitrary decisions of the president that highly affected the well-being of the Mexican people and implied a massive abuse of power for personal or political ends. 39 Therefore, the quality of Mexican policy depends to a large extent on the personal qualities of the currently ruling president. 40 According to the so-called pendulum theory the policy of Mexican presidents swings from left to right following the preferences of the president and his camarilla. 41 The most prominent example of an economic policy that has been essentially shaped by a president is the term of president López Portillo. One observer classified his economic policy as a presidential economy rather than a policy that was conducted following any specific economic doctrine. There is evidence that in the years preceding the debt crisis the president personally blocked necessary cuts in public spending that were proposed by his advisors. 42 However, the most prominent example for his arbitrary decisions is the nationalization of the Mexican banks in 1982 that was announced without warning. The president obviously decided on this matter without consulting sufficient advice and considering affected groups. 43 The nationalization of the banks and the exchange controls were imposed by an executive decree. Article 28 of the constitution that prohibits monopolies was amended with a new paragraph that allowed for the bank nationalization

38 Rubio et al. state: "nuestro sistema constitucional de frenos y contrapesos de hecho no funciona porque los distintos órganos de poder no tienen intereses contrapuestos ni capacidad institucional de defenderlos." Rubio et al. (1994) p.168.
39 See Comelius (1996). As one observer states: "No matter how irrational a project may be in the eyes of specialists, if the president approves it, it must be carried out". Cited by Morris (1991) p.37. The detailed analysis of four presidential terms by Philips (1992) confirms the result that presidents often carry out arbitrary acts that have an important impact on the economy.
40 A British observer commented: "It seems to me that this system is workable only so long as the candidates successively selected by the retiring president are people of restraint and sound common sense. The opportunities for abuse of power and the apparent lack of any of the normal checks and balances usually associated with democratic regimes do not offer any guarantee of permanent political stability. Cited by Philip (1992) p.169. Philip (1992) argues that the presidential terms of Diaz Ordaz (1964-1970), Echeverria (1970-1976) and in particular López Portillo (1976-1982) were characterized by weak ruling performances.
which was again suspended in 1990 when president Salinas initiated the reprivatization of the banks. The nationalization of the banks is not the only example for arbitrary changes of the constitution according to political objectives. See Rubio et al. (1994).

44 The fact that a single political actor can make decisions that deeply influence the economy may serve to illustrate the inherent dangers of this massive concentration of political power.46

5.1.2.3 The Legislative Branch of Government
De jure the Mexican constitution provides the legislative body of the Mexican political system with great powers.47 The chamber of deputies and the senate have the right to present fiscal initiatives, to control the annual budget and ministers as well as to participate in the designation of important officials in public administration. Considering these constitutional powers of the Mexican congress one is attempted to conclude that its power is similar to that of the US congress. However, as already pointed out, during the last 70 years the presidency exerted the central role in Mexican politics. The reasons for this de facto weakness of the Mexican congress stem from the particularities of the Mexican political system. One important reason is the minor role of opposition parties. Between 1940 and 1961 the percentage of seats in the chamber of deputies attributed to the PRI attained 96%. Due to cautious political reforms that strengthened the role of opposition parties this percentage fell to 83% and 61% for the periods 1964-1976 and 1979-1994 respectively.48 The distribution of seats in the senate during the last years followed similar patterns. Until 1988 the PRI controlled 100% of the seats in senate.50 Opposition parties therefore had little influence on policy making.51 However, it may be argued that the long time dominance of one party does not necessarily imply a weak position of the congress. What additionally reinforces the presidential power in the Mexican case is the principle of no reelection of legislators, the high internal discipline of the PRI and the fact that until 1994 the president was simultaneously head of the PRI.

To allow for a better understanding these particularities will be examined more closely. In the first place the constitutional principle of no reelection hinders the development of legislative knowledge by members of congress. The complete

44 See Maxfield (1990).
45 Elizondo (2001) argues that the expropriation of the banks was not an illegitimate violation of property rights since the Mexican constitution permits the discretionary restriction of property rights by the president. Paragraph 5.3.3.4 gives a more detailed analysis of the risk of expropriation in Mexico.
47 In the 1960s Vernon commented the role of the Mexican legislature as following: "... in practice, the legislature is a passive creature which hardly ever fails to carry out the wishes of the president; independent action on its part is almost unknown." Vernon (1963) p.11.
change of congress members after every election avoids that legislators gain experience in the complex programs and procedures of government which impedes a continuity in legislative policy of congress. Moreover, this principle leads to strong incentives for legislators of the president’s party to remain loyal as their political future entirely depends on the benevolence of the party leader to assign them to lucrative posts. So every member of congress, independent of the party he belongs to, has an incentive to rather vote according to party discipline instead of representing the interests of his constituencies.

Up to the times of Zedillo the president was simultaneously head of the PRI. It may be argued that this fatal combination was the source of presidential dominance and the de facto irrelevance of the Mexican congress. Consequently presidential bills to congress nearly always passed without substantial amendments of the legislative body. In fact there have been no serious conflicts neither between the two legislative bodies nor between the executive branch and congress in the past. The bill success rates that were presented in table 5.1 are an important empirical evidence for the minor role of the Mexican congress in shaping governmental policy. Thus, the long year dominance of the PRI in congress, the president’s role as head of the PRI and high internal discipline within the party combined with the principle of no reelection implied that the legislative’s role to provide for checks and balances of the executive branch of government could not be properly executed.

The minor role of congress as an institution of democratic control of government is also reflected in the low esteem of Mexican citizens of congress that is illustrated in table 5.2. While 83% of US citizens expressed confidence in congress in 1990 the corresponding figures for Mexico are 16%, 28% and 21% for the years 1988, 1998 and 2000 respectively. Moreover, the confidence of Mexican citizens in national political parties is considerably lower than in the US although here the difference is less striking.

Despite of the negative view of citizens, the role of the Mexican congress is gradually strengthened by the growing importance of opposition parties. The first important step to a better control of executive power was the national election of 1988 where the PRI for the first time in history lost its two-thirds majority in congress that is crucial for constitutional amendments.

52 See Massicotte (1999).
55 See Weldon (1997) who analyses in greater detail the prerequisites for the metaconstitutional powers of the Mexican presidency.
56 See Massicotte (1999). The exception in Mexican history is the time of the so-called “maximato” (1928-1935) when the former president and party leader Calles dominated congress and the direction of Mexican policy. See Weldon (1997). Morris states that “congress has historically served as a virtual rubber stamp to presidential desires”. Morris (1991) p.27.
Table 5.2: Confidence of Mexicans and US Americans in Congress and Parties

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<tr>
<td>Congress</td>
<td>83</td>
<td>16</td>
<td>28</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Political Parties</td>
<td>-</td>
<td>56</td>
<td>-</td>
<td>29</td>
<td>20</td>
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In the midterm elections of 1997 the PRI even lost its majority to the opposition parties leaving president Zedillo faced with a majority of the opposition parties in congress. The experience of the first years with higher opposition control suggests that the role of congress in Mexican politics becomes more important. The current president Fox essentially faces the same situation as congress is not controlled by a majority of the president’s party PAN. Hence, the beginning democratic transformation of the Mexican political system implies that the traditional “presidencialismo” of former years is no longer existent. With this particularity of the semi-authoritarian past diminishing the importance of congress for the design of Mexican politics is expected to be growing in the future. This process implies that the Mexican legislative branch is changing from a de facto irrelevant institution to a legislative body that may be able to fulfill the tasks that it is contributed to in the constitution. That is to say, that for the years to come one may expect a more effective control of the national executive by the legislative branch of government that may better limit arbitrary executive actions.

5.1.2.4 The National Judiciary

As already pointed out in paragraph 3.1.2.4 a functioning judiciary is essential for democratic countries with market based economic systems. Like in the US the Mexican judicial system has courts at the local, the state and the national level, the last comprising a court of appeals and a supreme court. At present the supreme court consists of 11 judges that may serve for up to 15 years and are appointed by the president with a two-thirds approval of the senate. These current rules are the result of an ambitious judicial reform that has been enacted under the rule of president Zedillo to fight the inefficiency and the corruption that prevailed in the national judiciary. In part the reform is a reaction to the violation of the principle of the separation of powers which, although explicitly stated in the Mexican constitution, has never been achieved. As it was the case for the legislative branch of government, the role

58 Nacif (2003) presents a formal model of the Mexican political system modeling an executive that is constrained by divided government. Despite of critics highlighting the danger of deadlock policy in this situation the model shows that efficient government is still possible through coalition building.
of the judiciary as an independent power in government has not been exerted in the Mexican political practice of the last years. In fact, also the judiciary has been largely dominated by the president as he played a decisive role in the process of the appointment of judges.\(^{60}\)

At the governmental level a supreme court is influential for national decision-making when it is independent from other branches of government and when it can legislate through rulings. The German supreme court for example may declare that laws are violating the constitution which obligates the parliament to alter existing legislation. The Mexican constitution of 1917 establishes no legal base for annulling laws or decrees that violate the constitution. Thus, the power of the court to shape national policy and to control constitutionality by rulings was nearly inexistent or at best inefficiently exercised. The reforms of Zedillo strengthened the role of the judiciary by granting the supreme court the right to decide on the constitutionality of laws and regulations which implies that norms that violate the constitution may be suspended.\(^{61}\) Individual constitutional guarantees however, only offer protection for the citizens if they can be effectively enforced.\(^{62}\) In the past only few individuals could protect themselves against arbitrary governmental acts.\(^{63}\) To foster independence of the court no politicians, government officials or congress members are allowed to be appointed. Additionally the power of the senate in the decision process on the appointment was enlarged to restrict presidential influence. The administration of Fox continued Zedillos policy of strengthening the supreme court which recently lead to some cases in which the judges qualified presidential initiatives as anti constitutional.\(^{64}\) Thus, on the governmental level the reforms enabled the Mexican judiciary to better perform its constitutional role as a counterbalance to the executive power.

In spite of these reforms the lower levels of the judiciary are still taunted by severe problems of corruption, political manipulation and long duration of trials. The lack of transparency and consistency makes it nearly impossible for the average citizen to resort to the system to protect his or her individual rights.

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\(^{61}\) What existed before was a limited form of judicial revision called *amparo* that was focused on the protection of individual rights. See Holland (1999). For a detailed analysis of judicial constitutional control see Castro (2000).

\(^{62}\) As a Mexican jurist states: “La historia ha demostrado que un pretendido derecho sin el respaldo judicial no es más que una declaración en el papel. El problema central de la ley constitucional es encontrar un modo práctico de asegurar al individuo una protección plena y efectiva contra los excesos arbitrarios del poder. Esto sólo es posible mediante la intervención judicial.” Tamayo y Salmorán (1989) p.248

\(^{63}\) In 1992 only 11% of all *amparo*-lawsuits that claimed the inconstitutionality of laws or administrative acts were successful. 77% of the claims were revised because they lacked the necessary formal prerequisites of constitutional claims. In addition, the *amparo* could only protect individual rights but not declare the inconstitutionality of laws. See Rubio et al. (1994).

\(^{64}\) See Camp (2003).
Criminal justice is still characterized by massive human rights violations up to the use of torture to obtain confessions. In particular citizens with low incomes or with indigenous origin are targets of human rights violations as they do not dispose of contacts or sufficient means to pay bribes.65 A sufficiently large bribe in turn, may buy a verdict of innocence or the ignorance of law enforcing institutions towards crime. Additionally the judicial system is bureaucratic and slow which implies that bribes are not only paid for a favorable judgement but also for speeding up the decision. The fact that judges are badly paid further increases corruption and the payment of bribes to judges. The absence of transparency, reliability, integrity and consistency imply that the respect of the Mexican citizens for the law remains low.66 Mexicans do not feel protected by the law since the impunity of criminals may be viewed daily. The same is true for the national police that is widely known for inefficiency and corruption. The low quality and efficiency of the system is confirmed by the low esteem that it enjoys in the Mexican public. Table 5.3 depicts the results of surveys in Mexico and the USA where people were asked if they had confidence in the judiciary and the police.

Table 5.3: Confidence of Mexicans and US Americans in the Judiciary

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<tr>
<td>Law/Courts</td>
<td>-</td>
<td>80</td>
<td>32</td>
<td>31</td>
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The results show that despite of the enacted reforms the trust of Mexicans in the judicial system has not grown significantly during the last years indicating that the efforts were not sufficient. As GONZÁLEZ GÓMEZ writes the unreliability and intransparency as well as the low levels of esteem for the law and the enforcing organizations creates a “culture of illegality” in Mexico.67 Even the winning of the presidency by the PAN in 2000 did not result in higher levels of confidence for the national legal institutions. However, it is to be expected that growing pressure from interest groups inside and outside the country for a better functioning of the Mexican judiciary will improve the situation in the future.68

5.1.2.5 The Political Parties

Up to the year 1988 the analysis of Mexican political parties may be limited to an investigation of the PRI as the only party with a significant level of political influence in society. The official party held large majorities in both chambers of

67 See González Gómez (2001). For a closer analysis of rule of law in Mexico see paragraph 5.3.2.2.
68 See Domingo (1999).
congress and dominated public administrations, the judiciary and other key governmental organizations. The long history of the PRI as the unique, corporatist party that had to integrate all parts of society implied that its influence spread to nearly every important interest group including unions and peasant organizations. This dominant role led to a virtual fusion between the party and the state that resembled the former Soviet Union which is symbolically pictured by the fact that the PRI’s emblem has the same colors as the Mexican flag (green, white and red) and that public social spending used to be accompanied by colorful propaganda evoking the party’s emblem.

The role of opposition parties was merely limited to enhance the legitimacy of the semi-authoritarian regime that was governing Mexico. Despite of their presence in congress their de-facto influence on the design of Mexican policy was severely limited either by repression of the regime or by their lack of unity. The transformation of the Mexican society towards a true democracy during the 90s however, implied a steadily growing importance of opposition parties. The severe problems of inefficiency, corruption and the inability of the one-party regime to enhance public welfare initiated a process of democratization in Mexico that was partly rooted in the growing awareness of the Mexican population of the importance of democracy and partly due to cautious reforms inside the PRI. Faced by the devastating consequences of the Mexican economic crisis during the 80s the population offered massive resistance to the usual governmental practices of corruption, inefficiency and electoral fraud to ensure PRI dominance. One important consequence of this democratic transformation was the enhanced role of the opposition parties in Mexican politics. The emergence of a multiparty system with higher electoral competition completely changed the characteristics of the Mexican political system as opposition parties for the first time faced a nearly level playing field to compete with the PRI. This democratic transformation reached a climax in the 2000 presidential election in which for a first time a non PRI member won the presidential race.

The current political system has five influential parties. The most important in terms of their current electoral support are the former governing party PRI, the conservative-center party PAN, and the left-center PRD that was founded by ex-PRI members. The other two with a lesser share in votes are the Mexican ecological or green party and the labor party. The growing competitiveness and the erosion of the PRI’s superior position imply that the role of the parties inside the political process grows. In the years of PRI dominance the role of

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69 For a detailed analysis of the structure and the functioning of the PRI see Rodriguez (1998b).
70 See Otero (1996) p.11.
71 See Gómez Tagle (1999).
72 See Chand (2001) for an excellent analysis of the sources of the Mexican process of democratization.
73 For an analysis of the party ideology and position in the political spectrum of PRI, PAN and PRD see Moreno (1998) and Rodriguez (1998a)
other parties was reduced to accept presidential bills in congress and to provide a stable basis for executive domination. This domination was further enhanced by the absence of democratic structures inside the PRI that would at least have ensured a competitive electoral process inside the party.\textsuperscript{74} As the ancient regime's practices of executive dominance will no longer work in the current political environment the parties will inevitably become a more decisive force in the Mexican political system. The competitiveness of elections and the absence of fraud are most likely to produce governments that do not face majorities in congress which implies a need of cooperation between parties to enact legislation. Moreover, the former official party PRI will have to modify from being a corporatist party without real need of ensuring electoral success by good governance to an organization that is capable of competing in a multi-party framework. The former opposition parties in turn, have to show how they will perform in governing the country and to overcome the role of being just alternatives to the unique dominating party. Therefore, Mexican political parties will play a major role for the design of future Mexican politics.

5.1.2.6 The Federalist System
By the constitution of 1917 Mexico is a federalist republic where the states play an important role for the government of the country since articles 39 and 41 of the constitution divide power between federal government, state government and the municipalities. On the state level the governors, town councils and mayors are directly elected by the population and the constitution proclaims that local governments are sovereign and independent from the central government in its internal matters.\textsuperscript{75} Despite of these constitutional guarantees during the years of PRI dominance, the autonomy of the states was subject to important limitations. To get nominated as candidate for a post as a local governor politicians usually had to show their loyalty to the federal government. Moreover, like on the federal level, local elections were influenced by fraud, manipulation and repression. In remote areas fraud was even more severe because due to lacking resources it was hard for opposition parties to guarantee free and fair elections.\textsuperscript{76}

To avoid excessive autonomy of regional governors the president often made use of his right to remove state governors from office.\textsuperscript{77} So in spite of the federalism prescribed in the constitution the Mexican political system is de facto highly centralized.\textsuperscript{78} Despite of cautious decentralization efforts since the late 80s Mexico still remains a country where the local entities are in fact highly dependent of the federal government.\textsuperscript{79} Another fact that underlines the reduced role of the states and municipalities is the distribution of fiscal

\textsuperscript{74} See Gómez Tagle (1999).
\textsuperscript{75} See Penner (1999).
\textsuperscript{76} See Chand (2001). In some elections in remote rural areas the PRI obtained "soviet-style" results with nearly 100\% of approval.
\textsuperscript{77} See Rodriguez (1999) and Weldon (1997).
\textsuperscript{78} See Bolaños Guerra (1994).
\textsuperscript{79} See Penner (1999) and Cornelius (1996).
resources. In the past the federal government retained control of 85% of revenues that only under multiple control has been recently lowered by congress to 75%. Like other characteristics of Mexican politics however, also Mexican federalism has been affected by the democratic transformation of the country. More and more local governments are now controlled by opposition parties which implies that the influence of the federal government on local affairs is slowly diminishing. In particular the economically important northern states are by now dominated by PAN governments. In the year 2000 eleven states were controlled by the opposition parties PAN and PRD accounting for 33% of the population and 48% of national GDP. Although the role of states and municipalities as a constraint for the central government is still limited, the ongoing process of decentralization and the establishment of opposition party rule in several states is likely to further strengthen the role of local entities.

5.1.2.7 Freedom of Speech, Press and Media

Freedom of speech as well as free press and media play a vital role in democracies in fulfilling the task of a proper information of the public and an external control of government and the public administration. It is obvious that these important task can only be properly fulfilled if the press and media are not subject to governmental controls or censorship and if individuals are free to express their point of view since only a free press and media may inform the citizens about corruption and other abuses of public office and evaluate properly governmental initiatives and programs. Hence, only a free press can exert external control over governmental action by mobilizing public opinion against violations of political principles or national law.

Freedom of press and media as well as the individual freedom of speech are guaranteed in article 60 and 70 of the Mexican constitution. Nevertheless, in Mexico the freedom of media is a difficult topic. Although not directly controlled, politicians may exert considerable influence on the press by the placement and withdrawal of financially lucrative government advertising. Moreover, for a long time the national monopoly on newsprint ensured that delivery to unfriendly dailies could be suspended. Critical articles and commentaries could be answered by the canceling of government contracts that ensure the economic survival of the medium or by the suspension of newsprint supply. Besides, payments of bribes for political journalists and publishers were an institutionalized part of Mexican press and media. Therefore, much of the governmental control of the media relied on collusion instead of coercion. A widespread practice in the Mexican printing press is the publishing of paid political announcements that are disguised as news.

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80 See Camp (2003).
84 See Orme (1997). As Evelyn P. Stevens argues: "It would be an exceptionally courageous publisher, or a very foolish one, who would bite the hand which feeds him". Cited by Morris (1991) p.54.
stories, the so-called *gacetillas*. Although reliable data on the importance of *gacetillas* is not available, it is estimated that they are responsible for a large share of the newspaper’s incomes and that the economic survivability of many papers would be endangered without these payments. In addition pressure on critical journalists was also exercised by outright coercion as threatening, kidnapping, violence and even assassinations. Although press freedom still remains limited, there has been great progress in this topic, in particular in the print media where many newspapers now show more independent reporting. Hence, the process of democratization was also influential for the media which implied that over time the coverage of governmental policy in the printing press became more critical. However, an important characteristic of Mexico is that the societal influence of the printing press remains limited as the number of sales of even the most renown national newspapers is comparably small. Moreover, the high degree of government intervention discouraged the Mexican business community to invest in the press since a profitable press with independent reporting is too risky and a safe press without government criticism is hardly profitable.

Consequently television is the most important mean of information for Mexican citizens. Despite of growing independence in the printing press major television channels remained essentially pro-government. In particular the dominating television broadcasting company *TELEVISa* had close ties to the PRI and for a long time favored the party in its media coverage of electoral campaigns. There is also evidence that *TELEVISa* broadcasting of the Chiapas uprising was heavily pro-government biased. During the years of PRI dominance the official party heavily relied on its priority access to the media to stabilize its influence in the Mexican society and to ensure a positive outcome of elections. Thus, more equal access to the media was one of the most important achievements that allowed for the success of Mexican opposition parties. Other reforms of the press were already enacted under the rule of Salinas when the government newsprint monopoly was ended, direct government payments to journalists were cut and privatizing a government

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55 See Keenan (1997).
56 See Conger (1997), Moynihan (1997) and Solomon (1997). Assessing the number of attacked or murdered journalists is a difficult task. Some of the cited authors nevertheless compare the level of violence against journalist with Colombia. Though it cannot be guaranteed in all cases that violence is connected to the reporting of the journalist and enacted by the government investigation on the cases is nearly always unsuccessful or even intentionally delayed by officials which creates a situation of impunity for the masterminds of the attacks.
57 See Riva Palacio (1997).
59 See Belejack (1997), Miller/Darling (1997) and Castañeda (1997). After the 1994 presidential election the PAN candidate Diego Fernández stated that the success was not the PRI’s but a triumph of PRONASOL (a program for poverty alleviation), PROCAMPO (a program of rural subsidies) and *TELEVISa*. See Otero (1996) p.15.
60 See López (1997).
A television network created the first competitor for TELEVISÁ. The government of Zedillo cautiously followed the course of reform.\footnote{See Orme (1997). It has to be stated that the number of violent aggressions against journalists increased heavily in the Salinas administration. See Conger (1997).}

Despite of these successes compared to other countries the freedom of press and media is still severely restricted in Mexico. The Freedom House press freedom indicator that is depicted in figure 5.1 confirms this statement suggesting that recent improvements and reforms were not sufficient. An index value of 100 represents a fully controlled press while 0 stands for a fully free press though the average index scores of western democracies usually vary around a value of 10. The inspection of the data for Mexico reveals that the enacted reforms of press and media only had a minor impact on the freedom of Mexican press and media.

**Figure 5.1: Freedom House Press Freedom Indicator for Mexico (1994-2000)**

![Press Freedom Indicator](image)

Source: Own figure using data of Freedom House (2003).

The comparison of Mexico with other Latin American countries in figure 5.2 reveals that its degree of press freedom is one of the worst in the region since only press freedom in the authoritarian Peru of Fujimori received a lower rating.
With index values varying around 50, that are comparable to those of Pakistan, Nigeria or Tanzania, Mexico still has a long way to go to establish a free and reliable media sector comparable to Western democracies. In this context it is interesting that the NAFTA contract limits the foreign equity participation in Mexican television companies and newspapers to 49% with the exception of simply translated foreign-edited newspapers. One may conclude that the important task that a free press plays in democracies can still not be properly executed by the Mexican press. Despite of the considerable progress during the last years information of the public and control of government by the Mexican press are still unsatisfactory.

5.2 Foreign Capital Flows to Mexico
5.2.1 Brief Economic History
5.2.1.1 Overview
The independence of Mexico in 1821 and the preceding wars marked the beginning of a weak nation state that still suffered from the long years of Spanish paternalism. The years following independence were characterized by durable political instability and economic stagnation. In the last quarter of the nineteenth century the authoritarian rule of Porfirio Díaz (1876-1911) restored political stability for the first time since independence. As a consequence Mexico experienced higher growth which was mainly stimulated by the dynamic export sector. Although the dominating development strategy was characterized by a "desarrollo hacia afuera", the 1890s mark the beginning of Mexican Industrialization in sectors as textiles, steel, cement glass etc. The

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92 See Orme (1997).
93 The export sector grew at an annually average rate of 6.1% during the years of Díaz's rule. See Knight (2000). For a short analysis of the economic policy of Díaz see Haber/Razo/Maurer (1999).
socio-economic situation which was characterized by the authoritarian and racist political regime, an agricultural sector linked to peasant dispossession and labor coercion and the inequality in the distribution of benefits from the development process led to growing social unrest and finally to the outbreak of the Mexican revolution. During the long period of armed conflict and social tensions the economic downturn reached its peak in 1917 with collapsing exports, high inflation and growing poverty. Short periods of recovery and decline followed until Mexico was hit by the consequences of the great depression. The fall in global demand harshly affected the export sector and between 1929 and 1932 Mexican exports fell by 64.9% leading to a general economic downturn.

The presidency of Lázaro Cárdenas from 1934-1940 was marked by a complete restructuring of the state and its relation to the economy. The focus of the public sector shifted from the wealthy groups to peasants and workers leaving the private industrial sector largely untouched. An agrarian reform that benefited a large part of the population shifted additional resources from commercial agriculture to industry which in turn fostered the process of industrialization. During the Second World War the increasingly centralized and authoritarian government focused on the expansion of public infrastructure and urbanization for the benefit of the industrial sector and commerce. Mexico experienced high growth due to the increasing demand for Mexican commodities and natural resources during the war period.

In 1948 the Mexican minister of economy obtained the right to change the list of goods under protection reinforcing the restrictive policy on imports. Throughout the 50s the protection scheme was gradually enlarged culminating in the practice that every industry which substituted imports automatically enjoyed full protection implying that the scope of protection changed from being a tool for the management of balance of payment-problems to a development strategy. By protecting domestic industries the government sought to foster the national process of industrialization and to reduce Mexican dependence on imported capital goods which in turn would diminish the vulnerability of the Mexican economy to external shocks.

The decade of the fifties saw real aggregate investment growing with an average annual rate of 17% while GDP grew at a rate of 6.2%. Growth rates of

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94 See Knight (2000) p. 124-131. Many developments of Mexican politics in the 20th century can only be understood being aware of the revolutionary heritage of the Mexican society. The emergence of "Mexicanization" as a form of economic nationalism for example is based on revolutionary principles and has been very influential for the debate about foreign investment in Mexico. See paragraph 5.2.2.1.1 for an analysis of its influence on the national FDI legislation.

96 For a detailed analysis of the land reform of Cárdenas see Gordon (1975).
97 See Cárdenas (2000b) p.182-185
real GDP continued to be high throughout the 60s stimulated by a dynamic industrial sector despite of declines in agriculture and the traditionally strong mining sector. At the same time inflation rates kept at a moderate level. The Mexican development model during this time (desarrollo estabilizador) may be seen as a success. However, already the late 60s mark a turning point for the economic development of Mexico by bringing to light the first signs of weaknesses of the chosen national development strategy. As a reaction to the considerable entries of foreign firms the Mexican business community was seeking further governmental protection. So, instead of protecting the domestic market the government now switched to a strategy of protecting domestic producers. Among other restrictive measures foreign control of shares in Mexican companies was limited to a maximum of 49%. Over time the extensive protection of domestic firms led to a steady decline in competitiveness of Mexican producers. Many businesses were inefficient operating with high profit rates and high cost to public finances due to subsidies at the expense of tax-payers. The “infant industry protection” of domestic sectors finally implied a total loss of international competitiveness and a high inefficiency of Mexican firms. Nevertheless, the national government did not review its development policy by gradually liberalizing and opening up to foreign trade and investment. A result of maintaining this strategy was the growing dependence on external borrowing. The oil boom of the 70s and the excess of investment seeking liquidity from banks in industrial countries fostered a growing external debt throughout the seventies. When economic growth was slowing in the 70s and political tensions mounted after the 1968 massacre of students, the governments of Luis Echeverría (1970-1976) and López Portillo (1976-1982) embarked on a populist strategy of heavy public spending and expansion of the public sector. This tendency was aggravated when large oil reserves were discovered in the wake of the first oil shock. The important increase of international interest rates and the elevate level of external debt finally led to the outbreak of the great Latin American debt crisis causing severe economic problems not only in Mexico but throughout Latin America.

Mexico declared a moratorium on external debt in 1982 which led to important disturbances of the international financial system as the credit exposure of many international banks was considerable. In a last desperate struggle to manage the crisis Mexico announced the complete nationalization of the banking system leading to an even bigger loss of investor confidence. As a consequence of the debt crisis Mexican growth rates fell sharply and remained low for the rest of the 80s. Inflation rates grew reaching three digit rates and

100 See Ros (1993).
101 See the review of the Mexican FDI legislation in paragraph 5.2.2.1.
103 See OECD (1992) p.16.
104 For a general review of the Latin American debt crisis see Ffrench-Davis (2000). For an overview of the events in Mexico see Krämer (1997) p.112-152.
real wages declined leaving the country in a deep economic crisis.\textsuperscript{105} The outbreak of the debt crisis ended the strategy of import substitution and initiated a period of profound economic reforms that deeply influenced the economic performance of the years to come. Hence, the great debt crisis of the 80s marks a watershed in the economic history of Mexico because the following liberal reforms were to endure until the beginning of the new millennium.

5.2.1.2 The Reform Period 1982-today

The policy responses to the 80s debt crisis involved drastic exchange rate and fiscal adjustments as well as a complete change of the national development strategy. The government of de la Madrid initiated an austerity program to overcome the crisis and liberal reforms were implemented to bring the Mexican economy back to economic stability and growth. In 1982 three devaluations took place that were designed to cut the unsustainable balance of payments deficit. Fiscal adjustments relied on a decrease in public investment, real salary reductions for government employees, and increases in indirect taxes and public prices. Long negotiations with the IMF and the consortia of lenders followed to achieve a rescheduling of Mexican external debt.\textsuperscript{106} Figure 5.3 shows that the aftermath of the debt crisis was characterized by a severe fall of per capita growth rates which only showed signs of recovery during the late 80s.

Figure 5.3: GDP per Capita Growth between 1980-1990

![Graph showing GDP per capita growth between 1980-1990](image)

Source: Own figure using data from World Bank Development Indicators 2002

Although by the end of the 80s the Mexican government succeeded in assuring macroeconomic stability, the adjustment policy implied high costs to the population since in particular already deprived members of the Mexican society had to shoulder the heavy burden of the national stabilization policy. Low growth severely affected poverty levels in the country. As public spending

\textsuperscript{105} See Krämer (1997) p.112-121.

\textsuperscript{106} For an overview of the management of the debt crisis in Mexico see OECD (1992) and Krämer (1997) p.121-144.
was cut people depending on public transfers were heavily affected by the adjustment process. Throughout the 80s real incomes were on average 30% lower than in the years preceding the crisis.\textsuperscript{107} As an reaction to the surge in poverty and the resulting potential for social unrest the Salinas administration initiated the PRONASOL program with the objective of alleviating poverty and strengthening the legitimacy of the PRI government.\textsuperscript{108}

Following the short term management of the debt crisis the Mexican government started important economic reforms aiming at liberalizing and opening the economy to foreign trade and investment. Under the de la Madrid administration import liberalization measures were initiated that culminated in Mexico’s signing of GATT in 1986. Besides to fighting inflation, the Economic Solidarity Pact of 1987 led to a further reduction of tariffs and import licensing requirements.\textsuperscript{109} As a consequence of these liberalization measures Mexican non-oil exports rose from 5.5 billion US$ in 1981 to over 16 billion in 1990 with the automobile and maquiladora sector being the most important drivers of growth.\textsuperscript{110} Moreover, large privatization programs reduced the enormous number of public enterprises in Mexico. Between 1983 and 1988 the government sold 122 state-owned enterprises. In this period the Mexican government was involved in only 13 of the 28 productive sectors in which it was active in 1982.\textsuperscript{111}

During the sextenio of de la Madrilds successor Salinas de Gortari the process of opening and liberalizing the economy accelerated and efforts were concentrated on promoting macroeconomic stability and a continuing opening of the economy to the world market. Tariffs were reduced and the restrictive FDI legislation was reviewed.\textsuperscript{112} The output coverage of import licenses was reduced from 92% in 1985 to 20% in 1990. Average tariffs fell from 24% to 13% over the same period. An additional focus of Mexican efforts was to promote the export sector. The production coverage of export restrictions fell from 25% in 1987 to below 18% in 1990.\textsuperscript{113} For the period between 1988 and 2000 Mexican exports grew at a yearly average of 15,1%. Public sector-specific industrial policy was reduced to allow for a better functioning of market processes.\textsuperscript{114} From 1989 on the Mexican government continued the process of privatization by starting the sale of large public enterprises, some of them monopolies. Among the privatized enterprises were the telephone company TELMEX, the airlines MEXICANA and Aéreo Mexcio, the copper mining

\textsuperscript{107} See Krämer (1995a).
\textsuperscript{108} For an overview of the PRONASOL program see Krämer (1995b). Otero (1996) states that PRONASOL was rather a political tool for avoiding electoral success of the opposition. He shows that PRONASOL tended to spend more where electoral competition from the PRD was more intense. See Otero (1996) p.15.
\textsuperscript{110} See Ros (1993) and Peters (2001).
\textsuperscript{111} See Sánchez et al. (1993) and Krämer (1997) p.147-150.
\textsuperscript{112} See paragraph 5.2.2.1.1.
\textsuperscript{113} See OECD (1992) p.137-141.
company CANANEA, the insurer ASEMEX, several steel companies and 18 commercial banks.\textsuperscript{115} The absolute number of public enterprise fell from 1155 in 1982 to 223 in 1992.\textsuperscript{116}

By 1990 Mexico succeeded in bringing inflation down to rates around 20%. Low international interest rates as well as growing investor confidence in the Mexican reform process stimulated massive inflows of portfolio investment to Mexico leading to a real appreciation of the Peso. The current account deficit rose quickly and capital inflows led to a domestic credit boom in the absence of prudential supervisions in the financial sector. The enhanced international credibility Mexico gained through the signing of the NAFTA treaty was reflected in an enormous increase of FDI and other capital flows. The armed uprising in Chiapas and the assassination of the PRI presidential candidate Colosio in 1994 provoked the first foreign capital withdrawals finally leading to the substantial depreciation of the Peso. The dollar parity went from 4 pesos in December 1994 to 7.55 pesos in March 1995 when finally stopped by an emergency economic program involving the US government, the IMF and the Bank of International Settlements.\textsuperscript{117} The so-called "Tequila-Crisis" was followed by a sharp recession of the Mexican economy. GDP dropped by 6.6\% ,capital formation even by 30\% and open unemployment nearly doubled in 1995. The Mexican crisis had a negative impact on Latin America as a whole.\textsuperscript{118} However, recovery from the crisis was quick with growth rates of 5.1\% in 1996 and 6.8\% in 1997 due to growing export revenues and high fixed investment growth.\textsuperscript{119}

Despite of the problems caused by the Tequila-Crisis for Mexico the decade of the 90s is characterized by a further integration of the country into the world economy and a continued liberalization of the foreign investment regime.\textsuperscript{120} In the 90s Mexico negotiated the NAFTA and pursued various other bilateral free trade agreements with a variety of countries or regions. Mexico now participates in 13 free trade agreements (FTA's) and is currently engaged in negotiation with other partners.\textsuperscript{121}

Figure 5.4 gives an overview over the multilateral and bilateral treaties Mexico signed recently. The large amount of bilateral agreements reflect the efforts of the Mexican administration to reduce the dependency of the national economy from the evolution of the US markets. Nevertheless NAFTA and the treaty with the EU are of particular importance to the Mexican economy given the large potential for further trade with and investment from these regions.

\textsuperscript{116} See OECD (1992) p.88-93.
\textsuperscript{118} See Ffrench-Davis (2000) p.195-205.
\textsuperscript{119} See Lederman et al. (2001).
\textsuperscript{120} For an overview of the Mexican trade liberalization see OECD (1996a).
\textsuperscript{121} See WTO (2003) p.63.
Although Mexico up to now showed an impressive success in the implementation of economic reforms during the 90s, there still remains an important agenda of reforms. Modernizing the education sector, reducing the reliance on oil-revenues, enhancing the efficiency of public spending and fighting poverty are just a few examples that may be given here.\footnote{See OECD (2000).} After having drawn a broad picture of the evolution of the Mexican economy during the last years the next paragraph is dedicated to the analysis of incoming FDI flows to Mexico and to the attitude towards foreign investors, as well as to developments in the national FDI legislation.

5.2.2 The Evolution of Foreign Investment to Mexico
5.2.2.1 The Mexican Foreign Investment Legislation
5.2.2.1.1 The Evolution of the National FDI Legislation
The policy of regulating FDI flows to Mexico can be traced back to the passing of the Mexican constitution in 1917 which already established restrictions and conditions on foreign acquisitions of land and concessions. Article 73 empowers congress to encourage the promotion of Mexican investment and regulation of foreign investment. However, the legal foundation for most regulation of foreign investment activity were the articles 27 and 28 of the constitution. Article 27 has three important provisions that have impacted the regulation of foreign investment. First, it grants sovereignty over national resources which in fact abolishes foreign private property rights for all subsurface mineral and petrol deposits. Second, it implements the so-called Calvo clause to which foreigners wishing to own property or to engage in business in the country had to agree. With this agreement the investor limits his rights with respect to a contract or his property and the means available to him of enforcing those rights to the same as are accorded by Mexican law to its own citizens. All other means like the right to seek diplomatic intervention or
the help of an international claims tribunal are waived. The breaking of this agreement implied the expropriation of the investor's assets or the ending of the contract or license.\textsuperscript{123} Third, article 27 defined the so-called restricted zone that forbid foreign ownership within a zone of 100 km along the borders and 50 km along the shores. Article 28 identified strategic sectors of the economy that were reserved for the Mexican government and was the legal basis of many expropriations during the 20s and 30s with the most prominent example being the oil sector in 1938.\textsuperscript{124}

The articles of the 1917 constitution reflect the revolutionary principle of "Mexicanization" and explain the tendency of Mexican politics to restrict the influence of foreigners on the economy. This fear of exploitation in turn, is a national heritage that resulted from the excessive dominance of foreign investors during the time of the Porfiriato. These constitutional rules based on revolutionary principles supported a restrictive Mexican policy towards FDI that predominated until the middle of the 80s when the aftermath of the debt crisis marked the beginning of a liberalization of the FDI regime in Mexico.\textsuperscript{125}

In addition to these constitutional norms explicit legislation on FDI did not exist until the year 1944. Based on an executive decree from this year foreign investors had to obtain a permit issued by the Mexican Foreign Ministry for the acquisition of Mexican firms or other property.\textsuperscript{126} In 1945 the Ministry issued an interim list of industries where a majority of Mexican capital would be required. Sectors mentioned on this list were transportation, radio broadcasting, motion pictures, publishing, advertising, fishing, and beverages.\textsuperscript{127} In 1947 a commission composed of several Mexican ministries formulated general norms for the application of the 1944 decree. The aim of the commission was to "maintain the right equilibrium between national and foreign capital in investments that are made in Mexico". Eventually, the commission decided that Mexican capital should participate with at least 51\% of total capital in any foreign investment although the application of this rule was subject to

\textsuperscript{123} See Sandrino (1994), Wright (1971) and Vázquez Tercero (1971) p.111. The Calvo clause gained importance on the international stage when in 1974 the United Nations passed several resolutions for the establishment of a new economic order. A key component was the Charter of Economic Rights and Duties of States intended to strengthen the independence of developing nations. One main principle of the charter was that every state has the right to regulate foreign investment including the activities of multinational corporations and the right to expropriate alien property upon the payment of adequate compensation. Currently there is a consensus that an expropriation is a legitimate act of national autonomy provided that public welfare is fostered and that a fair compensation is granted. See Gudofsky (2000).

\textsuperscript{124} The nationalisation in particular hit British and US investors. See Sandrino (1994) and Wright (1971) p.61-70. For a detailed analysis of the expropriation during the 20s and 30s see Gordon (1975).

\textsuperscript{125} See Sandrino (1994).

\textsuperscript{126} See Sandrino (1994).

\textsuperscript{127} See Whiting (1992) p.71.
enormous discretion, that is, the Mexican government often granted exceptions.\footnote{128}{See Sanchez-Gamper (1989) and Pescador-Castañeda (1971).}

The strategy of import substitution led to an even more restrictive policy towards FDI during the 70s. FDI was limited in many important industries as steel, cement, glass, aluminium paper and fertilizers.\footnote{129}{See Secretaria del trabajo y prevision social (1994) p.14.} To facilitate the transfer of know-how and technology the government passed several laws that regulated the purchase of technology and licenses by Mexican and foreign firms. The law on inventions and trademarks that was passed in 1976 included restrictions on the use of international trademarks in Mexico.\footnote{130}{The most controversial part of the new law was an obligation to use international trademarks jointly with a trademark originally registered in Mexico. General Electric for example had to link its trademark with the partner of a Mexican joint venture: General Electric/Esamex. See Whiting (1992) p.108-136. Most of the laws that targeted technology transfer were revised when the Salinas administration prepared the joining of NAFTA and passed the Law for the Promotion and Protection of Industrial Property in 1991.} The “Law to Promote Mexican Investment and Regulate Foreign Investment” passed in 1973 reflects this general tendency. The law restricted FDI in product groups that were reserved for public Mexican investment which included petroleum and other hydrocarbons, basic petroleum products, radioactive and strategic materials, nuclear energy, electricity, railroads, telegraphic and radio communications as well as banking. Moreover, FDI was restricted in product groups reserved exclusively for Mexican public or private investment. Among these sectors were radio, television, agricultural activities, road, air and maritime transportation as well as forestry, gas distribution and financial intermediation. In addition the law defined product groups in which FDI was only allowed up to a specific share of the firm’s capital. For instance in mining FDI was limited to a 49% share of the firm’s total capital. For secondary petrochemicals and the fabrication of automobile components the maximum share was at a level of 40%.

Although in absence of a specific regulation foreign equity participation should not exceed 49% of total capital, the law contained a grandfather clause according to which foreign holdings that already existed prior to the effective date of the new law were allowed to continue to exist as long as the proportion of local and foreign capital remained unchanged.\footnote{131}{See Whiting (1992) p.99.} Table 5.4 gives an overview of the restrictions of the 1973 FDI law.\footnote{132}{See paragraph 5.2.2.2 for an analysis of the law’s effects on FDI flows to Mexico.}

Moreover, the law created two organizations to supervise and regulate FDI. The Comision Nacional de Inversiones Extranjeras (CNIE) was in charge of determining and regulating potential investment projects according to the national development strategy while the Registro Nacional de Inversiones Extranjeras was designed to provide statistical data about the operations of
foreign companies in Mexico. Moreover, the CNIE had the power to pass regulation as to clarify the application of the law.133

Table 5.4: Restrictions of the 1973 FDI Law

<table>
<thead>
<tr>
<th>Restriction</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign equity participation must not exceed 49% of total capital</td>
<td>All sectors (if no other regulation has been established)</td>
</tr>
<tr>
<td>Economic activity is reserved for the state</td>
<td>Petroleum and other hydrocarbons, Basic petroleum products, Radioactive and strategic materials, Nuclear energy, Electricity, Railroads, Telegraphic and radio communications, Banking</td>
</tr>
<tr>
<td>Economic activity is reserved for Mexican citizens or the state</td>
<td>Radio, Television, Agricultural activities, Road transport, Air transport, Maritime transport, Forestry, Gas distribution, Financial intermediation</td>
</tr>
</tbody>
</table>

Source: Own Figure

Following the debt crisis Mexico embarked on a strategy of economic reform aiming at macroeconomic stability, privatization and liberalization. Part of the liberal reform program was opening the economy to foreign trade and investment. Nevertheless, the de la Madrid administration maintained the 1973 law on FDI and only changed the approach as to how the law was to be interpreted and applied. In 1984 the CNIE issued new guidelines for FDI with the objective to encourage investment in high priority areas as heavy machinery, electronic equipment, high technology products and tourism.134 The guidelines were complemented by a list of activities in which foreign participation could foster national development and the CNIE signaled that it would even allow a foreign equity share of more than 50%.135 These new guidelines mark a watershed for the evolution of Mexican foreign investment legislation. Following Mexico’s *apertura* in 1985 the government further liberalized FDI by eliminating restrictions for petro-chemical investment and by engaging in a debt-equity swap program.136

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133 See Secretaría del trabajo y previsión social (1994) p.15.
135 See Peres-Nuñes (1990a) p.41-46. One of the first multinational that took advantage of the liberalization was IBM that build a 100% owned production plant in Guadalajara in 1986. However, the negotiations with the Mexican government to obtain the permission for the majority ownership took nearly two years. See Whiting (1992) p.194-210.
136 See Munro (1995) and Peres-Nuñes (1990a).
Efforts to open Mexico to foreign trade and investment continued under the succeeding administration. The National Development Plan of Salinas de Gortari assigned a key role to foreign capital since FDI was expected to create new employment, to provide the country with financial resources, to provide modern technology and to advance the country’s efforts to increase manufactured exports. Consequently the Mexican government further liberalized the investment law of 1973. The most important changes to the 1973 law were made in 1989 (Law for the Promotion of Foreign Direct Investment), 1993 (Law for Foreign Direct Investment), 1996 (Reform of the Law for Foreign Direct Investment) and 1998 (Amendment to the Law for Foreign Direct Investment). However, up to 1993 FDI was liberalized without changing the restrictive law of 1973 but by imposing liberal regulations for its application. The new investment law issued in 1993 already anticipated Mexico’s joining of NAFTA in 1994 and consequently continued to promote a further opening of the Mexican economy.

The basic framework of the current investment legislation in Mexico is still the Law for Foreign Investment of 1993. With the new law coming into effect the old law of 1973 and the decree of 1944 requiring the necessity for foreigners to obtain a permit by the government to acquire assets are repealed. Furthermore, Article 27 of the Constitution that established the Calvo clause and restricted private ownership of national resources was changed. Although as a principle access to the Mexican market is free, the current legislation defines various exceptions from this general rule. The oil industry as well as the market for petrochemicals and electricity are still reserved for the state and not open to FDI. For several other sectors like for example television and radio broadcasting as well as development banks the law only permits investment from Mexican citizens or corporations. Furthermore, the Mexican investment law defines sectors with specific regulations where investments up to a certain threshold of 10%, 25% or 49% of total capital are allowed. For certain sectors like for example the construction and operation of airports the CNIE is in charge of controlling investment from abroad. Moreover, the commission establishes policy guidelines regarding foreign investment,
determines its terms and conditions and establishes criteria for the application of the legal and regulatory provisions of the investment law. The CNIE is comprised of several ministers of government and a committee of representatives that carry out daily functions.\textsuperscript{145} Table 5.5 provides an overview of the current foreign investment legislation in Mexico.

Table 5.5: FDI Legislation in Mexico

<table>
<thead>
<tr>
<th>FOREIGN INVESTMENT LAW (1993)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Foreign investment may participate in ANY proportion in the social capital of Mexican societies (Article 4) excepting:</td>
</tr>
<tr>
<td>I. Activities reserved for the State (Article 5)</td>
</tr>
<tr>
<td>II. Activities reserved for Mexicans (Article 6)</td>
</tr>
<tr>
<td>III. Activities that have a special regulation where specific percentages are determined (Article 7)</td>
</tr>
<tr>
<td>IV. Activities that need a favorable resolution from the Commission to participate in a percentage higher than 49% (Article 8)</td>
</tr>
<tr>
<td>2) Any acquisition of an interest in a Mexican corporation exceeding 49% of its capital stock requires a permission of the Commission, but only if the total value of the assets of such corporation is higher than an amount that is fixed annually by the Commission (Article 9)</td>
</tr>
<tr>
<td>3) Neutral Investment (Article 18):</td>
</tr>
<tr>
<td>Is a specially regulated investment, where foreign flows are not taken into account to determine the percentage of a foreign investment to a Mexican company. In the case of Fiduciary Institutions, it may be done through investment instruments which allow a monetary return for investors, but a limited right to vote in assemblies of the institutions. In other societies, neutral investment may be accounted for actions without the right to vote.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>REFORM OF THE FOREIGN INVESTMENT LAW (1996)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Reforms to the specially regulated sectors are introduced:</td>
</tr>
<tr>
<td>Article 7, III includes a complemented list of activities that may participate up to a percentage of 49% in Mexican companies, which replaces the one existing in 1993.</td>
</tr>
<tr>
<td>In Article 8, the sectors which need a special permission from the commission in order to receive more than 49% FDI changes.</td>
</tr>
<tr>
<td>2) Regulation of acquisition of real property and trust is extended</td>
</tr>
<tr>
<td>3) The foreign individuals and entities intending to acquire real estate outside of the restricted zone or to obtain concessions for the exploration and development of mines and waters anywhere within Mexico, shall previously submit before the Ministry of Foreign Affairs and obtain the corresponding permit from that Ministry.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>REGULATIONS TO THE FOREIGN INVESTMENT LAW (1998)</th>
</tr>
</thead>
<tbody>
<tr>
<td>In this regulation procedures for applying the Foreign Investment Law are stated:</td>
</tr>
<tr>
<td>1) procedures needed to constitute societies, acquire permissions of neutral investment, register foreign investment and generally register as a society</td>
</tr>
<tr>
<td>2) In the list of reserved activities, some exceptions are determined.</td>
</tr>
<tr>
<td>3) Acquisition of real estate, exploitation of mines and national territorial waters, and trusts are further regulated</td>
</tr>
</tbody>
</table>

Source: Own figure

Investors who are willing to hold more than 49% of total shares of Mexican companies in these industrial sectors require a permission of this commission. As a general rule the law states that acquiring a majority stake (>49% of total capital) in a Mexican company requires a permission of the CNIE if the total

\textsuperscript{145} See Alexander (1995) p.72-73 for an overview of the CNIE.
value of such a company exceeds an amount which the commission itself determines on an annual basis.146

### Table 5.6: Restrictions on FDI to Mexico

<table>
<thead>
<tr>
<th>Restriction</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic activity is reserved for the state</td>
<td>Petroleum and other hydrocarbons</td>
</tr>
<tr>
<td></td>
<td>Basic petro-chemical products</td>
</tr>
<tr>
<td></td>
<td>Electricity</td>
</tr>
<tr>
<td></td>
<td>Radioactive and strategic materials</td>
</tr>
<tr>
<td></td>
<td>Nuclear energy</td>
</tr>
<tr>
<td></td>
<td>Emission of money</td>
</tr>
<tr>
<td></td>
<td>Telegraphic and radio communications</td>
</tr>
<tr>
<td></td>
<td>Control and supervision of airports</td>
</tr>
<tr>
<td>Economic activity is reserved for Mexican citizens</td>
<td>National road transport</td>
</tr>
<tr>
<td></td>
<td>Commerce of gasoline and petrol</td>
</tr>
<tr>
<td></td>
<td>Radio and television broadcasting</td>
</tr>
<tr>
<td></td>
<td>Credit unions</td>
</tr>
<tr>
<td></td>
<td>Development banks</td>
</tr>
<tr>
<td>Sector specific regulations</td>
<td>International road transport (maximal foreign share of 49% of total capital)</td>
</tr>
<tr>
<td></td>
<td>Cooperatives of production (10%)</td>
</tr>
<tr>
<td></td>
<td>Satellite communication (49%)</td>
</tr>
<tr>
<td></td>
<td>Automobile parts (49%)</td>
</tr>
<tr>
<td></td>
<td>Construction (49%)</td>
</tr>
<tr>
<td></td>
<td>Fishing (49%)</td>
</tr>
<tr>
<td></td>
<td>Local and long distance telecom services (49%)</td>
</tr>
<tr>
<td></td>
<td>Pension funds (49%)</td>
</tr>
<tr>
<td></td>
<td>Water transport (49%)</td>
</tr>
<tr>
<td></td>
<td>Production and distribution of explosives and arms (49%)</td>
</tr>
<tr>
<td>Investment of more than 49% of total capital requires an authorization of the NCFI</td>
<td>Exploration of minerals</td>
</tr>
<tr>
<td></td>
<td>Shipping companies</td>
</tr>
<tr>
<td></td>
<td>Construction of pipelines for the transport of petrol Oil-or gas-seeking</td>
</tr>
<tr>
<td></td>
<td>Services related to railways and ports operation</td>
</tr>
<tr>
<td></td>
<td>Administration, construction and operation of airports</td>
</tr>
<tr>
<td></td>
<td>Private educational services</td>
</tr>
<tr>
<td></td>
<td>Legal services</td>
</tr>
</tbody>
</table>

Source: Own Figure based on Peters (2000).

Currently there are no limitations for the repatriation of profits to home countries or other restrictions on balance of payment operations for foreign companies. Table 5.6 gives a short overview of the current sectoral restrictions for FDI in Mexico.147


147 A comprehensive overview of the current sector restrictions is given in table A.3 in Annex II.
Despite of liberalization and a further opening of the country, current legislation still leaves considerable power to the government for the control of FDI inflows. In particular the required permission of the CNIE for the acquisition of majority stakes leaves room for an influence of the government on foreign investment policy. In modifying the critical asset value which requires a permission of the CNIE the government possesses a powerful tool to influence amounts and structure of foreign investments to the country. To put it in other words, the government did not fully commit to a liberalization of FDI because it reserved considerable discretionary freedom to decide on a case to case basis. Although FDI to Mexico is highly welcome at the moment, the current legislation may also be applied in a more restrictive way if this general attitude changes in the future. This may be the case if the government is subject to high societal pressure as it was the case in 2003 when peasant organizations demanded a re-negotiation of the NAFTA regulations concerning agrarian products. National FDI legislation however, is currently complemented by international law that will be reviewed in the next paragraph.

5.2.2.1.2 Investment Legislation of NAFTA and other Bilateral Agreements

In addition to national investment laws Mexico signed various multilateral and bilateral agreements which contain regulations on investment matters. Among them the most prominent are NAFTA and the free trade agreement with the EU. Therefore, the content of the investment chapters of these two treaties will be briefly reviewed here. The signing of NAFTA not only confirmed the further integration of Mexico into the system of international trade but also marked the beginning of a new approach towards foreign investors. Beside the liberalization of trade the signing parties agreed to significant disciplines of how nationals of other parties are to be treated on another party’s territory. Enhanced legal certainty and better protection of foreign property are essential elements of this convention. In Mexican law international treaties may be signed by the president and have to be ratified by the senate of the republic. Once ratified and being consistent with the national constitution international treaties become a full part of the national legislation and are comparable to constitutional norms. As a consequence the provisions of NAFTA may be seen as a measure that enhances credibility of the Mexican government because they tie its hands on the international level. Opportunistic government behavior which has a long tradition in Mexican policy towards foreign investors

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148 Rubio et al. (1994) highlight that articles 25 and 28 of the Mexican constitution still permit the regulation of every field of economic activity including the nationalization of so-called strategic industries implying that Mexican constitution would allow for a step backward in economic liberalization. This is of particular importance in Mexico as demanding restrictions on FDI is still a viable tool for gaining populist votes. In 1996 for example members of the left wing opposition party PRD and even conservatives demanded new legislative limits on FDI. In addition, all efforts to permit foreign investment in petrochemicals and petroleum have been denied by the government. See PRS Group (1999) p.A10.

thus becomes less likely. If arbitrary government intervention occurs, investors have the possibility to put forward a claim to an international dispute settlement tribunal.\textsuperscript{151} Therefore, NAFTA ensures an enhanced protection of foreign property rights and fosters legal certainty of foreign investors by creating an organization with decisional power in international investment disputes.\textsuperscript{152}

Chapter 11, the NAFTA Investment Chapter, extends significant protection to Mexican, US and Canadian investors who own or control investments in the territory of another party. The NAFTA Investment Chapter covers a NAFTA party or state as well as all business entities which are constituted or organized under the laws of a NAFTA Party. Moreover, the provisions of the NAFTA Investment Chapter are not only valid for investors from NAFTA parties but also for those having substantial business activities in NAFTA states. This implies that for example European enterprises with considerable activities in the U.S. also enjoy enhanced legal protection. Furthermore, the treaty covers past, present and future investors extending the protection of NAFTA also to those investors that have already been present in a member country before the agreement was signed and to those that are in the process of making an investment.\textsuperscript{153}

Since chapter 11 includes 39 articles and 4 annexes, table 5.7 provides only an overview of the most important regulations of the NAFTA investment chapter. As a general rule signing parties are obliged by Article 1102 to treat NAFTA investors and their investments no less favorably than domestic investors. Article 1103 extends this general rule by stating that the signing parties have to treat investors from NAFTA states at least as favorable as other investments from third parties which is known as the most favored nation principle. Additionally NAFTA assures in Article 1105 that investors have to be treated "in accordance with international law including fair and equitable treatment and full protection and security."\textsuperscript{154}

The imposition of performance requirements like domestic content, sourcing or trade balancing rules or technology transfer regulations is limited in Article 1106. Moreover, all monetary transfers of investors to their home countries related to investments are guaranteed in article 1109 of the treaty. Article 1110 of the Investment Chapter provides for the protection of foreign investment against nationalization, expropriation and other measures that lead to a

\textsuperscript{151} For an overview of the NAFTA dispute settlement process in investment matters see Siqueiros (2001).
\textsuperscript{152} For an overview over the policy towards foreign investors see paragraph 5.2.2.2. The NAFTA Investment Chapter represents a major change of policy towards international investors because adherence to the Calvo clause is given up and Mexico accepts general principles of international law concerning the protection of foreign property. Moreover, Mexico may be hold accountable for its conduct through a binding dispute settlement mechanism that is described in greater detail in this paragraph.
\textsuperscript{153} See Mcilroy (2002).
\textsuperscript{154} This article reflects giving up adherence to the Calvo-clause.
"creeping expropriation" of investors. Confronted with the legacy of many expropriations of foreign property by Mexican administrations in the past this contractual safeguard is of particular importance for investors.\textsuperscript{155} According to general international law, a state is free to adopt measures of expropriation given the existence of a public interest, a due process and the payment of a fair compensation.\textsuperscript{156}

Table 5.7: Overview of the NAFTA Investment Chapter

<table>
<thead>
<tr>
<th>Article</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 1102</td>
<td>NAFTA investors have to be treated like domestic investors</td>
</tr>
<tr>
<td>Article 1103</td>
<td>Most-Favored-Nation Principle</td>
</tr>
<tr>
<td>Article 1105</td>
<td>Investors have to be treated in accordance with international law</td>
</tr>
<tr>
<td>Article 1106</td>
<td>The imposition of performance requirements is limited</td>
</tr>
<tr>
<td>Article 1109</td>
<td>Guarantees all financial transfers that are related to an investment</td>
</tr>
<tr>
<td>Article 1110</td>
<td>Protection against expropriation, nationalization and creeping expropriation</td>
</tr>
</tbody>
</table>

Source: Own table

Adhering to these general principles article 1110 states that investments of NAFTA members may not be expropriated except for a public purpose, in accordance with due process of law and upon the payment of a fair compensation. Although the precise definition of creeping expropriation remains unclear, the article extents the protection beyond the coverage of direct expropriations implying a total loss of assets. The difference between a direct expropriation and a creeping expropriation is, that, unlike in the case of the former, the latter does not result in a property owner relinquishing title to his property, that is, a creeping expropriation does not result in a formal dispossession of property by its owner. Instead, a creeping expropriation...

\textsuperscript{155} For a short overview over the expropriations in Mexico see paragraph 5.2.2.2.
\textsuperscript{156} Also de-facto expropriations are covered by international law. An OECD draft for the protection of private property states: "...applied in such a way as to deprive ultimately the alien of the enjoyment or value of his property, without any specific act being identifiable as outright deprivation. As instances, may be quoted excessive or arbitrary taxation; prohibition of dividend distribution coupled with compulsory loans; impositions of administrators; prohibition of dismissal of staff; refusal of access to raw materials or of essential export or import licenses." Cited by Sacerdoti (2000) p.120. A general problem of identifying creeping expropriation is drawing the line between general and discriminatory regulation. Likewise the determination of a legitimate public interest is problematic. Due compensation should correspond to the value of the property taken, be paid speedily and in a currency which the owner can transfer from the expropriating state. Under general international law States do not have to compensate for losses suffered in case of war or civil disturbances. See Sacerdoti (2000) p.121-125
implies that governmental action reduces the benefits which an investor may receive from his property by diluting his property rights.\textsuperscript{157} This, in turn, is of particular importance as in the past the actions of the Mexican government to harm foreign investors have been far more subtle than outright expropriations.\textsuperscript{158} For the settlement of investment disputes the NAFTA treaty provides a system of international arbitration. Investors who are convinced that a member government has broken the commitments of NAFTA can put forward a claim to an international dispute settlement institution that will decide on the matter. Furthermore, the treaty, as most of the other agreements as well, includes a section devoted to the resolution of private commercial disputes among parties in the free trade zone.\textsuperscript{159}

The negotiation of a Free Trade Agreement with the EU extends the level of NAFTA investor protection to European MNEs implying that European firms now face a level playing field for investments in Mexico. Besides the progressive and reciprocal liberalization of trade in goods, in conformity the agreement also sets up a consultation mechanism with respect to intellectual property matters. Like the NAFTA treaty, it further provides for a liberalization of investment and related payments and establishes a dispute settlement mechanism for the case of conflicts.\textsuperscript{160}

Investment chapters of bilateral agreements are important instruments to enforce legal certainty and property rights of foreign investors. The massive increase of FDI flows to Mexico following the passing of the NAFTA investment chapter shows that foreign investors took advantage of the

\textsuperscript{157} For a detailed description of the legal situation see Gudofsky (2000) p.257-286.
\textsuperscript{158} See paragraph 5.2.2.2 for a few examples. A wide spread practice was for example to restrict the import of necessary inputs for foreign firms to force them out of business. In their final statement on the arbitration case Metalclad vs. Mexico where the US firm claimed a violation of the NAFTA treaty before the investment dispute settlement tribunal the judges argued: “Thus, expropriation under the NAFTA includes not only open, deliberate, and acknowledged takings of property, such as outright seizure and/or formal or obligatory transfer of the title in favor of the host state, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be effected economic benefit of property even if not necessarily to the obvious benefit of the host State”. Cited by Weiler (2001) p.694.
\textsuperscript{159} See Sandrino (1994), Rugman/Gestrin (1994) and Siqueiros (2001). For legal details of the investment settlement procedure see Gudofsky (2000). For an overview of the Mexican experiences with the arbitration mechanism see González de Cossio (2002). The up to now most prominent case of the investment dispute settlement process has been the case of the US waste disposal firm Metalclad. After acquiring a local waste disposal firm Metalclad was denied necessary permits for the operation of the facility. Later Metalclad was de-facto expropriated when the local governor declared the region of the facility an ecological reserve. The dispute settlement tribunal saw a violation of the NAFTA treaty and awarded 16.685 million dollars of indemnization to Metalclad. Mexico then initiated a suit before the revision court and part of the award was set aside. See Weiler (2001) and González de Cossio (2002) who argues that challenging the award Mexico send a negative message to the international investment community.
\textsuperscript{160} See Consulado General de México (2001).
enhanced security of their investment projects. It further shows that the intensification of legal protection and the reduction of hazards for investors has proven an efficient strategy for Mexico to make it a more attractive destination for direct investment. In this respect the international agreements for the enforcement of investor rights have been an important step towards a better institutional framework for FDI in Mexico.\footnote{The bilateral investment agreements are part of an international strategy of risk mitigation. See paragraph 5.4.2.}

\begin{quote}
"En vista de la experiencia de México en materia de inversiones extranjeras en la época de Porfirio Díaz, cuando México fue llamado madre de los extranjeros y madrastra de los Mexicanos, dados los sucesos dramáticos relativos al caso de la experiencia petrolera, y el fondo económico colonial de México, sería en verdad sorprendente que la masa de la población mexicana no viera al capital extranjero con suspicacia y hostilidad"\footnote{Mosk (1951) cited by Pescador-Castañeda (1971) p.99.}
\end{quote}

5.2.2.2 Mexican Foreign Investment Policy and Inflows of FDI to Mexico

Basically all Latin American countries have a long tradition of skepticism towards the presence of foreign companies which has affected local foreign investment policies in many ways.\footnote{An early explanation of this scepticism is given by Wionczek (1966).} As the citation above demonstrates, also for the Mexican population foreign investors have long been a symbol for the economic exploitation of the country from abroad. Hence, past and present Mexican foreign investment policy can only be fully understood being aware of the historical development of foreign business in the country.\footnote{See Vernon (1966a) who describes the Mexican dilemma with the following lines: "Confronted with a great flow of industrial investment coming principally from the United States, the reaction of a succession of Mexican administrations has been understandingly ambivalent. On the one hand, no president of Mexico could afford to embrace the presence of the foreign investor; on the other hand, this particular breed of investor was obviously being helpful to the Mexican economy in a number of different ways: in helping to tide over the short-term pressures on the Mexican balance of payments; in helping to meet the challenges of the import replacement program which Mexico so badly wished to achieve; and in bringing technology of an advanced kind into the Mexican economy." Vernon (1966a) p.112. In this context Root speaks of the necessity for host governments to balance economic benefits and political cost of FDI. See Root (1994) p.640-644. Fayerweather (1973) discusses how host country nationalism affects MNEs.} Therefore, this paragraph briefly sketches the historical evolution of FDI flows to the country within the broader context of changing attitudes towards foreign investors in Mexico.

Since the aftermath of Mexican independence was marked by a massive loss of foreign capital due to political instability, politicians of both of the two prevailing streams of political thought at that time, liberalism and conservatism, were convinced of the necessity to implement policies that would attract FDI to make up for the massive flight of capital during the post-independence years.\footnote{See Camp (2003) p.33.} In reaction to this policy France and Britain were the origins of the first modest FDI flows to Mexico which were mainly destined to mining and
retail trade. Despite of earlier efforts to promote FDI Mexico experienced the first wave of FDI flows under the government of Porfirio Díaz (1876-1911) which for the first time ended the political instability of the post-independence years. Díaz and his economic advisors (científicos) were convinced of the need to achieve higher economic growth through enhanced FDI from Europe and the United States. Restored political stability and the liberal economic policy of the Díaz administration that largely neglected the interest of workers and farmers led to large inflows of foreign capital from those regions, in particular for infrastructure projects as railways and other transports or electricity. FDI however, was not limited to infrastructure projects but also went to mining, the construction of farms and to the oil sector. Although the available data is not fully reliable, it is estimated that in 1910 FDI represented a share of approximately 70% of total investment in Mexico. Despite of the presence of European companies in Mexico the inflow of US capital dominated during the Porfiriato. Much of the US capital went to the north of the country for example to the mines of Sonora and Chihuahua or the smelting industry dominated by Guggenheim interests as well as to the construction of railways. In 1911 total foreign investment amounted to 1.7 billion US$ of which 650 million was from the US, 500 million from Britain and 450 million from France. The liberal policy during the Porfiriato eventually led to a massive concentration of national wealth in the hand of foreigners. It is estimated that by the end of the Diaz era foreign capital dominated every area of productive enterprise except for agriculture and the handicraft industries. It is estimated that the participation of foreign capital in mining was 97.7%, in petroleum 100%, in electricity 87.2%, in railroads 61.8%, in banking 76.7%, and in industry 85%. Moreover, the agricultural policy of the government implied that substantial amounts of Mexican territory fell into foreign hands which should later turn out to be an important reason for upcoming antiforeignism during the revolution. Even before the end of the Díaz rule there was evidence of a growing discontent both within and outside government with this foreign domination that culminated in expropriations in the railway sector and an attempt to limit foreign ownership in mining and the extraction of petrol. Growing domination of foreign investors and a strict laissez-faire liberalism of the government finally provoked the outbreak of social unrest among the

166 See Pescador-Castañeda (1971) p.69-73. The author neglects that in fact the Spanish conquest of the Aztec empire already marked the beginning of an integration into the international economy and flows of foreign investment.

167 For an overview of the FDI policy of the Díaz administration see Wright (1971), Gordon (1975) or Pescador-Castañeda (1971).


169 Among the European companies was Siemens that produced Electricity in the Valley of Mexico. British investment was concentrated in mining with many Mexican mine shares being listed on the London Stock Exchange. See Pescador-Castañeda (1971).


171 See Wright (1971) p.53-57.


173 See Wright (1971) p.53-57. It is estimated that in 1910 foreigners owned roughly one seventh of the land surface of Mexico. See Vernon (1963) p.50.

Mexican citizens initiating the Mexican Revolution. It is argued that to a certain extent the revolution was a reaction to excessive foreign presence with MNEs being accused of "exploiting" the country and transferring excessive monopoly profits abroad.\textsuperscript{175}

The revolution marked the end of the period of liberal policies towards foreign investors since the revolutionaries eagerly sought to enforce national sovereignty and to reduce foreign dependence of Mexico. The new Mexican constitution of 1917 embodied the main principles of this revolutionary movement and was the beginning of a period of more than 60 years of extensive foreign investment regulation by Mexican governments.\textsuperscript{176} Following the military phase of the revolution foreign investors were hesitant to risk much new capital in the country. The oil industry was the only sector where the value of foreign investment exceeded pre-revolution figures. The decline in FDI continued with the onset of the great depression. Besides the depressing impact of the world wide economic crisis a main reason for declining investment flows was the presidency of Cádiz who proclaimed a "Mexicanization" of the economy as policy goal. In reaction to the enormous influence that MNEs exerted in Mexico, in particular in the oil sector, the Cádiz administration was characterized by outright hostility towards foreign capital flows. This hostility culminated in the nationalizations of the late 30s which included major redistributions of private owned land, the railroad system and the oil industry leading to a further decrease in investor confidence.\textsuperscript{177} Between 1926 and 1940 most of the large multinational investments in agriculture were expropriated.\textsuperscript{178} In contrast to the preponderant rule of foreign investment under Díaz, during the Cádiz administration the share of foreign capital fell to approximately 15\% of total investment. In 1940 total foreign investment reached an amount of under 500 million being only slightly more than one quarter of the level in 1920.\textsuperscript{179} Despite of the decline in total numbers FDI increased in the manufacturing sector with firms like Ford and General Motors establishing plants in Mexico during the 20s and 30s.\textsuperscript{180}

Cádiz\' successors Camacho and Aleman tried to improve the climate for foreign investment by settling the obligations, as for example the

\textsuperscript{175} See Munro (1995) p. 121. Vernon argues that the economic policy of the Díaz rule deeply influenced later Mexican policy: "The stamp of Porfrian policy was so deep on Mexico's economy that the traces can still be glimpsed in the 1960s. The Porfrian policy regarding foreign capital, for instance, still provides part of the emotional backdrop against which foreign investors are judged today in Mexico's economy." Vernon (1963) p.39.

\textsuperscript{176} See Sandrino (1994).

\textsuperscript{177} See Pescador-Castañeda (1971) p.88-94. For a detailed analysis of the expropriation of the oil industry see Knight (1988). Vernon (1966a) argues that the nationalizations of the 1930s reflect the public opinion of the time. Indeed Diego Rivera's mural in the presidential palace of Mexico City where greedy and debauched Wall Street millionaires are depicted confirms this argument.

\textsuperscript{178} See Munro (1995) p.130.

\textsuperscript{179} See Wright (1971) p.61-70.

\textsuperscript{180} See Cádiz (2000b) p.181-182.
compensation of American Oil Companies, inherited from the previous government. During the war years FDI increased slowly with total foreign investment rising from 450 million US$ in 1940 to 575 million US$ in 1946.\textsuperscript{181}

In particular Aleman tried to attract foreign capital that was needed to promote economic development by convincing foreign investors, in particular from the US, that their capital was safe in Mexico.\textsuperscript{182} In spite of the urgent need for investment in the electricity industry the government did not succeed in attracting investment of foreigners because they saw their assets endangered due to the in the long run unstable political environment in Mexico.\textsuperscript{183} Nevertheless, during the rule of Aleman FDI accelerated again reaching an amount of nearly 730 million US$ by 1952. Growing FDI inflows went hand in hand with a drastic change in the preferred target sectors of foreign investors whose main focus shifted from primary materials to manufacturing to take advantage of the growing domestic market. Whereas in 1940 the share of the traditional sectors like mining, public utilities and transportation accounted for 90% of total FDI this value fell to only 41% in 1956. For the same time FDI in manufacturing rose from a share of below 1% in 1940 to a share of 46% in 1956.\textsuperscript{184} The enormous increase in manufacturing FDI reflected the beginning protection of the domestic market initiating the strategy of import substitution. Faced with rising tariffs, MNEs that used to export to Mexico, established plants in the country to take advantage of the dynamic and protected Mexican market.\textsuperscript{185}

Figure 5.5 depicts the evolution of FDI flows to the Mexican economy from 1940 to 1970 clearly indicating the dynamic development of FDI during the late 60s.\textsuperscript{186} However already the upward swings of FDI during the 40 and 50s led to demands of Mexican industrialists represented by the industrial chambers Canacintra and Concamin for limiting FDI and fostered "mexicanization".\textsuperscript{187} The skeptical attitude towards FDI gained momentum during the sextenio of Lopez Mateos who limited foreign participation in certain industries and promoted the nationalization of the electric power industry by means of discriminatory regulation policy although the government was careful to avoid the public offending of foreign investors by offering a compensation.\textsuperscript{188}

\begin{itemize}
  \item \textsuperscript{181} See Wright (1971) p.71-76.
  \item \textsuperscript{182} See Sanchez-Gamper (1989).
  \item \textsuperscript{183} See See Pescador-Castañeda (1971) p.97. Vernon argues that since the late 1930s new foreign investment in electricity was low due to continuous expropriation threats by the Mexican government. As a consequence dim-outs and failures grew common in Mexico. See Vernon (1966a) p.105-109.
  \item \textsuperscript{184} See Wright (1971) p.71-76 and Sanchez-Gamper (1989). For a detailed analysis of the structure of Mexican FDI see paragraph 5.1.2.3.
  \item \textsuperscript{185} See Cárdenas (2000b) p.187-188.
  \item \textsuperscript{186} It has to be noted that the reliability of the older data on FDI to Mexico is questionable. Therefore, it has to interpreted carefully. However, the data set that has been used here was published by the Mexican central bank and is therefore the best available data set as most of the other consulted publications also rely on it.
  \item \textsuperscript{187} See Cárdenas (2000b) p.192-193.
  \item \textsuperscript{188} See Whiting (1992) p.75. The nationalization was celebrated by the Mexican public with posters reading: Land-1917, Oil-1938, Electricity-1960”.
\end{itemize}
In 1961 the government continued its efforts to "mexicanize" by forbidding new mining concessions and limiting the duration of existing concessions of foreign investors. The policy to displace foreign investors also continued in other sectors of the economy.\footnote{See Wright (1971) p.80-86.} Also foreign ownership of forestry and real estate was further restricted under the López Mateos rule.\footnote{See Whiting (1992) p.75.} Despite the absence of legal restrictions on FDI the Mexican administration found other ways to limit foreign participation for example by withholding tax concessions or necessary import licenses. As a consequence of this policy and an general economic downturn foreign investment at the beginning of the 60s fell to levels below amounts in 1956. The decline of FDI flows provoked various governmental efforts to regain investor confidence and in the second half of the López Mateos rule FDI flows rose again.\footnote{See Wright (1971) p.80-86.} Despite of these efforts, the share of FDI in total capital accumulation fell to 5% during the 60s.\footnote{See Cárdenas (2000b) p.192-193.}

The new government of Diaz Ordaz proclaimed that FDI was welcome but that it should be preferably associated in a minority position. His term initiated with the lifting of restriction on incoming FDI flows in sectors as fertilizers, insecticides, basic chemicals and food products.\footnote{See Whiting (1992) p.76.} Due to this declarations and promising outlooks for the Mexican economy FDI flows accelerated during the second half of the 60s. Nevertheless, the Mexican government continuously promoted its goal of further "mexicanizing" the economy with the biggest example being the nationalization of the sulphur industry. Although the transaction consisted in a public bid for 66% of total capital of foreign enterprises, there is evidence that the Mexican government exerted pressure
to achieve the nationalization of the US company. Moreover, the government limited the acquisition of Mexican firms and forbid foreign participation in Mexican financial institutions. The sulphur case and the other restrictions on FDI contributed to cooling investor enthusiasm of the previous years.\textsuperscript{194} In 1965 a series of decrees forbid any foreign participation in the capital of Mexican banks, insurance companies, bonding companies and investment companies.\textsuperscript{195}

During the 70s skeptical attitudes towards foreign investors grew which was reflected in the passing of a new investment law in 1973 that restricted foreign participation to 49% of total capital.\textsuperscript{196} This law was a reaction to the rapid growth of FDI in Mexico, a large part of which were acquisitions of Mexican firms by foreign companies.\textsuperscript{197} Nevertheless capital inflows to Mexico did not totally loose momentum. Instead, the years preceding the debt crisis were marked by a massive upswing in FDI flows spurred by the pre-crisis boom of the Mexican economy. High domestic growth rates and the oil boom attracted foreign investors and by 1981 FDI reached a peak.

Figure 5.6 and figure 5.7 depict the evolution of FDI flows to Mexico since 1970 as yearly flows in constant US$ and as percentage of GDP.

\textbf{Figure 5.6: FDI Inflows to Mexico 1970-2000 (in Million US$ of 1995)}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{fdi_flows.png}
\caption{FDI Inflows to Mexico 1970-2000 (in Million US$ of 1995)}
\end{figure}

Source: Own figure using data from World Bank (2002b), World Development Indicators.

Despite of the restrictive policy on FDI that culminated in the 1973 law, FDI experienced no important declines and showed an upward dynamic that, with a minor decline between 1976 and 1978, continued during the early 80s. The


\textsuperscript{195} See Whiting (1992) p.77.

\textsuperscript{196} For an overview of the legislation of 1973 see paragraph 5.2.2.1.1.

\textsuperscript{197} Whiting describes in greater detail the positions of different Mexican interest groups towards a new legislation on FDI. See Whiting (1992) p.80-107.
decline during the 1976-78 period may not be solely attributed to the 1973 law since FDI also has been influenced by the global recession following the 1973-74 oil crisis. Between 1978 and 1981 excellent growth prospects of the Mexican Economy that were bolstered by the discovery of large oil reserves implied an enormous stimulation of FDI flows and average flows doubled compared to the 1974-1977 period.\footnote{198}

**Figure 5.7: FDI Inflows to Mexico as a percentage of GDP 1970-2000**

![Bar chart showing FDI inflows to Mexico as a percentage of GDP from 1970 to 2000.](source)

Source: Own figure using data from World Bank (2002b), World Development Indicators.

As the analysis of Mexican FDI data does not reflect a negative impact of the restrictive legislation of 1973 it is interesting to see if Mexico lost FDI relative to other host countries. Mexico's share in worldwide FDI is depicted in figure 5.8. Though it must be stressed that there is no way of knowing for sure what the level of FDI would have been without the passing of the legislation the analysis of Mexico's share in worldwide FDI does not confirm the hypothesis that Mexico lost FDI in relation to other countries. Instead, it may be argued that, since Mexico already passed restrictions on FDI in the years preceding the new law, the 1973 law was more a codification of yet existing rules than complete new legislation.\footnote{199} In contrast figure 5.8 clearly mirrors the increase of FDI preceding the debt crisis.

\footnote{198}{See Peres-Nuñez (1990a).}

\footnote{199}{See Whiting (1992) p.90.}

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Therefore, the new legislation only formalized more drastic actions by the Mexican government that had already been taken earlier when foreign equity participation was limited in many industries and foreign copper mining firms were nationalized during the late 60s and early 70s.\footnote{See Munro (1995).} This governmental policy and the hostile rhetoric of president Echeverria against foreign corporations, that according to his view created “chains of dependency”, already increased concerns of international investors before.\footnote{See Philip (1992) p.81.} Falling FDI flows in the period from 1969 to 1972 are a support for the hypothesis that the actions that preceded the passing of the law were more influential than the law itself.\footnote{See Munro (1995).}

The massive decline of FDI in the first half of the 80s is due to the outbreak of the Latin American debt crisis that began with Mexico’s moratorium on international debt in 1982. Nevertheless, it also reflects the perception of industrialized countries that legal protection of FDI in developing countries in a time of such political and economic uncertainty was insufficient.\footnote{See Sandrino (1994).} The value of FDI flowing to Mexico dropped from an annual average of 2.5 billion US$ in 1980-1981 to 0.4 billion US$ in 1983-1985.\footnote{See OECD (1992).} The liberal reforms of the post-crisis years were accompanied by a consecutive opening of the economy to FDI leading to growing inflows from the mid 80s on. However, it must be stressed that the extremely high inflows of FDI in 1986 and 1987 are biased by the introduction of a debt-equity swap program that permitted the swap of public debt against shares in public or private enterprises. Consequently, flows
in 1988 decreased heavily when the program was suspended in 1987.205 The implementation of the Brady plan to tackle the Latin American debt problem and a further liberalization of the investment law in 1989 accelerated FDI.

During the 90s growing inflows continued as a consequence of growing stability, further liberalization of the investment regime but also due to the growing worldwide investment flows to developing countries. While worldwide FDI flows between 1985 and 1990 averaged 142 billion US$ annually the annual average for the years 1990 to 1998 was 336 billion.206 Mexico participated successfully in this upswing of FDI to developing countries. The joining of NAFTA in 1994 led to a further increase in FDI, reflecting higher investor certainty due to the protection of the NAFTA Investment Chapter and the access for investors to the US market. However, already the negotiations of NAFTA that were begun in 1991 and the new investment law of 1993 stimulated FDI in Mexico as is depicted in figures 5.6 and 5.7.207 With the starting of NAFTA in 1994 FDI inflows to Mexico attained levels of around 3% of GDP, a level that with exception of 1987, a year that is biased by debt-equity-swaps programs, has never been attained before. Mexico's stock of FDI rose from 37.1 billion US$ in 1990 to 81.5 billion US$ at the end of 1998 and average flows represented more than 15% of the country's gross fixed capital formation.208 In 1999 Mexico was the third important recipient of FDI in Latin America and the Caribbean.209 FDI inflows maintained a high level with a short decline in investment in 1995 and 1996, which may be attributed to the recession following the Tequila crisis. However already in 1997 FDI flows were superior to 1994 when the effect of the Asian crisis implied lower inflows in 1998 until flows consolidated again in 1999 and 2000. For the next years the projections for FDI flows to Mexico seem positive. The further liberalization in the framework of NAFTA and the continuing efforts to enhance investor confidence point to a further growth of FDI in the future.

To sum up, Mexico's policy towards foreign investment has undergone drastic changes during the last century. The liberal economic policy of the Porfiriato was followed by a occasionally aggressive nationalistic policy that limited and restricted FDI in Mexico. This nationalistic development policy has been pursued for many decades until the outbreak of the debt crisis highlighted the economic inefficiencies of this model. Despite the initial success, economic reforms and liberalization of FDI are relatively new phenomena in Mexican economic policy implying that societal resistance against this policy is still high. Growing electoral support for the left-wing PRD in the midterm election 2003

205 See Peres-Nuñez (1990a). Schinke estimates that from 1985 to 1989 on average 43% of FDI and Portfolio Investment in Argentina, Brazil, Chile and Mexico were financed by debt equity swaps. See Schinke (1993) p.97.
206 See Ramirez (2002).
207 The Bank of Mexico writes: "Direct investment into Mexico has increased substantially, owing to improved confidence, structural change, and the prospect of a North American Free Trade Agreement with the United States and Canada." Banco de México (1993) p.8.
208 See Ramirez (2002).
209 See UNCTAD (2000).
and the resistance of "conservative" politicians inside the PRI, which promote a halt of liberal reforms may serve as a hint to demonstrate the existence of these societal forces. In presence of this revisionist forces in the Mexican society international lock-in mechanisms like NAFTA gain fundamental importance for the country.\textsuperscript{210}

5.2.2.3 The Structure and Geographical Origins of FDI to Mexico
Traditionally FDI flows to Mexico have been largely concentrated in the primary sector and in particular extractive industries since for the Spanish the extraction of precious metals from the colonies of the New World was the main focus. This traditional pattern changed slightly when the government of Porfirio Diaz promoted the development of the national infrastructure and in particular the construction of railroads. Apart from railways FDI was largely concentrated in mining, the oil industry and other agricultural products whereas manufacturing and commerce only received a minor share. Figure 5.9 depicts the structure of FDI to Mexico in 1911, the last year of the Diaz rule.\textsuperscript{211}

Figure 5.10 depicts the geographical origins of FDI flows to Mexico for the same year. Due to the geographic proximity and the great economic and political influence the United States were the most important source of FDI being responsible for more than 40\% of total FDI. The second rank was taken by British investors with a share of slightly more than 30\% whose investments were largely concentrated in mining and the oil industry. French investors followed on the third place holding a share of 20\%.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5.9.png}
\caption{Structure of Mexican FDI in 1911}
\end{figure}

Source: Own figure based on data of Wright (1971) p.54.

\textsuperscript{210} See paragraph 5.4.2 for an analysis of the effects of Mexico's internationalization strategy.
\textsuperscript{211} It has to be noted that the reliability of the older data on FDI to Mexico is questionable. Therefore, it has to interpreted carefully.
While the geographical origin of foreign investment did not alter considerably and the dominant position of US FDI should prevail in the future, the sectoral distribution of FDI flows to Mexico experienced a considerable change.

**Figure 5.10: Geographical Origins of Mexican FDI in 1911**

![Pie chart showing geographical origins of Mexican FDI in 1911: USA 43%, UK 31%, France 20%, Other 6%]

Source: Own figure based on data of Wright (1971) p.54.

More and more foreign investors began to invest in the manufacturing sector while traditional strong sectors as for example mining experienced a sharp decline. There are many reasons for this continuous upgrading of the sectoral FDI distribution. First, since the railway sector and the petroleum industry were nationalized in the 1930s Mexican governments made enormous efforts to mexicanize "strategic" industries of the primary sector. Although already the constitution of 1917 stated that all subsoil wealth belonged to the Mexican people, it took several years before these sectors were totally in the hands of Mexicans.

In the mining sector for example, laws that limited foreign ownership were not passed before the 1960s although over time the government ensured Mexican ownership in the primary sector and in other industries which were considered as strategic. Second, the growing domestic market protection induced tariff hopping FDI in the manufacturing sector since foreign firms that used to export manufacturing products to Mexico now transferred their production across the border to avoid tariffs and to benefit from the protected and fast growing domestic market.

Figure 5.11 depicts the structure of cumulated incoming FDI to Mexico between 1940 and 1950. Compared to 1911 FDI in the industrial sector rose significantly to a share of 19%, which was nearly equivalent to FDI in the mining sector. At the same time the share of FDI in commerce experienced a fast growth.
These structural changes of FDI to Mexico endured during the 60s and 70s. As figure 5.12 shows for the period from 1960-1970, FDI in the industrial sector passed to an impressive share of 69% while FDI in commerce rose to levels of 17% of total incoming flows. On the other hand, mining that still made up for 22% between 1940 and 1950 passed to a share of 8% of total flows from 1960-1970. FDI in transport and communication passed from a level of 22% to a share of below 1% of cumulated inflows.
The nationalization of the electricity sector implied a decline of FDI from a share of 26% for 1940-1950 to levels of below 1%. The share of FDI to construction remained constant at a low level. Therefore, between 1940 and 1970 the fastest growing recipient sectors were commerce and the industrial sector while traditional sectors as mining, transport or communication were in constant decline. Although already low in 1950, the share of agricultural FDI further fell to levels of around 1%.

During the 70s and 80s this general trend continued since the manufacturing sector continued to receive the lion share of incoming FDI. From the mid 70s to the end of the 80s the share of the industrial sector in total FDI reached 75%. For the same period the share of the mining sector constantly declined from 6.3% in 1975 to 1.5% in 1989. Likewise the share of commerce declined from 11.4% in 1975 to 7.1% in 1989. The share of FDI in agriculture constantly kept at a low level of under 1%. The fastest growing sector for this period has been the service sector rising from a share of 7.0% in 1975 to 24.7% in 1989.\textsuperscript{212} Figure 5.13 showing the sectoral distribution of cumulated FDI for the time period 1994-1998 highlights that during the 90s the role of the manufacturing sector remained strong since its share of FDI was 62% with 28% of it flowing to the maquila sector.

\textbf{Figure 5.13: Structure of Mexican FDI from 1994 - 1998 (cumulated flows)}


\textsuperscript{212} See Ortiz (1994) p.168-171.
During the 90s the structure of FDI flows to Mexico has been affected by the continuing liberalization of the national FDI legislation. In particular the service sector in Mexico experienced a fast growth of incoming FDI flows. For the period 1994-1998 37% of total FDI went to the service sector with commerce, telecommunication and the financial sector being the most important recipient sectors. A great fraction of these FDI flows to the service sector consisted of international M&A transactions as many foreign investors entered the Mexican market by purchasing blocks of shares in financial institutions or local retail chains.213

Figure 5.14 illustrates the geographical origins of FDI flows to Mexico from 1994-2002. Despite of considerable changes in the sectoral structure of FDI geographical origins of FDI only changed slowly as the lion share of FDI flows to Mexico still comes from the US making up for 63% of total FDI. Among European nations the share of British FDI declined considerably over time with the Netherlands and Spain now holding higher shares of FDI to Mexico.

Figure 5.14: Geographical Origins of Mexican FDI 1994-2002 (cumulated flows)

Source: Own figure based on data from Dirección General de Inversión Extranjera

Analyzing the local distribution of FDI flows inside Mexico reveals that not all regions of the country equally profited from the dynamic evolution of FDI flows to Mexico. Table 5.8 indicates that the Federal District (Mexico City) received the lion share of incoming FDI with 60.8% of incoming flows for the period from 1999 to 2002. If the State of Mexico is added, the share of the Federal District increases to 65.3% of total incoming FDI. Moreover, the nearby Puebla which is an important center of automobile production receives 2% of incoming FDI. For the rest of the country the structure of incoming FDI clearly mirrors the north-south divide of economic development in Mexico. While the northern

states Nuevo León, Baja California, Chihuahua, Tamaulipas and Sonora received shares of 9.2%, 5.7%, 4.4%, 2.5% and 1.4% respectively, southern states like Chiapas, Oaxaca, Michoacán or Campeche received 0.1 or less of total FDI.

Table 5.8: Regional Distribution of FDI in Mexico (in thousands of US$)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>FDI Total</td>
<td>12,856,062.6</td>
<td>15,484,403.8</td>
<td>25,334,517.0</td>
<td>9,696,385.2</td>
<td>63,371,368.6</td>
<td>100.0</td>
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<td>Aguascalientes</td>
<td>68,152.4</td>
<td>59,991.7</td>
<td>86,268.8</td>
<td>8,032.0</td>
<td>222,444.9</td>
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<td>Baja California</td>
<td>1,133,124.8</td>
<td>952,735.8</td>
<td>775,594.9</td>
<td>772,580.4</td>
<td>3,634,036.0</td>
<td>5.7</td>
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<tr>
<td>Baja California Sur</td>
<td>87,340.3</td>
<td>54,609.8</td>
<td>64,928.6</td>
<td>97,033.4</td>
<td>303,912.1</td>
<td>0.5</td>
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<tr>
<td>Campeche</td>
<td>3,035.7</td>
<td>11,353.2</td>
<td>-21,414.4</td>
<td>17,981.1</td>
<td>10,955.8</td>
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<td>Coahuila</td>
<td>166,699.1</td>
<td>201,426.2</td>
<td>128,130.7</td>
<td>109,071.2</td>
<td>605,327.2</td>
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<td>Colima</td>
<td>4,203.7</td>
<td>7,045.0</td>
<td>1,382.0</td>
<td>4,153.2</td>
<td>16,783.6</td>
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<td>Chiapas</td>
<td>3,326.8</td>
<td>2,209.5</td>
<td>-902.8</td>
<td>978.4</td>
<td>5,612.0</td>
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<td>Chihuahua</td>
<td>583,975.3</td>
<td>940,386.8</td>
<td>693,771.0</td>
<td>565,155.0</td>
<td>2,803,288.1</td>
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<td>Distrito Federal</td>
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<td>7,582,778.4</td>
<td>19,478,996.7</td>
<td>5,525,381.3</td>
<td>38,502,755.5</td>
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<td>Durango</td>
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<td>4,216.4</td>
<td>80,571.7</td>
<td>97,155.2</td>
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<td>Guanajuato</td>
<td>135,909.0</td>
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<td>206,300.6</td>
<td>123,146.6</td>
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<td>966.8</td>
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<td>Jalisco</td>
<td>526,630.0</td>
<td>1,026,372.1</td>
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<td>129,916.4</td>
<td>1,942,922.9</td>
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<td>123.5</td>
<td>194,157.3</td>
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<td>32,130.6</td>
<td>12,714.2</td>
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<td>Nuevo León</td>
<td>1,317,145.7</td>
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<td>918,416.7</td>
<td>5,814,770.6</td>
<td>9.2</td>
</tr>
<tr>
<td>Oaxaca</td>
<td>691.3</td>
<td>-1,739.9</td>
<td>-1,655.3</td>
<td>1,559.2</td>
<td>-1,348.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Puebla</td>
<td>132,021.3</td>
<td>546,510.5</td>
<td>206,825.2</td>
<td>395,844.8</td>
<td>1,281,201.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Querétaro</td>
<td>135,337.1</td>
<td>156,910.3</td>
<td>140,622.8</td>
<td>44,721.1</td>
<td>477,591.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Quintana Roo</td>
<td>91,641.1</td>
<td>22,305.9</td>
<td>45,482.3</td>
<td>3,063.1</td>
<td>162,492.5</td>
<td>0.3</td>
</tr>
<tr>
<td>San Luis Potosí</td>
<td>209,754.8</td>
<td>276,448.9</td>
<td>166,776.8</td>
<td>3,119.8</td>
<td>556,101.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Sinaloa</td>
<td>40,819.4</td>
<td>12,182.5</td>
<td>36,695.9</td>
<td>-1,127.1</td>
<td>88,570.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Sonora</td>
<td>186,974.3</td>
<td>385,122.7</td>
<td>161,836.3</td>
<td>146,586.8</td>
<td>880,518.9</td>
<td>1.4</td>
</tr>
<tr>
<td>Tabasco</td>
<td>52,734.8</td>
<td>38,413.4</td>
<td>4,088.3</td>
<td>827.5</td>
<td>96,064.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Tamaulipas</td>
<td>460,701.2</td>
<td>475,857.2</td>
<td>329,359.2</td>
<td>321,752.7</td>
<td>1,587,670.3</td>
<td>2.5</td>
</tr>
<tr>
<td>Tlaxcala</td>
<td>43,859.4</td>
<td>4,215.4</td>
<td>12,701.6</td>
<td>127.8</td>
<td>61,110.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Veracruz</td>
<td>-73,266.0</td>
<td>21,767.8</td>
<td>117,192.6</td>
<td>2,561.1</td>
<td>68,255.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Yucatán</td>
<td>41,303.8</td>
<td>47,205.9</td>
<td>126,272.3</td>
<td>6,962.2</td>
<td>221,744.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Zacatecas</td>
<td>11,100.6</td>
<td>12,151.6</td>
<td>5,516.4</td>
<td>5,292.0</td>
<td>34,059.6</td>
<td>0.1</td>
</tr>
</tbody>
</table>


The only southern state with a considerable share of FDI is Jalisco with a share of 3.1%, most probably related to the presence of the state oil company PEMEX in this federal state. These regional pattern of FDI implies that the capital and the 5 northern states account for 90.5 percent of total incoming FDI flows to Mexico.
It has been shown that Mexico has been constantly upgrading its locational specific advantages, inducing changes in the structure and motives for FDI although the debt crisis in 1982 and the financial turmoil in late 1994 implied a short break in this general transition of the FDI structure towards manufacturing and services. While in the beginning of the century FDI was largely natural-resource-seeking investment, the import substitution period was characterized by a dominant position of market seeking foreign investors avoiding high national tariffs and profiting from the protected domestic market. Access to the local market still seems to be the dominant motivation for FDI in financial services, telecommunication, retail trade and some industrial sectors as food, beverages and tobacco. Despite of these market-seeking investments, the more Mexico became integrated to the North-American market through the signing of NAFTA the more FDI changed to being led by efficiency seeking motives. In sectors as automotive, computer, electronics and the clothing industry the need to cut costs and potential opportunities for exports to the NAFTA market stimulated the location of productive investments in Mexico. Fostered by the continuous opening of the economy to foreign trade Mexico more and more became an export-platform for MNEs profiting of the cheap but comparably skilled labor in the country. For MNEs located outside the US in turn, NAFTA was an important motive for productive engagements in Mexico as it implied access to the large and dynamic US market.

In general the empirical literature indicates positive implications of increasing FDI flows for the Mexican economy. Empirical work of RAMIREZ confirms the hypothesis that Mexico attracted FDI in sectors where international trade links are strong and potential positive spill-over effects associated with the transfer of technology and learning-by-doing are high. Consequently, he shows that FDI has a positive impact on labor productivity. Other empirical investigations likewise suggest that the presence of technological spillovers of FDI enhance economic efficiency in Mexico. To sum up, the changing structure of FDI in Mexico towards manufacturing and services suggests that Mexico profits from transfers of technology and managerial know how. As recent empirical research indicates the overall impact of FDI on Mexican economic performance seems to be positive. Problematic is the regional concentration of FDI around the capital and in the northern states which further increases the regional divide of economic development in Mexico.

214 See Calderón/Mortimore/Peres (1995).
5.3 Political Risk in Mexico

5.3.1 Overview

The following paragraphs evaluate political risks for foreign investors in Mexico between the years 1984-2003 using the available risk data and analyzing the relevant literature. Although it would have been interesting to analyze the impact of political risk in different industrial sectors with different degrees of reversibility, these tests could not be performed due to the lack of reliable disaggregated data. Due to the small size of the political risk data set methods of advanced time series analysis have not been considered a viable methodology for this empirical analysis. Instead, to show initial evidence for the influence of political risk indicators on FDI simple statistical correlations are reported in scatter plots. All numerical statistical results are depicted in table A.2 in Annex II. It is obvious that due to the lack of a reasonably sized data set and the resulting methodological deficiencies results have to be interpreted with caution. To facilitate the empirical analysis I use the three groups of political risk that have already been used for the empirical analysis in Chapter 4. Paragraph 5.3.2 analyzes the evolution of macroeconomic risk factors in a similar fashion as orthodox country risk analysis would propose. Paragraph 5.3.3 in turn, is dedicated to the analysis of risks that result from governmental behavior or the structure of national institutions. Eventually, paragraph 5.3.4 is dedicated to the analysis of political risk that originate in societal characteristics of the host country. The last paragraph offers a general evaluation of the institutional environment for FDI in Mexico and an analysis of Mexico's risk mitigation strategy since the outbreak of the debt crisis.

5.3.2 The Macroeconomic Environment

It has been argued that the establishment and maintenance of a stable macroeconomic environment is one of the basic economic tasks of a national government and an important prerequisite for national economic development. However, macroeconomic stability has been a problem in Mexico since the beginning of the time period that is analyzed here. In 1982 Mexico's moratorium on its international debt initiated the outbreak of the Latin American debt crisis and left the country with nearly unacceptable business conditions for foreign investors. In the following years a central focus of national economic policy was to overcome the effects of the severe crisis that had affected the country. Nevertheless, it took the Mexican government nearly 10 years to overcome the effects of the economic crisis that hit the country during the early 80s. Following the stabilization policy that was implemented in the aftermath of the crisis the country entered into a severe recession and living standards fell drastically. During the early 90s Mexico successfully continued the economic reform process and macroeconomic stabilization,

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1 Furthermore, this test entails the difficulty to theoretically determine the degree of reversibility of investment projects in different industrial sectors.
2 Excluding 2003 the number of available observations is 19.
4 In 1986 BERI rated Mexico as a country with “unacceptable business conditions” for foreign-owned businesses. In this year Mexico’s index scores were similar to those of Egypt, India, Iraq and Kenya. See Howell/Chaddick (1994) p.80-81.
economic liberalization and debt rescheduling over time restored investor confidence.

The most suitable indicator for measuring the evolution of macroeconomic country risk is the interest spread that is charged on a country’s sovereign debt since spreads measure the difference between interests charged for sovereign debt of highly credible international debtors and emerging market countries. For taking the higher risk of default inherent to investments in government bonds of emerging markets investors are compensated by this risk premium.

**Figure 5.15: Mexican Interest Spreads on Sovereign Debt 1993-2000 (in %)**

![Figure 5.15: Mexican Interest Spreads on Sovereign Debt 1993-2000](Image)

Own Figure using data of the World Bank (2002b).

When investing in riskier assets, investors demand higher spreads in order to cover expected losses from default. Therefore, interest rate spreads are good indicators of country risk as they picture the expectations of international financial markets about the default risk of country bonds and other obligations of emerging market countries. Figure 5.15 shows the evolution of Mexican interest spreads over LIBOR during the 90s and highlights the near tripling of Mexican spreads during the financial crisis that hit the country in late 1994. Following the Tequila-Crisis however, Mexican spreads have been constantly declining. In 2000 and 2001 the three major rating agencies Moodys, Standard and Poors, and Fitch assigned Mexico an investment-grade rating on its long-term foreign currency debt. Now being an attractive investment destination for a broader range of investors interest rates on public debt fell and country risk further decreased. Between September 1998 and March 2003 Mexico's score in the institutional investor country risk index rose from 45.4 points to 58.5 points indicating a marked improvement in the country's fundamentals.\(^5\) In May 2003 Mexican interest spreads reached the all time low of 233 basis points.\(^6\)

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\(^5\) See Blázquez/Santiso (2003).

\(^6\) See BBVA (2003).
Figure 5.16 illustrates the evolution of Mexican interest rate spreads over US treasury bonds from 1997 to 2003 indicating the important decline in spreads between 1999 and 2001.

**Figure 5.16: Mexican Interest Rate Spreads over US-treasury bonds (in basis points)**

![Graph showing Mexican Interest Rate Spreads over US-treasury bonds from 1997 to 2003]

Source: BBVA (2003), Latinfocus.

Besides the inspection of hard data one may use pooled information about the macroeconomic situation given by political risk indicators that focus on macroeconomic risk. An indicator that pools the information of several sub-indicators to a single measure of macroeconomic risk is the Economic Risk Rating developed by PRS Group. This measure is "a means of assessing a country's current economic strengths and weaknesses. In general, where strengths outweigh weaknesses, a country will show low risk and where weaknesses outweigh strengths, the economic risk will be high. To ensure comparability between countries, risk components are based on accepted ratios between the measured data within the national economic/financial structure, and then the ratios are compared, not the data. Risk points are assessed for each of the component factors of GDP per head of population, real annual GDP growth, annual inflation rate, budget balance as a percentage of GDP, and current account balance as a percentage of GDP. Risk ratings range from a high of 50 (least risk) to a low of 0 (highest risk), though lowest de facto ratings are generally near 15."  

Figure 5.17 depicts the evolution of this risk indicator for the period from 1984 to 2003. An inspection of the data indicates that the economic risk indicator shows an upward trend since the beginning of the economic reforms in the mid 80s that is interrupted twice. The first time due to the recessive effects of the financial crisis in late 1994 and the second time in 1999. With exception of these two periods the economic risk rating mirrors the efforts of the national government to maintain macroeconomic stability. Despite of its obvious

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7 See PRS Group (2003).
success it took the national government a long time to see the results of its stabilization policies as Mexico needed 19 years for an increase of 10 index points.

**Figure 5.17: Economic Risk in Mexico 1984-2003**

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003). Index values for 2003 are calculated using data for January and February.

To assess the impact of the economic risk rating on the inflow of FDI the two scatter-plots in figure 5.18 depict the correlation between the economic risk indicator and FDI flows on the left as well as between the indicator and the FDI/GDP ratio on the right. The statistical correlation suggests a positive impact of lower economic risk on FDI flows as well as on the FDI/GDP ratio.

**Figure 5.18: Correlation between Economic Risk and FDI**


Although lower risks pictured by the index coincide with higher FDI flows to Mexico, it has to be underlined that the correlation has to be interpreted with
caution due to the limited data sample. Since the economic risk indicator has not been available for all Latin American countries included in the panel analysis in Chapter 4 there is no additional empirical evidence about the influence of this indicator on FDI. Nevertheless these results give an indication that economic risk exerts an important influence on FDI which seems to confirm the relationship between the two variables that has been postulated theoretically.

Another approach to assess macroeconomic risk is to measure a country’s ability and willingness to fulfil its financial obligations. Again one could examine several macroeconomic indicators to analyze the current situation or pool relevant data in one single measure of financial risk. The Financial Risk Indicator of PRS Group is a “means of assessing a country’s ability to pay its way by financing its official, commercial and trade debt obligations. To ensure comparability between countries, risk components are based on accepted ratios between the measured data within the national economic/financial structure, and then the ratios are compared, not the data. Risk points are assessed for each of the component factors of foreign debt as a percentage of GDP, foreign debt service as a percentage of exports of goods and services, current account as a percentage of exports of goods and services, net liquidity as months of import cover, and exchange rate stability. Risk ratings range from a high of 50 (least risk) to a low of 0 (highest risk), though lowest de facto ratings are generally near 20. 8

Figure 5.19: Financial Risk in Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003). Index values for 2003 are calculated using data for January and February.

Due to the country’s severe problems with external debt, in particular during the 80s, it seems highly probable that financial risk in Mexico influenced the

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8 See PRS Group (2003). Due to the sub-components of the indicator it is comparable to the macroeconomic risk indicator that has been used in Chapter 4.
decisions of foreign investors. The evolution of the financial risk indicator between 1984 and 2003 that is depicted in figure 5.19 shows that following the debt crisis Mexico's financial risk rating reached highest possible de facto levels indicating that the country's moratorium on external debt and difficult negotiations about debt rescheduling obviously rendered financial risk of the country prohibitively high.

However, after the process of debt rescheduling had been agreed on and efforts of stabilization showed first success Mexican financial risk experienced a steady upward movement reaching its summit in the mid 90s which reflects the successful implementation of macroeconomic stabilization policy by the Mexican government. The unstable development since the mid 90s however, illustrates the volatility of financial risk on the Mexican market. Although the financial crisis in 1994 and its aftermath affected the financial risk rating since the late 90s, financial risk has been maintained on a stable level. To analyze the impact of financial risk on FDI to Mexico the correlation of the index with FDI is reported in figure 5.20. The two scatter-plots illustrate the correlation between financial risk and FDI flows and the FDI/GDP ratio respectively. Both graphs indicate a positive relationship which implies that Mexican data confirms the hypothesis of a positive correlation that has been postulated before.

Figure 5.20: Correlation between Financial Risk and FDI


Again it has to be underlined that the small data set limits the viability of these findings. However, as additional empirical evidence from the panel analysis on the impact of the indicator is not available it may be cautiously concluded that financial risk has an impact on the decisions of foreign investors in Mexico. Since the same result holds for the economic risk rating the analysis of Mexican data leads to different results than the panel analysis in Chapter 4. While the results of the panel analysis did not permit to label macroeconomic risk factors as robust determinants of FDI, the empirical analysis of the
Mexican data suggests an influence of macroeconomic risk variables on FDI. These deviating results for the Mexican case may be due to the preponderant role of macroeconomic risk factors in Mexico during the 80s. That is to say, the severe imbalances that Mexico experienced during the "lost decade" may have been a major impediment to incoming investment flows. However, despite of severe macroeconomic problems in Mexico during the debt crisis also other Latin American countries suffered from macroeconomic distortions. Therefore, explaining the diverging results with characteristics of Mexico is not very convincing. Another possible explanation for the diverging results is the different indicators that were used. Although the construction of the indices and the sub-indicators are similar, it is possible that the two indicators differ. Whatever the reason for this results the analysis of this paragraph permits the conclusion that macroeconomic risk factors have been an influential determinant of FDI flows to Mexico.

5.3.3 Mexican Institutions and Risk
5.3.3.1 Government Stability, Political Constraints and Regime Type
The analysis of the Mexican political system showed that for a long time power was largely concentrated in the hands of the executive branch of government. Although formally a democracy, the "meta-constitutional powers" of the president dominated every aspect of Mexican politics including economic policy. In turn, congress and the judiciary were found to be weak institutions without sufficient power to efficiently control the executive branch. In sum, the PRI dominance of Mexican politics reduced the checks and balances that are established in the constitution to not more than a mere theory.9 Although universal suffrage existed, elections were often fraudulent to ensure the victory of the PRI. Nevertheless, the assessment of regime type in Mexico is a difficult task because the political system is as MORRIS states "neither fully democratic nor blatantly authoritarian; public policies are neither wholly capitalistic nor decidedly socialistic; interest groups both mobilize and demobilize; and elections are neither honest nor completely fraudulent".10 Although the institutional design laid down in the Mexican constitution is undoubtedly democratic, de-facto policy was characterized by dominant authoritarian-corporatist patterns.11 Using the criteria that have been presented in paragraph 3.1.3.1 for characterizing democratic systems Mexico before the presidency of Zedillo can hardly be labeled as democratic. The division of power was at best incomplete, press and media partly controlled and elections fraudulent.

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9 See Penner (1999). Moreno Ocampo (1993) argues that this is a common Latin American problem: "El obstáculo fundamental es nuestra pesada tradición de poder hegemónico, que no desapareció junto con los gobiernos autoritarios. Los nuevos gobernantes ya no llegan al poder por golpes militares sino por el voto, pese a que luego pretenden ejercer el poder del modo irrestricto y discrecional con que actúa un gobierno de facto." Moreno Ocampo (1993) p.38


11 See Morris (1991) p.25. Elizondo writes: "Formalmente México es una democracia: tiene elecciones periódicas, un sistema de partidos y un presidente y un congreso electos; sin embargo, aunque existe un pluralismo limitado, la sociedad estuvo administrada hasta hace muy poco de manera autoritario por el gobierno y por el presidente, quien dirige el gobierno." Elizondo (2001) p.73.
Although violent repression has not been systematically used and freedom of speech and political participation were not severely restricted, Mexico did not have the characteristics of a democratic political system. Consequently in an investigation on democracy in Latin America MAINWARING classifies Mexico as authoritarian from 1821 to 1988 and as semi-democratic from 1988 onwards. This classification is confirmed by ratings of Freedom House. Since 1972, Freedom House has published an annual assessment of freedom by assigning each country and territory the status of "Free," "Partly Free," or "Not Free" as an average of political rights and civil liberty ratings. Those whose ratings average 1-2.5 are generally considered as "Free," those with ratings between 3-5.5 as "Partly Free," and those with scores between 5.5-7 as "Not Free." For all periods between 1972 and 2000 Mexico has been rated as partly free which confirms the picture of an intermediate status that has been drawn above. Using the terminology of WINTROBE before the reforms enacted by Zedillo Mexico was a "timocracy" with comparatively low levels of repression but high loyalty due to the distribution of rents by the corporatist party system. However, with the strengthening of the opposition parties and electoral reforms in the second half of the 90s the country made a transition towards a true democratic system with fair elections as well as checks and balances for the executive branch. Although since the electoral victory of Fox in 2000 Mexico's Freedom House-rating has been upgraded to the status "free", the credibility enhancing effects of a functioning democracy which have been exposed in paragraph 3.1.3.2 are largely absent for the analyzed time period. In other words, the institutional environment for investors has not been characterized by a proper protection of basic constitutional rights and effective checks on the actions of the national executive that should be given by a functioning democratic system.

A careful examination of the political system of Mexico has many implications for the analysis of political risks for MNEs. Following PRITZL one may distinguish three levels of institutional instability in a political system: regime instability, policy instability and arbitrary actions of government officials. The first object of study for political risk analysis is therefore the stability of the political system. It is straightforward to see that an unstable government may

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12 Guillermo O'Donnel called Mexico a "dictablanda" (soft dictatorship). Cited in Peeler (1998) p.119. Przeworski et al. argue that Mexico was not democratic because the opposition had no realistic chance to come to power. See Przeworski et al (2000) p.17.

13 See Mainwaring (1999) p.7. In the same paper he argues that many democracies in Latin America are defect in the sense that minorities like indigenous or the rural population have formal citizenship rights but are frequently marginalized. Furthermore, countries in the region face the problem of weak democratic institutions and a limited rule of law.


15 Mainwaring finds that for the Latin American countries democracy measured by the Freedom House Index weakly positively correlates with the level of per-capita income which is an initial indication for the potential wealth enhancing effects of democratic governance in the region. Interestingly this correlation is lower than in other regions of the world. See Mainwaring (1999).

16 See Pritzl (1997) p.72-76.
imply risks to investors. Governments that only have a weak hold to power or that may be easily removed by other societal forces are a possible source of instability that may affect the economy as well as the returns of private investment projects. In the worst case political stability is undermined by revolutions, violent protests or upheavals. In less severe cases rapidly changing governments cannot guarantee a basic continuity of policy that produces a reliable framework for private economic activity. Radical policy swings induced by quickly changing governments produce a climate of discontinuity and instability that depresses private investment because governing institutions cannot give a credible commitment to protect private assets.¹⁷

Unlike in many other Latin American countries in Mexico stability of government has not been a problem.¹⁸ Since the political instabilities of the revolutionary period had been overcome the establishment of the one party government produced a stable political climate.¹⁹ The corporatist one party state which effectively channeled societal conflict by occasional repression and distribution of rents to system loyalists produced a political system that did not suffer severe problems of instability.²⁰ Since the presidential term of Cardenas (1934-1940) the political system of Mexico has not undergone periods where the volatility of governments was high.²¹ Unlike other Latin American countries Mexico neither experienced revolutions, coup d'etats or military governments. Even during the years of severe economic crisis the grip of the PRI to power has not been seriously menaced.²²

Although it is obvious that the empirical measurement of government stability is not straightforward, I use an indicator that has been constructed by PRS Group. The index is a measure of the government's ability to stay in office and carry out its declared programs, depending upon such factors as type of governance, cohesion of government and governing parties, approach of an election, and command of the legislature. Figure 5.21 depicts the evolution of

¹⁷ Empirical research has confirmed the link between political instability and expropriation. Between 1960 and 1979 40% of all expropriations followed revolutionary transformations of socioeconomic and political systems. See Kennedy (1991) p.21.
¹⁸ Rodriguez (2000) argues that political instability was an important impediment for growth in Latin America.
²¹ Langston (2002) argues that the sharpest threats to the stability of the system came from internal splits inside the PRI. Hence, the ruptures of 1940, 1952 and 1988 when party dissidents challenged the official PRI candidate were the greatest threat to political stability in Mexico. See Langston (2002).
²² The only exception were the events of 1988 when PRI candidate Salinas de Gortari was challenged by the PRI dissident Cuauhtémoc Cárdenas.
government stability from 1984 to 2003. Despite of its comparative stability the inspection of the empirical data for Mexico suggests that there have been variations of government stability in the analyzed time period.

**Figure 5.21: Government Stability in Mexico 1984-2003**

However, when the consequences of the debt crisis reduced government stability during the second half of the 80s recovery to old levels of stability was rapid. In the early 90s however, in particular following the dramatic political events of 1994, government stability dropped to all time lows. After the effects of the political and economic crisis had been overcome stability ratings accelerated again reaching a peak in the year 2000, which is unusual for election years. The change of presidency in 2000 and the difficult situation in congress afterwards reduced index values again to levels of the early 90s.

To determine if government stability has an impact on FDI flows to Mexico I examine the correlation of the index and yearly FDI flows and FDI/GDP ratio respectively. The two scatter-plots in figure 5.22 depict the relationship between the government stability index and Mexican FDI data. The data does not permit a decisive conclusion about the impact of government stability on FDI although the statistical correlation between the two variables indicates a weak positive correlation. However, it has to be underlined that this result may be due to the lack of econometric sophistication that has been caused by the small sample of available data.
Besides regime instability, other important sources for institutional instabilities are lacking policy stability and arbitrary actions of government officials. Billet argues that a high degree of government intervention in the host country economy increases risks for MNEs as governments most likely want to regulate key corporate decisions once the investment is made.\(^{23}\) The theoretical analysis in Chapter 3 identified political discretion and the absence of checks and balances as an important source of risk for current and potential investors since arbitrary changes of the status quo are more likely if constraining societal institutions are lacking.\(^{24}\) Thus, investors face a higher risk of opportunistic policy changes when governments are not subject to an efficient control of other societal institutions. In other words, unlimited governments do not succeed in giving credible commitments not to interfere in the investor's property rights. A detailed analysis of presidential politics in Mexico during the last years indeed reveals an abundance of anecdotal evidence that arbitrary presidential decisions repeatedly affected the Mexican economy.\(^{25}\)

Although the exact quantification of governmental constraints remains a difficult problem, I use POLCON to proxy checks and balances in national politics.\(^{26}\) Chapter 4 already offered econometric evidence on the effects of political constraints on FDI concluding that political constraints were no robust determinant of FDI for a sample of Latin American countries, although it turned

\(^{23}\) See Billet (1991) p.37. In fact a survey of private sector senior managers shows that in Latin America more than 38% of the respondents spent more than 15% of their working time with negotiations with government officials compared to 10% in OECD countries. See World Bank (1997) p.43.

\(^{24}\) See Pritzl (1997) p.73.


\(^{26}\) See paragraph 3.3.5.
out to be robust as part of a governance indicator.\textsuperscript{27} Despite of these findings analyzing the influence of governmental discretion on FDI to Mexico is interesting. As already pointed out POLCON measures veto points in the political system corrected by current partisan powers in the legislative chambers. The indicator is normalized to a value between 0 and 1 where a level of 0 represents the theoretical case of an absolute absence of checks and balances while a value of 1 represents the theoretical case of a fully constrained executive. Although it has to be noted that the upper extreme value is not often observed, authoritarian regimes approach values around zero which indicates a massive concentration of power in the hand of the executive.\textsuperscript{28} Figure 5.23 depicts the evolution of this indicator for the period between 1960 and 2001:

Figure 5.23: Political Constraints in Mexico 1960-2001

\begin{figure}
\centering
\includegraphics[width=\textwidth]{POLCON111_2002}
\caption{Political Constraints in Mexico 1960-2001}
\end{figure}

Source: Own figure using yearly data from POLCON.

The Mexican data shows that initially the level of checks and balances in the political system was extremely low which implies that the Mexican government ruled nearly unchecked by other societal institutions. For the early 60s the indicator attains levels that are only slightly higher than zero representing an absolutely unchecked government which is usually characteristic for personal dictatorships. In fact the level of political constraints in Mexico for that time is similar to that during the authoritarian rule of Diaz. Insofar the indicator is in line with the previous analysis of the political system that highlighted the meta-constitutional powers of the Mexican president and the irrelevance of other governmental branches. Despite of cautious political reforms constraint levels remained low throughout the 70s and 80s implying that the executive branch could still implement policies without any effective control of other political branches. With the PRI loosing its grip on power, the level of constraints for

\textsuperscript{27} See paragraph 4.2.4.

\textsuperscript{28} For Castro’s Cuba, Mexico under Porfirio Diaz, Spain under Franco and Chile under Pinochet index values score 0.
the federal government was growing constantly. The first important upward move of the indicator occurred in 1988 when the PRI lost its constitutional majority. With higher presence in congress and a growing importance in the political process opposition parties successfully limited the discretionary freedom of the Mexican government. In other words, growing political constraints were caused by political reforms in Mexico. The process of democratization during the 90s resulted in a more limited government that faced higher levels of checks and balances and was more effectively constrained in its implementation of policy. The similar higher rankings of the PRS Group's democratic accountability ranking which is depicted in figure 5.24 demonstrate that higher levels of democracy coincided with higher constraints for the executive. Currently the levels of political constraints in Mexico already roughly resemble average values of the USA.

Figure 5.24: Democratic Accountability in Mexico 1984-2001

![Graph showing Democratic Accountability in Mexico 1984-2001](image)

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

Having in mind the theoretical implication of strengthening political constraints this analysis indicates lower risks for MNEs of becoming victims of opportunistic government action since additional mechanisms of control make radical policy swings less likely. Nevertheless, there are two important additional arguments. First, it has to be stated that the POLCON indicator for Mexico is systematically upward-biased as the objectively derived indicator is not able to picture the characteristics of the Mexican political system. Since compared to the US system all governmental branches except for the executive are still weak, the objective derivation of the indicator does not properly picture the characteristic role of the Mexican presidency. The high bill success rates of president Zedillo who already faced an opposition majority in congress may serve to illustrate this point. In addition, the inability of the judiciary to act as a contra-weight to executive dominance shows that the level of checks and balances in Mexico is still considerably lower than in the US.

For an overview of the political events see Nacif (2003) p.8.
The other important objection to the use of the indicator is the integration of Mexico into the world economy by signing free trade agreements and other multilateral treaties. Since these agreements imply obligations that limit governmental discretion by international law the sole focus on national institutions neglects checks and balances by international law which produces a systematic downward-bias of the indicator.

Figure 5.25: Correlation between Political Constraints and FDI

![Figure 5.25: Correlation between Political Constraints and FDI]


Despite these limitations POLCON permits to calculate the statistical correlation between political constraints and FDI flows to Mexico. Although sophisticated econometric evidence is missing, the correlation in figure 5.25 suggests a positive influence of political constraints on FDI to Mexico as higher level of constraints appear to coincide with higher inflows of FDI or higher FDI/GDP ratios.

Given the positive correlation between growing constraints and higher values of democracy it will be analyzed if this results also holds for the index of democratic accountability. Figure 5.26 depicts the correlation between the values of democratic accountability and FDI to Mexico. The inspection of the two scatter-plots also suggest a positive correlation between democratic accountability and FDI flows and the FDI/GDP ratio respectively. Despite of the already mentioned difficulties in interpreting these results one may come to the conclusion that higher democratic accountability and political constraints go hand in hand with higher FDI flows and FDI/GDP ratios. Therefore, the correlation may be seen as a weak empirical indication for an impact of democratic accountability and political constraints on FDI flows to Mexico.
Another risk factor that traditionally has been influential in Latin American countries is the involvement of the military in political decisions. Military governments or military controlled governments can become a threat for investors because democratic reliability is severely diminished, basic citizen rights may be suspended and property be expropriated if an individual's political ideology does not coincide with the beliefs of the military government. Moreover, military governments can initiate politics that rather aim at ensuring power and redistribute wealth to members of the junta instead of promoting general societal welfare.\textsuperscript{30} To quantify the military's involvement in politics I use an indicator that has been provided by PRS group that measures the risk for foreign investors that their businesses will sooner or later be affected by military rule.\textsuperscript{31} In Mexico military involvement in politics has traditionally been more scarce than in other countries of the region. Moreover, unlike other countries in Latin America, since the end of the unstable revolutionary period Mexico has neither experienced a military coup or a military government.\textsuperscript{32} Nevertheless, it is interesting to analyze the potential impact of political

\textsuperscript{30} Wintrobe (1998) writes "... the military regimes in Latin America in the 1970s and elsewhere, whose most concrete and lasting achievement has been to increase military salaries and the military budget." Wintrobe (1998) p.26.

\textsuperscript{31} PRS Group writes: "Since the military is not elected, involvement, even at a peripheral level, diminishes democratic accountability. Military involvement might stem from an external or internal threat, be symptomatic of underlying difficulties, or be a full-scale military takeover. Over the long term, a system of military government will almost certainly diminish effective governmental functioning, become corrupt, and create an uneasy environment for foreign businesses." See PRS Group (2003).

\textsuperscript{32} Langston (2002) argues that president Alemán (1946-52) made an important step to ensure civil primacy over the military by breaking with the habit to recruit politicians with revolutionary background from the military. Instead, he started to recruit university trained bureaucrats that were usually trained at the Universidad Nacional Autónica (UNAM). See Langston (2002) p.
involvement of the military on FDI and figure 5.27 depicts the evolution of this indicator for Mexico between 1984 and 2003.

**Figure 5.27: Military In Politics in Mexico 1984-2001**

![Graph showing the evolution of military involvement in politics in Mexico from 1984 to 2003.](image)

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

The inspection of the data suggest that indeed the degree of military involvement in Mexico has traditionally been low as ratings picture the lowest level of risk until 1994. After 1994 however, the risk of military involvement in political decision making has been considerably growing implying that in only nine years Mexico's rankings in military involvement dropped by 50%. Since in the late 90s and the first years of the new millenium military involvement in Mexican politics has been constantly growing, the rating may reflect the tendency of the Zedillo administration to assign many additional task to the military that have formerly been the responsibility of civilian institutions.  

There are many reasons for this development. First, the violent uprising in Chiapas entailed a more important role for military decision makers in politics. Second, the rising problems with drug trafficking in Mexico has been answered by higher military presence and involvement of the armed forces. In addition, Zedillo also assigned military leaders to lead the demoralized and corrupt national police force. Third, migration problems at the northern and southern border imply a massive presence of the military in border regions. Therefore, the role of the military in Mexican political life seems to be growing unless these problems have been tackled. In spite of the growing influence of the military during the last years the army fulfilled its role without seeking to increase its political power as an institution. This implies that the Mexican tradition of civilian dominance over the military seems to be secure.

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35 Since then reports of human rights abuses have multiplied. See PRS Group (2000) p.41.  
Figure 5.28: Correlation between Military Involvement in Politics and FDI

Source: Own figure using yearly averages of monthly data by PRS Group 2003 and yearly data of the World Bank (2002b).

To analyze the potential impact of higher military involvement in Mexico on FDI, figure 5.28 reports the correlation between military-in-politics and FDI as well as the FDI/GDP ratio. The Mexican data indicates an inverse relationship between the two variables suggesting that higher levels of military presence coincide with higher levels of FDI. If this counter-intuitive evidence is a product of the bias that arises due to the lack of reliable data or due to growing levels of public insecurity which cause a positive effect of higher military presence on investor security, is unclear.

Summing up, I find weak empirical evidence for the hypothesis that the degree of government stability has a positive impact on FDI. At the same time the hypothesis that higher military involvement depresses FDI is rejected by the analysis of Mexican data. On the other hand this paragraph offers empirical evidence for a positive impact of democratic reliability and political constraints on FDI flows to Mexico. This is of particular interest, as not only the direct implications of unconstrained government and lacking democratic reliability for incoming FDI are important. Instead, lacking constraints and low levels of democratic accountability might as well have an impact on other institutional variables. For example, unlimited governmental discretion may be detrimental for a functioning rule of law since high levels of discretion and lack of control by other societal institutions make it unlikely that the government restricts itself by obeying to existing legislation. Moreover, as has been argued in the literature high levels of corruption are fostered by a political system that lacks functioning mechanism of control since lacking checks and balances facilitate the establishment of a system of institutionalized corruption that is harmful for foreign investors.37

"La movida para mis amigos, y la ley para mis enemigos." 38

5.3.3.2 The Rule Of Law

As argued before lacking rule of law may not only be caused by domestic legislation but also by inefficient institutions of law enforcement. The short analysis in paragraph 5.1.2.4 already highlighted that the judiciary and other institutions of law enforcement are not efficiently working in Mexico. Like in other Latin American countries this lacking rule-of-law-tradition is partially a heritage from Spanish colonialism. As laws and regulations were passed in Spain but had to be applied by local administrations in the New World legal norms were usually interpreted with high levels of discretion. This situation over time led to a lack of respect for the law which may be illustrated by the common Latin American sayings "obedezco, pero no cumpllo" and "la ley se acata, pero no se cumple." 39 In Mexico the divergences between de-jure and de-facto rules including constitutional norms imply that many national laws loose relevance because they are not properly enforced. Despite of judicial reform Mexico today is still characterized by an enormous discrepancy between de-jure norms and legal reality. 40 Non enforcement of the law however, fosters a societal culture where the respect of citizens for the law is constantly decreasing. That is, if the benefits of breaking the law are higher than the cost of doing so, individuals have a constant incentive for violations of the law. 41 Furthermore, Mexican laws are inconsistent and sometimes even contradictory. The excessive legislation is often unclear and applied with high levels of discretionary freedom by the authorities. Access to the law is not equal in the sense that poor people often do not have the possibility to successfully enforce legal claims undermining the legal principle of equality before the law. 42

In criminal justice enforcement problems imply that criminals are seldom convicted which leads to a situation of continuous impunity. Furthermore, like in many other Latin American countries the national police, which is essential for the enforcement of the law, is perceived as inefficient, underpaid, poorly qualified, corrupt and not being respectful of basic citizen rights and liberties. 43

40 See Rubio et al. (1994).
42 The hourly salary of a qualified lawyer in Mexico equals the value of 21 to 42 daily minimum salaries. The services of public lawyers are of low quality and in general do not permit successful access to the law. Other cost that potential claimants have to bear are bribes, administrative fees and bails. See Rubio et al. (1994). This situation may be illustrated with the Mexican saying: "El código civil se aplica a los ricos, y el código penal a los pobres." Cited in Rubio et al. (1994) p.18. This characteristic of many Latin American countries leads to a situation that Mario Vargas Llosa once called legal apartheid. Cited in Pritzl (1997) p.141.
In 1990 91.4% of the crimes that have been committed in the federal district remained unresolved. Informal vendors are active throughout the capital selling smuggled goods, pirated products or other contraband without being harmed by local administrations. Moreover, the police often applies torture to coerce confessions and prisoners are detained without conviction in precarious social conditions due to an overcrowding of state prisons.

In Mexico the second half of the 90s is characterized by a steady increase of crimes with a particular growth of robbery and theft. The growing crime rate went hand in hand with a growing number of complaints of Mexican citizens before the National Human Rights commission about lacking efficiency and human rights violations of the national police force. Increased public insecurity and high levels of crime that go hand in hand with an inefficient national police force affect any type of commercial activity by simply increasing costs of doing business. In a survey conducted in 1999 in Mexico City 47% of the interviewed people stated that crime and public insecurity were the most important problems, well ahead of economic problems with a percentage of 22% on the second rank. A fact that indicates growing public insecurity is the large number of private security firms that operate in Mexico to protect private

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44 See Rubio et al. (1994) p.94.
46 In 1992 49% of Mexican prisoners were yet unsentenced and thus in preventive detention. In 1993 Mexican prisons were at 128% of capacity, in 2001 at 136 %. See Bekker/Patrick (1998) p.1-3 and INEGI (2003). Police violence and abuses of power are widespread in Latin America. See Bekker/Patrick (1998) p.5-9.
47 Denounced crimes per day in Mexico City increased by 57% from 445 daily cases in 1994 to 700 daily cases in 1997. Moreover, it has to be underlined that these figures are downward-biased because not all committed crimes are reported by the victims. Complaints about the police increased by 45 % from 1812 in 1995 to 2623 in 1997. See Alvarado/Davis (2001). According to a recent survey reported by PRS Group 90% of the crimes are not reported because citizens think they will receive no help or will even be harmed by a police force that protects criminals. See PRS Group (1999) p.D3. In 1983 a group of police was discovered operating a large ring of auto-theft and bank-robbery, in 1989 the Mexico City office of the Federal Intelligence Directorate (ID) was accused of kidnapping, extortion, robbery, torture and homicide. During the 80s reports of police and military involvement in criminal activities grew common. The severe involvement of Mexican police and military in crime led one observer to the conclusion that "society has come to fear the police more than it fears the criminals". See Morris (1991) p. xvi. When the opposition party PRD took control of Mexico City's government, they discovered a pyramidal structure of institutionalized corruption in the Mexico City police department where lower levels were coerced to make payments to their superiors and promotion to midlevel positions required the payment of bribes. Therefore, members of the police force had to engage in various forms of illegal activities. See Garibaldi (2001) p.12-14.
48 In a large scale firm survey conducted by Brunetti/Kisunko/Weder nearly 90% of the respondents from Latin America stated that crime and theft substantially increase their costs of doing business. Nearly 80% of all surveyed persons from Latin America did not feel confident that state authorities would protect their person and their property from criminal actions. According to the same survey businesspeople from Latin America ranked crime and theft as the third most important obstacle to business after corruption and an inadequate infrastructure supply. See Brunetti/Kisunko/Weder (1997) p.17-18 and 25.
property and businesses as banks, malls or restaurants.\textsuperscript{50} With around 2000 kidnappings every year Mexico has the second highest kidnapping rate in Latin America after Colombia. Although kidnappers generally target wealthy Mexicans, executives of MNEs are also at risk.\textsuperscript{51} Only these few facts impressively highlight the problem of public security in particular in major Mexican cities, remote rural areas and border regions. Currently Mexico encounters a situation where high levels of crime, violence, low protection of individuals against arbitrary government actions and an unpredictable judiciary severely endanger the rule of law and the governability of the country.\textsuperscript{52}

However, these inefficiencies of the legal system have more far reaching consequences for the Mexican economy than just augmenting the direct cost of private security and doing business.\textsuperscript{53} In private law the outright consequences of an inefficient judiciary are severe distortions for private business activities. The theoretical analysis of prerequisites for credible commitment revealed the crucial role of third party enforcement for complex economic transactions. Assuming that self interested private actors will only enter in welfare-enhancing economic activity if they are sure that they will reap the benefits from their engagement it was pointed out that it is necessary that agreements between individuals are enforceable. In other words, incomplete contracts, contractual hazards and potential opportunistic behavior of contracting counterparts require an efficient institution for conflict resolution. To lower the cost of wealth enhancing private transactions national institutions have to assure by coercive power that contracts between individuals are honored. Thus, economic theory suggests that the judiciary plays an important part in providing a suitable framework for private economic activity.

Therefore, the poor performance of the Mexican judiciary severely limits the possibilities of economic actors to engage in welfare-enhancing transactions.\textsuperscript{54} As the enforcement of private contracts cannot be ensured by national institutions Mexican firms often limit their business activities to those contract partners that are well known as family and friends because if contracts with unknown partners were negotiated, the need to investigate the commercial reputation of the contractual partner would imply a considerable increase of transaction costs. Hence, the inefficiency of the legal sector implies an inefficiency of markets because potentially wealth-enhancing transactions are

\textsuperscript{50} See Alvarado/Davis (2001).
\textsuperscript{52} The World Bank refers to the combination of these factors as "lawlessness syndrome". See World Bank (1997) p.41.
\textsuperscript{53} In a survey conducted by Brunetti/Kisunko/Weder over 70\% of the surveyed firms from Latin American countries state that an unpredictable judiciary is a major problem for their business operations. See Brunetti/Kisunko/Weder (1997) p.19.
\textsuperscript{54} Poor law enforcement is a common Latin American problem. In a regionwide survey of business court users 55\% responded that they prefer to negotiate a partial settlement rather than adjudicate in the formal court system. See Buscaglia/Dakolias/Ratliff (1995) p.6.
not performed due to high levels of transactions costs.\textsuperscript{55} In Mexico the resolution of private law conflicts is the task of the local and federal judiciary. However, the quality of the first local instances is that low that in a great number of cases the decisions of the local courts are overruled by federal tribunals.\textsuperscript{56} Further empirical evidence highlighting the inefficiency of Mexican jurisprudence is that US companies doing business with Mexican firms usually negotiate the responsibility of the US judiciary in the case of contractual conflicts.\textsuperscript{57} Although there recently has been progress in tackling the problem of severe judicial corruption, enormous trial lengths imply that private parties to a conflict try to negotiate private agreements to avoid lengthy court decisions.\textsuperscript{58} This incapacity of the Mexican judiciary to provide for credible enforcement of private contracts limits national commercial activities. At the same time it becomes an important obstacle for foreign investors since it is obvious that the situation of foreign firms that are doing business in Mexico does not differ from the one their national competitors face. One may even argue that foreign firm activity is more severely affected by the prevailing legal insecurity as foreign managers lack the necessary local information or personal ties to promote a quick resolution of legal conflicts between contracting parties. Impediments to foreign firms however, are not limited to private contracting as Mexican law neither offers effective protection against

\textsuperscript{55} Thus, in the absence of an efficient third party enforcement individuals rely on social contract enforcement which is based on long-term personal relationships. See World Bank (1997) p.45. There are many examples for market inefficiencies in Mexico resulting from high transaction costs. The excessive legal protection of individuals renting apartments in Mexico City implies that landlords are extremely cautious to rent to strangers and most of the time do not rent at all explaining the insufficient offer on the market. The inefficient enforcement of the commercial code implies that legal suits against debtors take a long time and imply legal insecurity as well as high costs. This situation leads to many "private" solutions that avoid courts and at the same time limits the offer for credit contracts. See Rubio et al. (1994).

\textsuperscript{56} In 1994 over 35\% of local courts decisions have been revised by federal judges. Local judges are often not very well qualified, poorly paid and often subject to pressure from the local political elite. Nevertheless they are the first instances in commercial matters. Therefore, for improving the Mexican judiciary it is crucial augmenting the quality of the local courts. See Rubio et al. (1994).

\textsuperscript{57} See Holland (1999).

\textsuperscript{58} In a survey about judicial corruption where a score of 10 represents a completely honest and a score of 0 a completely corrupt judiciary Mexico received a rating of 3.18. Canada in turn received 8.87, Chile 7.94, the US 7.79 and Colombia 3.44. See Buscaglia/Dakolias/Ratliff (1995) p.40. It usually takes up to 304 days to settle a simple commercial matter before Mexican tribunals. If the contractual partner disposes of "competent lawyers", commercial law suits may take up to 5 years. Additionally the low transparency of the system makes it hard to ex ante anticipate the legal outcome. In the case of financial contracts the fact that the opportunity costs of the trial length which the creditor has to bear are not adequately covered aggravates this problem. In most legal suits against the public administration there are no indemnifications for commercial losses that occurred due to administrative actions. This fact further increases the vulnerability of private citizens for illegal and arbitrary interventions by the government and contractual violations by business partners. See Rubio et al (1994). The Mexican saying "Un mal aregio es mejor que un buen pleito" impressively highlights the effects of lacking legal certainty.
predatory governmental actions. Therefore, the negative impact of the inefficient judiciary extends to the relation between government and private investors. To put it in other words, if the judiciary is not able to protect property rights of private investors against arbitrary predatory interference by governmental authorities, potential risks for foreign investors are further growing. Summarizing it may be concluded that the high cost of contract enforcement as well as the low degree of legal security for investors are a potentially important disincentive for incoming FDI.

It is straightforward to see that the exact quantification of political risk that is caused by lacking rule of law is hardly possible. Nevertheless, data provided by the PRS Group gives an impression of how rule of law in the Mexican society developed over time. The rule of law measure of PRS measures two characteristics of the rule of law where each of the sub-components has a weight of 50%. The "law" sub-component assesses the strength and impartiality of the legal system whereas the "order" sub-component assesses the popular observance of the law.

Figure 5.29 depicts the evolution of the rule of law rating from 1984 to 2003. Analyzing the PRS rating the judicial reforms enacted by the Zedillo were not particularly successful in providing higher rule of law in Mexico.

Figure 5.29: Rule of Law Rating In Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

Likewise the reforms of the Fox administration do not seem to have produced measurable progress in rule of law in Mexico. It has been shown in the literature that usually the powerful interest groups in societies with lacking rule-of-law show resistance to reforms as they are the ones that most profit from

59 See paragraph 5.3.3.4 for the evaluation of property rights protection in Mexico.
legal uncertainty and impunity. Therefore, reforming the judiciary is a lengthy and costly process that is difficult to implement. Therefore, possible reasons for the lack of positive results is the resistance of mighty interest groups in the Mexican society that benefit from the existing status quo as well as the limited availability of financial resources for judicial reforms.

To assess the influence of the rule of law indicator for FDI flows to Mexico figure 5.30 depicts the correlation of FDI and the PRS rule of law indicator. In contrast to the expected sign the correlation between the indicator and yearly FDI flows as well as the FDI/GDP ratio indicates a negative relationship between the two variables.

**Figure 5.30: Correlation between Rule of Law and FDI**

![Graph](image)

Source: Own figure using yearly averages of monthly data by PRS Group (2003) and yearly data of the World Bank (2002b). Index values for 2003 are calculated using data for January and February

Therefore, the analysis of the Mexican data does not confirm the theoretically postulated positive relationship between rule of law and incoming FDI flows. Explanations for this counter-intuitive result are the small number of observations and the minor number of variations of the data over the available time period implying that the results have to be interpreted with caution. The interpretation that these results stem from methodological deficiencies seems reasonable since the empirical evidence drawn from the panel analysis in Chapter 4 indicates a significant influence of rule of law on FDI flows to Latin America.

An important variable that is related to rule of law is the quality of the national bureaucracy since a reliable and competent public administration offers a favorable framework for private economic activity and fosters legal security and continuity in state business relations. Institutional strength and quality of the bureaucracy therefore are a shock absorber that tends to minimize revisions of policy when governments change. Typically, in low-risk countries,
the bureaucracy is somewhat autonomous from political pressure. In turn, low quality public administrations produce legal uncertainty and are an obstacle to forming a reliable framework for private economic activity.

**Figure 5.31: Bureaucratic Quality in Mexico 1984-2003**

![Bureaucratic Quality in Mexico 1984-2003](image)

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

Foreign investors in Mexico are often daunted by bureaucratic impediments as well as by a lack of clear regulations. Figure 5.31 depicts the indicator values of bureaucratic quality for the time period 1984-2003. While deteriorating temporarily during the mid 80s bureaucratic quality experienced a considerable upward swing during the mid 90s, most likely as a result of the reforms enacted by the Zedillo administration. The change of government in 2000 however, up to now did not result in a better rating for the public administration compared to the ratings of the mid 90s.

Concerning the impact of bureaucratic quality on incoming FDI flows the scatter-plots in figure 5.32 show the correlation between the index values and total FDI flows as well as the FDI/GDP ratio. The inspection of the graphs suggests a positive impact of bureaucratic quality on FDI flows to Mexico with a more convincing evidence for the correlation between the index value and total incoming flows as depicted in the left graph of figure 5.32. Again it has to be stated that these results have to interpreted carefully as evidence from sophisticated econometric analysis is missing due to the lack of data.

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Figure 5.32: Correlation between Bureaucratic Quality and FDI


However, as the results of the panel data analysis in Chapter 4 provides additional empirical evidence it is most likely that the depicted correlation for Mexican data is not spurious. Therefore, it may be plausibly argued that the quality of public administration is an influential factor for FDI flows to Mexico.

5.3.2.3 Corruption

An analysis of Mexico's history shows that political and administrative corruption have a long tradition in the country. Although several times leading intellectuals of the country publicly denounced the excessive corrupt practices of governments and public administrations, corruption is still an ubiquitous phenomenon in the modern Mexican society that may be found on

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64 For an overview of the older literature see López Presa et al. (1998). For more historical details on corruption in Mexico see the contributions in Lomnitz (2000). For Vernon corruption in Mexico is a heritage of colonial rule: "As long as the [colonial] law was so pervasive in its scope and so particularistic in its application, it was inevitable that corruption would exist. First of all, the pervasiveness of regulation meant that any operating business was at the mercy of the law. There was always some provision or other that constituted a threat, actual or potential, to the continued existence of a going business; so any business that hoped to stay afloat had to find some way of securing immunity from a hostile application of the regulations. ... So bribery in one form or another was an unavoidable part of the system; ..." Vernon (1963) p.30. For Daniel Cosio Villegas corruption originates in revolutionary times: "La deshonestidad administrativa de México tiene sus causas (....) ellas no quitan adarme a su monstruosidad social, ni mucho menos reducen en nada los funestos efectos políticos que ha tenido, pues (....) ha sido la deshonestidad de los gobemantes revolucionarios, más que ninguna otra cosa, la que ha rajado el tronco mismo de la Revolución Mexicana."
all levels of societal activity. On low administrative levels the famous *mordida* (literally: bite) is paid to low rank officials (as policemen) to avoid the payment of fines as for example for the violation of traffic rules, to buy impunity in criminal justice, or to receive favorable treatment in public administration. However, corruption in Mexico is not restricted to lower societal levels but also widespread among high rank government officials including the president. Incentives for the corrupt misuse of public power are particularly high in Mexico as the principle of no re-election dilutes the responsibility of politicians. Office holders that are not restricted by the need to get re-elected and only have a limited time for the misuse of public power have a higher incentive to engage in corrupt transaction to ensure their personal benefits. Indeed there is evidence that corruption levels augment in the final year of a *sexenio* which is publicly referred to as the “Year of Hidalgo” while the influence of anti-corruption campaigns is decreasing with the approaching end of the term. During the last years there have been several serious accusation of governmental corruption or personal enrichment of presidents and other high ranked government officials. Likewise other governmental organizations, the judiciary and the police force are accused of corrupt practices in office. In particular the public administration is characterized by severe problems of corruption.

The long history of corruption in Mexico suggests that the public abuse of power in this country is no sporadic phenomenon that can be described by the existence of a few “bad apples”. Instead, the long years of PRI dominance, the lack of controlling institutions like opposition parties or a free press and the importance of public posts as the most important way to make a career shaped a system where corruption was widespread. It was argued above that whenever public officials have wide discretion and little accountability incentives for corrupt behavior arise. In Mexico high discretionary freedom of politicians and public servants and lacking controls combined with a high level of governmental intervention in the economy produced a climate that was

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65 The literature denouncing political corruption in Mexico is too large to cite it completely. Representative works are Elizondo (1987) and Moheno (1979).
68 There have been several serious accusation of presidential corruption with the most prominent case being the rule of president Salinas whose private wealth is estimated around 400 Mio. US$. The private wealth of Mexico’s ex-president López Portillo (1976-1982) is estimated to amount between 1 to 3 billion US$. It is estimated that president de la Madrid transferred between 10 and 20 million US$ outside the country in the last year of his sexenio. See Morris (1991).
70 See the examples in López Presa et al. (1998).
71 In 1977 a major Mexican newspaper commented the strengthening of opposition parties by López Portillo with the words: “the political monopoly of the PRI has been a determining factor in corruption”. Cited by Morris (1991) p.94.
conducive for extensive corruption. Rather than being a rare societal event corruption in Mexico showed patterns which allow for the conclusion that corruption is instead deeply rooted and institutionalized. The high involvement of the state in the economy, excessive regulation and the inefficiencies in the public administration further stimulate levels of corruption. Indeed an empirical investigation of the patterns of corruption in Mexico concludes that 59.5% of discovered corruption cases involved extortion or fraud of government officials. The inefficiencies of the national judiciary that have been exposed in the previous paragraph imply that corrupt practices are often not properly sanctioned which further increases private incentives for the misuse of public power. In addition the partly controlled press could not efficiently fulfill its role of discovering and publicly denouncing corrupt practices and misuse of power by government officials.

In the Mexican literature on the matter it is often argued that high levels of corruption resulted from the need to stabilize the corporatist political system that has been exposed in paragraph 5.1. This system that organized loyalty to government with stick and carrot experienced a crisis when the economic downturn during the 80s rendered the financing of corrupt practices more difficult. Moreover, high levels of political corruption slowly eroded the credibility and the legitimacy of Mexican political institutions. Eventually the process of liberalization and democratization in Mexico reduced the potential for this kind of institutionalized corruption. The fight against high level political corruption has been initiated by the establishment of controlling organizations like the Federal Electoral Institute (IFE) and the strengthening of the national congress. Another important factor that helped limit excessive corporatist corruption is the growing independence of the electorate, the emergence of civil organizations, effective opposition parties and the growing role of public opinion that permit a better societal control of corrupt practices. To combat corruption in public administration several reforms were initiated to allow for a better persecution of corrupt government officials. Usually every incoming

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72 See Jain (2001) and World Bank (1997) p.102-109 who argue that high levels of discretionary authority lead to high levels of corruption.
74 See Rubio et al. (1994) p.31-34.
75 See Morris (1991) p.56-64.
76 In a recent study the World Bank finds a negative correlation between an index of corruption and an index measuring the predictability of the national judiciary. See World Bank (1997) p.104.
77 The World Bank argues that exposure of corruption in the media is a viable tool for checking abuses of power. See World Bank (1997) p.108.
78 See the overview in López Presa et al. (1998).
80 See López Presa et al. (1998) and Morris (1991) p.115-137. As Morris states: "In sum, the Mexican state embarked on a series of reforms that envisage greater limitations on the power of the state, a greater reliance on the private sector, and greater political openness. Forces in society, in the meantime, pushed their own autonomy and demands with greater vigor than ever before. As an integral part of the political system, corruption is clearly affected by both the economic and political changes of the decade". Morris (1991) p.130.
administration promises to fight the high levels of political and administrative corruption and initiates anti-corruption campaigns. However, measures to combat the sources of corruption in a preventive manner were scarce. In the past the results of the anti-corruption campaigns have been at best limited and high levels of corruption persisted despite of the reforms that have been initiated. As MORRIS argues over time the composition of corruption changed from extortion and fraud to bribery of government officials and a growing importance of drug-trade related corruption which more severely endangers political stability.

The best method to assess national levels of corruption is the use of population surveys. When in 1986 Mexicans were asked how often it is necessary to pay a bribe when dealing with the government, 40.4% said always and another 38.3% indicated that it was required much of the time. More recent quantitative empirical evidence on corruption is offered by the “Encuesta Nacional de Corrupción y Buen Gobierno” (ENCBG), a recent national survey on corruption realized by Transparency International. The survey registered 214 million acts of corruption in the use of public services during the year of the investigation. The average cost of a “mordida” for a Mexican household was 109.50 Mexican pesos (ca.10 US$) which implies a sum of 23.4 billions of pesos (2.34 billion US$) annually paid to the public sector in the form of bribes. This sum is equivalent to 0.4% of Mexican GDP and it is estimated that the total societal cost of corruption amounts to 15% of total annual tax income or 30 billion US$. The survey also reveals that the average Mexican household uses 6.9% of its personal income for the payment of bribes to the public sector for obtaining services. For poor households living on minimum salary this percentage goes up to 13.9% of total income. The survey found that on average, Mexicans pay bribes for 10.6 percent of the public services they receive. The services for which bribes are most frequently paid are related to cars: retrieving an impounded car required a bribe 57.2 percent of the time; avoiding traffic tickets, 56 percent; and avoiding other traffic offenses, 54.5 percent. In the Federal District 80% of the surveyed people confessed having paid bribes to the local police for avoiding fines for traffic offenses. However, corruption also affects other levels of social and economic activities.

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82 In 1983, as a part of his moral renovation campaign, the Penal Code has been reformed by the de la Madrid administration to allow for a more efficient persecution of corruption in the public administration. In the following years several controlling organizations, like in 1994 the Secretary for Control and Administrative Development (SECODAM) and in 1995 an auditing commission for fiscal matters, were created to ameliorate the supervision of the public administration. In 1995 a program for the modernization of the public administration was launched to ameliorate the efficiency and reduce corrupt practices. See López Presa et al. (1998). However, de la Madrid refused to arrest high PRI officials on charges of corruption including ex-president López Portillo who was likewise not put to trial. See Philip (1992) p.136-137.
84 See Morris (2000).
85 See Morris (1991) p.71
political life in Mexico. National programs to fight corruption in the Federal District discovered extensive corrupt practices in the granting of licenses, the supervision of businesses, the public control of environmental pollution, the issuing of driving licenses, the operation of the Mexico City Airport, the police force and the distribution of fuel by the state-controlled oil company PEMEX. According to a recent report by the national radio network, Radio Red, some Mexico City high school students even purchase their grades from teachers with the current rate for an A being 10 US$. Empirical evidence on regional differences in corruption levels indicate that the Federal District and the State of Mexico show the highest levels of corruption. For the rest of the country the survey suggest a slight north-south bias with the northern states like Chihuahua, Sonora and Baja California showing lower levels of corrupt acts than their southern counterparts.

To quantify the extent of corrupt practices in Mexico over time figure 5.33 shows the evolution of the Corruption Perception Index (CPI) that has been developed by Transparency International.

Figure 5.33: Corruption in Mexico 1980-2003 measured by the CPI

The CPI ranks countries concerning the degree to which corruption is perceived to exist among public officials and politicians. Index values vary between 0 (high corruption) and 10 (low corruption). In the 2002 rating Mexico ranked on the 57th place with a score of 3.6 among 102 ranked countries. As a benchmark Finland on the first place has been rated with a score of 9.7 for the same year. An inspection of the Mexican data reveals a continuous downward trend in the levels of perceived corruption since the middle of the 80s that has only been interrupted by a short decline of index values during the year 1997.

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87 See López Presa et al. (1998).
89 For details of the methodology of the index see Lambsdorf (2002).
Since compared to the situation in the 80s perceived levels of political corruption are considerably lower in the 90s the CPI-Index suggests a success of the anti-corruption campaigns that have been initiated by the federal government. Among other OECD member countries however, Mexico still holds the penultimate position in the ranking only being surpassed by Turkey which indicates that the level of corruption in Mexico still by far surpasses average corruption ratings of industrialized countries.

Another index to quantify the evolution of corruption in Mexico during the last years is the index of governmental corruption that has been constructed by PRS group. The difference between the latter indicator and the CPI is that it does not determine a country's level of corruption but the political risk involved in corruption, two factors that may differ considerably. Figure 5.34 depicts the evolution of the PRS index for the period from 1984 to 2003. Indeed the inspection of the data paints a completely different picture of corruption in Mexico. Since from 1984 to the mid 90s index values remain unchanged the data suggests a total failure of public anti corruption campaigns initiated during this period indicating that despite of reforms political risk due to corruption has not significantly diminished. The last years even show rising levels of political risk from corruption although the Fox government made the fight against corruption one of the most important points on its political agenda. The distinct empirical evidence about the extent of corruption offered by the PRS indicator and the CPI-index highlights the severe problems that are related to the empirical measurement of national corruption levels.

Figure 5.34: The PRS Corruption Index in Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

90 This empirical finding is in line with the hypothesis that societal levels of corruption are not necessarily influenced by regime type. Nevertheless it has to be underlined that a better functioning democracy may limit corrupt practices by establishing better mechanisms of control. See López Presa et al. (1998). Morris (2000) argues that corruption has changed from misuse of public power to drug related corruption.
To analyze the impact of political corruption on FDI I use the governmental corruption index that has been constructed by PRS Group which has been normalized to values between 1-10 where higher values represent less corruption. The scatter-plots in Figure 5.35 depicts the relationship between the corruption index and FDI flows to Mexico.

**Figure 5.35: Correlation between Corruption and FDI**

![Graph showing correlation between Corruption and FDI](image)


Mexican data does not confirm the theoretical hypothesis of a negative correlation between corruption and FDI. Instead, the scatter-plots as well as the numerical statistical correlation indicate a counter-intuitive positive correlation implying that higher levels of corruption would attract higher FDI flows. These result are clearly at odds with empirical evidence of the panel analysis in Chapter 4 and other empirical research on this matter. Therefore, it is most likely that the counter-intuitive results for the Mexican case are due to the lack of econometric sophistication of the analysis or the small data sample. Given other empirical results and the qualitative empirical evidence on corruption in Mexico it is in turn most likely that foreign investors are, like their national counterparts, affected by corruption. Nevertheless, this analysis does not provide empirical evidence for the theoretical hypothesis postulating a negative correlation between corruption and FDI.

### 5.3.2.4 Protection of Property Rights

Economic theory argues that property rights protection is a necessary prerequisite for a functioning market economy since weak protection of

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91 The CPI index is not used here because the number of available data is considerably smaller.

92 See Wei (2000) who uses corruption indices provided by the Economist Intelligence Unit, ICRG, and Transparency International. His results indicate an important influence of corruption on FDI flows. As Wei also used data from PRS Group his findings also indicate that the counter-intuitive results for Mexican data are not biased by the use of the PRS corruption indicator.
property rights distorts incentives for private investment. Therefore, well defined and enforceable property rights are an important prerequisite for a favorable national investment climate. As the historical review of Mexican policy towards MNEs demonstrated, the protection of property rights in the country has long been feeble. Elizondo argues that in contrast to the United States the constitutional protection of property rights in Mexico is weak since national interests (represented by the state) are valued higher than private interests, namely private property rights. In particular article 27 of the constitution may serve as a legal basis for dilutions of property rights as it permits expropriations for reasons of public utility and through indemnification. Although article 27 guarantees indemnification, in the past the inefficient judiciary only offered weak protection of individual constitutional rights.

Furthermore, in line with these constitutional principles the expropriation law from 1936 gives the president the right to expropriate private property to achieve a more equitable income distribution. In addition a law from 1950 permits an extensive regulation of prices by the executive branch. Based on these legal norms it takes nothing more than a simple signature of the president to expropriate private property. Since in the past the Mexican government extensively used this capacity to expropriate foreign property MNEs are aware of potential problems caused by predatory intervention of the state.

Although the risk of expropriation is hard to quantify, I use an indicator that has been constructed by PRS Group. Figure 5.36 depicts the evolution of this indicator that is available for the period 1982-1997. After the large scale nationalization of Mexican banks in 1982 expropriation risk showed a decline during the mid 80s until a liberal policy initiated a steady process of diminishing expropriation risks. Expropriation risk further declined with the initiation of the NAFTA negotiation process due to the fact that the treaty contained explicit regulation forbidding expropriations without due reasons or proper indemnification of affected parties which helped strengthen legal security for foreign investors in Mexico by recognizing common principles of international law.

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93 Elizondo (1999) argues that high degree of liquidity on Mexican financial markets and the preference for US dollars are signs of weak property rights and fears of inflation or devaluation.


95 Article 27 states: "The nation shall have at all times the right to impose on private property such modalities as the public interest dictates, and the right to regulate the use and exploitation of all natural resources susceptible to appropriation, in order to preserve and to effect an equitable distribution of the public wealth." English translation cited by Whiting (1992) p.243-244. Conflicts with Mexico over the implications of Article 27 for US investors led the US government to refusing the recognition of the Mexican government until 1923. See Whiting (1992) p.62. For a detailed discussion of Article 27 see Elizondo (2001) p.59-72.

Figure 5.36: Expropriation Risk in Mexico 1982-1997

Source: Own figure and calculations using yearly data from PRS (1998) normalized to a 1-10 scale.

In other words, the signing of NAFTA was an important step towards a better institutional framework for foreign investors because it widely extended the protection of foreign owned property in Mexico against acts of direct and creeping expropriation.

For empirical evidence on the impact of expropriation risk on FDI in Mexico I calculated the statistical correlation of the index variables with FDI inflows and the FDI/GDP ratio respectively. The results are displayed in the two scatter-plots in Figure 5.37.

Figure 5.37: Correlation between Expropriation Risk and FDI

Source: Own figure using yearly averages of monthly data by PRS Group 2003 and yearly data of the World Bank (2002b).
An inspection of the Mexican data strongly suggests a positive impact of lower expropriation risk on FDI as both scatter-plots indicate a positive correlation. Moreover, additional empirical evidence for the panel of Latin American countries from Chapter 4 indicates that the reported correlation is not spurious as the risk indicator turns out to be positive, significant and robust.\textsuperscript{97}

It has already been argued that private property rights are not only affected by outright expropriations but also by more subtle policies that do not imply a total loss of the title to private assets but that nevertheless seriously reduce their value. To give only a few examples foreign property may be affected by discriminatory taxation, restriction of operations, excessive labor legislation and costs, repatriation restrictions as well as governmental breach of contract and so on. Although the variety of potentially influential variables that determine the risk of creeping expropriation make the concept hard to quantify, the Investment Profile indicator of PRS Group is a suitable proxy variable. This indicator is "a measure of the government's attitude toward inward investment as determined by four components: the risk to operations, taxation, repatriation, and labor costs".\textsuperscript{98}

Figure 5.38 which depicts the evolution of the investment profile in Mexico between 1984 and 2003 shows that in the aftermath of the Mexican debt crisis the investment profile of the Mexican economy was continuously declining.

**Figure 5.38: Investment Profile in Mexico 1984-2003**

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

The process of liberalizing and opening the economy however that begun thereafter entailed a steady improvement of the investment profile which

\textsuperscript{97} The governance indicators GOVI and GOVII that contain the subindicator "Expropriation Risk" were found to be robust determinants of FDI. See Table 4.4 and 4.5 in Chapter 4.

\textsuperscript{98} See PRS Group (2003).
reached its peak during the early 90s. Political turmoil and the financial crisis in 1994 implied a short fall of investment profile which thereafter shows a steady upward trend that is peaking in 2003. It has to be stressed that the signing of NAFTA considerably influenced the investment profile of Mexico in various ways. First, as already pointed out NAFTA property rights protection also covers actions of creeping expropriations. Although legal enforceability and security are still limited by difficulties to provide for clear evidence of acts of creeping expropriation by host governments, NAFTA clearly strengthens legal certainty of foreign investors. Second, NAFTA forbids transfer restriction on foreigners and the imposition of performance requirements which could both considerably dilute foreign property rights. Despite of these guarantees figure 5.38 shows that the amelioration of the investment profile did not start until 1995. However, the period when NAFTA came into effect was a period of crisis for the Mexican political system as well as for the economy. Therefore, the missing empirical evidence that NAFTA strengthened the investment profile in Mexico may be due to the fact that the amelioration of legal certainty may have been statistically outweighed and overcompensated by the deterioration of other sub-parts of the indicator.

To assess the influence of the investment profile on FDI to Mexico figure 5.39 depicts the correlation between the indicator and incoming FDI as well as the FDI/GDP ratio.

Figure 5.39: Correlation between Investment Profile and FDI

Source: Own figure using yearly averages of monthly data by PRS Group 2003 and yearly data of the World Bank (2002b).

The two scatter-plots permit the careful conclusion that investment profile has a positive impact on FDI in Mexico although the evidence for the FDI/GDP ratio is less striking. However, it is hard to decide if the empirical results suffer from the small data set bias as additional evidence from the panel analysis in
Chapter 4 is missing for this indicator. Although the conclusion of this paragraph necessarily has to be careful, the empirical evidence from Mexican data suggests a positive impact of lower expropriation and creeping expropriation risk on FDI flows to Mexico.

5.3.4 Societal Factors of Risk
5.3.4.1 Overview
The following paragraphs are dedicated to analyzing the impact of societal political risk variables on FDI flows to Mexico. For the analysis I use the simple theoretical framework based on the concept of social capital that has been described in paragraph 3.1.2.4. evaluating the impact of socioeconomic variables on transaction costs and private investment incentives. All numerical statistical results are depicted in table A.2 in Annex II while the following paragraphs simply show scatter-plots illustrating the correlation. Although it has to be underlined that the interpretation of results has to be careful due to the lack of reliable data, the analysis indicates the impact of a given variable on FDI flows to Mexico. The following chapter starts with the evaluation of societal tensions due to religion, ethnic provenience or other internal factors.

5.3.4.2 Ethnic, Religious and other Internal Conflicts
Despite of many other problems, since the revolution Mexico did not experience greater societal instabilities or even political turmoil. With the exception of left wing guerrilla activity and student protests during the late 60s and early 70s that have been violently repressed by the government Mexico neither experienced violent manifestations of social unrest. Instead, the well-established corporatist PRI rule ensured a degree of societal stability that is unusual for a Latin American country. As a legacy of the Spanish colonial rule the vast majority of the country is roman-catholic. The dominating ethnical group are the "mestizos", descendants of Spanish and indigenous people. Despite of these facts contemporary Mexico is still characterized by a vast ethnic, social and economic heterogeneity holding enormous potential for future conflict. In the south and the southeast of Mexico live large proportions of indigenous people, who largely only speak pre-hispanic languages and often live in poor economic conditions or poverty. The economic reforms in the agrarian sector during the 80s and 90s that dismantled the old system of subsidies and transfers hardly hit rural small scale producers of coffee, maize and other crops. In 1994 economic difficulties and problems of racial discrimination of ethnic minorities provoked an armed uprising in the southern federal state of Chiapas by the Ejército Zapatista de Liberación Nacional

99 An empirical analysis of this indicator could not be performed because it was not available for all countries in the sample.
100 See Philip (1992) for an analysis of the student movement and the guerilla groups. Mainwaring underlines that most of the left wing groups were never serious contenders for power. See Mainwaring (1999).
(EZLN). Although one central focus of the EZLN is the strengthening of minority rights, it is hard to decide if the uprising was essentially motivated by ethnic reasons or rather by the poor economic situation and extreme poverty in the south of Mexico as well as by a rejection of the liberal reforms implemented by the Mexican government. Although actively promoting the strengthening of indigenous rights and basic autonomy for these groups, the zapatista movement is not characterized by exclusionary nationalism or secessionist motives. A second group of rebels, the Popular Revolutionary Army (EPR) emerged in Oaxaca and Guerrero indicating that the problem of societal unrest is no longer limited to the state of Chiapas.

To quantify political risk that originate in ethnical or religious differences I use indicators that are provided by PRS Group. The ethnic tension indicator is "a measure of the degree of tension attributable to racial, national, or language divisions". Lower ratings (higher risk) are given to those countries where tensions are high because the opposing ethnic groups are intolerant and unwilling to compromise with the government. Classifying the EZLN in this manner is difficult as talks between the rebel leaders and the central government were initiated shortly after the conflict and are still underway. However, even if the national government initiated a constitutional amendment that guaranteed autonomy and the protection of indigenous rights in 1998, the negotiations have been difficult and were occasionally interrupted by large scale protest or even violent acts.

Figure 5.40 depicts the evolution of the ethnic tensions indicator in Mexico between 1984 and 2003. As evidenced by the data levels of ethnic tensions remained unchanged at a low level during the 80s and 90s. Ratings began to deteriorate when the new government of president Fox did not manage to reach an agreement with the EZLN. Despite of this problem and the deterioration of the rating it has to be underlined that the economic implications of the problems in Chiapas and in other southern states are only of minor importance for MNEs since foreign investors, whose installations are not situated in those regions are hardly affected by these local instabilities.

103 The fact that ethnic origin and economic conditions are often correlated suggests that both factors are relevant for the uprising. On the motives of the Chiapas rebellion see Rabasa/Arias (2002) and López y Rivas (2002).
107 See Rabasa/Arias (2002). In December of 1997 45 Chiapas Indians were killed in the village Acteal by paramilitary forces apparently linked to the armed forces and the PRI. In the aftermath of the killings Zedillo replaced his interior minister and the governor of Chiapas resigned. See PRS Group (2000) p.39. In 1998 eight Zapatistas were killed in a firefight with the army. See PRS Group (1999) p.B11.
108 For the reasons of the deterioration of the peace talks see López y Rivas (2002).
109 FDI in Chiapas and other southern states is scarce due to the economic backwardness of the region. See table 5.8 in paragraph 5.1.2.3.
Figure 5.40: Ethnic Tensions in Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

However, since poor economic conditions of the indigenous population in rural areas are a problem that is not limited to the state of Chiapas, future conflicts may also arise in other poor and remote rural areas of the country as for example in Guerrero, Puebla, Oaxaca or Tamaulipas. Despite of possible risks in the future the correlation between the ethnic tensions rating and the inflows of FDI and the FDI/GDP ratio respectively show no indication of a positive relationship between the two variables.

The same result holds for an analysis of the influence of religious tensions on FDI. As already pointed out religious beliefs are homogenous in Mexico and dominated by the roman catholic confession. Furthermore, the revolutionary heritage of Mexico implies that education and public life were not dominated by religious convictions implying that the potential risk of violent social conflicts due to religious divisions is limited. For the quantification of the variable I use an indicator that is provided by PRS group. This indicator is “a measure of religious tensions arising from the domination of society and/or governance by a single religious group, or a desire to dominate, in a way that replaces civil law by religious law, excludes other religions from the political/social processes, suppresses religious freedom or expressions of religious identity. The risks involved range from inexperienced people imposing inappropriate policies to civil dissent or civil war.”

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110 See López y Rivas (2002).
111 As the relationship between the two variables was of no major importance the scatter-plot will not be displayed here. For the results of the statistical correlation see Appendix II.
112 According to PRS Group (2000) 89% of Mexico’s population is Roman Catholic and 6% protestant.
113 See PRS Group (2003).
Figure 5.41: Religious Tensions in Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

The development of the rating which is depicted in figure 5.41 suggest that religious tensions have not been an influential risk factor in Mexico since for all the years prior to the 2000 rating the country attained the lowest possible level of risk. That is, the measure indicates the absence of political risks resulting out of religious conflicts.

Another suitable measure for the assessment of internal political conflicts is the indicator “Internal Conflict” that has been developed by PRS Group. Instead of focusing on societal risks that result from ethnic or religious tensions this indicator is “a measure of political violence and its actual or potential impact on governance, taking into consideration such factors as whether threats exist, whether they have political objective considering the size and strength of support, and the geographic nature of the conflict”.

Figure 5.42 depicts the evolution of this indicator between 1984 and 2003. The high indicator values suggest only a minor risk position for foreign investors. Nevertheless, the political difficulties of the late 80s and the mid 90s are clearly mirrored by the deteriorating development of the indicator values during this periods although risks originating in internal conflicts still remain on a moderate level. Despite of the severe economic crisis during the 80s public demonstrations caused little civil strife.

The severest problems of violence usually were related to drug trafficking. Between 1989 and 1995 reported terrorist attacks totaled 93 including 31 assassinations, 12 kidnappings and 22 bombings. Between 1991 and 1997 Mexico registered 297 cases of terrorist attacks including 85 assassination, 54

kidnappings and 22 bombnings. During 1996 Mexico City experienced more than 3000 protest marches and 1997 a large protest of teachers paralyzed the City. Despite of these events most serious violence remained largely confined to the Chiapas region and was not directed against foreign businesses.\textsuperscript{116}

**Figure 5.42: Internal Conflict in Mexico 1984-2003**

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

Despite of the Zapatista conflict and growing societal resistance to liberalization policies and the opening of the economy, internal risk seems not to be among the most important risk factors for foreign investors.

**Figure 5.43: Correlation between Internal Conflict and FDI**

Source: Own figure using yearly averages of monthly data by PRS Group 2003 and yearly data of the World Bank (2002b).

\textsuperscript{116} An exception was the kidnapping of a leading Japanese businessman in 1996 that spread fear among foreign executives. See PRS Group (1999) p.D2.
Figure 5.43 depicts the correlation between internal conflict and FDI flows and the FDI/GDP ratio respectively. The initial hypothesis that postulated a minor role of internal conflict for foreign investment decisions is confirmed by the inspection of the data which does not indicate a positive correlation between the measure of internal conflict and the inflows of FDI to Mexico. The analysis of internal conflicts confirms the general result that measures of societal conflict do not seem to be influential variables for FDI inflows to Mexico. This result is in line with the results of the panel analysis in Chapter 4 that likewise did not find a robust influence of societal risk variables on FDI inflows to Latin American countries.\textsuperscript{117}

This additional empirical evidence concerning the impact of societal risk variables on FDI flows does not suggest that the results for the Mexican case are simply biased by the small data sample. One may therefore conclude that indicators of societal risk do not have a major impact on FDI flows to Mexico and that although reforms in this field may be socially desirable they are hardly an improvement of the institutional environment for foreign investors. Even the major upheavals and conflicts in Mexico, as the uprising in Chiapas, do not imply elevate risks for foreign companies as these conflicts are restricted to remote rural areas whereas foreign investors are usually concentrated in urban areas. In spite of these findings, it has to be underlined that these risks may become more influential in the future, if the government does not succeed in resolving these societal conflicts.

5.3.4.3 Governmental Legitimacy in Mexico
The importance of regime legitimacy for transaction costs has been underlined in Chapter 3, where it was argued that regimes with low levels of legitimacy may cause the risk of future civil strife when discontent of the population is growing over time.\textsuperscript{118} Despite of its theoretical importance the empirical measurement of regime legitimacy is not straightforward. One approach is to assess the degree of confidence that people have in national institutions as low levels of legitimacy should coincide with low confidence and vice versa. The description of the current political system in Mexico already showed that the level of trust and confidence that Mexicans have in political institutions is rather low. Therefore, using societal level of confidence in governmental institutions as a proxy for regime legitimacy implies low ratings for the Mexican government.

Other important social strains in Mexico during the late 80s and the 90s are the rapidly increasing population, an inequitable income distribution, vast regional differences in development, as well as crime and corruption.\textsuperscript{119} High population growth in Mexico is an important potential source of societal conflict since between 1967 and 1996 the Mexican population doubled leading to one million new workers every year entering the labor market without great

\textsuperscript{117} See Table 4.3 in Chapter 4.
\textsuperscript{118} See World Bank (2003).
\textsuperscript{119} Problems of crime and public insecurity have already been discussed in paragraph 5.3.3.2.
chances to get a proper job.\textsuperscript{120} Moreover, the liberal reforms of the 80s considerably lowered living standards that have been kept up artificially by high consumptive government spending. The decade witnessed a particular massive decline in real wages which nearly fell by 30\% during the 80s which is shown in figure 5.44.

\textbf{Figure 5.44: Real Wages in Mexico 1980-1990 (1981=1)}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{real_wages_mexico.png}
\caption{Real Wages in Mexico 1980-1990 (1981=1)}
\end{figure}

Source: Own figure with data from Krämer (1995).

In addition, a wave of bankruptcies hit those smaller companies which could not compete with the intensified competition of foreign companies. The 1994-95 financial crisis increased hardships as the economy passed into recession and many workers have been laid off.\textsuperscript{121} As an immediate consequence of the crisis real wages fell by 25\% in 1995.\textsuperscript{122} In particular the southern states of Mexico have lagged export-oriented northern states have profited from the integration with the US.\textsuperscript{123}

An empirical indicator of societal satisfaction containing these variables has been provided by PRS Group. The indicator Socioeconomic Conditions is an “estimate of the general public’s satisfaction or dissatisfaction with the government’s economic policies, covering a broad spectrum of factors ranging from infant mortality and medical provision to housing and interest rates. Different weights are applied in different societies, depending upon the relative political impact.”\textsuperscript{124} Hence, the indicator measures how the socioeconomic situation in a given country influences the satisfaction of the people with government policy. Although a proxy variable, it is reasonable to argue that low levels of public satisfaction with governmental institutions coincide with low levels of regime legitimacy and vice versa.

\begin{itemize}
\item \textsuperscript{121} In 1995 Mexican GDP fell by 6.2\%.
\item \textsuperscript{122} See PRS Group (1999) p.G3.
\item \textsuperscript{123} Life Expectancy is 20 years higher in the North than in the South. Per capita consumption and average wages are five times higher in the North. See PRS Group (2000) p.15.
\item \textsuperscript{124} See PRS Group (2003).
\end{itemize}
An inspection of the Mexican data shows that the indicator for socioeconomic conditions largely coincides with the evolution of the economic situation. This direct correlation between national economic performance and socioeconomic conditions stems from the fact that social benefits as unemployment insurance or public welfare are scarce in Mexico which implies that economic cycles have a direct effect on living standards of the population. As figure 5.45 indicates the socioeconomic situation ameliorates during the late 80s after the most serious effects of the debt crisis have been overcome.

Figure 5.45: Socioeconomic Conditions in Mexico 1984-2003

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003) normalized to a 1-10 scale. Index values for 2003 are calculated using data for January and February.

Between the late 80s and the financial crisis in 1994 conditions kept stable. Following the financial crisis of 1994 and the resulting recession socioeconomic conditions quickly deteriorated reaching again the low levels of the post debt crisis years. As late as in 2000 the indicator shows the first signs of recovery reaching again mid 90s levels.

To analyze the impact of socioeconomic conditions on FDI flows to Mexico the two scatter-plots in figure 5.46 show the correlation between the indicator and FDI flows and the FDI/GDP ratio respectively. An inspection of the data does not reveal a clear pattern that would indicate the positive relationship between the two variables that would have been theoretically expected. As further empirical evidence from the panel analysis in Chapter 4 is not available for this indicator the analysis of the data does not permit a clear cut conclusion about the influence of regime legitimacy proxied by the socioeconomic conditions variable. One of the two depicted correlations rather suggest the counter-intuitive result that worsening socioeconomic conditions imply higher levels of FDI.
Figure 5.46: Correlation between Socioeconomic Conditions and FDI

Although it has to be underlined that this result may also be due to the size of the available data set, it has to be concluded that the empirical analysis of Mexican data does not permit the conclusion that societal risk factors have an influence on incoming FDI. This empirical evidence is supported by the results of the panel analysis in Chapter 4 that could not identify a robust relationship between societal indicators of risk and FDI inflows to Latin American countries. The joint findings of the two empirical studies suggest that the influence of variables that determine the level of societal transaction cost is not as important as the influence of governance related variables. The following paragraphs analyze the impact of aggregate political risk indicators on FDI flows to Mexico.

5.3.5 Aggregate Political Risk in Mexico

After reviewing the sub-indices of political risk this paragraph is dedicated to the analysis of aggregate political risk levels in Mexico. To do so three different aggregate risk indicators will be used and the evidence of preceding paragraphs will be briefly summarized. Up to now the empirical evidence highlights the importance of macroeconomic and governance related risk factors for FDI to Mexico. Economic and financial risk as well as democratic reliability, political constraints, expropriation risk and bureaucratic quality showed a positive correlation with incoming FDI. Other theoretically influential variables as the rule of law and corruption however, showed no evidence of a positive correlation contradicting the empirical evidence from Chapter 4. Despite of these findings it is most likely that these risk factors are nevertheless of particular importance in Mexico as evidenced by the study of qualitative empirical evidence on Mexico.\(^{125}\)

\(^{125}\) See the literature on corruption and rule of law that is cited in the paragraphs 5.3.3.2 and 5.3.3.3.
At the same time the empirical evidence on the influence of societal risk factors suggested that these variables play a minor role in determining Mexican FDI since religious, ethnic or other societal tensions did not turn out to be of major importance for FDI flows. Even the most severe societal instability in Mexico, the Chiapas conflict, does not seem to be a menace for foreign asset holders. Likewise this study did not find a positive correlation between socioeconomic conditions and FDI. Nevertheless, it has to be underlined that social conflicts in Mexico, although locally restricted at the moment, are a potential risk that may gain importance in the near future. High levels of poverty, violation of human rights and high distributive inequality in Mexico are all potential reasons for serious societal conflicts. This future threat is even more important as the process of political reform and democratization in Mexico weakens the power of the central government to violently repress social tensions.

In addition to these findings this paragraph assesses if aggregate political risk variables have an influence on FDI flows to Mexico. For this analysis three different aggregate risk indicators will be used. The first indicator that will be examined in this context is the Opacity Index that has been calculated by PWC for the year 2001. This Index that is based on global surveys of company officials, bankers, equity analysts, and in-country PWC consultants provides an estimate of the adverse effects of opacity on the cost and availability of capital in 35 countries. Opacity is defined as “the lack of clear, accurate, formal, easily discernible, and widely accepted practices”. The Global Opacity Index offers a composite "O-Factor" ranking for each country, based on opacity data in the following five areas:

1) Corruption in government and the bureaucracy
2) Laws governing contracts or property rights
3) Economic policies (fiscal, monetary, and tax-related)
4) Accounting standards
5) Business regulations

Together, these create the acronym CLEAR (Corruption, Legal, Economic, Accounting, Regulatory). Opacity in any of these areas will raise the cost of doing business as well as curtail the availability of funds. Two unique measures result from the Index: the O-Factor, and rankings as well as measurements of the risk premium that is attributable to opacity when countries borrow through sovereign bond issuances in international or domestic capital markets. These multiple measures help demonstrate real-world costs associated with opacity where the O-Factor is the score of a country based on survey responses. High numbers indicate a high degree of opacity and low numbers indicate a low degree of opacity.\(^{126}\) Due to its characteristics the opacity index is suitable as a proxy variable for aggregate political risk and may be used to calculate the amounts of foregone FDI flows due to opacity. Table 5.9 summarizes the results for Mexico. Opacity in the country has been estimated at a score of 48 with the benchmark score being

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\(^{126}\) See PWC (2001a), PWC (2001b).
13 in Singapore. The index values of the sub-categories illustrate that in particular legal certainty, economic policy and the regulatory environment are weak in Mexico, a result that with the exception of the economic policy environment is in line with the preceding analysis of political risk in Mexico. The tax equivalent shows the effect of opacity when it is interpreted as if it imposes a hidden tax on private corporations. The index score of 15 for Mexico indicates that the effects of opacity in the country are equivalent to levying an additional 15-percent corporate income tax.

Table 5.9: Effects of Opacity in Mexico

<table>
<thead>
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<th>O- Factor</th>
<th>C</th>
<th>L</th>
<th>E</th>
<th>A</th>
<th>R</th>
<th>Tax-Equivalent (%)</th>
<th>Risk Premium (Basis Points)</th>
<th>Deferred FDI (%) Lower Bound</th>
<th>Deferred FDI (Mio US$ Lower Bound)</th>
<th>Deferred FDI (%) Point est</th>
<th>Deferred FDI (Mio $) Point Est.</th>
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<td>63</td>
<td>6477</td>
<td>70</td>
<td>8554</td>
</tr>
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</table>

Source: PWC (2001a), PWC (2001b)

The Risk Premium indicates the increased cost of borrowing faced by countries due to opacity, expressed in basis points (100 basis points = one percentage point) since on average, countries with higher opacity tend to have to pay higher interest rates on issued debt. The score of 308 for Mexico indicates that the country needs to pay international investors an extra 3.08 percent on sovereign debt due to opacity. The columns Deferred Investment show how incoming FDI flows would respond if the country managed to reduce its current level of opacity to that of the benchmark, that is, to the level of the average of the 4 countries with the lowest ratings. The results for Mexico show that the country could increase its inward FDI by 53 to 70% if it could reduce its opacity to the level of the benchmark group. In dollar terms this would represent an amount between 6477 to 8554 Mio. US$. Considering the scores of the sub-categories, in particular improvements in the fields of legal certainty, national economic policy and the regulatory environment show enormous potential of attracting higher inward FDI. Unfortunately lacking data does not permit to analyze the evolution of the Opacity Index over time.

The aggregate political risk indicator that has been constructed by PRS Group is "a means of assessing the political stability of a country on a comparable basis with other countries by assessing risk points for each of the component factors of government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religion in politics, law and order, ethnic tensions, democratic accountability, and bureaucracy quality. Risk ratings range from a high of 100 (least risk) to a low of 0 (highest risk), though lowest de facto ratings generally range in the 30s and 40s." This indicators thus pools the information of the various sub-

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127 See PWC (2001b).
indicators and thereby constructs an overall measure of aggregate political risk in Mexico.

Figure 5.47 shows the evolution of this aggregate risk indicator for the time period 1984-2003.

**Figure 5.47 Political Risk in Mexico 1984-2003**

![Graph showing political risk rating from 1984 to 2003](image)

Source: Own figure and calculations using yearly averages of monthly data by PRS Group (2003). Index values for 2003 are calculated using data for January and February.

Again the mid 80s are marked by a serious deterioration of the risk index. Since the beginning of the economic and political reform period in the mid 80s however, the risk index shows a steadily growing pattern reaching its summit in the mid 90s indicating a success of the reforms implemented by the Mexican government. Following the financial crisis of 1994 the aggregate risk rating fell again showing a slow pace of recovery afterwards that with small variations extends to the present time.

To test for the statistical correlation of aggregate political risk and FDI figure 5.48 depicts two scatter-plots illustrating the correlation between political risk and yearly FDI inflows as well as the FDI/GDP ratio. The patterns of the scatter-plots and the statistical correlation between the two variables indicate a weak positive influence of aggregate political risk on FDI flows to Mexico. However, as additional empirical evidence from the panel analysis in Chapter 4 is missing these findings have to be interpreted with caution. The weak correlation is surprising as several sub-indicators of the aggregate political risk index turned out to be positively correlated with FDI inflows. A possible explanation for the weaker correlation of the aggregate risk index is that the index also contains societal risk variables that were not found to be positively correlated with FDI and produce a bias.
Another PRS measure of aggregate risk is the so-called composite index that is constructed by using a weighted average of economic, financial and political risk.\textsuperscript{129} Higher values of the index indicate lower risk and vice versa. Ratings range from 0–100 with values in the interval 0-49.5 characterizing a high risk environment and index values from 80-100 representing countries of low risk. Figure 5.49 shows the development of the indicator for the period 1984-2003. Similar to the aggregate political risk index the composite risk index reaches its all time low in the mid 80s reflecting the economic downturn of Latin American countries following the debt crisis.

\textbf{Figure 5.49: Composite Risk in Mexico 1984-2003}

\textsuperscript{129} The exact formula for calculating the index is $0.5 \times (\text{Political Risk} + \text{Financial Risk} + \text{Economic Risk})$. 

After the implementation of liberal economic reforms the composite risk index experienced a long upward movement with the first decreases following the financial crisis in 1994. After the Tequila-crisis however, the index shows a rapid recovery and is since then oscillating around pre-crisis levels. Since an important subpart of the risk index focuses on macroeconomic risks this empirical observation is in line with theoretical considerations and highlights that the period of economic reform is accompanied by an important amelioration of composite risk.

To analyze the effects of composite risk on the inflows of FDI to Mexico figure 5.50 depicts the correlation between the risk index and FDI as well as the FDI/GDP ratio which suggest a positive influence of lower composite risk on FDI inflows and the FDI/GDP ratio.

Figure 5.50: Correlation between Composite Risk and FDI

Again there is no further econometric evidence from the panel analysis in Chapter 4 that could remove doubts concerning the small sample bias of the presented results implying that these findings have to be interpreted carefully. However, given the important role of economic and financial risk for the calculation of the index it is hardly surprising to see a positive correlation as the two sub-indices also showed a positive correlation with FDI flows to the country.

Summing up, one can conclude that both composite and political risk are positively correlated with inflows of FDI to the country suggesting a positive impact of lower risk ratings on Mexican FDI. In addition simulations based on the Opacitiy-Index suggest that political risk is an important obstacle for incoming FDI.
5.4 Risk Mitigation Strategies in Mexico
5.4.1 National Risk Mitigation Strategies
5.4.1.1 Investment Enhancement by Incentives
Since the outbreak of the debt crisis Mexico initiated a process of political and economic reform to restore its attractiveness for FDI. In Chapter 3 the establishment of investment incentives has been identified as a theoretical possibility to compensate international investors for high levels of political or country risk. It was argued that although the establishment of investment incentives may in the short run be a successful measure to attract foreign investors it is doubtful that it is the most efficient strategy since the granting of incentives is costly for host governments.  

Although since the mid 80s Mexico eagerly tried to attract FDI, the government never engaged in large programs of investment incentives. This has been part of the general Mexican economic strategy not to accord foreign investors any more favorable treatment than their domestic counterparts. Exceptions from this general practice of risk mitigation without the granting of incentives are governmental programs to foster the establishment of businesses that are located outside the metropolitan areas of Mexico City, Guadalajara and Monterrey. Some industries enjoyed tax incentives when they were considered to foster employment levels or to fulfill other beneficial societal tasks. Moreover, some of the state governments granted incentives to attract new industries in form of reduced prices for land or reductions in property taxes. However, there are no tax incentives that are specifically designed to attract FDI. The most extensive programs of incentives under the Mexican development plan are those that are provided to stimulate the exports of manufactured goods. But again also in export promotion programs there are no special measures that exclusively benefit foreign investors.

The absence of large scale incentives programs may in part be explained by Mexico’s attractiveness for FDI due to strong fundamentals. Mexico offers a large domestic market, a rich and diverse resource endowment, an urbanized, educated workforce and a developed infrastructure. These advantages and liberal reforms of the outworn economic development strategy made international investors aware of the investment opportunities in Mexico. The successive liberalization of the foreign investment law and the opening of the economy to foreign trade implied a further growing attractiveness of Mexico as a destination for FDI. Comparatively low labor costs and the geographic proximity to the large US markets have all been contributing factors that rendered Mexico an attractive destination for FDI. The integration of the

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130 See paragraph 3.4.2.1.
131 See OECD (2000). The big exception is the Maquiladora-program which grants several incentives to firms as for example exemptions from import duties.
134 Whiting (1992) considers that these factors create an important advantage for Mexico’s attractiveness for foreign investors if compared to other developing countries in the region and elsewhere. See Whiting (1992) p.27-30.
country into the North American market with the signing of NAFTA enforced Mexico's attractiveness to MNEs without the granting of special incentives programs. It is important to stress that the establishment of a large scale investment incentive program would not have tackled the main obstacles for FDI in Mexico. As pointed out in this chapter a major problem in Mexico was lacking credibility and efficiency of various governmental institutions, lacking rule of law and widespread political corruption. Investment incentives however, are no longer proper instrument to attract foreign investors when a minimum credibility of the national government is missing. This is essentially due to the fact that investors cannot be sure that promised incentives are really granted afterwards and that established contracts are honored in the long run. A lacking rule of law and inefficiency of the domestic judiciary aggravate this problem as MNEs do not have access to a credible organization of conflict resolution. Therefore, it seems reasonable that Mexico chose another strategy of risk mitigation without extensively relying on the potentially positive effects of investment incentives. The next paragraph discusses the Mexican strategy to foster international investments by reforms of the domestic institutional structure.

5.4.1.2 The Beauty Contest
Despite of the economic and political reforms in Mexico during the last years the previous chapters still identified impediments for a favorable investment climate in Mexico. Nevertheless, it is evident that Mexico made enormous progress in the amelioration of its domestic investment climate during the period 1982 to 2003. As already discussed in Chapter 3, the strategy of establishing domestic reforms to attract foreign capital is theoretically efficient but faces many problems of efficient implementation. The so called domestic “beauty contest” basically consists of reforming national institutions that have been turned out to be an impediment for private economic activity. Mexico's efforts in this field have been high and were not solely concentrated in the economic sphere but also consisted in promoting the process of political opening and democratization. Important political determinants of investment that have been identified in the previous paragraphs have been missing constraints on the executive branch, expropriation risk and bureaucratic quality. Although the empirical evidence for other potentially influential variables has not been convincing, other empirical findings and qualitative assessments suggested that also corruption and the rule of law are important institutional determinants of FDI flows.

Political constraints and democratic reliability of the government increased during the last years due to political reforms and democratization. The downfall of the one party state dominated by the PRI and the limitation of Mexican presidentialism by a better functioning system of opposition parties diminished the discretionary freedom of the Mexican government to freely conduct national policy. Although far from being complete, judicial reform and the strengthening of the legislative branch implied a better control of governmental decisions that ensured a higher degree of political continuity. At the same time
abuses of public power and political corruption are more difficult to flourish in a political environment that establishes better mechanisms of control and societal checks and balances. A higher degree of rule of law permits creating an atmosphere of higher legal certainty and transparency that is favorable for private investments.

In economic policy the establishment of a stable macroeconomic environment and continued efforts to liberalize helped create a favorable investment climate in Mexico. Compared to the desastrous macroeconomic environment after the debt crisis Mexico achieved important goals by promoting fiscal discipline, limiting inflation and fostering international trade. Despite of its social consequences macroeconomic stabilization policy in Mexico has been a success story as evidenced by falling risk spreads on sovereign debt. Although the financial crisis in 1994 that was followed by a severe recession was a reminder of macroeconomic volatility and instability in the country, Mexico's bonds were rated as investment grade at the beginning of the new millennium.

Summing up, Mexico's efforts and results in the amelioration of national institutions and the maintenance of macroeconomic stability have been enormous. Nevertheless liberal economic policies are still rejected by a large part of the population and by leftist parties explaining the need to lock-in domestic policy reform. To do so, Mexico accompanied its domestic reform efforts with a strategy of international risk mitigation by signing various international agreements to promote the integration of the country into the world economy.

5.4.2 The International Risk Mitigation Strategy
As already pointed out above the idea of international risk mitigation strategies is integrating the country into a framework of international law and thereby limiting potential risks for foreign investors by increased international credibility. Although the objectives of Mexican foreign policy changed considerably during the 20th century, its scope has always been limited by the need to ensure the external capital flows on which the country depended. After the outbreak of the debt crisis international credibility of Mexico reached an all time low and economic crisis affected the country more severely than ever before. For that reason Mexico's foreign policy of the post-debt-crisis years and in particular of the de la Madrid government is to a large extent dominated by economic goals and limitations. WHITING even argues that the internationalization of the world economy and the outbreak of the Latin American debt crisis were the most important international constraints for the Mexican government that promoted the enactment of liberal economic reforms while avoiding a fallback to the economic nationalism of the pre-crisis years. The de la Madrid administration managed to gain the support of international actors and to tackle the immense economic problems by reforming public

\[\text{\textsuperscript{135} See Heredia (2000).}\]
\[\text{\textsuperscript{136} See Rico (2000) p.119-176.}\]
\[\text{\textsuperscript{137} See Whiting (1992).}\]
finances, liberalizing international trade and promoting macroeconomic stability. To lock-in these reforms against societal pressure and to gain further international credibility Mexico joined GATT in 1985 which has been the first important step of Mexico's international risk mitigation strategy.

De la Madrid's successor Salinas continued on the path of economic reform and liberalization. During his administration the strategy of regaining international credibility that made it possible to attract FDI and technology has been the driving force behind the conduct of foreign policy. Salinas sexenio was thus characterized by an "economization" of foreign policy which culminated in the signing of NAFTA. Foreign policy and the presentation of Mexico on the international stage were means of demonstrating the capacity of Mexico to continue on the path of economic reform, to attract foreign investors, and to integrate the country into the world economy.\(^{138}\)

To reach these objectives Mexico embarked on a strategy of an intensification and diversification of its international relations. Internationalization was realized on the multilateral level as well as on the bilateral level by various international agreements and memberships in free trade agreements. Despite various integration projects in Latin America and other regions of the world the major ambition of the Salinas administration was to achieve a deeper economic integration with the North American market and in particular with the USA. Moreover, Salinas sought to promote Mexico's integration with other developed nations by signing an cooperation agreement with the European Union in 1991 and joining OECD in 1994.\(^{139}\) Since then Mexico signed various bilateral free trade agreements or bilateral investment treaties designed to increase the reciprocal protection of international investors.\(^{140}\)

All these international agreements and treaties implied obligations for the Mexican government concerning the implemented economic policy as well as the reform of the political system. Besides adhering to basic investor protection, joining OECD also meant accepting and domestically promoting the values and principles of this organization as the protection of human rights, plural democracy and the establishment of a market economy.\(^{141}\) Following the dramatic events in 1994 Mexico was subject to severe international criticisms for the lack of democracy, inequality, poverty and injustice with the most important criticism coming from sources inside the US that opposed the signing of NAFTA. Although Mexico initiated various efforts to evade the demands of international organizations, together with national efforts international pressure helped sustaining the process of political and economic reform. Thus, international obligations did not only help to lock-in reforms but were also in part responsible for further efforts of the Mexican government.

\(^{139}\) See Castro Rea et al. (1999).
\(^{140}\) See Siqueiros (2001).
\(^{141}\) For an overview of the FDI related rules of OECD see Fernandez (2002) p.269.
All Free Trade Agreements that have been signed by Mexico include investment chapters. These chapters contain provisions concerning the national treatment of international investors, on expropriation and compensation, on investment related transfers and on dispute settlement mechanisms.\(^{142}\) However, the deepest credibility enhancing consequences for Mexican politics resulted out of the signing of NAFTA, in particular if one focuses on the credibility effects for international investors. Although NAFTA's explicit focus is on trade barrier reduction, the agreement had a powerful impact on decisions to locate production.\(^{143}\) The treaty intensified the ties between Mexico and the North American market and contained many regulations that helped enhancing investor confidence. Given the preponderant role of US investment in Mexico it held enormous potential for the stimulation of further FDI flows. As already pointed out the reduction of trade barriers, the further opening of the economy for international investment and the higher legal security and protection of foreign investors were a major step towards a better institutional environment for foreign investors.\(^{144}\) Even before NAFTA came into effect the mere possibility of such an agreement stimulated FDI flows to the country.\(^{145}\) The empirical evidence for the positive effects of NAFTA on FDI inflows is overwhelming. After NAFTA negotiations were announced in 1990 FDI flows to Mexico already showed an important upward trend between 1991 and 1993.\(^{146}\) After coming into effect in 1994 FDI flows to Mexico nearly tripled and sustained these high levels during the 90s despite of the detrimental impact of the financial crisis in late 1994. Likewise the FDI/GDP ratio reached new heights after the signing of the agreement by temporarily rising from around 1% in the pre-NAFTA-years to levels around 3% during the late 90s.\(^{147}\)

But the effects of NAFTA also extend to the future since the treaty makes national policy reversals more costly. NAFTA is an instrument through which Mexican governments will be bound to their commitments and a political tool that increases investor confidence by locking in reforms and immunizing

\(^{142}\) An Investment Chapter is also part of the negotiations of the Free Trade of the Americas (FTTA). See Fernandez (2002) p.268-272

\(^{143}\) Peres (1990) argues that FDI promotion was a central motivation for the Mexican administration to negotiate NAFTA. See Peres-Nuñez (1990b).

\(^{144}\) The Bank of Mexico writes: "The NAFTA removes significant investment barriers, ensures basic protection for NAFTA investors, and provides a mechanism for the settlement of disputes between NAFTA investors and NAFTA countries. The NAFTA requires each country to provide non-discriminatory treatment to investors and investments from other countries. Thus, each country will accord NAFTA investors "national treatment" (treatment no less favorable than that accorded to its own investors), as well as "most favored nation treatment" (treatment no less favorable that it accords to investors from other countries)." Banco de México (1994) p.192.


\(^{146}\) See paragraph 5.2.2.2.

\(^{147}\) In an analysis of the stimulating effects of NAFTA for FDI to the Mexican market Graham/Wada find that better investor protection and the access to the North American market were the most influential factors. See Graham/Wada (2000) p.786-789.
national politicians against populist pressure. At the time of writing the lock-in-mechanism has turned out to be a success. Despite of extensive public pressure during the last years that has been particularly severe in the agrarian sector, up to now NAFTA contents have not been altered or renegotiated. Moreover, the Mexican experience with the dispute settlement mechanism highlights that the arbitrating body defended the principle ideas of the agreement to protect foreign investors. In addition NAFTA was in part responsible for the lower country risk rating and lower interest rate spreads for Mexican sovereign debt. The fact that Mexico has recently been assigned an investment grade by international rating agencies was also related to the signing of the FTA.

The success of the NAFTA investment chapter as a tool for fostering FDI flows even made it a raw model for other trade and investment negotiations, for example with the European Union. Therefore, it is to be expected that lower risk levels for European investors will likewise result in higher levels of FDI to Mexico by European companies. However, up to now there has been no substantial rise in the amount of European FDI to Mexico since the Free Trade Agreement between the two parties has been signed. Thus, empirical

148 See World Bank (1997) p.101, Munro (1995), Ramirez (2001) and Ramirez (2002). Perez-Nuñez argues that limiting the discretionary freedom of future Mexican governments to enhance investor confidence was one of the explicit goals of the Salinas administration. See Perez-Nuñez (1990b). Grosse writes: „This logic [increased foreign investment] has to do with the increased confidence that investors feel now that Mexico is tightly tied to the US market and the US policy framework. Investors are anticipating a much more stable and transparent policy framework for MNEs to deal with, thus encouraging them to include Mexico as a “safe” location for globally integrated production and distribution.“ Grosse (2003) p.664. The need for a lock in mechanism for economic reforms is demonstrated by the electoral success of PRI dissidents from the left wing Corriente Democrático in 1988. These politicians that should later found the left-center party PRD essentially wanted to revise “neo-liberal” economic reforms. See Langston (2002) p.74-79. After the Salinas administration a new wave of economic nationalism emerged led by PRI conservatives and members of the PRD. Part of the PRD’s program is also a revision of NAFTA itself. Theses forces are also responsible for the failure of the Zedillo government’s efforts to privatize and open the electricity sector for foreign participation. Probably the greatest resistance against free market reforms came from the EZLN which launched their upheaval in Chiapas on 1 January 1994 exactly the date when NAFTA came into effect. See PRS Group (2000). However, as the PRS Group’s political risk report for 1999 argues that even if the PRD were to participate in government, it could not fully nullify trade and investment liberalization, as certain commitments given in the NAFTA treaty are irreversible. See PRS Group (1999) p.E4.

149 See González de Cossio (2002) who reviews the Mexican experiences with the arbitration mechanism. The most prominent example of arbitration was the case of the US firm Metalclad that was awarded a compensation because necessary licenses for production have not been granted by the Mexican authorities.

150 Blázquez/Santiso write: “The FTA (Nafta) served as a credibility anchor since it was perceived by the financial markets as a mechanism that could reduce adverse selection and eliminate a potential problem of time-inconsistency with respect to the Mexican reform process.” Blázquez/Santiso (2003).

evidence for the credibility enhancing effects of the European Free Trade Agreement is still missing.

Nevertheless the signing of NAFTA impressively illustrates the important role of international risk mitigation in the economic strategy of Mexico. While the results of domestic institutional reforms, except for the maintenance of macroeconomic stability, are still moderate, international integration succeeded in attracting immense FDI flows in short time. In addition Mexico's integration strategy placed the economy back on a growth path and diminished the probability of major economic shocks in the future.\textsuperscript{152} This empirical evidence leads to the conclusion that Mexico's international risk mitigation strategy played an important role in regaining international investor confidence and in defending liberal economic reforms against populist domestic pressure. Nevertheless, most Mexican NAFTA critics tend to neglect these important dynamic effects of regional integration with the Northern American market.

5.5 Conclusion
The empirical investigation of political risk and the institutional environment for foreign investors revealed that the impact of political risk variables on FDI varies considerably with the sources of risk. In accordance with the empirical results of the panel analysis in Chapter 4 this chapter showed that the most influential political risk variables are those that are closely related to governmental action or the political system of Mexico. In particular expropriation risk, political constraints, bureaucratic quality and democratic reliability showed the theoretically expected positive correlation with incoming FDI. In contrast to the results of Chapter 4 I find that macroeconomic risk factors are influential political risk variables in Mexico since an index of macroeconomic stability has been found to be positively correlated with FDI flows to the country. The same holds for an indicator of financial risk that measures the government's ability to fulfill its financial obligations from official, commercial and trade obligations. Variables that measured socioeconomic phenomena in turn, did not indicate high risks or did not turn out to be correlated with FDI which is in line with the empirical results of the panel analysis in Chapter 4 that likewise finds a minor importance of societal risk factors as determinants of FDI flows. An index of aggregate political risk turned out to be weakly correlated with FDI while an indicator of composite political risk, that additionally comprises economic and financial risk showed a stronger positive correlation. Furthermore, the Opacity-index permits an evaluation of deterred FDI due to political risk that indicates that FDI flows to Mexico could be increased by up to 70% when political risk in the form of opacity could be diminished to risk levels of a benchmark group. Summing up, despite of methodological deficiencies due to missing data the empirical evidence

\textsuperscript{152} The successful integration of Mexico with the US economy led other Latin American Nations to seeking closer ties with the US. Ecuador recently adopted the US dollar as official currency linking itself to US monetary policy. Chile has been seeking to join NAFTA and now negotiated a bilateral treaty with the US. Members of the Caribbean Common market and the Central American Common market likewise have been pursuing efforts to link themselves with the US. See Grosse (2003) p.664 -666.
suggests a strong impact of government related risk factors and macroeconomic risk indicators. Faced with the dramatically high risk ratings as a consequence of the Latin American debt crisis Mexico embarked on a mixed strategy of risk mitigation based on domestic institutional reform and international risk mitigation via regional integration. It is argued that the signing of NAFTA played a crucial role for the increased investor confidence by improving market access, increasing investor protection, locking in domestic reforms and "importing" credibility from the northern neighbors.

5.6 Chapter Summary

Chapter 5.1 offers an analysis of the current political system of Mexico and its implications for the economy of the country which is restricted to those characteristics that are assumed to be influential for the investment decisions of foreign investors. It argues that the Mexican political system of the past was characterized by high levels of political discretion for the executive branch and low levels of checks and balances. A weak congress and national judiciary implied that the executive was not adequately controlled and individual constitutional guarantees were hard to enforce. Despite of reforms the national media remained partially controlled which further reduced the possibility to effectively control the government. Moreover, it is argued that the process of political reform and democratization only slowly changed this patterns of governance in Mexico.

Paragraph 5.2 presents some stylized facts of Mexican economic history and analyzes the historical development of the presence of foreign companies in Mexico. It is argued that Mexico has a long interventionist and nationalist tradition in its policy towards foreign investment that in part stems from the domination of foreign capital in the years preceding the revolution. With the example of NAFTA the chapter briefly describes the increased property rights protection and legal certainty that international treaties offer for foreigners willing to invest in the country. Furthermore, it describes the evolution of the structure of FDI flows to Mexico showing that the country succeeded in constantly upgrading incoming FDI from natural resource exploration to manufacturing and services.

Paragraph 5.3 is dedicated to the analysis of potential political risk factors and their impact on FDI to Mexico. The chapter analyzes the impact of macroeconomic risk factors, governance related risk factors and societal risk factors. Since more sophisticated econometric methods could not be applied due to data limitations, instead qualitative assessments and statistical correlations are used to evaluate the influence of political risk on FDI. I find that governance related risk factors have an important influence on FDI to Mexico, while the role of societal risk factors seems limited. In contrast to the findings in Chapter 4 however, also macroeconomic risk factors have turned out to be positively correlated with FDI flows to Mexico. With the exception of the influence of macroeconomic risk factors the results are in line with the
results of the panel analysis in Chapter 4 which likewise indicate an important impact of governance related risk variables.