"Fortress America" As Created By NAFTA And Its Impact On Foreign Direct Investments

Javad Gorjidooz, (E-mail: jgorjido@adams.edu), Adams State College

Abstract

The inauguration of the North American Free Trade Agreement (NAFTA) by the United States, Canada, and Mexico in 1994 created an outstanding economic opportunity for all three members. It contains an ambitious schedule for elimination of all trade barriers in the NAFTA community. The free trade agreement encourages NAFTA members to share and complement each other's resources, and to use comparative advantages and enhanced economies of scale to maximize efficiency and productivity. Accordingly, the insider MNCs can generate competitive advantage against outsider MNCs in their trading bloc and globally.

If NAFTA could create such a positive economic impact for insider MNCs and negative economic impact for outsiders, how do foreign MNCs respond to this trading bloc? Particularly, how does the "fortress America", as created by NAFTA, impact the foreign direct investment strategies of outsider MNCs?

The analysis of investment patterns by foreign MNCs since implementation of the NAFTA indicates an increase in their foreign direct investments in the NAFTA community, particularly in Mexico. This increase in FDI by foreign MNCs could be explained in three ways: First, it is due to the fear of "fortress America" as MNCs invested in the NAFTA bloc to penetrate the region's open market. Second, investors are looking to capitalize on the tangible financial attractions of modern-day Mexico, namely its location as a Latin America gateway, affordable primary resources, and increasingly competitive open market conditions. Third, the MNCs who had capital and global plans for such intensive foreign investments had already permeated North America.

1. Introduction

The intrinsic nature of regional trade agreements and trade blocs is to give "insider" competitive advantage to member nations and MNCs. Trading blocs insure insider advantage by building up trade barriers such as higher tariffs or cost-increasing restrictions and requirements for "outsider" nations, while decreasing or eliminating tariffs and economic borders for trade community members. Through free trade among member nations, the consumer base for insider corporations grows exponentially, as partner economies open new markets and opportunities for their products or services. Trading blocs also encourage member nations to share and complement each other's resources and comparative advantages to maximize efficiency and productivity. As a result, insider MNCs can generate competitive advantage against foreign counterparts in their home markets as well as in the global arena.

If regional trading blocs create such a positive economic impact on member economies, and a real disadvantage for "outsider" nations, how do they affect global trade and/or investment patterns of MNCs? How do multinational corporations and nations respond to trading blocs with their foreign investments? This paper attempts to answer these questions and examines the FDI strategies of foreign MNCs in the North America in response to "fortress America" created by NAFTA.

Readers with comments or questions are encouraged to contact the author via email.

In this paper, the following topics are being discussed.

- Overhaul of Mexico's Foreign Investment Law
- NAFTA and Foreign Direct Investment in Mexico
- NAFTA and Foreign Direct Investment in the United States
- NAFTA and Foreign Direct Investment in North America (NAFTA Community)
- United States' Direct Investment Abroad
- Conclusion

2. Overhaul of Mexico's Foreign Investment Law

NAFTA is designed to foster increase trade and investment among the three countries involved. Although NAFTA's main goal is trade liberalization, the agreement includes four other objectives that complement the trade provisions:

1. Substantially increase investment opportunities
2. Protect and enforce intellectual property rights
3. Promote fair Competition
4. Create effective procedures for the agreement's implementation and application, joint administration and dispute resolution.

These investment provisions are aimed at creating greater opportunities for NAFTA community and attract investment from international companies that seek to penetrate the region's open markets.

An important outcome of NAFTA's investment provision was an overhaul of Mexico's foreign investment law to reconcile it with the agreement. Mexico's foreign investment law stipulated that foreign investments must be held in a minority position (up to 49%). In other words, all investments in Mexico had to be majority owned by Mexicans. NAFTA has changed the Mexico's position on foreign investment. The new investment law, based on NAFTA agreement, allows companies from participating countries up to 100 percent ownership of their investments, with exceptions in only a few sectors such as petrochemicals.

Although NAFTA did liberalize Mexico's financial sector from its pre-NAFTA conditions, Mexico kept this sector somewhat restricted to foreign investment even within the agreement. However, in February 1995 – outside of NAFTA agreement – Mexico enacted laws that opened the sector much more to foreign investment. Also, in 1998 Mexico further liberalized the foreign investment rules that applied specially to the banking industry.

Both the United States and Canadian foreign investors responded positively to Mexico's more favorable climate, as evidenced by the increased foreign direct investment.

3. NAFTA and Foreign Direct Investment in Mexico

The dynamic promotion of NAFTA agreements and strong domestic deregulation and trade liberalization policies has made Mexico attractive to FDI inflows. From 1991 to 1993, the annual average inflows of FDI in Mexico amounted to $3.9 billion, whereas from 1994 to 2000 the average inflow of FDI per year reached $12.5 billion, three times as much (Exhibit 1). It was evident that regional trading blocs had an absolute effect on foreign investment in the nations that were members of NAFTA. It seemed sensible for foreign corporations to invest in trading bloc regions to secure the raw materials and resources that are, or could be valuable sources to their global strategies (Markides &Berg).

The slight decrease in investment into the U.S. from Europe and Japan in 1994 indicates that outsider MNCs wanted presence in Mexico, the largest and most crucial US market, free of tariffs, while paying a fraction of the costs of U.S. labor and resources. With NAFTA, foreign MNCs could have immediate, duty free access into the U.S. and exploit the cheap labor and land Mexico offers next door. Outsider MNCs did not want to lose their com-

petitive prowess in the U.S. market, so they wanted to use Mexico as a manufacturing platform and an immediate export springboard into the United States. NAFTA must have diverted foreign direct investments into Mexico that would have otherwise gone to other nations such as Brazil and China, competing economies to Mexico for manufacturing investment capital.

Further research into foreign direct investment in Mexico during the inauguration of NAFTA, produced surprising results on how foreign MNCs responded to Mexico in light of NAFTA. The foreign MNCs that poured investments into Mexico to utilize their cheap labor and resources for export purposes into the United States were not overseas MNCs that rushed into Mexico to hedge against fortress America, but the United States itself. U.S. MNCs took advantage of the benefits accrued from NAFTA to export back to the U.S., and significantly improve their competitiveness in their own U.S. home market against overseas competitors (Exhibit 5). The other surprising finding was that the investment capital that came into Mexico was not simply intended for manufacturing and immediate exporting. The investments actually came from North American as well as overseas companies who wanted to tap into the promising Mexican consumer market with their products or services. Most of these MNCs entered the Mexican market by buying out local enterprises and producing locally in order to supply this new growing consumer market.

Exhibit 1 Foreign Direct Investment In Mexico (Billions Of Dollars)		
Annual Average FDI 1991-1993	Annual Average FDI 1994-2000	Increase in Annual Average FDI (Times)
$3.9	$12.5	3.21
Sourse: United Nations Conference on Trade and Development Handbook of Statistics		

4. NAFTA and Foreign Direct Investment in the United States

As a developing country, Mexico does not have an abundance of capital; thus, it has traditionally not been a big player in direct investment abroad. There are, however, several notable examples of such investments in the United States. CEMEX, the third largest cement company in the world and Mexico's most multinational corporation has U.S. operations in California, Texas, and Arizona. Another Mexico's multinational company, Grupo Bimbo, Mexico's leading bread maker has about 30 operations in the United States. Grupo Vitro is the largest glass producer in Mexico, is another multinational company, which has been active in the United States through acquisitions and joint ventures, including joint ventures with Libbey and General Electric Company.

Although Mexican FDI flows were at a negative $110 million in 1993, they jumped to $1.01 billion in 1994, NAFTA's first year. Mexican FDI was negative in 1995 and 1996 as a reflection of crisis conditions in Mexico's economy, but turned positive again in 1997 and increased further in 2001 to $3.71 billion. When taking into account the historical cost of total Mexican FDI in the U.S. before and after NAFTA, Mexican FDI grew from $1.2 billion in 1993 to over $8.7 billion in 2001.

Canada's FDI into the US has also increased significantly since 1994. As Exhibit 2 indicates, between 1991 and 1993, annual average FDI from Canada into the US was $1.95 billion whereas flow of FDI between 1994 and 2000 averaged to $10.6 billion, almost 5.4 times.

Other significant increase in FDI into the US come from the Europe and Japan. From 1991 to 1993, the annual average inflows of FDI from Europe into the US amounted to $20.21 billion, whereas from 1994 to 2000 the average inflow of FDI per year reached $98.78 billion, almost five times as much. Japan's FDI into the US also increased from an average of $6.66 billion in 1991 to 1993, to an average of $9.37 billion between 1994 to 2000 about 1.4 times.

Exhibit 2 also shows that world total FDI inflows into US has increased from an annual average of $45.21 billion between 1991 to 1993 to an annual average of $150.06 between 1994 to 2000, about 3.32 times. It seemed logical and prudent for outsider multinational corporations to invest in trading bloc member economies to ensure their presence and competitiveness in that foreign market. The foreign MNCs that poured investments into the US

partially were to hedge against fortress America as created by NAFTA.

Exhibit 2 Foreign Direct Investment In U.S. (Inflows) (Billions Of Dollar)			
	Pre-NAFTA Agreement Annual Average FDI 1991-1993	Post NAFTA Agreement Annual Average FDI 1994-2000	Increase in Annual Average FDI Inflows (Times)
Canada	$1.9	$10.60	5.58
Mexico	$.24	$.54	2.25
Europe	$20.21	$98.77	4.49
Japan	$6.66	$9.37	1.41
World	$45.21	$150.06	3.32
Sourse: United Nations Conference on Trade and Development Handbook of Statistics			

5. NAFTA and Foreign Direct Investment in North America

NAFTA has helped create a more integrated North American market. The Agreement strengthens trade by reducing barriers and guaranteeing access to each country's market. This frees businesses to make decisions based on the most efficient use of resources and fosters production-sharing partnerships in which different parts of the manufacturing process are performed throughout the region. NAFTA has increased tremendous opportunities for investors. Since 1994, investment in North America has been dynamic and growing. While the annual average FDI inflows in North America were $26.4 billion between 1991 and 1993 (pre- NAFTA Agreement), it increased to annual average FDI inflows of $171.8 billion from 1994 to 2000 (post NAFTA Agreement). A 6.5 times increase (Exhibit 3).

Exhibit 4 also shows that foreign investor responded positively to North American favorable investment opportunities, as evidenced by the increased foreign direct investment inflows to North America as a percentage of world total FDI inflows. While annual average FDI inflows between 1991 and 1993 were 17.76 percent of world total FDI inflows, it jumped to an annual average of 25.44 percent from 1994 to 2000.

Exhibit 3 Foreign Direct Investment in North America (NAFTA Community) (Billions of Dollars)		
Pre-NAFTA Agreement Annual Average FDI 1991-1993	Post NAFTA Agreement Annual Average FDI 1994-2000	Increase in Annual Average FDI Inflows (Times)
$26.4	$171.8	6.51
SOURSE: United Nations Conference on Trade and Development Handbook of Statistics		

Exhibit 4 Foreign Direct Investment Inflows (Billions Of Dollar)			
	North America	Total World	FDI Inflows To North America as a Percentage of World Total FDI Inflows
Pre-NAFTA Agreement Annual Average FDI 1991-1993	$26.4	$148.7	17.76%
Post NAFTA Agreement Annual Average FDI 1994 -2000	$171.8	$675.6	25.44%
Sourse: United Nations Conference on Trade and Development Handbook of Statistics			

6. United States' Direct Investment Abroad

Exhibit 5 clearly shows the United States FDI into Mexico. U.S. FDI in Mexico equaled $1.3 billion in 1992. The following year FDI jumped to $2.5 billion, very likely in anticipation of NAFTA, and in 1994, NAFTA's first year, U.S. FDI increased further, to $4.5 billion. U.S. FDI flows averaged $4.04 billion per year during 1994-2000, up almost 100 percent from an average annual level of $2.05 billion during 1991-93.

As we discussed earlier, the average annual inflows of FDI in Mexico from 1994 to 2000 reached $12.5 billion, three times as much. Where did all this money come from? Surprisingly, the majority of foreign direct investment into Mexico came from the United States. Some important examples of U.S. FDI in Mexico since inception of NAFTA are found in the telecommunications and insurance industries. AT&T Corp., MCI WorldCom, and other U.S. long distance carriers are now part of the Mexican telecommunications landscape. Also, major U.S. insurance companies have increased their presence in Mexico including New York Life Insurance Company, which purchased Mexico's third largest insurance company, Seguros Monterrey Aetna. British banks and European product manufacturers such as Nestle invested heavily in the Mexican market. While Asia accounted for less than 5% of the total investment into Mexico, the U.S. MNCs have been the most aggressive in using Mexico as a manufacturing platform, and an export springboard into its own U.S. market as well as the Latin American and global markets (Markides &Berg).

EXHIBIT 5 US Direct Foreign Investment in Selected country or region (Billions of Dollar)

	Pre-NAFTA Agreement Annual Average FDI 1991-1993	Post NAFTA Agreement Annual Average FDI 1994-2000	Increase in Annual Average FDI Outflows (Times)
Canada	$2.33	$9.80	4.21
Mexico	$2.05	$4.04	1.97
Europe	$28.14	$57.67	2.05
Japan	$.70	$3.23	4.61

Sourse: United Nations Conference on Trade and Development Handbook of Statistics

7. Conclusion

In conclusion, the analysis of investment patterns by foreign MNCs since implementation of the NAFTA indicates a significant increase in their foreign direct investments in the NAFTA community, particularly in Mexico. This increase in FDI by foreign MNCs could be explained in three ways: First, it is due to the fear of "fortress America" as MNCs invested in the NAFTA bloc to penetrate the region's open market. Second, investors are looking to capitalize on the tangible financial attractions of modern-day Mexico, namely its location as a Latin America gateway, affordable primary resources, and increasingly competitive open market conditions. Third, the MNCs who had capital and global plans for such intensive foreign investments had already permeated North America. With or without NAFTA, the European and Asian (especially Japanese) MNCs continued to develop their global plans to produce their products regionally to supply key and major markets with locally made products. NAFTA drove forward the evolution that was inevitable, as non-American corporations would become "American Made."

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Notes