

**Deloitte**  
**Haskins + Sells**

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"MEXICO: THE BUSINESSMAN'S PERSPECTIVE"

JANUARY 22, 1987

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DIGEST OF CONFERENCE

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**"MEXICO: THE BUSINESSMAN'S PERSPECTIVE"**  
**Held On January 22, 1987**

**I. BACKGROUND**

The political and economic stability of Mexico is of major interest to U.S. policy-makers because of the country's geographical proximity to and economic relations with the United States. However, Mexico's current economic crisis is endangering this stability. In the midst of this crisis, a potentially stabilizing force is growth in the private business sector.

As part of a larger effort to improve its understanding of Mexico's political and economic system, the Central Intelligence Agency requested that Deloitte Haskins & Sells prepare and host a conference to explore both the prospects for growth in the private business sector and the consequences these prospects would have for political and economic stability in Mexico. Deloitte Haskins & Sells proposed to provide the viewpoint of U.S. businesses operating in Mexico, particularly with regard to the potential for future business opportunities.

On January 22, 1987, Deloitte Haskins & Sells hosted the conference titled "Mexico: The Businessman's Perspective." The speakers were businessmen, academicians, and economists. The participants consisted of personnel from several government agencies, including representatives from the Agency. The results of the conference are summarized in the following digest.

**II. OBJECTIVE AND SCOPE**

The objective of this digest is to summarize and highlight the major issues raised and discussed at the conference for future reference by Agency personnel. The major points presented in the panel sessions by the various speakers are listed below, including issues discussed during the question and answer sessions that followed the panel presentations. Brief summaries of the principal conclusions reached in the panel sessions are also included.

**III. KEYNOTE ADDRESS**

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**A. Major Points:**

- (1) Economic changes are affecting the political process in Mexico.
- (2) There is mounting pressure on the current highly structured and centralized one-party political system--ruled by the majority party PRI--to change. This pressure is the result of two recent developments:

- . A growing consensus among the politically active urban middle class segment of the population in favor of a genuinely decentralized multi-party system, which is indicated by a rise in support for the minority party PAN
  - . A growing desire among the aforementioned group for a genuinely federal political system in which elected officials more clearly represent their constituents.
- (3) Both developments are intensifying as a result of the increased circulation of dissenting literature.
- (4) While the PRI candidate will likely win the next election, he will also likely rule with little legitimacy.

## B. Conclusions

The potential for a change in the political process is increasing steadily. The ramifications of how the current governing elite respond to this potential will significantly affect future political and economic policy-making.

## II. PANEL 1 -- POLICY ISSUES

### A. Major Points



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- . Indicators of the investment climate in Mexico are providing conflicting signals.
- . Recent policies have met with mixed success:
  - .. "fiscal hemorrhaging" has stopped under the International Monetary Fund (IMF) program, but deficits remain very large
  - .. monetary policy has essentially "ratified" past inflation, but real interest rates are lower
  - .. exchange rate policies have helped to offset the decline in oil exports through more capital in-flow and more non-oil exports
  - .. subsidization of domestic industries has decreased and public sector prices have increased
  - .. while the number of state-owned enterprises (SOEs) has decreased, the amount of public sector output has not significantly decreased
  - .. with Mexico's entry into the General Agreement on Tariffs and Trade (GATT), tariffs have been reduced and the trade situation is improving
  - .. the debt-equity conversion program is reducing debt and encouraging new capital infusions
  - .. direct financial intermediation by the state is decreasing.

- . There are three main concerns about the goals of current policy:
  - .. the probable growth rate in 1987 of 4.5 to 5.5% will be enough to keep pace with the growth in the labor supply, but not enough to help in the servicing of external debt
  - .. an apparent acceptance of high nominal deficits indicates inflation reduction is a low priority, which could have a negative impact on private investment as the government finances the deficits
  - .. presidential elections typically have been disruptive in terms of policy stability, and de la Madrid's six-year term expires in two years.

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- . Recent developments in trade relations between the U.S. and Mexico have not been well coordinated and indicate a lack of recognition on the part of U.S. trade policy-makers of Mexico's trade situation:
    - .. in exchange for reductions in domestic subsidies, the 1985 trade agreement granted relief to Mexican exporters by requiring application of the "injury test" before the imposition of countervailing duties under the current U.S. law
    - .. Mexico's entry into GATT has resulted in lower tariffs, but at great cost to the Mexican economy
    - .. Congressional prioritization of the criteria for awarding duty-free concessions under the Generalized System of Preferences (GSP) has not recognized Mexico's policy initiatives and resulted in fewer benefits.
  - . Protectionist pressures in the U.S. are worrying Mexican business interests, particularly with respect to the countervailing duty law; continued subsidization of energy products for domestic industries could subject Mexico to future countervailing duties.

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- . There have been recent significant changes in both U.S. and Mexican tax laws; changes in the latter are designed to fulfill commitments to the IMF program and broaden the tax base.
  - . Mexico has suffered significant reductions in tax revenue due to reductions in the tax base, caused by:
    - .. inflation
    - .. tax avoidance and tax evasion.

- . In order to increase tax compliance, Mexico has instituted:
  - .. more mandatory reporting
  - .. broader powers for tax authorities
  - .. increased civil and criminal penalties.
- . On balance, the new tax laws are neutral with respect to investment, but some provisions offer substantial investment incentives, including:
  - .. immediate depreciation of taxable assets by 36 to 93% in which the present value of future deductions are taken up front in one lump sum
  - .. the writing down of inventories.
- . Mexico is not a tax haven for offshore manufacturing interests, since the maquiladoras are not tax-motivated creations.

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- . While 6,978 companies with foreign capital participation are operating in Mexico, direct foreign private investment in Mexico is only 5% of total investment.
  - . The current recessionary period, which dates back to 1982, has had both a psychological and investment confidence impact; prospects for moderate future growth are dependent upon domestic and external factors and the timing of those factors, all of which are very unpredictable.
  - . New fixed investment decreased in 1986 by 15% in real terms, but growth rates in the future should be better, depending on:
    - .. the real and perceived success of de la Madrid's overall economic recovery efforts
    - .. the level of domestic and foreign funds available for investment
    - .. how successful companies in Mexico are in export markets.
  - . A current goal of the Mexican government is to average 30% annual growth in manufactured exports (in dollars) for the period 1986 to 1990; this goal is extremely ambitious, considering industrial production in real terms is down in many key sectors.
  - . Direct foreign investment has been regulated since 1973 by the so-called foreign investment law, which among many areas restricts foreign equity participation in Mexico to a maximum of 49%; major exceptions to the law are in the in bond or maquiladora industries, where plants can be 100% foreign-owned.

- . New private foreign investment has decreased sharply in recent years in all major sectors except for the automotive, computer-related, and in bond industries.
- . Government policy toward direct foreign investment is currently more liberal than at any time since the foreign investment law was promulgated:
  - .. projects are being handled on a case-by-case basis by the National Foreign Investment Commission (NFIC)
  - .. more exceptions to the law are being allowed in different manufacturing areas which provide for 100% foreign equity ownership
  - .. some financially troubled companies are being "de-Mexicanized" through temporary allowances for majority or 100% foreign ownership.
- . Government policy is currently directed at encouraging foreign companies to offer:
  - .. substantial fixed assets investment
  - .. a definitive and ongoing exports program
  - .. the transfer of technologies, particularly in manufacturing.
- . New factors affecting investment decisions in Mexico are:
  - .. the new tax laws in the U.S. and Mexico
  - .. the updated controversial law on patents and trademarks in Mexico
  - .. the credits capitalization or debt-equity conversion program
  - .. the revised laws regulating mutual funds which open up foreign participation in the establishment and operation of such funds, subject to NFIC approval.
- . The maquiladora industries showed the strongest growth and represent the best opportunity for future direct foreign investments.

(5) Question and Answer Issues:

- . Flexibility in foreign investment policy is still subject to capricious decision-making.  STAT
- . There is a tendency in the maquiladora industries to accept U.S. inputs and place the factories near the border.  STAT  
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- . Attempts to increase the tax base are not likely to be successful because of governmental legitimacy problems and a pervasive unwillingness to pay.  STAT
- . Many experts expect a boom in the underground economy to result from the changes in the Mexican tax law.  STAT  
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**B. Conclusions**

Economic policies, especially in the areas of trade and foreign investment, are creating a more favorable climate for foreign business opportunities. However, confidence in the future direction and success of these policies is not high in either Mexico or the U.S. Furthermore, U.S. policy initiatives are not fully responsive to the needs of the Mexican economy. The prospects for future growth in the economy--and growth in foreign investment in particular--are consequently uncertain.

**II. PANEL 2 -- ISSUES FACING MANAGEMENT**

**A. Major Points**

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- . The official open unemployment figure reported to the International Labor Organization (ILO) by Mexico of 6 to 7% does not reflect the economic reality, particularly in the hard hit industrial sectors and major urban centers.
- . The level of training and expertise in many areas of Mexico is low and does not fulfill the expectations of foreign firms attempting to operate there.
- . Many of the maquiladora factories hire women, which leads to a step-wise migration and immigration problem: the men follow the women to the northern areas (where most of the factories are located), crossover into the U.S., and are eventually followed by the women as well; skilled labor is lost in the process.
- . Generally, the unions have cooperated with the government and kept silent, despite the government's failure to keep real wages from falling; the potential for future labor unrest is growing.
- . The transfer of technologies and information is often limited by cultural factors which preclude the foreign companies from an awareness that the transfer is incomplete.

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- . The primary concern of the Mexican government regarding foreign business ventures is what the operation leaves behind for Mexico, particularly in the areas of exports and technology transfers.
- . The government is the largest client for computer and computer-related products due to:

- .. the government's centralized structure
  - .. the centralized and nationalized nature of the financial industry
  - .. the number of state-owned enterprises.
- . Moving hardware and equipment across the border is easier than moving software because of:
    - .. translation problems
    - .. cultural differences
    - .. different laws and business practices which require different approaches to software development than those used in the U.S..
  - . The computer industry is capital intensive, resulting in a high cost of operation; labor costs are also high because of the shortage of computer specialists and the high wages these specialists earn world-wide.
  - . Even though the level of technology in Mexico (e.g., real-time telecommunications) is not sophisticated, the ability of Mexican personnel to operate with what they have is comparable to what exists in the U.S..
  - . The reduction in the amount of the foreign tax credit under the new U.S. tax law is potentially damaging to U.S. business interests with respect to current and future Mexican ventures.



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- . Operating a business in Mexico is facilitated by examining worst-case scenarios and adopting appropriate strategies in advance of crises.
- . The key steps in understanding the "prosper-survive" cycle operative in Mexico and managing effectively through it are:
  - .. decide the key personnel to be retained during the survival period
  - .. decide the tertiary customers to be released during the survival period
  - .. decide the marginal products to be eliminated during the survival period
  - .. examine the income statement to determine if a break-even result is possible during the survival period
  - .. decide the level of sales to the government during the survival period
  - .. price replacement costs in dollars
  - .. establish fall-back positions with respect to the supplies of inputs and foreign exchange.
- . After performing the above analyses, the following concerns should be addressed:




- .. the company's employment policies
  - .. the company's code of conduct
  - .. the company's direct and indirect labor costs.
- . A low profile with respect to the government is the best approach for a company to take.
  - . On balance, Mexico is a good place in which to operate.



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- . The Mexican worker is typically bright and eager to learn, but is not particularly loyal in the face of competing recruitment offers which confront the more skilled workers.
- . The government is actively promoting growth in the in bond industries, which are now the second largest source of exports; labor is the principal value added in these industries, with inputs typically coming from the U.S..
- . The principal concerns facing Mexican exporters are:
  - .. unresponsive or negative attitudes of U.S. trade policy-makers towards Mexican exports, particularly the exports from in bond industries
  - .. the resistance of U.S. policy-makers to classifying Mexico as a beneficiary of the Caribbean Basin Initiative (CBI) rather than as a donor
  - .. the political and economic stability of Mexico
  - .. the government's potential inability to deal with growing labor unrest and the current socialist labor laws which, for example, require that workers laid off must still be paid
  - .. the view of indigenous companies that the in bond industries represent a potential threat to current export markets
  - .. punitive measures taken by the U.S. against Mexican exports.
- . U.S. policy-makers should develop a comprehensive trade policy and recognize private sector initiatives from U.S. businesses.

(5) Question and Answer Issues:

- . It was the general consensus of the group that while corruption in the Mexican government is a problem, the long-term interests of foreign businesses operating in Mexico are best served by not engaging in it.
- . Potential harassment tactics by the Mexican government should be accounted for in the strategic planning of a foreign business. 

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**B. Conclusions**

While it is possible to operate profitably in Mexico, an understanding of the political, economic, and cultural factors and sound strategic planning by management are necessary in order to effectively manage through the "prosper-survive" cycle which exists in Mexico.

**III. PANEL 3 -- BUSINESS OUTLOOK**

**A. Major Points**



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- . Much of the discussion about the need for policy changes is a "smoke-screen"; the principal factors to consider in assessing the potential for policy changes are:
  - .. the geographical proximity of Mexico to the U.S.
  - .. the rise in Mexico's population
  - .. the large role the state plays in Mexico's economy
  - .. the changing and predictable political cycle which Mexico exhibits because of the six-year presidential term
  - .. the form of the political system--authoritarian and centralized--affects how business is done in Mexico
  - .. the growing "internationalization" of Mexico from increasing economic and cultural contacts with the international community.
- . Within the last two years of de la Madrid's term, radical policy changes are highly unlikely.
- . U.S. investment in Mexico will continue, but it is necessary for U.S. policy-makers to be as open in dealing with Mexico as possible.



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- . The main issues in formulating the forecast are:
  - .. the announced and applied economic policy in Mexico
  - .. the choice of policy goals: economic growth versus inflation reduction
  - .. the impact of external debt on the economy.
- . The main assumption of the forecast centers on the degree to which announced policy is applied, particularly with regard to the growth-inflation trade-off.

- . The forecast also builds off the assumptions that soon-to-be-introduced foreign financing will increase general credit availability and that optimistic increases in private and public investment will occur.
- . The results of the forecast are as follows:
  - .. average annual growth over the next two years of 3 to 3.5%
  - .. higher inflation in 1987 and 1988
  - .. higher current account deficits in 1987 and 1988
  - .. negative transfer of credit from abroad
  - .. likely introduction of major economic reforms (an Azteca plan) as soon as 1987 and as late as 1989
  - .. renewed external debt renegotiations as early as 1988.
- . Renegotiation of external debt will likely be repeated every two to three years until the international monetary system finally writes off the debt; only if the problem of negative transfer of credit from abroad can be permanently solved will these renegotiations cease.
- . If one compares average annual rates of inflation and growth under de la Madrid with average annual rates under previous administrations, one finds significant variances:
  - .. previous rates of growth all averaged around 6%, while de la Madrid's will likely exhibit zero average growth
  - .. previous rates of inflation averaged between zero and 30%, while de la Madrid's will likely exhibit 100% average inflation.
- . The risks associated with the forecast are:
  - .. the Mexican government placing a higher priority on reducing inflation as a result of social strain
  - .. introduction of an Azteca plan--currently being contemplated--of radical economic reforms
  - .. significant changes in oil prices which alter the level of IMF relief (over \$14 per barrel means less relief and less than \$9 per barrel means more)
  - .. foreign exchange problems in 1988 resulting from postponements of banking agreements.

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- . Massive global economic structural change will occur in the mid to late 1990s, resulting in:

- .. exchange rate realignment
  - .. movement of currently prospering countries into the survival period of the "prosper-survive" cycle
  - .. greater prosperity for the U.S. and more opportunities for both domestic and foreign investment in the U.S.
- . Mexico can potentially benefit from these changes and the externalities they will generate around the U.S.
  - . In addition to the foreign financing which Mexico has sought, there are significant monies available for short-term use immediately across the border; these monies would have to be included in any comprehensive measure of the Mexican money supply and constitute an additional source of funds for financing economic policies.
  - . Future investment will focus on the maquiladora industries, and the U.S. government should work with the Mexican government to exploit this as the area with the most potential for growth.
  - . U.S. businesses will have to re-orient their strategies away from trying to penetrate local markets and toward developing export markets for their Mexican products.

(4) Question and Answer Issues:

- . 1987 is a highly political year, so only hyper-inflation could generate tensions severe enough to result in radical policy changes.  STAT
- . The PRI is still the party with which to cooperate for most Mexican businessmen--even in the northern areas--despite recent apparent gains in public support for the PAN party.  STAT
- . Most of the increase in the nominal government deficit is directly due to the high inflation which Mexico has experienced, and inflation impacts more on the internal component of debt than the external component (which is valued in dollars.)  STAT

B. Conclusions

The outlook for future investment opportunities in Mexico is uncertain because of the modest prospects for growth and the potential for future policy instability. In the long term, prospects look much better for Mexican exports and for foreign investment opportunities in the exporting industries. Any decision to invest will have to be balanced against an assessment of the short-term and long-term interests of the company and an assessment of the political and economic stability of Mexico.