



Nearshoring in Mexico

During the last two years, supply chain disruptions have been one of the main obstacles for companies worldwide, especially for companies with offshore operations.¹ As a result, nearshoring has emerged as an attractive alternative to the offshoring method, particularly for economies like Mexico, which has an intensive commercial relationship with several countries, including its major partner, the United States.² However, media outlets and experts have highlighted the challenges that companies need to consider before shifting their operation to Mexico, such as political, operational or regulatory risks, among others.³

This issue brief analyzes political and investment concerns that should be addressed while planning nearshoring strategies in Mexico. The article proposes a detailed study of Mexico's specific context before planning any possible investment project related to the offshoring method.

Opportunities and Risks

According to the World Trade Organization (“WTO”) global trade is expected to remain subdued in 2023 as multiple shocks keep weighing on the global economy. WTO economists now predict global merchandise trade volumes will grow by 1.0% —down from the previous estimate of 3.4%.⁴

The main economic impact of the crisis has been a sharp rise in commodity prices. Russia and Ukraine are key suppliers of essential goods including food, energy, and fertilizers, which are now threatened by the war.⁵ Household spending in Europe will be constrained and manufacturing costs will rise due to the high energy prices caused by the conflict. Similarly, interest-sensitive spending in sectors like housing, motor vehicles, and fixed investment in the United States will be affected by monetary policy tightening.⁶

Furthermore, transport costs are expected to soar.⁷ The New York Times has reported that shipping rates could surge from US \$10,000 per 40-foot container to US \$30,000, while air freight rates could jump even higher.⁸ According to the Organisation for Economic Co-operation and Development (“OECD”), the war has underlined the importance of reconsidering the appropriateness of market design with a view to ensuring efficiency wherever possible and multilateral support for logistics.⁹

Within this context, the supply chain disruptions over the past two years have highlighted the fragility of offshoring, the business strategy of manufacturing outsourced to distant countries. Offshoring once allowed industries like automotive, retail, and pharma to operate more affordably. However, as supply chain constraints have been intensified by a lack of diversified resources, many businesses are considering transferring operations to nearby countries or close to their points of sale. Nearshoring has emerged as an attractive alternative to the offshoring method.¹⁰ As a consequence, an increasing number of companies has decided to shift and/or diversify their supply chains.¹¹



According to the International Monetary Fund, diversifying resources in the global supply chain would add necessary support and reduce the impact of shocks and shortages.¹² Latin America, and specifically Mexico, is poised to profit the most from this developing trend given its strategic location.¹³

As manufacturers continue to explore their options in 2023 and beyond, it's important to identify three of the most important cost benefits of nearshore manufacturing in Mexico:

1. A strategic location close to the U.S.;
2. Competitive labor costs, and,
3. Tax exemptions through the Manufacturing, Maquila and Export Services Industry Program ("IMMEX"),¹⁴ which allows foreign manufacturers to import raw materials and components into Mexico, tax and duty free, under the condition that 100% of all finished goods will be exported out of Mexico within a government mandated timeframe.¹⁵

As the United States' largest trade partner,¹⁶ Mexico has relevant advantages for manufacturers. According to the World Bank, Mexico is transitioning to a "Knowledge-Based Economy."¹⁷ The country's manufacturing clusters offer concentrated areas of skilled workers, advanced industry-specific technology, and an established knowledge base.¹⁸ These locations have steadily expanded Mexico's presence in industries like aerospace, automotive, electronics and medical devices.¹⁹

Some companies have already started the move from China to Latin America. For example, companies such as Lizhong, Citic Dicastal, Alibaba, CF Moto, and BOE Vision Electronic Technology, have already started to migrate their manufacture operations from China to Mexico.²⁰ Furthermore, Toyota, Mazda, and Nissan, which are Japanese companies, have relocated some of their production to Mexico.²¹ Border Now reports that around 172 out of 260 executives from companies that have manufacturing facilities in China have expressed their inclination towards Mexico as a source to cater to the U.S. market.²²



Another recent example of the effects of nearshoring in Mexico relates to Tesla, the automotive, artificial intelligence, and clean energy company, which at the beginning of 2023 expressed interest in establishing a new plant in the state of Nuevo León, Mexico.²³ The Mexican government's immediate response was proposing location alternatives, such as the state of Hidalgo, in central Mexico,²⁴ alleging the lack of water in Nuevo León (the state had suffered a severe drought in 2021 that affected a large part of the state's population).²⁵ *Mexican media*²⁶ highlighted that the change of location could respond to political and not environmental interests, since companies like Kia, Ford, Toyota, General Motors and Stellaris have automotive assembly plants in northern Mexico.²⁷ According to pundits, the reason behind the government's reaction was that Nuevo León's governor is affiliated to an opposition party.²⁸

Finally, on March 1, 2023, during Tesla's Investor Event 2023, Elon Musk confirmed that the company will construct a new manufacturing plant in Nuevo León, Mexico, as part of a new strategy of lowering logistics costs.²⁹ Media outlets have also highlighted the importance of ESG factors in investment decisions, as is the case with Tesla.³⁰

The case of Tesla and the Mexican state of Nuevo León, demonstrates the relevance of social, ecological and political factors, among others, for companies interested in moving their operations to countries

like Mexico. According to experts, most plants in the automotive sector use wastewater and non-potable water for their operations.³¹

Political analysts have emphasized the importance of understanding the political risks that could affect companies that want to nearshore in Mexico.³² The Corruption Perception Index 2022 published by Transparency International,³³ ranked Mexico 126 out of 180 countries with more corruption in the world, considering, among several factors, bribe schemes and unlawful payments to government officials. During an interview with Forbes, Ryan Berg, Director of the Americas Program at the Center for Strategic & International Studies highlighted the importance of companies to understand that "much of the nearshoring interest in Mexico is occurring in spite of Mexico's government's policies, rather than because of them."³⁴

Media outlets and experts have also identified risks of shifting production to Mexico. Among the several risks, the most relevant are:³⁵

- Structural Risks: Corruption, fraud, weak rule of law, perceptions of insecurity, risks to cargo, theft and extortion.
- Operational Risks: Lack of infrastructure investment in Mexico, deficiencies on current infrastructure and uncertainty in the electricity sector.
- Regulatory Risks: Allegations of corruption in regulatory agencies, especially in matters of market authorizations, import permits and manufacturing certifications. Additionally, experts highlight the common administrative delayed response on permits that prevent companies for proper planning.
- Government Procurement: Recent government policies that have created uncertainty regarding the lack of transparency, absence of clear rules and doubts in the government tenders.
- Sustainability Risks: Barriers from the Federal Administration to the renewable energy sector that could complicate companies' commitments to sustainability.³⁶



It is also important to mention the regulatory impact of international sanctions on countries like Russia or China on nearshoring schemes.³⁷ Even though Mexico did not impose any economic sanctions on Russia due to the invasion of Ukraine, it is worth mentioning that the Executive Order 14065 issued by President Biden's Administration on February 21, 2022 defines the scope of applicability of sanctions to "not only United States persons but also any person in the United States."³⁸ This definition includes any "US citizen, lawful permanent resident, entity organized under the laws of the US, or any jurisdiction within the US (including foreign branches), or any person in the US."³⁹ Therefore, companies operating in Mexico with substantial operations in the US could be subject to this regulation on economic sanctions against Russia.⁴⁰

Security factors should also be considered while moving business operations to Mexico. As of 2023, extortion is one of Mexico's main concerns in terms of public security.⁴¹ Most extortions are conducted through telephone calls in which criminal groups contact managers demanding money in exchange for "protection" or to avoid harm. Companies operating in Mexico should analyze the effects of this situation for two reasons:

1. The security conditions of their employees, and
2. The compliance and regulatory impact of paying "protection" or ransoms to criminal organizations.

Regardless of the risks, Mexico, as a key player in North America, is increasing its exportation role in the region due to a strong U.S. demand and a revival of several

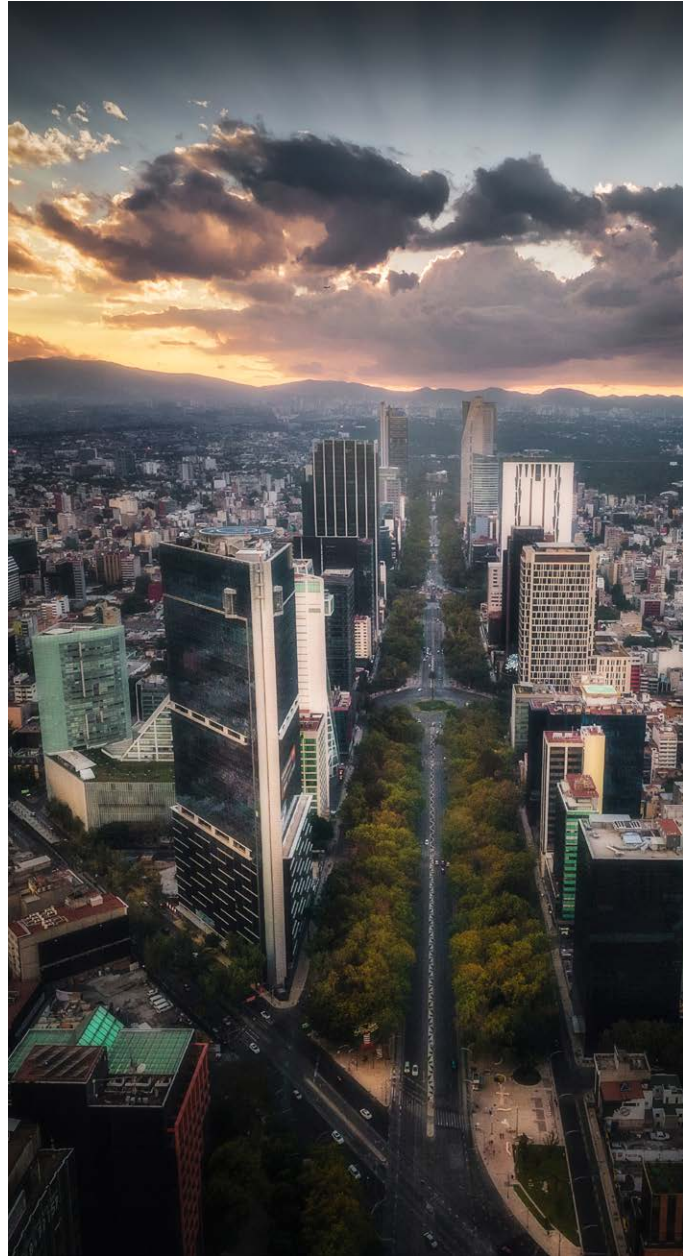
industries including medical supplies, cars and other non-petroleum goods.⁴² Bloomberg reported that Mexican factory-filled states along the U.S. border are thriving, with Mexico's exports surpassing US \$80 billion in the first two months of 2022.⁴³

Mexico's position as the U.S. largest goods trading partner is expected to continue for years to come as experts name tension with China, new trade agreements, and the effects of the COVID-19 pandemic as key factors for companies pushing to rethink their supply chains.⁴⁴ As such, Mexico stands out as the natural alternative to reduce costs and logistical constraints.⁴⁵ There are 60 ports of entry along the length of the border and every day 427,000 vehicles, 30,000 trucks and 1,000,000 people cross the divide.⁴⁶

In this process, companies must take care when choosing alternate sourcing locations for key commodities, as doing so can increase industry reliance on supplier hubs that are already nearing capacity. Today, nearshoring represents a new opportunity for companies to facilitate the movement of goods to end markets, while reducing transportation costs, especially in the Latin American region.⁴⁷ However, this new opportunity also requires enhanced guidance in understanding the risks associated, as well as in compliance policies to prevent them, such as the implementation of background checks, ethics and anti-fraud programs, documented policy in accordance to ethical standards, investigations of incidents, or performing analysis of anti-money laundering.⁴⁸

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