S&P Global
Market Intelligence

Ep. 178 - Nearshoring to Mexico The big picture

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You're listening to the economics and country risk podcast from S&P Global Market Intelligence. In each episode, our experts will provide you with the where, how and when to make decisions that transform your business. You may have heard about companies near-shoring to Mexico. Each week, there seems to be another headline announcing an investment in the country's manufacturing sector.

In our 3 episode series on Nearshoring to Mexico, you will hear the story behind the attraction and how long the love affair may last. We'll start in this episode with an overview of the economic and geopolitical risks and opportunities, then in episode 2, we'll delve into the operational side. And in our last episode, we'll share the supply chain story.

I'm Kristen Hallam, Content Strategist for S&P Global Market Intelligence and your host for this episode of the Economics and Country Risk podcast. Joining me for the same setting episode are Rafael Amiel, Director of Latin America Economics; and Jose Enrique Macip, Senior Analyst, Latin America Country Risk. Thank you, Rafael and Jose Enrique, for returning to the podcast about a year after our previous discussion on near shoring. It's good to have you back.

Rafael Amiel

Thanks to you, Kristen.

Jose Enrique Macip

Thank you, Kristen.

Kristen Hallam

Near sharing has only gotten more popular since we last spoke. Why is that? Does it have to do with an economic calculation? Or is it due more to geopolitical drivers?

Jose Enrique Macip

Certainly, the near-shoring story has both a geopolitical and an economic narrative to itself. I would like, however, to begin talking about the geopolitical drivers as we believe these are the ones that first put Mexico on the scene and on the verge of this huge opportunity because if we think back, a reshuffling of the supply chains that fit the U.S. market has been underway for at least 5 years, at least since former U.S. President Trump imposed tariffs on imports from China.

But then, however, Mexico and the U.S. as well as Canada, we're having a difficult negotiation process to reshuffle the North American Free Trade Agreement. Therefore, the preferential market access to the U.S. for Mexican export was not a clear-cut guarantee for companies in the long run. Fast forward to 2022, 2023, well, we have now USMCA, which just this July has turned 3. Mexico has preferential market access to the U.S. market.

USMCA set up stricter rules of origin that push companies to increase the share of their production in North American countries and U.S. and Mexico trade has been ever increasing. During the past 3 years, there has been several months in which Mexico has been the largest exporter to the U.S. even above Mainland China. So that's on one hand.

On the other hand, we have the geographical factor, which has been increasingly important following the severe supply chain disruptions after the pandemic, the first and the war in Ukraine, in the second. Considering the potential of future supply chain disruptions, any Asian competitor that wants to sell into the U.S. market that can have more competitive advantages than Mexico, perhaps it's more productive in terms of operational risk, it's a better environment, but they don't have this land vicinity to the U.S., which means Mexican trade is mostly insulated from seaborne supply chain disruptions.

80% of Mexican export to the U.S. are moved by land. So any future risk of seaborne supply chain disruptions won't affect Mexico. So these are the main geopolitical drivers behind nearshoring, the push for nearshoring and they're going to be around for years to come. So I would start setting that discussion with these 2 main factors.

Kristen Hallam

Some significant advantages there for Mexico. And what are the economic forces driving companies to come to Mexico, Rafael?

Rafael Amiel

Well, Jose mentioned one, which is the major advantage, which is the geographical situation compared to other countries, let's say, in Latin American region. But not only is the geography, it's also the Mexico over the years with what previously was NAFTA, the North American Free Trade Association, and now the USMCA.

Mexico has built experience in serving the U.S. market, especially the automotive sector, but then the aerospace and defense follow. And then Mexico will try to expand to supply the North American market with semiconductors, with pharmaceuticals and other products. So this is the great advantage that Mexico has. Mexico has the experience of serving the North American market, has experience of doing [maquila] is a term that was coined in Mexico, which is assembly for reexport.

We see that as a major advantage. All of this, the freight, the shipment costs are there. And then you can think about the possibilities of a very large country to serve not only the larger market of the U.S. and Canada, but also serve the domestic market of Mexican economy start moving up these important source for demand.

Kristen Hallam

We're going to talk about some of that expertise you just mentioned in our next episode in the series on nearshoring. Thanks for mentioning that. So are most of these companies that are nearshoring to Mexico or expressing an interest in nearshoring to Mexico, are they new to Mexico? Or are they expanding operations?

Jose Enrique Macip

That's a great question because part data is not telling us yet that nearshoring is moving at the speed that we perceive through the media and through, let's say, the foreign exchange market, which I'll elaborate in a minute. So foreign direct investment into Mexico grew significantly in the first quarter of 2023, but it was mostly reinvestment of profits.

And compared to investment of profits of 2022, the growth was 32%. We've seen years with not this record recorded in Q1 2023, but with higher than Q1 2022. So -- and then if you see the numbers for new investments, we're talking about USD 930 million, not even $1 billion. If we compare to Q1 2022, we need to make an adjustment because there were purchase of assets, just the ownership moving from hand to hand, but not really a new investment in Mexico.

And still, this is almost a 50% decline with respect to Q1 2022. So we are seeing that near shoring is happening, firms established. They are taking advantage of their expertise, their knowledge and Jose mentioned operational and security risk, their knowledge of the country, how to move around and making their investments. But in terms of the announcements that we hear, there was a very big announcement of the largest electric vehicle producer in the world, Tesla.

The government said this is going to be a USD 5 billion investment. Then Tesla announced that we will build a factory in 1 year and 2024, they will be producing 0.5 million units and their capacity was for 1 million units. So -- now we, with the expertise of colleagues, we are refining the numbers. We know there's $1 billion coming in the next 12 months of investment. So things in the [medium] sound a little bit higher or bigger than what we are actually seeing or projecting.

But still, there are so many announcements. Chinese companies are coming into the play. They want to serve the North American market. There are local content requirements that they have to adhere to and comply with. But still, we see that this is moving. I mentioned the foreign exchange market because if you see the strength of the Mexican peso in the past 4 to 8 weeks is incredible. It's something that we would have not projected without this near-shoring wave.

Kristen Hallam

You mentioned the impact on the peso. And I do want to ask you how this trend, how these announcements about nearshoring are impacting Mexico's economy. Is it enough to move the needle? Is it enough to make you adjust your forecast, Rafael?

Rafael Amiel

Yes. We are adjusting the forecast. Certainly, the foreign exchange market reacts very rapidly, is volatile, too, but reacts very rapidly. We've seen on the level of foreign exchange reserves, which is not exactly foreign direct investment, but we see that there's been an increase in the stock of hard currencies held by the Central Bank of Mexico, and this is clearly a reflection on the foreign exchange market.

But from the growth perspective, from the economic activity perspective, we are adjusting this not moving more than 1 percentage point in our growth forecast. We still have adjusted less than 0.5 percentage point on the growth perspective because we want to see the numbers, we want to see if this is materializing into actual investment. And let me give you numbers. Foreign direct investment has averaged around USD 30 billion, okay? If we want to have a miracle economy like the one in India, we have to see $60 billion figure for a boom to happen in Mexico.

But then -- and here, Jose Enrique can elaborate more, then Mexico had to surpass some obstacles, especially in infrastructure. Beyond the security reason, the operational part risk, there are issues and concern about power generation, electricity supply, water issues in Mexico that has to be solved. If we want to sell the capacity of Mexico to build industrial parks, I would say, yes, they do have it. They have the expertise. They can build industrial parts rapidly. Whether the infrastructure to support this is there, that's a question that we still ask ourselves.

Kristen Hallam

Those were some big numbers you threw out, too, there in terms of what we would need to see. And it reminds me of that famous line from the movie Jerry Maguire, show me the money. So we need to see the money, I guess, before we adjust the forecasts anymore. Is that right?

Rafael Amiel

Let me add that. I say $60 billion to see India-type growth rates, right? And Mexico can move slowly from 2.5% to 3%, 4% growth with, I mean, lower growth in foreign direct investment and also in domestic investment because that's something that is needed in Mexico.

Kristen Hallam

Got it. So in terms of policy orientation, Jose Enrique, is Mexico ready to take advantage of this opportunity? What is the current government's approach to nearshoring?

Jose Enrique Macip

Well, it is commonly said that Mexico's President, Andrés Manuel López Obrador or AMLO, as he's commonly known, has an overall negative view of foreign direct investment. But this is not entirely true. What is true is that under his administration, economic management of the country has become increasingly politicized.

What this means is that companies that are perceived by him of having very close ties to former governments have been facing increasing regulatory obstacles, contract cancellations, license cancellations and issues like that. But AMLO is usually welcoming of FDI flows as long as they come to Mexico under the condition posed by his administration. That's what I'm talking about when I say that economic management has become increasingly politicized.

And in that sense, since AMLO perceives any new investment announcement as a political endorsement to his policies, then he's welcoming to that extent. So we do not have a government that is against private companies per se. It's just this increasing politicization of the economic policy. Now when thinking about near-shoring specifically, we need to be fair and say that Mexico's industrial policy has been rather slow in responding to the opportunities posed by nearshoring because, for example, there's a few, if any, talk of incentives for companies relocating to Mexico, at least at the national level.

Kristen Hallam

Surprising.

Jose Enrique Macip

The only talk about tax incentives, for example, from AMLO himself is restricted to one of the major projects of his administration, which is the transoceanic corridor in the southern states of the country. Being one of the policy priorities to develop the poorer southern states of Mexico, AMLO is willing to give some tax incentives to companies that invest in the southern states of Mexico.

But otherwise, there has not been so much talk about tax incentives, tax breaks, tax credits at the national level. This does not mean that there is no specific policy at the national level towards nearshoring. In the second half of 2022 and more so during the first half of 2023, the Ministry of Economy has begun taking some steps, particularly on strategic planning, aiming to improve regulatory efficiency and coordination between the national government and the 32 state governments in order to attract and support the settlement of new businesses in Mexico.

For example, in March, the ministry called upon the 32 state governments to create an action plan that will develop in a 2-year time span, to prioritize sectors like automotive industry, which Rafael already mentioned, its importance in Mexico and North America in general, semiconductors, advanced electronics manufacturing, medical devices and pharma. In many of these sectors, particularly automotive, electronics and medical devices, Mexico already has a big footprint. Semiconductors and pharma are the ones that are more challenging and that need more efforts from the government to attract companies in these sectors.

We do have these nascent efforts at the national level. But when we move to the state level, the picture is significantly different, and it varies a lot depending on which state you're talking about. If we think of Mexico's 32 states, we can say that states bordering the U.S. and states in the central part of Mexico, which are already manufacturing powerhouses, those are the ones that are best positioned to benefit from nearshoring and are also the ones in which state administrations have been more willing to provide incentives at the local level to attract firms.

For example, Nuevo Leon, which is bordering the U.S., it's the state in which Tesla is going to build its new manufacturing facility in Mexico. The state government has been, for example, willing to pay all the toll roads for companies that wish to settle in the Monterrey area, which is about 200 kilometers from the U.S. border. These kind of incentives at the local level, we are seeing many state governments trying to develop those. We've seen, for example, in Baja California, in Coahuila.

And in the central part of the country, states like Querétaro, which is very strong in terms of the aerospace manufacturing industry. States like Jalisco, which wants to develop an innovation hub to attract semiconductor manufacturers, there, we see more efforts to provide incentives. At the national level, before moving on, I would also like to mention that in the past year, another effort is the development of a new industrial hub in the northern state of Sonora.

And the reason this is important is because this is personally endorsed by the President, which, given the politicization of economic policy, it's important. And it's a hub that is expected to be powered by renewable energies and very closely associated to lithium mining because as of now, the data that we know puts Sonora as the top state in terms of lithium reserves. It's also a state with a lot of potential for solar power.

So the idea of this development is to attract companies in advanced manufacturing, in semiconductors that would be based on renewable energies and this raw production of lithium. This is on the very early stages, but I consider it important to mention it because it shows how the Mexican government is albeit a bit slowly, but responding to the opportunities of nearshoring.

Kristen Hallam

So what are the main risks that companies need to consider before nearshoring to Mexico or before expanding their operations there, thinking particularly about like policy and political risks, Jose Enrique?

Jose Enrique Macip

From the political standpoint, the main risk that we've seen in Mexico and AMLO are associated to the sanctity of contracts. We've seen a lot of contract renegotiation or changes in legislation that make permitting process more restrictive or more onerous for companies. And although we have seen contract alteration risk decline a bit in the last couple of years, there's still a very high risk of that.

It is also highly likely that future negotiations, particularly of the largest investments, become increasingly politicized in the sense that companies would benefit from having a good personal relationship with high-ranking government officials and the President himself. I mean AMLO has only left 1.5 years in office. But whenever there's a big investment announcement, he wants to be involved, not only to showcase that his policies are being endorsed by international companies, but he also wants to have an incidence in the negotiation itself.

That level of involvement always necessarily entails uncertainty around personal relations. So that's an important risk that we believe that it's not only going to remain for this 1.5 years that amyloid got left in office, but perhaps in the future.

Kristen Hallam

So let's talk about that. Mexico, as you mentioned, has elections coming up next year, and there seems to be a lot at stake for the nearshoring drive. Is that right?

Jose Enrique Macip

Yes, definitely. And I would say not only due to the Mexican general election, but also associated to the U.S. general election. First, let's discuss what's at stake right from the Mexican election itself. In general, we expect a broad policy continuity towards nearshoring in any scenario, even if AMLO's Morena party wins or if an opposition candidate wins, the view towards new shoring is going to be positive.

In the event that an opposition candidate were to be the next president, it is highly likely that we will see a lot more of talk about tax incentives, tax breaks, tax credits for companies. But even if Morena stays in power, we're going to continue seeing increasing policy efforts to attract nearshoring because despite an ideological stance very similar to AMLO, this idea that new investment means political backing of the government is going to continue.

We should expect more talk of incentives if the opposition wins, but even if Morena remains in power, we're going to see government policies and government efforts to attract nearshoring. Perhaps not as attractive as tax incentives, but other policies to do so. At the state level, we're going to continue seeing this kind of incentives. And it is likely that these incentives at the local level will generalize as state governments see that, in this case, Nuevo León has been having success in attracting firms via these incentives.

After next year's selection, it is highly likely that we see a decline in contract risk, whoever wins the election, particularly because contract risk arise from this personalized fashion in the exercise of power that is typical of AMLO. None of the potential candidates from Morena or from the opposition have this personal charisma and willingness to exercise power in such a personalized fashion. So whoever becomes Mexico's next President is likely that they carry out a more institutionalized approach towards doing business.

I mean, personal relations are going to continue being as important as ever, but we're not going to have this charismatic figure as AMLO. Although it's fair to say that if Morena wins, AMLO is highly likely to continue influencing policy direction. And big government decisions are going to have some degree of input from AMLO at some point. So that's on the Mexico side. From the U.S. side, we need to take into account 2 major issues. One, Mexico is likely going to be a campaign issue as it was, for example, in 2016.

And any talk about being tougher with Mexico in terms of security, but also on enforcement of the USMCA labor provisions that unions pressuring U.S. candidates to push for more labor rights in Mexico, those could change the policy direction from the U.S. into Mexico and could have an impact on the competitiveness or the attractiveness of Mexico's labor cost.

Also, and perhaps that's the most important factor, is that in 2026, we are due to review the first 6-year review of the USMCA. So Mexico, the U.S. and Canada are basically going to sit and decide if the agreement has worked for them, and if they want to continue with the agreement for the next 16 years. So that's going to put a bit of uncertainty on the matter, but that also depends on how much the issue of trade with Mexico plays in the U.S. general election.

Kristen Hallam

That will be really interesting, that 2026 review because I believe all 3 countries will have new leadership because I think Canada needs to hold elections by 2025. So very interesting there. So I think it's a good time to wrap up our conversation with some top takeaways that you'd like to share or any particular signposts that you're watching. How about we -- since you have the floor, Jose Enrique, how about we start with you?

Jose Enrique Macip

Sure. Well, first, perhaps to be very clear that as strategic competition is the name of the geopolitical game, Mexico will continue to stand out with a lot of potential for near-shoring. Mexico is a committed trade partner to North America and to the U.S. in particular, and its exports can reach almost any point of Continental U.S. within 20 hours moving by land.

So you don't have the issue of seaborne trade disruption. So these 2 factors are going to remain there, whoever wins elections in the U.S. and in Mexico next year. Mexico's attractiveness for new shoring is going to remain there regardless of domestic political considerations. The main signpost, and I'm going to repeat myself, is going to be the scenario around the USMCA review in 2026.

We ought to be very attentive of talk about results derived from USMCA and how each of the 3 countries are going to approach this. Are they happy with the implementation? Have they all perceived benefits from the implementation of the USMCA? The mood of the talk around USMCA towards a review is going to be fundamental to craft a good forecast of what's to come for USMCA after 2026.

Kristen Hallam

All right. And Rafael, would you like to share 1 or 2 top takeaways or any particular signposts that you're watching?

Rafael Amiel

Sure. First thing, we are assuming policy continuity after the elections, and we have incorporated nearshoring in our forecast, not the full wave of nearshoring that would Mexico grow that India-type rates, but it's what I mentioned before, 4 to 5, 10 percentage points in the next 1 to 2 years. And the signpost, well, we need to wait for balance of payment information to get the hard data on how much money is coming into the country.

When we see that the second quarter balance of payment information, we will have a better assessment of how fast or how slow is this money coming in, are these investments coming into Mexico, beyond the announcements that we read every week, as you mentioned at the beginning of this session. So those are the 2 things that I want to highlight.

And If you see our forecast, it's published, we assess that there's been an overshoot of the exchange rate of the Mexican peso. So the Mexican peso is overvalued right now. There should be a partial correction once we get better numbers. But the wave is there. And I'm an optimist myself. Eventually, we will have to review this for the better, but we are cautious about imputing assumptions that we cannot be very sure of.

Kristen Hallam

And I'll go back to what I said earlier, show me the money. Thank you both for sharing your insights with us today, Rafael and Jose Enrique, and thank you for listening. Come back next week when we'll discuss the operational risks and opportunities of nearshoring to Mexico.

Rafael Amiel

Thanks to you, Kristen.

Jose Enrique Macip

Thank you very much, Kristen.

Kristen Hallam

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