Ep. 179 - Nearshoring to Mexico Operational insights

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Emily Crowley

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You're listening to the Economics & 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.

Kristen Hallam

Building your manufacturing facility in Mexico can pay dividends. It can also pose risks to your business. How do companies weigh these factors when deciding whether to locate their operations there?

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. In our first episode, we set the scene with an overview of the economic and geopolitical forces driving the trend. In this episode, we'll delve into the operational side. And in our last episode of the series, we'll tell the supply chain story.

I'm Kristen Hallam, content strategist at S&P Global Market Intelligence and your host for this episode of the Economics & Country Risk podcast. Joining me for the operational story are Emily Crowley, a Director in our Pricing and Purchasing team and expert on North American labor markets; and Johanna Marris, senior analyst with our Latin America, Country Risk team.

Emily, welcome back to the podcast. And Johanna, great to have you on. So what is attracting companies to Mexico?

Johanna Marris

Thanks, Kristen. Yes, it's great to be here on the podcast. Mexico, I mean it really has some huge advantages for companies that are considering relocation, particularly for those who are interested in exporting to the U.S. These advantages have been really evident in the fact that we're already seeing such a big increase in investment and companies saying that they're interested in investing now.

The main one that I would highlight is the very extensive infrastructure that's already established across the country for those exporting to the U.S., possibly unmatched level of transport connections. We've got extensive highways, railways as well, which we don't have in a lot of the rest of Latin America. Several large ports, airports as well.

We've also got, and particularly across the north of the country, several industrial hubs, which is a huge benefit for companies in specific sectors, for example, automotive, electronics, textiles manufacturing, agriculture as well where we have areas where these companies are investing and they also have the supply services. They have other relevant infrastructure around them, which really enables them to establish themselves in Mexico and tap into that network rather than having to come and start something from scratch.

And as we heard as well in the previous podcast, there was a lot of other benefits from Mexico. We've got a large number of trade agreements, investment incentives as well that the government has been offering. So there is a lot in Mexico's favor on this.

Emily Crowley

If I can jump in from a labor market perspective, there are 2 major attractive things about Mexico. The first is really the size of the labor force and the demographics within the country.

If we put Mexico in context, we're talking about a population of around 130 million people. So U.S. is 330 million people, Canada is 40 million people. So if we're talking about North America, Mexico has really, really deep labor resources.

And coming from the perspective of some of these companies that have been operating either in North America or in Europe, one of the issues that we have seen recently is labor force availability. Looking at Mexico, it's really in a nice situation. It's in a nice place as far as having a relatively young population and a population that's still growing.

Why do we care about a young population? It means that an investment now means that you're going to be getting a fair amount out of it. The median age in Mexico in 2020 was 29. So this is up from 26 in 2010. So it is aging, but if we were to put it in comparison of Canada where median age is 40; U.S.A., we're talking about 38. So if we're going to compare Mexico to some of these other major kind of low-cost country, mainly China, the median age is 39.

I do think that Mexico is a bit of a cusp right now. Demographics play out over decades. We are looking at a gradually aging population. By 2045, Mexico is going to look a lot more like the U.S. today. But still we're talking about really a 20-year horizon before we get there.

The other thing that's really suggesting Mexico was that we've seen a fair amount of growth in education. Johanna mentioned we have these regional hubs of expertise. We're starting to see that play out as well in education. We've seen the level of education improve. So we had a 2020 census where the average years of education increased to 9.7% versus 8.6% in 2010. If we look at the statistics, 39% of Mexico has at least a higher secondary education. The highest is in Mexico City. It's higher in the border states. So we're talking about 40% in most of those northern border states.

But there is this disparity when we talk about Mexico is that there is the economy of the north and the central and then there's a separate economy in the south where we have really the biggest disparity in education, and really where that starts playing out is at higher education.

That's one of the things we have seen, continued improvement. And Mexico has continued to move in the right direction and that is really important from skilled labor force availability. And I think we'll touch on this later about where investment is going in, in the country.

But there are some things to keep in mind when investing in Mexico that the Mexico that we've seen over the past 2 decades and the Mexico that we have today is not necessarily the Mexico that we're going to be looking at in 20 years. So important to be aware of how these demographics are changing, but still the baseline is very, very supportive of a helpful operating environment from a labor availability standpoint.

The other major consideration in Mexico is labor cost, and Mexico remains very competitive from a labor cost standpoint. So relatively low minimum wage compared to the region. It sits slightly higher than Central America, but it's lower than a lot of the Southern American countries. Wage levels comparing to, again, other low-cost countries like Mainland China is sitting below. It's about 15% lower if we were looking at base wages in Mexico.

So there's a lot of positives: access to infrastructure, proximity to the United States, large labor force, improving education that is there and is able to set someone up for success that they decide to operate in Mexico.

Kristen Hallam

Lots of pluses there between the two of you. And I know we're going to come back to labor cost in a bit. So what expertise does Mexico have that it can build on? For example, in certain sectors or at certain points in the supply chain or on any other measure you want to talk about, Emily?

Emily Crowley

Johanna mentioned some really interesting points. Mexico is really good at trading. It's really good at receiving and shipping goods. And it's really good at making things. And we've seen that play out over the past few decades where we've seen this ramping up in the manufacturing capability from lower value-add to higher value-add. And right, we've seen growth in the automotive sector. That's been a huge part of USMCA discussions, but there's also been a building out of the more advanced supply chain when it comes to electronics; when it comes to aerospace and defense, aircraft manufacturing, parts manufacturing. So that's one of the nice things.

And again, it's why this education piece is so important, why labor force availability is so important because that's really the path that Mexico is on, is this upskilling and increasing the value-added chain of its manufacturing capability.

What comes with that, again, is there are these nodes. There are these clusters that have created the specialization. So you have access to suppliers that are producing your inputs that are just down the road or infrastructure that is supportive of that manufacturing base is already in place.

Mexico has been doing it for 20 years. They're good at it. But there are also some risks. I think Johanna can talk about these as well, but even been from like an electricity grid standpoint, from a water standpoint, even at capacity standpoint in especially these northern border region and central border regions, which might actually be a little bit of a constraining factor going forward.

Kristen Hallam

But just staying with you, Emily, while you've got the mic there, companies have to pay for expertise. And we were talking about labor costs earlier. I just wanted to come back to that and ask you if we're seeing upward pressures on wages in Mexico the same way that we're seeing them in the U.S.? And if so, what's driving that?

Emily Crowley

So Mexico has had a fair amount of upward pressure on wages, but it's interesting because it is a completely different story from what we're seeing in other parts of the world, and especially in comparison to United States or Western Europe, where it's labor shortages that are putting bargaining power in the hands of employees and especially that combined with the recent inflation rate increases has been really levering up those wages.

So Mexico is a very low-wage environment and this has caught the eye of the current President, Andrés Manuel López Obrador. He came to power in December of 2018. We are nearing an election cycle, so that will be coming up. The reason why I bring that up is that part of his platform was increasing wages, especially for those lowest paid workers. The easiest way to implement that is through minimum wage increases.

If we look at what has been put in place in Mexico, the federal government has increased the minimum wage by 135% since 2018. So more than doubled. Again, this is not necessarily disqualifying for Mexico from a labor cost perspective because its wages are still quite low. Now they're moving closer in line with some of these other potential regional players you might go to, but they're still well below Brazil, still well below Chile, slightly above your Central American countries, but again still 15% below Mainland China.

So that has been one of the major kind of levers that we've seen is that by increasing the wage floor, you do end up pushing everything up. For instance, in 2022, we had a minimum wage increase of 20%. This was the second consecutive 20% minimum wage increase. Potentially, it does look like the Morena party is in a good position to be reelected. So we may see this aggressive stance on raising this base wage continue.

But when we talk about minimum wages versus top line wages, that 20% increase when we look at a manufacturing wage is going to boil down to a 10% increase for where you're actually paying for that skill level because those wages do sit above that minimum wage. So it's not necessarily a one-to-one pass-through. So wages are increasing, but it's not necessarily because of fundamental difficulties in the labor market. It's really more of a government policy platform to increase the living standards within the country.

Kristen Hallam

With wages, at least minimum wages rising at that kind of pace, Emily, what is the risk of labor unrest or of strikes? Does that minimize that risk in Mexico right now?

Emily Crowley

It's interesting. There's been some changes to how the labor environment is operating, and this is following on to the USMCA. This is a free trade agreement that came in to replace NAFTA. So part of that trade agreement was strengthening labor's position and protecting labor's position and making sure that workers have the right to unionize, to hold blind ballots, so your employer can't see who's voting pro union versus who's voting against it.

Obviously, that would have a dampening incentive for unitization. But part of this included a rapid response labor mechanism. Essentially, this gives the U.S. government or Canadian government expedited enforcement actions if they have received a report of individual factories, which are -- or at least appear to be denying the right of workers to collectively bargain.

It's put labor in a little bit of a stronger position. So now if you are being leaned on or discouraged from unionizing or holding a strike or whatever labor action you're pursuing, you can raise that to these rapid labor response mechanism and have the USTR start to do an investigation.

We've seen this use 12 times so far, 12 times since 2021. And it's interesting because, despite this, we've actually seen a decline in labor disputes if we were going back to 2019. So labor has gotten a little bit more power, and I think what we might be seeing is that factories and employers are being more cautious and staying inside the lines as far as playing by the rules. So we actually may have seen a kind of de-escalation there.

But again, I think it's still pretty early into the establishment of these rapid response hearings to make a definitive call there.

Johanna Marris

It's an interesting point that Emily raises and I think the USMCA mechanism has, in some ways, offered an incentive to some labor groups. It's offered them an additional recourse to raise their concerns, raise their demands and for those to be addressed at that level that has raised risks of more challenges to employers in several sectors, particularly mining.

And we also see within the mining sector a lot of disputes between workers over worker affiliation when they have these collective contracts where they'd choose which union they want to be affiliated with. There's a lot of competition and quite a strong rivalry. So sometimes we do get occasionally violent protests between those 2 groups as those unions kind of vie for the allegiance of the workers within different projects and different companies.

Generally comparing Mexico with other parts of Latin America, I think that the labor strike risks are fairly moderate and we don't tend to get really violent strikes with a lot of physical damage of company property as we would see somewhere like Peru. And a lot of worker demands are taken through legal channels and particularly now over sort of environmental issues or working conditions and things like that, we will see them sometimes raised at that level rather than always being disruption to production.

So yes, lower violent risks. But the thing to watch out for is that there is a bit of a precedent in Mexico for them to become prolonged. So we've got, again, in the mining sector, I think the longest running one has been going on for 16 years at Cananea mine in Sonora state, which is pretty interesting.

And that's over working conditions, several issues there that have been addressed at different points unsuccessfully. And production has carried on partially, but obviously it's had a huge impact on the affected company. There's another couple of projects that have had really long ones as well.

Kristen Hallam

16 years, that's quite a lot.

Johanna Marris

Yes.

Kristen Hallam

So we've talked about potential risks related to labor. What other operational risks should companies have on their radar, Johanna, when they're looking at relocating to Mexico?

Johanna Marris

One of the key shifts that we're now seeing with the arrival of a lot of new companies, which, just to give some of the figures of that the government said they expect to see, I think it's about 400 new companies in the next couple of years investing in Mexico, relocating to Mexico and they're constructing at the moment 25 new industrial parts that they want to be ready by the end of this government term in October 2024.

So there's this rapid acceleration, I suppose, of preparations to receive these interested companies. But what we're seeing in assessing the operational risks is that this investment is arriving more rapidly than the capacity to absorb all the demand for, particularly water and also electricity. And this is mainly because, as Emily mentioned, the nearshoring investment in Mexico is very heavily concentrated in the north and the center of the country in all of those, obviously, northern border states, but also those kind of just to the north and surrounding Mexico City, much more than in the south.

And in these exact same states is where we're seeing deteriorating drought conditions. The Mexican state water agency is highlighting over the last decade we've seen gradually worse drought conditions with more parts of the country affected than previously. Currently, about 40% of national territories got some degree of drought. This is overwhelmingly in the north and center of the country rather than the south, where there's more rainfall.

And so the arrival of all these new companies is definitely going to place more pressure on water supplies, exacerbate shortages where we already have them during periods of scarcity. And so that's definitely one that we would highlight as being risk both of disruption of water supplies to companies operating, tariffs for water likely to increase as well as demand is rising and also likely government intervention to demand the companies return some of their concession water to be used for public use.

And we've seen this actually happening at least twice in the last year where in both Mexico City and Nuevo León companies were asked to do that. And that in Nuevo León, the government actually took control of all the water to redistribute it for public use because the shortages were so acute back in July.

And so that's something to watch out for. So that obviously does impact production. It does impact what you're able to do with the water that is under your concession. And also if the government is becoming more restrictive with awarding concessions, it said that in 16 of the countries, northern and central states, it's not going to award any more concessions for water. So that's one of the main ones.

And then the other one was electricity that we've been looking at just because some of the largest industrial chambers have been saying that already in some of Mexico's industrial parks, the [indiscernible] electricity is inadequate. And actually, just in June, the Mexican electricity regulator issued an alert that the reserve margin of electricity was down to 6% and it's recommended to be at around 20%, leaving much less room for any emergency requirements.

So that's something as well, but investors are raising now more as a concern. And we're looking at the risk of how much more capacity is there to absorb the additional demand from a lot of these countries. Plus what happened in June when the electricity supply became much more restricted was because of the use air-conditioning because of warmer temperatures in these northern states. So as soon as you get all of these houses and industries using that sort of equipment, which uses so much more power, that increase will rise, too.

Kristen Hallam

So with this sort of competition for resources like water, Johanna, are we seeing more social unrest in these areas? Are people protesting because, as you said, there's maybe not enough water supply. Are there concerns -- or are there other reasons for people to be protesting that could pose risks to companies' operations in Mexico?

Johanna Marris

We have seen an increase in protest over water, particularly where it's disrupted, and also against companies in some cases where they're perceived to be using excessive amounts of water or contaminating water supplies. In general, protests in Mexico are very frequent. We see them across every city every day, but there are normally roadblocks in city centers or on highways that last for a few hours at a time. They're normally demonstrations as well rather than being necessarily violent or involving arson or vandalism.

The main risk in Mexico from protests is actually relevant to the nearshoring investment because the main impact is export disruption. A lot of the time, they will target some of the more strategic export routes to place maximum economic pressure on the government. And that in the past has seen huge losses. We have a recurring issue with education sector workers in Michoacán state where they've -- for several years, they've blocked the main rail route out to Lazaro Cardenas port, which is one of the main Pacific ports.

And I think in 2021, there was over 100 days of protest by this group and the losses from all exports that were disrupted was over $3 billion. And also in the north, it happens as well in Chihuahua, we've seen blockades also of rail lines. And I think even though the trend of those prolonged disruptive process has declined, we haven't seen that really since the end of 2021, I would still say that there is an ongoing risk of it happening again because of all these issues, as I've said, with water and environmental concerns. And current governments have been very receptive to environmental concerns, which can also incentivize that sort of protest.

I would expect that for agricultural workers, for example, in northern states like Sonora, Baja California, if there are issues in the future with access to water for their crops or crop prices, there would be a high likelihood still of them blocking the highways to the northern border, for example, which would affect a lot of these hubs located in the northwest. And Michoacán and other areas as well would, yes, be likely to see the same if those issues come up again.

Kristen Hallam

Pivoting a little bit, but staying focused on the risk factors here, I think another thing investors would probably want to know about and maybe our clients have asked us about is crime in Mexico and how much that is likely to impact companies, particularly in industrial areas.

Johanna Marris

Yes. And it's a really important one to raise. Mexico is well known, obviously, for having very highly sophisticated criminal groups. We're seeing in conversations with our clients, in surveys of companies operating in Mexico and considering relocating there, crime is consistently one of their main concerns. And I think in the whole nearshoring conversation, it's often in the top 3, 4 concerns that we're seeing alongside some of the other issues that we've been discussing operationally.

So it's an interesting one because under the current government, a lot of the crime rates have actually been quite stable. Homicides and kidnapping, for example, haven't seen any major increase since 2019. But there are a couple that are affecting businesses more. One is extortion, which is up by, I think, 40% since the first year of this current government.

And this often targets more local small businesses, but occasionally larger ones as well, but the impact is also there in terms of increasing costs for large companies because if a lot of their suppliers are affected by extortion, obviously, that gets passed along the value chain. And it also helps these criminal groups to consolidate their control in certain territories. So where there's a lot of extortion, it shows that they have an increased presence there quite often.

And the other one is cargo theft. Again, this was fairly stable in the first half of the current government, but just in the last year we've seen both rail and road cargo theft increasing again. Road cargo theft was up 12% in the first half of this year after steady decline since 2019. And this is very highly concentrated actually in the center of the country, so mainly Estado de México and Puebla. So it's not a widespread national risk equally.

But what we have still seen is that companies operating in the north of the country, Nuevo Léon, for example, a lot of them are saying that they are still being affected by it because obviously they have to transport their goods through other parts of the country despite the fact they operate in the north. So it is having an impact on companies located in different areas.

Rail theft as well was up 28% in the first quarter of this year, which was quite a large increase. So that's something we're watching and is also the reverse of the previous trends under this government.

And for companies operating in industrial areas, the risk of being directly targeted by violent crime is fairly low. I'd say for those in industrial hubs in northern states, one of the main risk would be disruption to cargo, not from theft, but because there are a lot of criminal groups operating and they've got quite a strong presence on a lot of the same highways that go up to the U.S. border because as well as being important cargo transport routes, they're also strategic drug trafficking routes.

These criminal groups will seek to retain their control over these or try and get greater control of them from the more dominant group. So we do see on those areas and sometimes quite near border crossings as well we see confrontations between criminal groups who are fighting for control of these routes and also competitions with security forces where they try and intervene.

And just in the last few months, we've seen that around Reynosa, Nuevo Laredo as well, which they're both on the Texas border and very close to the big border crossing. So that's something to be aware of. In general, it would more be that cargo is disrupted for a few hours. And on industrial sites themselves, there's a risk of theft of materials, but yes, lower risks in general for [indiscernible] because there's normally quite good private security provision.

Kristen Hallam

Okay. Some things definitely to watch out for, for companies who are considering relocating to Mexico or expanding in Mexico. So it would be great to wrap up with some top takeaways for our listeners today. Johanna, since you've got the floor, we could start with you. And then Emily, if you could share some of your top takeaways as well.

Johanna Marris

It's a really interesting moment that we're at for nearshoring. We're seeing the companies interested. We're seeing all of these benefits that Mexico has got to offer. But they're weighing up the risks. They're putting in the balance, what are likely to be my additional costs. What am I likely to face in 5, 10 years' time because these sort of investments aren't for a year, they're for often for much longer term. So we'll be looking at the government, how it's responding to this challenge of absorbing all this new capacity.

Will it make the investment that's required in industrial areas to mitigate some of these risks that we've been talking about in terms of capacity, and also better coordination between federal and state governments over these resources. And if there's enough allocation according to where companies are wanting to locate, and as well, this same issue of federal- and state-level coordination over public security because we often have sometimes quite separate strategies. And where they come in line together, they're often much more effective in terms of bringing crime rates down.

Kristen Hallam

All right. And Emily?

Emily Crowley

So Mexico, it's still very attractive. Large labor force, but we have seen some tightening. And I think it fits to Johanna's points as well about there are some pretty significant policy changes and federal and state coordination that needs to take place for Mexico to really capitalize on this potential opportunity.

We see that in the labor market as well. So if we look at unemployment rates, we've actually seen a fair amount of tightening. Unemployment rates in Mexico are at 3%. Now a 3% unemployment rate in Mexico means something completely different than a 3% unemployment rate in the United States, and that's because of a very high presence of informality. So that's really one of the things that I've been keeping an eye on.

And we've seen that rate of informality start to decline and we've seen labor force participation improve. But if Mexico is unable to break that cycle, it's going to mean that there's going to be some temporary or some -- continued constraints on labor force availability if we aren't able to hold these workers into the formal employment.

We've seen progress in education. But again, at that higher level there is a fair amount of disparity and that's something that's going to have to be addressed, especially if the opportunity is in the south given some of the constraints that we've highlighted. And I know that right now the government is pushing a major business investment corridor with transportation from the Pacific Coast to the Atlantic Coast, with the railways, you can get both ports.

But again, if we look at it from a labor market perspective and even a resource or infrastructure perspective, there's going to be more of a ramp-up to get to the conditions that are more of a plug-and-play as what you might see in the north. So how do these play out over time?

Kristen Hallam

Right. Well, thank you so much, Emily and Johanna, for sharing your insights with us today. And thank you for listening. Come back next week when we'll wrap up our series on nearshoring in Mexico with an episode on the supply chain.

Unknown Attendee

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