Latin America Watch

Assessing Mexico's Nearshoring Potential

Authors:
Fernando Prats, Ana Sofia German Aramburo, & Axel Aubry

Editor:
Elin Roberts

June 2023

LONDON POLITICA

About the Authors

Fernando Prats

Fernando Prats is a senior-year International Relations student - at the Rosario National University (UNR), Argentina who currently works as a research assistant at the Research Center for International Politics and Economics (CIPEI-UNR). He specialises in Latin America and is interested in the global economy and the tech sector.

Ana Sofia German Aramburo

Ana Sofia is a trade agreement specialist working on assisting the public and private sectors in international trade. Ana graduated from LSE with a master's degree in International Political Economy. She has previously worked at the Mexican Embassy in Spain and the Mexican Mission at the World Trade Organisation. Ana is also passionate about women's rights advocacy countering gender disparity within the field of trade.

Axel Aubry

Axel is a recent graduate of a Master's degree in International Relations from the University of Sciences Po Toulouse (France). His professional experiences in Brazil and Mexico have allowed him to acquire an in-depth knowledge of contemporary issues in the Latin American region, particularly in the field of security (transnational crime, cartel violence) and politics (Brazilian foreign policy, Brazilian politics).

Assessing Mexico's Nearshoring Potential

Abstract

Based on events such as the Covid-19 pandemic, increasing competition between the United States and China, and the Russian invasion of Ukraine, there is an ongoing discussion about the reorganisation of global supply chains. As a result, the term “nearshoring” has gained popularity in recent times. Nearshoring could be defined as a corporate strategy that involves relocating production close to destination markets, with the aim of reducing supply chain disruption risks. This report examines the potential of Mexico for nearshoring, considering the escalating discussion surrounding the restructuring of global supply chains and the recent announcements made by important companies to relocate their production to the country. In particular, this report analyses a set of issues deemed important for firms contemplating relocating their manufacturing operations in close proximity to the US market: macroeconomics, foreign trade relations, internal politics, security, energy, and demography.

Introduction

In March 2023, Tesla CEO Elon Musk announced that his company will be building a gigafactory in the State of Nuevo León, Mexico, following months of negotiations with Mexican President, Andrés Manuel López Obrador (AMLO). It is expected to be a billionaire investment, and may boost Mexico's economy by sourcing highly advanced manufacturing to the country. As well as Tesla, General Motors, and BMW have announced plans to produce electric vehicles (EVs) within the country. These announcements provide evidence that globalisation is being reshaped to a certain extent, and this ongoing process will have implications for the global economy, particularly in some countries such as Mexico.

For decades, as globalisation expanded, the tendency has been the offshoring of production to Asia, particularly China. In recent years, however, businesses have begun to reconsider this strategy due to recent global considerations and the restructuring of the world order. Geopolitical tensions between the US and China, which manifested in the tariffs imposed on Chinese imports by the Donald Trump administration in 2018, have caused issues in trade flows between both powerhouses. Additionally, the pandemic's bottleneck issues and supply chain disruptions caused by Russia's invasion of Ukraine highlighted the risk of dependency on overseas manufacturing. For these reasons, relocating production has been raised as an alternative to firms with a view to pursuing shorter and safer supply chains.

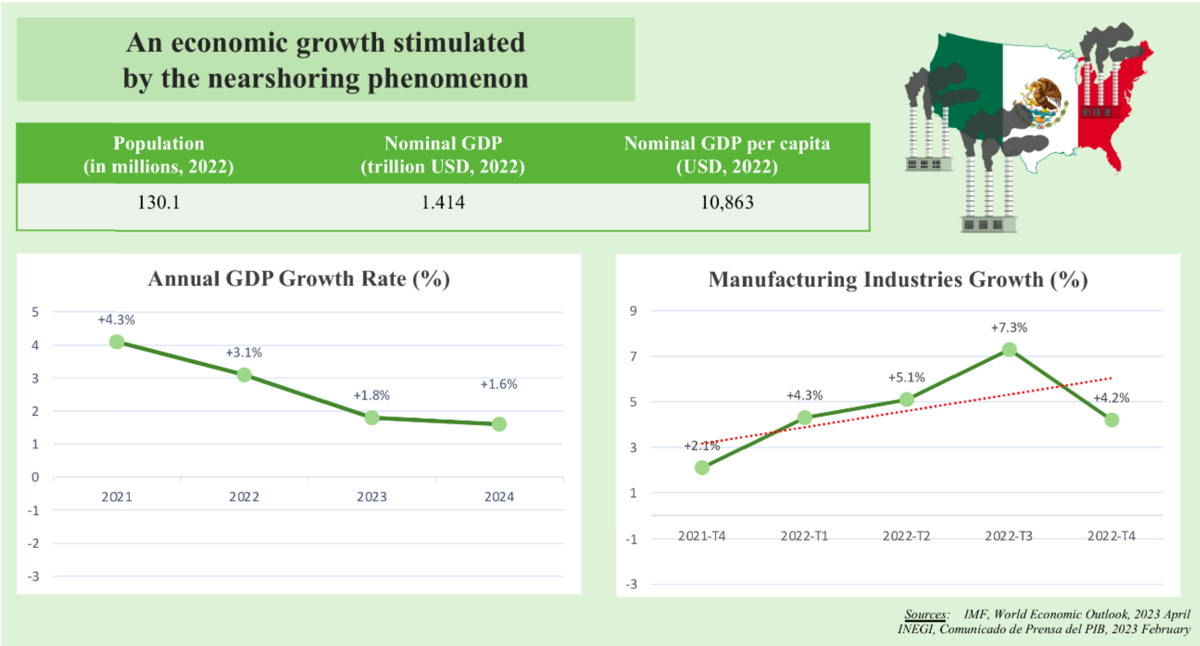
The major winners of the first wave of relocation between 2018 and 2021 were Malaysia, Vietnam, and Thailand, which are the largest exporters of semiconductors as tensions between China and the US rose. Nonetheless, other supply chain disruptions have forced business leaders to also consider geographic advantages when relocating. After the Covid-19 pandemic, the business community has become aware of the great extent to which a disruption in shipping costs can affect global trade and, therefore, the global economy. Consequently, relocating to regions closer to their destination for consumption has become increasingly attractive.

Nearshoring refers to "corporate strategy which seeks to locate its production near the market where it sells its products". In this context, Mexico has been rising as an attractive market to source production destined for the US market. Indeed, due to its proximity to the US market and the ability to transport most of manufactured goods by land throughout its territory, Mexico appears to hold a favourable position for companies looking to establish production facilities near the US. Apart from having a prime geographical advantage, Mexico also has the opportunity to capture most of this investment that is facilitated by the preexisting favourable relationship with its northern neighbours and openness to trade. For these reasons, projects from multinational companies to set up their manufacturing in Mexico have risen in recent years, as evidenced by the automotive sector examples mentioned earlier.

These plans have sparked discussions around Mexico's unique opportunity to capitalise on the rapidly changing global environment. However, when considering nearshoring, it is important to take into account a range of factors. This report, therefore, examines several aspects that are considered relevant in assessing Mexico's potential as a nearshoring destination. Through an insightful analysis of factors such as political and macroeconomic stability, demographics, security-related risks, and foreign economic relations, among others, this report aims to improve the understanding of Mexico's ability to capitalise on the ongoing shift in globalisation.

An economy spurred by the ongoing nearshoring dynamics

The expansion of the industrial sector has boosted Mexico's economic growth



Charts: Axel Aubry - London Politica · Sources: IMF, INEGI (2023) ·
Created with Adobe Illustrator

In 2022, Mexico's nominal Gross Domestic Product (GDP) amounted to US$ 1,4trn (INEGI). Despite expectations of a slowdown in Mexican economic growth[1] due to an unfavourable global climate, Mexico bounced back in the third quarter of 2022 to its pre-pandemic level of activity and closed the year with a growth rate of 3.1%. This gap between expected and actual growth can be attributed to the significant rebound in industrial activities in Mexico. Putting things differently, Mexico's economic growth has been stimulated by the nearshoring phenomenon. Due to uncertain global prospects, growth projections for Mexico are not in agreement across various institutions for the year 2023 and range from 1.6% (Banxico) to 2.6% (Mexican Secretariat of Finance). Despite these uncertainties, it is reasonable to assume that Mexican growth will continue to benefit from the ongoing nearshoring dynamics and may even exceed the most pessimistic forecasts once again.

[1] For instance, the IMF estimated the annual growth rate of the Mexican GDP at 2.1%.

What does Mexico's trade balance for goods reveal about the nearshoring phenomenon?

1) A foreign trade supported by the dynamics of nearshoring

Year	2020	2021	2022
Trade Balance (billion USD)	**34.2**	**-10.9**	**-26.4**
Total Exports (billion USD)	417.2	494.8	578.2
Manufactured exports (billion USD)	373.8	436.1	508.4
Share of manufactured exports in total exports	*89.6%*	*88.1%*	*87.9%*
Total Imports (billion USD)	383.0	505.7	604.6

2) The manufacturing sector dominates Mexico's exports

Rank	Exported products in 2022	Share in total exports	Variation compared to 2021
1	Vehicles	25.20%	+47.70%
2	Nuclear reactors, boilers, machinery	18.30%	+31.70%
3	Electronics	16.80%	+9.80%
4	Fuels, minerals, oils	6.36%	+21.50%
5	Optical equipment, photography, medical	4.10%	+19.70%

Rank (2021)	Customers	Share in Mexican exports (2021)
1	USA	82.41%
2	Canada	2.94%
3	China	1.91%
4	Germany	1.48%
5	South Korea	1.19%

3) Imports are primarily intended for the manufacturing sector, for re-export purposes

Rank	Imported products in 2022	Share in total imports	Variation compared to 2021
1	Electronics	19.5%	+24.4%
2	Nuclear reactors, boilers, machinery	16.1%	+25.6%
3	Fuels, minerals, oils	12.3%	+64.9%
4	Vehicles	8.1%	+34.2%
5	Plastics	5.6%	+10.5%

Rank (2021)	Suppliers	Share in Mexican imports (2021)
1	USA	44.14%
2	China	20.30%
3	South Korea	3.69%
4	Japan	2.97%
5	Germany	2.90%

Sources: INEGI, Central Bank of Mexico

Charts: Axel Aubry - London Politica · Sources: INEGI, Central Bank of Mexico (2023) · Created with Adobe Illustrator

Mexico's exports remain primarily composed of manufactured products, mainly destined for the North American market (United States: 82.41% of Mexican exports in 2021, Canada: 2.94%). This clearly demonstrates that Mexico functions as an assembly hub for North America. The current nearshoring dynamics are expected to enhance the significance of Mexico's manufacturing sector in exports, but also Mexico's dependence on the North

American economic environment. Mexico's trade relations with the United States and Canada will be analysed in more detail later in the report.

The composition of Mexico's imports also highlights the importance of assembling spare parts for re-export purposes. To put things differently, Mexico's imports consist primarily of intermediate and capital goods that are intended for the industrial sector. Although the United States remains Mexico's primary supplier (44.14% of Mexican imports in 2021), its influence is gradually waning as China gains ground (20.3%).

To sum up, in 2022, Mexico's economy surpassed expectations by achieving a growth rate of 3.1%. This remarkable performance can be attributed to the significant rebound in industrial activities, stimulated by the ongoing nearshoring trend. Mexico's exports predominantly consist of manufactured goods mainly intended for the North American market, and the country's imports indicate its role as a key assembly hub for the region. The nearshoring dynamics are expected to continue benefiting Mexico's manufacturing sector and may even exceed the most pessimistic forecasts regarding its economic growth for 2023. On the other hand, the current nearshoring trends are also expected to deepen the country's dependence on the North American economy. That is precisely the reason why understanding Mexico's existing foreign relations is key to assess the country's ability to capitalise on a nearshoring shift.

Mexico's foreign policy sets up the background for its nearshoring potential

Mexico's foreign policy has positioned the country as a global player in international business and cooperation well integrated into the world economic order. Officially, Mexican foreign policy is constituted as respectful of international law, the judicial equality of states, the sovereignty and independence of nations, peaceful resolution of conflict, and non-intervention in others' domestic affairs. Mexico has been championed for its commitment to international organisations and multilateral engagements as part of the G20, the first Latin American country at the OECD, and its role as a middle power. This has allowed Mexico to build a reputation for a growing economy open to international cooperation, global trade and investment.

When assessing a country's ability to capitalise on a nearshoring shift, it is important to take into account its existing foreign relations, which can make it more attractive to investors. According to Raquel Buenrostro, Mexico's Minister of Economy, over 400 North American companies intend to relocate from Asia to Mexico as of November 2022. The option of private actors looking over Mexico for manufacturing will be influenced by the existence of international legal frameworks that promote trade and investment in the country, the government's policy towards investment and key partners' political affairs.

Existing international agreements have eased trade and investment in the country

In terms of trade, Mexico has historically been at the forefront of countries that promote liberalisation. The country has 13 trade agreements[2] with 50 countries which cover more than 90% of its overall trade. This makes Mexico the country with the most free trade agreements, which allows it potential market access of up to 60% of the world's GDP. It is

[2] Some of the agreements are the USMCA, the CPTPP, the Pacific Alliance, agreements with the European Union, and with Central America. Among other trading partners include Japan, Peru, Israel, Chile, and Colombia.

also committed to making trade faster, easier, and less costly and has implemented all of its commitments from the World Trade Organisation (WTO)'s Trade Facilitation Agreement.

Mexico's trade with the United States and Canada has been the most consequential of all its trade partnerships. Since the North American Free Trade Agreement (NAFTA) entered into force in 1994, North America has become one of the world's most dynamic and economically competitive regions. In 2021, the combined GDP of the United States, Canada, and Mexico accounted for 27% of the world's total GDP. In 2022, the three North American countries engaged in US$ 7trn worth of trade (15% of global trade), with US$ 1.6trn being traded within the economic bloc itself. This has made the region increasingly interconnected, not only economically but also politically and socially.

The replacement of NAFTA with the United States-Mexico-Canada Agreement (USMCA), which entered into force in 2020, opened up opportunities for businesses and supply chains. It liberalised digital products and increased labour protections. Moreover, the agreement outlines better protection for SMEs and includes the establishment of an information-sharing tool for businesses to facilitate cross-border logistics. This has been reflected in a 31% increase in US imports from Mexico between 2016 and 2021.

One of the most attractive aspects of its existing trade agreements lies in its dispute settlement mechanisms. Since the lack of appointment of new judges to the Appellate Body in the WTO, its dispute settlement mechanism has been unable to solve trade-related issues in the organisation. Looking over the USMCA's mechanism allows companies to settle disagreements. In terms of investment, Mexico and the US negotiated on an annex to the USMCA allowing for investment arbitration on claims about expropriation and non-discrimination after failure to resolve issues in domestic courts. In the case of Canada, traditional investor-state arbitration is regulated under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

As for investment protection, most free trade agreements include a chapter dedicated to the provisions of foreign investment. These are included in Mexico's latest trade deals such as the USMCA and the CPTPP. Moreover, Mexico also has bilateral investment treaties with 32 countries in place to cover these issues and protect foreign companies in the country from issues such as expropriation. Regardless of these protections, there are still some restrictions in the country for foreign investment. These include activities that can only be carried out by the government, such as nuclear power generation, the control of the national electricity system, airport supervision, and hydrocarbon exploration. Activities in terms of domestic tourism and freight transport on land, development banking, and rendering of professional services are reserved for Mexican entities. Additionally, foreign investors holding over 49% of shares in certain companies or corporate capital of a Mexican company must be authorised by the Foreign Investment Commission. Hence, investors looking to relocate to Mexico might be protected under the umbrella of regional trade agreements or bilateral investment treaties but must be wary of existing industry protections.

AMLO's reshuffling of Mexico's policy abroad challenges foreign investment

The foreign policy stance of the current administration AMLO shifted from previous presidents. In contrast to previous administrations that have had a Northern or a more globalised focus, AMLO's government aimed to prioritise its leadership in Latin America and the protection of Mexicans abroad according to the National Development Plan (2019-2024). Another objective includes boosting economic development in Mexico's southern border and in northern Central American countries, to reduce the migration flows to the US.

Unlike his predecessor, AMLO's plan lies in increasing the state's role in Mexico's economy, especially in the mining and energy sectors. Policies aimed at attracting and coordinating private sector investment are not a priority for the Mexican President. Despite the increasing interest from companies to transition to Mexico, the latest administration has not openly expressed its willingness to encourage foreign investment in the manufacturing industry nor has it tackled some of the security concerns for investors. Therefore, AMLO's minimal interest in discussing the promotion of Mexico's manufacturing, as well as his efforts in renationalising oil and energy, have increased uncertainty for private investment.

AMLO has been accused by business leaders and investors of both halting some of the foreign investments and creating unnecessary barriers to entry into the country. The Spanish group multinational electric utility company Iberdrola was pressured for years by the administration (specifically through the President's morning news conferences) to sell a bulk of its Mexican power-generating assets to the Mexican state-owned company, the CFE (Spanish for Federal Commission for Electricity). This represents some of the efforts that AMLO is making towards the protection of certain industries and his efforts to renationalize them which increases uncertainty for foreign firms in these sectors. The continuous hostility towards some of these investments will depend on whether his political party, Morena, is elected after his presidency ends in September 2024. This matter will be discussed in more detail later.

American interests play a role in joint efforts for nearshoring

Despite the growth in economic ties between North American countries in recent decades, their internal political landscapes continue to shape trade and investment protections. The source of uncertainty extends beyond the Mexican political sphere and is also influenced by the governing party in the US. As seen during the administration of the former US President, Donald Trump used threats over tariffs and trade over Mexico in order to push a certain political agenda. The political discourse towards the "unfair" relationship between the US and Mexico and the renegotiation of NAFTA created uncertainty for investors as well as for the upholding of the previously normal trade and diplomatic relations. As the US elections approach, it is likely that presidential candidates will include Mexico in their discourses and threaten trade and economic relations to address migration and security issues. In any case, the bilateral relationship's nature will be influenced by the ballot outcome.

It should be noted that, so far, President Joe Biden's relationship with AMLO has been "somewhat complicated". The US administration has approached Mexico with a more cooperative proposition than his predecessor, despite AMLO dismissing some of Biden's efforts in the beginning. However, regional initiatives have been agreed upon specifically in terms of security, migration, and manufacturing. Last January, at the North American Leaders Summit, it was explicitly agreed that there would be an effort to relocate 25% of Asian imports to the region. There was a particular focus on semiconductors and critical minerals during supply chain discussions with the countries agreeing to develop the North American Student Mobility Project to increase Mexican education of specialised talent for the industries. The development of this project will also be determined by other commitments, such as migration efforts with the establishment of a migration centre in southern Mexico and a united front toward Fentanyl tracking and preventing its trafficking.

Overall, Mexico's positioning as an open middle power in the world economic order with preferential trade agreements and bilateral investment treaties with key global actors is an advantage and strengthens its nearshoring potential. However, the ability to capture investment from relocating companies is affected by AMLO's renationalisation policies and his passive stance to attracting foreign investment, as well as the US's political discourse and policy approach towards Mexico. In addition to foreign relation-related risks, Mexico's ability to attract foreign investment could also be influenced by internal political and policy factors

Internal political and policy risks are prone to shape the future of nearshoring

Regulations from both the current government and the one to be elected in 2024 are likely to impact the attractiveness of Mexico for nearshoring. What is more, current and upcoming political events, such as the electoral reform and the different ballots of 2023 and 2024, could contribute to undermining Mexico's political stability, which is however an important factor for companies looking to nearshore.

Ongoing electoral reform and upcoming gubernatorial elections in Coahuila and Edomex could have repercussions on nearshoring

In April 2022, President AMLO presented a proposal to reform the country's electoral system. On 22 February 2023, Mexico's Senate approved the so-called controversial "Plan B", after three months of intense discussions in Parliament. The opposition immediately condemned the reform as an "attack" to the National Electoral Institute (INE), an independent body in charge of organising elections that became a symbol of the end of the single-party regime and therefore a pillar of Mexican democracy. The reform provides for cutting INE's budget and reducing the number of its staff members, which has been raising questions about the effectiveness of the supervision of upcoming ballots. Recently, Javier Laynez, Minister of the Supreme Court of Justice of the Nation (SCJN), has been trying to frustrate the implementation of the reform by suspending it for an indefinite period. Developments are to be followed.

In any case, the Mexican Institute of Finance Executives (IMEF) showed concern as the electoral reform could, - by generating uncertainty and "undermining democracy" - create an unfavourable political climate for foreign investment. Putting things differently, by posing a risk to Mexico's political stability, "Plan B" and the divisions it sparked off could turn into a concern for foreign investors. In addition, elections scheduled for 2023 and 2024 could be affected by the ongoing reorganisation of the INE. However, some analysts have also anticipated that the electoral reform will be struck down by the Mexican Supreme Court, which would send a signal of the resilience of Mexican democratic institutions to investors and therefore would not slow down the nearshoring momentum.

In the realm of Mexico domestic politics, another event worth watching is the forthcoming gubernatorial elections, which will be held on 4 June 2023, in the States of Coahuila and Mexico. Both election processes could have wider implications for the country's economy and therefore for nearshoring activities. Firstly, the election taking place in the State of Coahuila seems to have a significant stake in the future of relocations of economic activities to the country. Indeed, the state shares a border with Texas and constitutes a relevant region for the Mexican energy and industry sectors. With more than 95% of Mexico's coal reserves and around 30% of its natural gas reserves, Coahuila is a territory of vital importance for electricity generation in the country. The very issue of energy and its connection to nearshoring will be discussed later. What is more, several major corporations and multinational companies have set up operations in the state, with many establishing plants and including headquarters, such as Industrias Peñoles, Chrysler, General Motors, and Grupo Modelo. Therefore, the forthcoming governor of the State of Coahuila will be inheriting an industrial setting that is heavily driven by energy-related concerns and the state's proximity to the United States. In Coahuila, four candidates were registered to run for the governorship of the State: Manolo Jiménez Salinas, from the *Va por México* coalition, which is made up of opposition parties (PAN[3], PRI[4], and PRD[5]), Santana Armando Guadiana, from Morena[6], Ricardo Sóstenes Mejía Berdeja, from the PT[7], and Evaristo Lenin Pérez, from the *Rescatemos Coahuila* coalition, made up of the PVEM[8] and the UDC[9]. According to the latest polls from April 2023, *Va por México* is leading in vote intentions.

The forthcoming election process in the State of Mexico also appears to carry notable implications for the expansion of nearshoring. It should be borne in mind that the State is

[3] *Partido de Acción Nacional* (National Action Party) – centre-right
[4] *Partido Revolucionario Institucional* (Institutional Revolutionary Pary) – centre-right
[5] *Partido de la Revolución Democrática* (Party of the Democratic Revolution) – centre-left
[6] *Movimiento de Regeneración Nacional* (National Regeration Movement) – centre-left
[7] *Partido del Trabajo* (Labor Party) - left
[8] *Partido Verde Ecologista de México* (Ecologist Green Party of Mexico) – centre-right
[9] *Unión Democrática de Coahuila* (Democratic Unity of Coahuila)

one of the biggest industrial hubs in the country (automotive, food and beverage, chemical-pharmaceutical, textile), connected to other industrial centres in Mexico by road and rail. This prominent economic role leads the State of Mexico to contribute 10% of Mexico's GDP. Consequently, the policies of the future State governor will be decisive in attracting foreign investment. Two coalitions are participating in the upcoming election for the governorship of the State of Mexico: Alejandra Del Moral, candidate for *Va por el Estado de México* (PAN-PRI-PRD-Nueva Alianza), and Delfina Gómez, candidate for *Juntos Hacemos Historia en el Estado de México* (Morena-PT-PVEM). According to the latest polls, dating from the end of April 2023, 42% of voters express an intention to vote for Delfina Gómez, putting the *Va por el Estado de México* coalition to second place. Whatever the outcome of the vote, it is worth noting that public safety constitutes one of the most concerning issues the future governor of the State of Mexico will have to cope with. And, as we will discuss later, insecurity can have major impacts on industrial activities. As a matter of example, the perception of insecurity in the industrial municipalities of Naucalpan, Tultitlan, Cuautitlán Izcalli, and Ecatepec is well above the national average and has recently shown a deterioration, which has reportedly been affecting the business sector.

The 2024 presidential election: to what extent could the ballot outcome affect investment relocations?

The year 2024 will also be a rich one for the political agenda of Mexico, since State positions will be renewed in Chiapas, Guanajuato, Jalisco, Morelos, Puebla, Tabasco, Veracruz, and Yucatán, and the Head of the Government of Mexico City, as well as the Head of the Federal Executive, will be elected. In particular, the 2024 presidential election appears to be key to capturing nearshoring's potential. Indeed, the future administration's policies regarding investment security, rule of law, reliability of infrastructure, and human capital could shape Mexico's ability to maintain its position as a nearshoring destination.

It should be recalled that this year, President AMLO will decide Morena's presidential candidates for 2024. His current options amount to at least four, nicknamed "*corcholatas*" ("bottle caps"): Claudia Sheinbaum (Head of Government of Mexico City), Marcelo Ebrard (Secretary of Foreign Affairs), Adán Augusto López (Secretary of the Interior), and Ricardo Monreal (Morena's leader in the Senate). According to the Business Coordinating Council (CCE), a Claudia Sheinbaum-led administration would present greater difficulties to ensure fiscal sustainability, which would undermine investor confidence. Indeed, investors may become uncertain and even lose confidence due to the perception that the current Head of Government of Mexico City has more "radical" ideas than AMLO. Moreover, Claudia Sheinbaum's popularity pales in comparison to that of the current President, which would make her economic policies more difficult to be accepted and implemented. On the other hand, the moderate positions of Marcelo Ebrard and Ricardo Monreal would open up more alternatives for the presidency, improving the investment outlook. In any case, AMLO's policy of increasing state intervention in the economy in the last five years has been criticised by some economists and businessmen. For example, in 2022, the President nationalised lithium resources and created a state-run lithium company, *Litio para México*, which was disapproved by some analysts for "increasing institutional corruption, hindering access to extractive technology, and reducing the inflow of foreign investment".

In this context, the Business Coordinating Council pointed out that the most likely outcome in order to "revive the Mexican economy" in the medium term would lie in the victory of a strong and coherent opposition in 2024. By the end of March 2023, the number of opposition figures who had been identified as potential candidates for the presidency had reached 22. Among them, the most popular at the moment are: Santiago Creel (Federal Deputy, PAN), Ricardo Anaya (former presidential candidate, PAN), Gerardo Fernández Noroña (Federal Deputy, PT), Mauricio Vila (Governor of the State of Yucatán, PAN), and Luis D. Colosio Riojas (Mayor of Monterrey, *Movimiento Ciudadano*). Nevertheless, the opposition contenders appear not to be as "politically powerful" as Morena's "*corcholatas*". For some, the condition for the opposition's victory thus seems to lie in the formation of a coalition between PAN, PRI, PRD, and *Movimiento Ciudadano*. In the end, given the opposition's fragmentation and the uncertainties surrounding the formation of a cohesive coalition, it seems challenging to gauge how investment relocations to Mexico would be impacted by the victory of a candidate from a political party other than Morena.

Overall, the political risks arising from the current administration's economic policies and their implications for nearshoring are likely to "remain constant" in the years to come. However, given the highly centralised decision-making process under AMLO, one could argue that such policy risks are likely to "slightly decline" from 2024 onwards. In any event, while a strong and coherent opposition victory in 2024 is seen by the business sphere as the best solution to capture Mexico's nearshoring potential, the most likely scenario is that Morena wins the election. Indeed, according to the *Power Ranking Presidencial*, Claudia Sheinbaum, Marcelo Ebrard, and Adán Augusto López currently make up the top 3 contenders with the most "political strength". Besides matters of economic policy, other divisive issues that may be of interest for investors will also be subject to debates during the forthcoming elections. One of them relates to the strategies to be pursued in tackling the problem of insecurity.

Security-related risks are likely to challenge Mexico's potential for nearshoring

Insecurity is prone to limit the nearshoring-related opportunities in Mexico. Security conditions in the country have long been one of the main concerns for investors, especially in certain areas such as along the northern border (Baja California, Sonora, Chihuahua, Coahuila, Nuevo León, and Tamaulipas), but also in the states of Colima, Guanajuato, Guerrero, Jalisco, Michoacán, Tabasco, and Zacatecas. Security-related risks have led the business sectors to adapt by calling on the services of security companies and risk management consultancies, for instance. However, the arrival of new investment in Mexico is likely to whet the appetite of organised crime which could disrupt the competitive advantages the country provides for nearshoring. Road-cargo theft, insecurity in industrial parks, and extortion constitute the main security-related risks identified by investors.

How does increasing road-cargo theft undermine nearshoring expansion in Mexico?

Insecurity on Mexican roads threatens nearshoring expansion. In recent months, vehicle theft, extortion of transport trucks, as well as merchandise theft from cargo transport are all showing upward trends. Such criminal activities provide alternative business opportunities to drug trafficking not only for local criminal groups but also for organised crime. And malfeasance on Mexican motorways may continue to rise given the growing lucrative opportunities nearshoring will create for these groups.

During the first two months of 2023, 356 reports of road-cargo theft were filed in the country, which represents an increase of 58% compared to the same period last year. It should be noted that some of these thefts were committed with violence. For instance, many of the reported cases follow a similar pattern, in which the offenders travel in one or two vehicles to stalk transporters. In this *modus operandi*, one of the cars blocks the road, while the other one boxes the victim in. Last year, foodstuffs and beverages were by far the most commonly stolen products from cargo transport, followed by electronics, construction, and industrial products.

According to the *National Chamber of Freight Transportation* (CANACAR), ten states accounted for 93% of road-cargo theft cases in 2022: Estado de México, Puebla, Guanajuato, Jalisco, San Luis Potosí, Michoacán, Querétaro, Hidalgo, Veracruz, and Tlaxcala. The region of Bajío, - the industrial core of Mexico, and one of the main destinations for nearshoring -, is thus particularly vulnerable to the risks associated with insecurity on the roads. More precisely, according to the National Association of Vehicle Tracking and Protection Companies (ANERPV), the most dangerous roads for the transport of goods are Road 57 (Coahuila and Nuevo León), Road 85 from Monterrey to the northern border, Road 45 from León to Aguascalientes, the north of the State of Mexico, Road 190 from Mexico City to Puebla, and Road 150 from La Tinaja to Veracruz (*see map below*). Therefore, all the country's industrial centres will have to cope with the increase in road-cargo theft in the years to come.

Map: Axel Aubry - London Politica · Created with Adobe Illustrator

Insecurity on the roads has led to economic losses for businesses, estimated at MX$ 230,967 per company in 2021. On the other hand, truckload theft also contributes to driving up commodity prices in the country. Indeed, insecurity has forced transport companies to modify routes and timetables, which has generated problems in the supply chain, and therefore has affected the availability and final prices of products. Although fighting insecurity is one of the strategies that the current Mexican administration is using to curb inflation, road-cargo theft remains a multifaceted issue, and this approach may not be enough. In particular, the lack of police coverage on the country's road network and the lack of denunciations (it is estimated that around 76.5% of cases go unreported) are two factors that contribute to the complexity of the problem.

Rising theft and extortion risks in Mexican industrial parks also pose financial challenges to industries

Insecurity within industrial parks (merchandise theft as well as extortion) constitutes another security-related risk, although secondary, that is increasingly decremental to the Mexican industry and therefore to relocations.

The industrial complexes located in the Valley of Mexico - Naucalpan, Tultitlán, Cuautitlán Izcalli, and Ecatepec - appear to be the most affected by instances of stealing. For instance, fibre optic cable thefts are commonplace in the region and have left several companies without internet and telephony. The occurrence of thefts in manufacturing parks therefore poses a challenge to the financial stability of industries. What is more, Tesla's arrival in Mexico and the construction of new industrial centres may increase the risk of theft. This trend is already noticeable in the recently established manufacturing parks in the region of Bajío, as well as in those associated with the aeronautics industry in Mazatlán and Yucatán.

Extortion is another problem prevailing in the country's industrial hubs, especially in the manufacturing centres located in areas marked by a strong presence of organised crime, such as Guanajuato, Nuevo León, and Tijuana. Extortion can take the form of "right to the floor" (*"derecho de piso"*), in which criminal groups demand regular payments from businesses in exchange for "protection". Although this type of extortion primarily affects small businesses, such as shops, bars and restaurants, rather than large manufacturing companies, this "criminal billiontax" could be a real cost for investors to consider. Another type of extortion is the one targeting cargo carriers. For example, truck drivers transiting through the municipality of Naucalpan (State of Mexico) have reported being forced to pay an average of MX$ 1,200 of "criminal tax", in order to continue on their way. It should be mentioned that extortion is a crime that has been registering an increasing trend in recent months, which has been worrying the business community. Overall, extortion increased by 17.3% in the Republic in 2022 (compared to 2021): 11,038 cases were reported in Mexico last year, many of which in the country's industrial corridor.

In a nutshell, when choosing Mexico for nearshoring, foreign investors must consider the cost of insecurity. Evidence of this is the fact that, in 2022, the total cost of security-related risks to business amounted to MX$ 120bn. What is more, there is no indicator pointing to a violence reduction in Mexico in the years to come, which means that crime will continue to affect business. In the face of this context of insecurity, companies have increasingly resorted to services from security consulting, analysis, and intelligence firms, in order to keep on exploiting their potential of growth despite an environment that is likely to endanger their employees and assets. In addition to security concerns, investors have also shown worries regarding the country's energy capacities, another factor that could put a brake on the expansion of nearshoring.

Energy capacity is slowing down Mexico's reception of investment

Concerns have been raised regarding the preparedness of Mexico's infrastructure to accommodate the massive capital inflow that could result from the nearshoring phenomenon, more specifically in terms of electricity. In 2022, Mexico's FDI increased by 12% compared to US$ 35bn in 2021. According to the Ministry of Economy in Mexico, the lack of electricity infrastructure is one of the main reasons impeding further growth and has led to several foreign investment projects being cancelled or postponed. Therefore, an increase in electricity generating capacity, as well as that of the distribution infrastructure, is needed to become a feasible recipient of investment in the nearshoring process, as most of the projects being developed are in the energy-intensive manufacturing segment.

The National Electric System Development Programme (PRODESEN for its Spanish abbreviation) estimates a 3% base yearly growth of energy demand between 2022 and 2036. The PRODESEN also expects that the capacity of electricity demand installed during the same period will amount to approximately 48%. This includes plans for increasing solar energy by 251%, nuclear energy by 155%, and internal combustion energy by 209% for 2036. This seems particularly challenging taking into account that the annual growth of transmission lines was only 1.6% between 2013 and 2021. Mexico needs around US$ 100bn in new power plants in the same period of 2022 and 2036, not only for generation but also for transport and distribution. However, PRODESEN has not particularly proposed a plan by the government to achieve this capacity, and wind and solar energy generation saw a reduction in 2022 for the first time, by 3.5 and 4.6% respectively compared to 2021.

One of the reasons why infrastructure in electricity is lacking is AMLO's efforts to roll back the 2014 energy reform implemented by the previous administration. The energy reform allowed more private-sector investment in the country and aimed to bring in new entrants and technologies, and therefore, lower energy costs for consumers in Mexico. AMLO's efforts to revert this reform have deterred the increase in energy investment since 2018, particularly in the renewable energy market. The administration has focused on modernising some of Mexico's oil refineries and strengthening the CFE . The fourth clean energy auction was cancelled despite three successful auctions that yielded contracts for 7 GW of wind and solar capacity at a very low cost (US$ 2.1 cents per kilowatt-hour). Therefore, strengthening state-run firms in electricity generation as well as the use of fossil fuels has been part of his efforts to renationalize these industries. An amendment to Mexican law passed in 2021 aimed to boost the CFE's share of the electricity market from 38% to at least 54%. These efforts have been undermining the confidence of foreign private companies and have contributed to a 67% drop in FDI in 2021 for electricity generation, transmissions, and distribution.

Alignment in environmental, social, and governance (ESG) interests is necessary for the long-term success of nearshorers

Clean energy will be one of the important issues that will determine if notional demand will be translated into effective demand in Mexico. As mentioned before, the current administration's efforts to promote and renationalise energetic industries have led to uncertainty for investors of clean energies in the country. Mexico's current energy policies undermine the deployment of clean energies and promote the use of fossil fuels, which is inconsistent with USMCA commitments. As the AMLO administration is focusing on modernising the CFE's existing generation and building new coal. Even the head of the CFE dismissed wind and solar energy expressing that it is expensive and unreliable.

As ESG issues are becoming increasingly important for private actors in the medium term, Mexico should prepare for an expansion focusing on clean energies. Noting that the US is the main source of Mexico's FDI inflows, it is important that private companies originating from there are guaranteed electricity supply and the availability of clean energy sources in order to continue to operate in Mexico. Canada and the US have taken this issue to the USMCA dispute settlement mechanism.

This was further materialised in last year’s Bipartisan Infrastructure Law in the US which placed clean energy technologies at the center of sustainable economic development. The law includes the Infrastructure Reduction Act, which will allocate US$ 365bn for energy security and climate change programs. This encourages the private sector to comply with strict climate regulations and to restructure their supply chains to adhere to sustainability targets. All of this, while Mexico builds a refinery and burns fuel oil.

State-level efforts aim to reduce the energy crunch

The current efforts to alleviate the energy crunch for nearshoring ventures are primarily being carried out by individual states, rather than by federal authorities. Some of the notable plans include those in Sonora and Jalisco.

The Sonora Plan, which was announced during COP27, aims to build up to five 1000MW solar parks in Sonora, which will help power new industrial plants and even export electricity to the US. With the aim of developing the entire supply chain for electric cars and semiconductors, Sonora will invest in transportation infrastructure, water, and even airports. The investment also includes the manufacturing of chips, batteries, and electric cars and even the extraction of lithium and other minerals. On the other hand, Guadalajara, the capital of the State of Jalisco, is a thriving industrial hub in the country that is also grappling with energy supply and distribution issues. This has led to the establishment of a pipeline from Waha, Texas (called the Wahalajara pipeline) which raised the share of natural gas supply coming from Texas imports from a 61% in 2019 to 72% in 2021.

Despite these efforts, energy capacity is still an issue to take into consideration when studying Mexico's nearshoring opportunities. In particular, energy investors are dealing with uncertainty over existing contracts, as there is a possibility that AMLO may cancel electricity generation permits. Additionally, competitiveness in the promotion of CFE by the administration as well as the intention to avoid labelling it a monopoly, despite engaging in anti-competitive practices, also poses a threat to competitiveness. These actions hinder

Mexico's ability to achieve the necessary energy capacity to address the demand coming from companies nearshoring.

Further, nearshoring might be hindered by energy capacity constraints that Mexico is facing due to a lack of infrastructure and AMLO's efforts to roll back the 2014 energy reform. Although projects such as the Sonora Plan aim to reduce the energy crunch, attempts to renationalise energetic industries that undermine the deployment of clean energies could be incompatible with many foreign firms' ESG goals. This might disincentivize firms from relocating to Mexico due to concerns about electricity access and conflicting long-term ESG strategies.

Mexico's workforce size and education level. A nearshoring advantage?

Current demographic situation and future trends

According to official data, Mexico boasts a population of approximately 130 million, making it the second most populous country in the Latin American region, outranked only by Brazil, and the 10th most populous country worldwide. Of particular note, approximately 50% of the Mexican population is currently under the age of thirty, which positions the country to enjoy a stable and reliable workforce for generations to come. This trend stands in stark contrast to the demographic challenges facing the developed world, including China, which has already experienced a population decline as of 2022. Moreover, the relatively small proportion of Mexican citizens aged 60 years or older – 12% as of 2022 – confers a significant fiscal advantage, given the substantial number of active workers contributing to a comparatively limited number of retirees. These elements are crucial to a country that seeks to be a manufacturing hub like Mexico since having a sizable workforce is a fundamental condition in order to achieve so.

Although Mexico's current situation appears promising, projections suggest that the country may face demographic challenges in the long term. By 2050, the population is expected to be around 148 million, marking a slowdown in population growth. By this year, the birth rate is expected to decline, with children comprising only 14% of the population - which represents a significant drop when compared to the current 20%. In contrast, adults aged between thirty and sixty years old are expected to represent 40% of the population, indicating relative stability compared to the 2022 figures. However, the number of young people (aged between twelve and twenty-nine) is expected to decrease from 30% in 2022 to 23% in 2050, which could have implications for the country's future workforce. Perhaps the most concerning demographic trend is the projected increase in the number of people aged over sixty, which is anticipated to rise to 22% of the population. This means Mexico will not escape from an issue that is rapidly becoming a concern for the global economy.

Nonetheless, Mexico still does hold a privileged position in this matter, which can be attractive to investors, as they would find a large and strong workforce in the country.

Mexican labour skills and education level: opportunities and limitations.

Around 25% of Mexico's workforce is employed in the manufacturing sector, making it the top Latin American country in this matter. This means that not only is the workforce young and of considerable size, but it also is more capable of working in the manufacturing sector than all of the countries in the region.

Another area where Mexico holds a competitive advantage over other markets is the cost of labour. Mexico's labour costs are 1.6 times lower than China's, which is a significant consideration. In 2020, the hourly wage of a Mexican manufacturing worker was US$ 4.82, while that of a Chinese manufacturing worker was US$ 6.50.

The level of education is another crucial factor to consider. Official figures reveal that 49% of Mexicans have basic education, 24% have completed high school, and 21% have a college degree. Only 5% of the population is uneducated. This accounts for a relatively skilled workforce. Nonetheless, in order to take full advantage of the nearshoring potential, the Mexican government should invest heavily in educating its citizens. By doing this, it will be able to receive considerably more FDI, especially in complex, high-tech sectors which require high-skilled workers.

Besides investing in its own education system, which will be key to improving its nearshoring potential in complex activities, Mexico has engaged with its North American partners in education and training programs. An excellent example of such initiatives is the recent agreement signed between the Mexican government and the Arizona State University (ASU), which will connect ASU with Mexican higher education institutions in order to improve Mexico's capabilities regarding semiconductor manufacturing. This deal is aimed at training Mexican workers with a view to building manufacturing capacity in Mexico, which will be partially funded by American Chips Act funds destined for international cooperation.

However, it remains uncertain whether nearshoring in Mexico will truly result in a substantial number of jobs, whether skilled or unskilled. The main reason for this uncertainty is the impact of automation processes on job creation. The EV industry serves as an illustrative example, with major companies like Tesla relying heavily on automation and robotisation to reduce labour costs and increase production efficiency. Consequently, the exact number of jobs that will be generated by such activities remains unclear.

Overall, Mexico's workforce is young, sizeable, and proficient in the manufacturing sector. Combined with lower labour costs than China and a reasonably well-educated population, this makes Mexico an attractive market for businesses looking to manufacture goods. However, it still faces challenges in terms of education and government spending in this area will be key to fully unlocking nearshoring potential. With a view to achieving this, it will be vital that policy-makers invest heavily in human capital, as well as engaging in different international cooperation programmes which will help the country’s workforce to be ready to adapt to a challenging and highly-competitive environment.

Conclusion

Mexico has the potential to become one of the main destinations for firms relocating their manufacturing plants. As highlighted in previous sections, the country boasts from a unique strategic geography, a deep political and economic relationship with its Northern neighbours, and access to over 60% of the world's GDP through trade agreements and investment treaties. Moreover, the country is attractive to firms looking to produce closer to the US due to its well-established manufacturing sector with low-cost labour, and a sizable, relatively educated and young workforce.

Nonetheless, several risks are likely to hinder Mexico's ability to capture this potential. In particular, renationalisation policies have been exacerbating Mexico's energy constraints. Rising road-cargo theft and extortion are also prone to thwart nearshoring-related opportunities in the country. Moreover, the foreign policy of Mexico and the US will determine whether both countries cooperate towards a joint initiative to incentivise nearshoring, or if local politics and inward-looking foreign policy will stress bilateral relations. Therefore, unless the current (and upcoming new) governments take action on attracting foreign firms, partnering with the US, and putting forward policies to address concerns on energy, security, and investment protection, Mexico may not fully capitalise on its nearshoring potential.

London Politica