The Rise of Nearshoring in Latin America: a spotlight on Mexico

Mexico to win big as geopolitics, disruptive events drive nearshoring to LatAm

December 2022
Although nearshoring to **Latin America** and the **Caribbean ("LatAm")** is not a new phenomenon, in the current context, the region is well positioned to benefit from the practice by contributing to the establishment of more reliable and resilient supply chains in the Western Hemisphere. Conditions in **Mexico** are particularly attractive due to its proximity to the **US**, advanced trade infrastructure and adherence to the rules set out in the **United States-Mexico-Canada Agreement (USMCA)**. To capitalize on these opportunities in a growing range of industries, however, organizations must not only understand the breadth of the challenges in the region, but also ensure that they are well equipped to navigate security, operational and regulatory risks as they transfer one set of risks for a different set.
Conscious decoupling

For strategic reasons, international companies have been seeking to relocate their business operations from Asia to the Western Hemisphere.

This process began prior to the COVID-19 pandemic, and has accelerated since 2018, when the decoupling of the US and Chinese economies began in earnest. Since the onset of the pandemic, however, severe supply chain disruptions and significant hikes in logistical costs have prompted more businesses to explore opportunities to shrink supply-chain distances, reduce associated costs and mitigate inherent geopolitical risks. The Ukraine-Russia conflict in Europe and the ensuing spike in fuel prices and transportation costs has only further highlighted the need for resilient supply chains.

In this context, strategic competition with China underpins US President Joe Biden’s National Security Strategy (NSS). Among other things, the NSS promotes investment in the US through industrial policies like the Chips and Science Act, which allocates USD 52bn for investment in semiconductor manufacturing and research, and the Inflation Reduction Act, which outlines tax incentives for electric vehicles (EVs) and battery components manufactured in North America.

Allies for progress

LatAm is particularly well placed to capitalize on the nearshoring trend.

According to a report published by the Inter-American Development Bank (IDB) in June, nearshoring could lead to USD 78bn per annum in additional exports of goods (USD 64bn) and services (USD 14bn) regionwide in the short to medium term. This will be underpinned by the wide variety of comparative advantages the region enjoys. In addition to geographical proximity to the US (and its massive market) and shared time zones, these include:

- Longstanding bilateral relations with the US and Canada (the nearshoring trend in the region is often referred to as “friend-” or “ally”-shoring). These relations extend to dozens of preferential trade agreements, many of which the US is a signatory to.

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Well established exported-oriented economic models that both focus on some of the sectors, products and materials regarded as strategic in the nearshoring context – including the automotive industry, textiles and pharmaceuticals – and leverage the region’s extraordinary mineral resource endowment. These economic models extend to the prioritization of developing considerable renewable energy capacity.

- An ever-quickening digital transformation that will enable more companies to export services (rather than just goods) and improve the capacity of government institutions promoting trade that will underpin the region’s burgeoning reputation as a technology and data hub.

- Demographic and social factors, such as a comparatively young working population; the relatively low cost of labor in some, though not all, markets (this includes an expanding talent pool of technology specialists); an ever-growing domestic consumer market; and extensive family ties between LatAm and the US. There are, of course, challenges for the region to overcome to fully realize its potential and capitalize on nearshoring. These include addressing infrastructure deficiencies to remove bottlenecks; improving schooling to address the skills gap between what employers need and the expertise available; and deepening regional integration to reduce trade tensions and increase competitiveness.

**Fig.1** Total nearshoring opportunities by country – additional exports of goods (USD)

Source: Inter-American Development Bank (IADB)
A Spotlight on Mexico

Mexico is one of the countries most likely to benefit from nearshoring.

It has unrivalled comparative advantages – such as its vast border with the US; an enormous transport network; well established cross-border infrastructure; huge renewable energy potential; a large, young and comparatively cheap workforce; and its status as a signatory to 13 free trade treaties, including the United-States-Mexico-Canada Agreement (USMCA). The latter covers important provisions on labour rights, digital trade, protection for intellectual property and dispute resolution mechanisms.

Specific opportunities and potential obstacles for nearshoring in Mexico are detailed in the following sections.

Fig.3 Mexico’s railway network

Source: Infrastructure, Communications and Transport Ministry (SICT), Tourism Ministry (Sectur)

Third country with the most airports in the world (2,315) 3,100km of US-Mexico border with 40 border crossings

102 ports and 15 out-of-port terminals 27,000km of railway track 365,000km of road

Source: Infrastructure, Communications and Transport Ministry (SICT), Tourism Ministry (Sectur)
In September 2022, Mexico and the US agreed to increase collaboration on supply chains related to semiconductor and EV production on the back of the Chips and Science Act and the Inflation Reduction Act.

Although US federal funds will not flow directly to Mexico, US grants are likely to favor projects that bring supply chains out of China and closer to the US. According to the Mexican Ministry of Economy, the Mexican states with the greatest specialization and growth potential for EVs and semiconductors are Baja California, Jalisco, Chihuahua, Tamaulipas, Nuevo León and Querétaro.

While there are nearshoring opportunities throughout Mexico, the north and Bajío regions stand out. The appeal of the former is tied to its geographic proximity to the US and the inherent logistics advantages. Meanwhile, the Bajío region is attractive because of its sophisticated multi-modal transportation network, which connects to national and international markets.

The manufacturing sector has benefited the most from the North American institutional framework. This is especially true for the automobile industry, but also for the textile, metal-mechanic and agricultural sectors. The current geopolitical context also opens the door for investment in new fields such as energy and critical minerals.

According to Mexico’s central bank (Banxico), nearshoring led to a 3% increase in Mexico’s manufacturing production during the period from June 2021 to June 2022. At the national level, 16% of firms registered greater demand for their products or increased FDI during this period. The figures are highest for companies in northern states (19.7%), followed by those in central states (15.1%) and central-northern states (14.8%). In the survey, 24.8% of manufacturing firms that export their products reported increases in demand or FDI; the figure was 16.6% among non-exporters.

Fig. 4 Top exports to the US, 2021 (USD bn)

Source: Ministry of Economy

1 The Bajío region comprises the states of Aguascalientes, Guanajuato and Querétaro, as well as portions of Jalisco, San Luis Potosí, Zacatecas and Michoacán.
Energy
Plans for regional integration in the energy sector have paused over the past four years due to President Andrés Manuel López Obrador’s (AMLO) statist policies. Despite AMLO’s position, the Mexican government is aware of the need for private investment to revamp the country’s energy infrastructure, which has resulted in agreements for the construction of pipelines and hydrocarbon terminals. Furthermore, as the September 2024 end of AMLO’s administration draws nearer, there is a growing appetite among foreign companies to invest in the renewable energy sector given the increasing pace of electrification, decarbonization, and energy transformation in the US and Canada.

Technology
While the US is a global leader in the tech sector, there is a dependency on critical components produced in Asia. Nevertheless, global trends have set the stage for all three North American countries to contribute to reduce this dependency. Mexico can help shift the balance by attracting FDI for research and development, design, and the overall production of key components such as semiconductors, thereby contributing to the establishment of an integrated regional tech market. Mexico is also well placed to capitalize on opportunities for software development and data center operations, not to mention social media networks.

Critical minerals
The US is also heavily reliant on critical minerals sourced from China, such as cobalt, copper, lithium and nickel, which are significant for the tech sector, the defense industry and energy transition. Nearshoring will help redress this imbalance, which is why the US and Mexican governments have expressed their intention to cooperate on supply chains for EV production in North America and incentivize the growth of the semiconductor industry in Mexico.

Chinese investment

Chinese FDI has been more significant in other countries across LatAm than in Mexico; the country has significant trade relations across Central and South America.

Nevertheless, Mexico remains particularly attractive for geographic reasons and the fact that the USMCA establishes unparalleled conditions for accessing the US market. By setting up operations in Mexico, companies from China seek to benefit from these conditions and circumvent the US tariffs that have been imposed on their products since 2018. Although Chinese FDI in Mexico remains low in comparison with US investment flows, it has increased significantly over the past five years and we would expect that trend to continue.
Challenges

Challenges with a positive outlook

Talent pool
Mexican human capital is perceived as having limitations vis-à-vis key sectors such as technology. In 2022, however, more than 110,000 university graduates completed engineering degrees in Mexico and the country has a reputation for its skilled workforce, and its contribution to the automotive and aerospace sectors. Additionally, the USMCA is likely to serve as a catalyst that fosters the specialization of human capital in high-skilled professions.

Sustainability
Because of the barriers that the AMLO administration has erected in the renewable energy sector, there have been growing concerns about Mexico’s commitment to sustainability. That said, North American efforts to expedite the energy transition (such as with the EV market) are already pushing Mexico to a more sustainable pathway. This, combined with the imminent change of government, provides a more positive outlook in the sustainability arena.

Regulatory risks
When AMLO took office in 2018, his political platform raised concerns for several industries that feared an uncertain regulatory environment. The most controversial parts of the president’s agenda, however, have been concentrated in the energy sector while the regulatory framework for other economic activities has remained benign.

Labor issues
Labor standards have significantly improved in Mexico over the past two decades. The implementation of the USMCA was a key element for labor reforms in Mexico in 2019 and 2020 with the aim of further enhancing conditions for workers to create a homogenous labor market in the region. Union democracy, transparency and accountability is growing, especially in export sectors; the minimum wage has almost doubled between 2018 and 2022; and outsourcing labor is now regulated with the aim of ensuring that workers’ rights are respected.

Operational challenges
Additional challenges include public infrastructure deficiencies and uncertainty regarding the reliability of electricity. The quality of infrastructure, however, is better in industrial hubs in the Bajío region and northern Mexico than in other areas of the country. The power sector will remain a top concern but compliance with USMCA provisions combined with a change in the federal government in 2024 will improve the operational landscape in the coming years.

Structural problems
Corruption and the weak rule of law are nationwide problems that sometimes deter business activity in Mexico. Perceptions of insecurity also affect the business environment. Small companies typically find themselves more vulnerable than larger ones because they generally have less human and financial resources to design and/or implement robust security and anti-corruption mechanisms; with the proper measures in place, companies can usually overcome these obstacles.

Despite the numerous factors that favor nearshoring operations in Mexico, there are also challenges to consider. These challenges can act as obstacles to realizing the country’s potential to attract FDI but, by understanding their complexity, solutions can be found and operations successfully established.
Despite some challenges, the security environment and social conditions do not impede normal business activities.

The security environment and/or social conditions sometimes impede business operations; routine business activities may require enhanced security provisions.

The security environment and/or social conditions present persistent and serious challenges for business; routine business activities generally require enhanced or specialized security provisions.

While the specifics of our recommendations will vary based on location, sector and activity, organizations can address risks through key mitigations such as the following:

- Regulatory, security and operational threat and risk monitoring
- Robust risk assessments, information security and intelligence capabilities to avoid cargo theft
- Regular due diligence on third parties and key internal positions
- Internal controls to identify counterfeit invoices and high-risk payments
- Corruption and ethics policies customized to the local legal framework and operating environment
- Compliance with certifications and the implementation of additional procedures for holistic security risk mitigation
- Tailored protocols to prepare for social unrest risks
- Updated security threat and risk assessments to identify critical operations and assets and to implement training and preventative and reactive security measures accordingly

Below, we have provided some additional thoughts on the mitigation of common operational challenges associated with expanding manufacturing and supply chain operations.

Cargo theft
Manufacturing companies operating in Mexico and other geographies in LatAm, often include cargo theft at the top of their risk registers. Mitigating the risk of cargo theft is complex and varied, as often occurs with critical risks affecting different companies and sectors. It necessitates a robust risk assessment that focuses on the attractiveness of the assets (cargo), the area of operation (routes and destinations) and existing vulnerabilities and strengths. Information security and management – covering internal personal as well as providers – is also crucial given the prevalence of internal collusion in cargo theft.

An intelligence apparatus that combines open and closed sources, communication and alert systems, and operational-focused threat analysis will also be key as the basis for mitigation measures and updating protocols.

Internal fraud
According to the Encuesta Nacional de Victimización de Empresas, fraud is one of the two crimes that most affected companies operating in Mexico in 2022. The COVID-19 pandemic transformed the standards of integrity within organizations, as some employees searched for and justified alternate sources of income in times of crisis. The principal catalysts for internal fraud in Mexico are a lack of internal controls and robust ethics culture within companies as well as skepticism that such criminal behavior will lead to judicial consequences.
Because internal fraud very frequently involves third parties, one of the most important preventive actions a company can take is to create a methodology to identify high-risk third parties and conduct periodic due diligence on them. Equally important is conducting due diligence on key positions within local operations. Internal fraud is almost always linked to a company’s cash flow; therefore, it is important to ensure that, in addition to a segregation of functions, companies have internal controls in place that enable the identification of red flags such as counterfeit invoices and high-risk payments. Any company entering Mexico, or LatAm more broadly, should also ensure that its corruption and ethics policies are customized for the new, local operating environment.

Drug trafficking
For operations with a cross-border component, the risk of smuggling or “contamination” is ever present. With an estimated 90% of illegal drug trafficking using legal transportation to penetrate international borders, nearshoring trends are likely to present additional opportunities for organized crime groups to utilize companies’ supply chains for illegal means.

Companies preparing for increased cross-border operations will need to pay particular attention to certification and compliance with programs such as the Customs Trade Partnership Against Terrorism (CTPAT) and the Operador Económico Autorizado (OEA). Over the last five years, these programs have been vastly expanded in terms of content as well as substance, moving away from a box-ticking exercise to a demand for holistic risk mitigation. The mitigation of smuggling risk, however, does not solely consist of CTPAT compliance. Companies must go further with regard to their compliance and vetting procedures and physical controls, combining technology applications (such as scanning and the detection of weight changes, and tampering, among others) with security procedures managed by local and remote personnel.

Protest action
Determining how to handle protests is high on the list of concerns for companies in Mexico. Doing so requires companies to not only take into account that protesters can consist of members of their workforces but to simultaneously assuage protesters’ concerns while implementing measures to ensure that protest actions do not escalate and threaten the physical integrity of a facility or the company’s reputation more broadly.

Manufacturing facilities need defined trigger-based and escalated protocols to ensure that they properly detect, prepare for and react to the risk of social unrest. Under such a system, companies define a list of triggers and assign corresponding actions for risk mitigation. Triggers might include informal employee complaints; negative social media activity by workers or the local population; union or other employee group communications or threats; and physical gatherings around the plant.

Offsite risks
Given that criminal activity represents a significant off-site risk in many locations, companies should take increasing steps to prepare and protect their workforces.

As a first step, and to ensure an integrated approach, companies should update their security risk assessments to ensure that all assets are appropriately identified and measured for criticality.

Once principal operational risks have been identified and/or confirmed, the corresponding risk mitigation actions should be implemented. These should consist, generally, of training for personnel and preventative and reactive security planning. All elements should be linked to a robust response plan, with clearly defined actions for common security scenarios, and how to escalate incidents into the company’s crisis management structure.

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Closing remarks and recommendations

The consolidation of trade in the Americas will be increasingly important because of prevailing geopolitical conditions.

As a result, the incentives for the three North American countries to jointly address the current challenges for smooth business operations in the region will not dissipate. This will make Mexico increasingly attractive for nearshoring, and the first movers will be best placed to capitalize on this persistent trend.

Currently, security, social and operational factors prevent Mexico and other countries in LatAm from capitalizing on their full nearshoring potential. That being said, even in hotspots where violence is a threat to employees, non-labor-intensive activities can usually thrive. Similarly, supply chain-disruption risks remain low for sectors that do not require the transportation of goods across countries and are experiencing value growth at a rapid pace due to strategic and geopolitical factors, such as software development.

Additionally, even companies in labor-intensive sectors usually find that—after carrying out granular assessments and implementing mitigations accordingly—what looks like a hostile environment from afar is, in fact, manageable or even harmless for their specific operations.
About Control Risks

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Working across disciplines, technologies and geographies, everything we do is based on our belief that taking risks is essential to our clients’ success. We provide the insight and intelligence you need to realize opportunities and grow.

Control Risks has operated in Latin America since the company was founded in 1975. Our teams based in Mexico, Colombia, Guyana and Brazil, with a technology-hub in Panama, have an extensive track record supporting international clients in navigating the shifting regulatory, political, security and social risks related to operating in Latin America. From pre-entry market studies to detailed, local, project-focused comprehensive compliance and due diligence research into political, social, security and reputational issues, we help our clients capitalize on opportunities through active risk management.

If you would like to talk to our experts about your company’s operations in Latin America, please reach out to:

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