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Nearshoring in Mexico: Mirage or the real deal?

Evidence suggests a stark comparison with Asian peers

Macroeconomic Research

Luis Lopez-Vivas,
Economist (Latin America),
Macro Research – Core Investments

Key points

- Moving production and services closer to their destination markets, i.e., "nearshoring" can help enhance supply chain resilience and reduce costs
- Mexico's proximity to the US, along with its large manufacturing base and free trade agreements, make it an attractive nearshoring destination
- Macro indicators offer no conclusive proof of nearshoring expansion in Mexico but there are subtle signs at the micro-level, such as growth in the industrial real estate sector
- To attract nearshoring, Mexico must address its structural challenges, particularly in education and governance. Currently, certain Asian countries excel in these areas and have benefited from the relocation of supply chains
- Investors should pay heed to 2024 Presidential election in Mexico. A new administration could potentially implement reforms to attract greater levels of nearshoring

Nearshoring: A solution to turbulent times?

The concept of "nearshoring" – where companies move their production and services closer to final markets – has become a hotly-debated topic. The growing interest reflects businesses' desire to strike a balance between cost-effectiveness and agility, while also mitigating the risks associated with long-distance outsourcing. Companies and industry experts acknowledge that against an increasingly complex global backdrop, it can potentially help them to enhance supply chain resilience and reduce costs.

Discussions on nearshoring have intensified in recent years for a variety of reasons – the disruption caused by the pandemic, geopolitical tensions, changing trade dynamics and the need to cut carbon emissions. As such, US companies are exploring the possible advantages of locating their operations in countries that are geographically and politically closer to home.

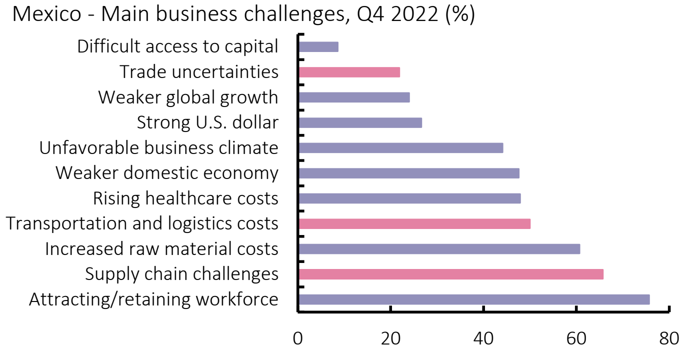
In this paper, we delve into the recent experience of Mexico, which is a prime contender to potentially benefit from nearshoring investment from the US. However, our analysis suggests recent increases in Mexico's exports are not primarily driven by nearshoring. Likewise, foreign direct investment (FDI) in Mexico is yet to witness a significant boost, certainly compared to some Asian economies. Despite this, there are noteworthy developments which suggest there is growing interest in Mexico as a nearshoring destination. One is the remarkable growth observed in the industrial real estate sector, another is in local survey data, which reflects positive sentiment towards nearshoring reported by a significant percentage of companies already integrated into international supply chains.

Unfortunately, Mexico's potential to leverage its inherent advantages – its proximity to the US, large manufacturing base, and free trade agreements – is hindered by its subpar performance in governance and education compared to competitors. Ultimately this is stopping it from fully capitalising on the current opportunities available in the nearshoring landscape.

Nearshoring: A response to supply security concerns

Despite the perception that nearshoring might be a passing post-COVID-19 trend, it remains high in corporate leaders' considerations for addressing ongoing supply challenges. Survey data from the National Association of Manufacturers (NAM) reveals that logistics are an increasing problem for US businesses as shown Exhibit 1 (pink bars). These responses were absent in a comparable survey conducted in 2016. Seven years ago, "rising healthcare costs" was considered the main challenge to US manufacturers.

Exhibit 1: Rising concerns over logistics issues



Source: Manufacturing Outlook Survey 4Q22 US National Association of Manufacturers and AXA IM Research, June 2023. Respondents were able to check more than one response, hence, responses exceed 100%.

Recent geopolitical challenges, such as the Ukraine conflict and tensions with China, have prompted a growing US government recognition of the need to address supply chain vulnerabilities that threaten its economic interests. These include issues in global energy markets in the wake of the Ukraine war; China's dominant position in the production of rare earth minerals, essential for high-tech products; and risks related to semiconductor manufacturing following tensions between China and Taiwan. In response to these developments, President Biden's administration has taken action by signing an executive order to fortify US supply chains to mitigate the risks associated with geopolitical disruptions. In this context, nearshoring is emerging as a strategic imperative for both the private sector and the American government.

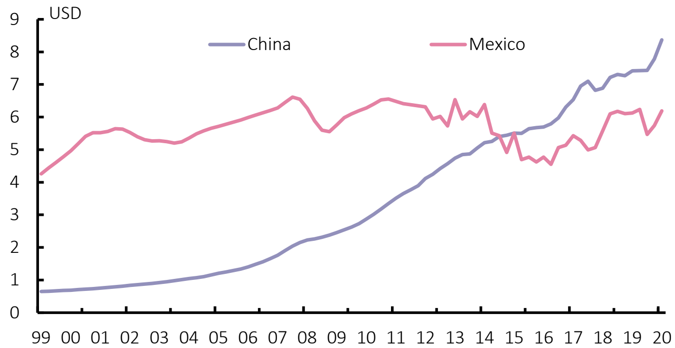
Mexico's strengths

Mexico's attractiveness as a nearshoring destination stems from several key factors, but perhaps none more so than its close proximity, both geographically and politically, to the US. For example, the transport cost margins for cars imported to the US from Mexico are just a fraction of those from China, or even regional competitors like Brazil and Colombia. This proximity also allows for shorter transportation times and increased responsiveness to market demands.

Moreover, Mexico's involvement in the US-Mexico-Canada Agreement (USMCA) provides companies with preferential trade access to the North American market. The agreement facilitates the flow of goods, reduces trade barriers, and ensures long-term stability in trade relations between Mexico and the US.

In addition to low transportation costs, Mexico also offers low labor costs for companies. In the past, China has stood out as the preferred choice for foreign investors due to its low wages and large population. However, Mexico's manufacturing sector wages have been consistently lower than China's since 2014 (Exhibit 2). This wage gap is likely to continue to widen over time as China's population abundance reverses as it ages quickly, while Mexico maintains healthy demographic growth.

Exhibit 2: Mexico's wages



Source: Oxford Economics and AXA IM Research, June 2023

Mexico also boasts a large manufacturing base, representing around 16% of GDP, which suggests an already rich and complex foundation on which to build. This offers numerous advantages, including economies of scale and synergistic benefits for new companies. Moreover, Mexico's manufacturing base is already deeply integrated into North American supply chains, further enhancing its appeal as a nearshoring destination.

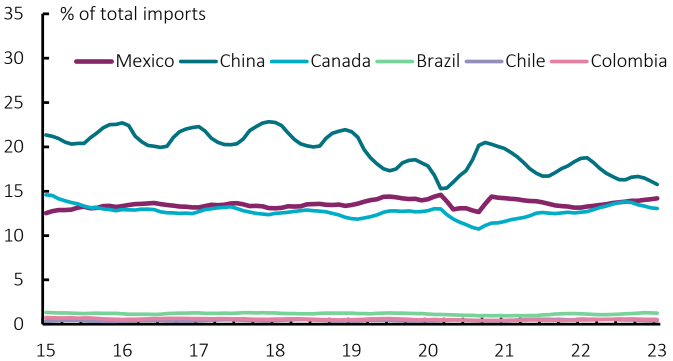
All that glitters is not nearshoring gold

Over the past two years, Mexico's exports have increased rapidly, fuelling speculation of the impact of nearshoring in the country. Mexican exports reached $53bn in March 2023, a single-month record high. More specifically, manufacturing exports grew by 5.3% compared to the previous year, led by booming car exports. But while exports are booming, an examination of more granular trade data, does not necessarily support the notion that this is a product of nearshoring.

Looking at US import data by origin, Mexico, as well as other large countries in the region, do not seem to have capitalized on significant recent disruptions, such as former PresidentTrump's tariffs, or the pandemic, to grow market share in the US. Since 2018, China's share of US imports declined to 17% from 21%, while Mexico's share increased just one percentage point to 14% (Exhibit 3). Moreover, an analysis of data on the origin of US manufacturing imports paints an even less optimistic picture. Despite a decline of five percentage points (ppt) in China's share to 19% since 2018, Mexico's portion in manufacturing imports has remained unchanged at 14% – it does not appear to be gaining a larger slice of the pie.

Exhibit 3: Share in US imports

US imports by country (6m MA)



Source: Refinitiv Datastream and AXA IM Research, June 2023

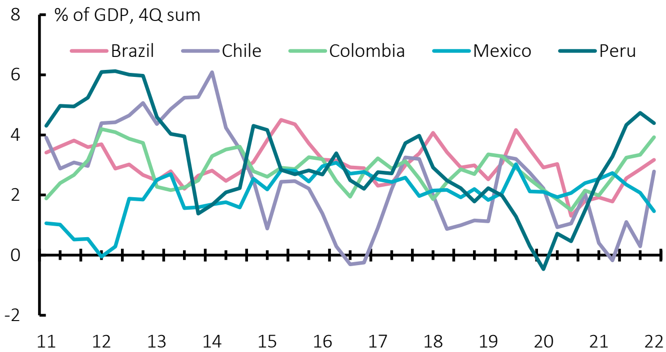
Foreign direct investment gains

Despite this, it may be premature to expect nearshoring to be reflected in trade data so quickly, plausibly requiring more time to materialise in final products. We therefore analysed FDI flows as early signs of nearshoring investment. These investments often precede the establishment or expansion of manufacturing operations in a country, indicating a longer-term commitment from companies seeking to relocate production.

However, Mexico does not stand out in net FDI inflows as a percentage of GDP in Latin America. In fact, flows into Mexico have been declining over the last few quarters amounting to less than 2% of GDP. In contrast, peer countries have experienced an upward trajectory (Exhibit 4). Data on gross FDI shows a very similar pattern with most major countries in the region experiencing an increase in flows while Mexico remains stagnant. Furthermore, net FDI inflows from the US into Mexico were lower during the 2018-2022 period compared to 2013-2017. As such, FDI inflows do not point to an increase in near-shoring activity overall, and specifically not from the US.

Exhibit 4: Net FDI inflows by country

Net FDI inflows

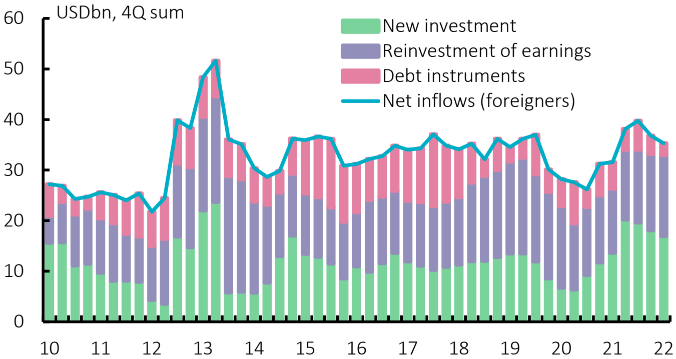


Source: Refinitiv Datastream and AXA IM Research, June 2023

On a more positive note, a closer look at the composition of net FDI inflows shows an increase in new investments, indicating a fresh capital injection into Mexico, rather than relying on earnings' reinvestments (Exhibit 5). This does suggest a growing interest among foreign investors to establish new ventures and expand their presence in the country. Yet while a positive development, the magnitude of this effect does not appear material on the national scale, as evidenced by the falling net-FDI-to-GDP ratio.

Exhibit 5: Composition of net FDI inflows

Mexico - Net Foreign Direct Investment inflows



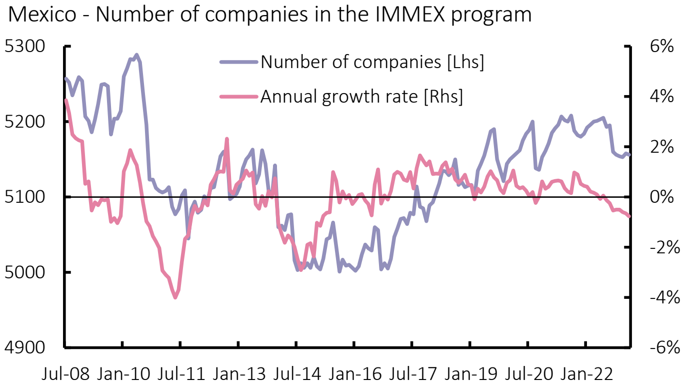
Source: Refinitiv Datastream and AXA IM Research, June 2023

Microscopic footprint?

While macro-level indicators do not provide conclusive evidence, more specific micro-level indicators may highlight more subtle signs of nearshoring.

The IMMEX, or *Maquiladora* program, is a government initiative to drive foreign investment which grants companies temporary exemptions from import duties or taxes on goods and equipment moved into Mexico for manufacturing. The number of companies participating has been steadily increasing since early 2017 (Exhibit 6). Yet, again it suggests Mexico has not been able to take full advantage of more recent shocks. As of February 2023, the number of companies participating in the program stood at 5,156, representing a modest increase of only 1% since February 2018. Moreover, these participation figures pale in comparison to the program's peak in May 2010, when it boasted 5,289 participants.

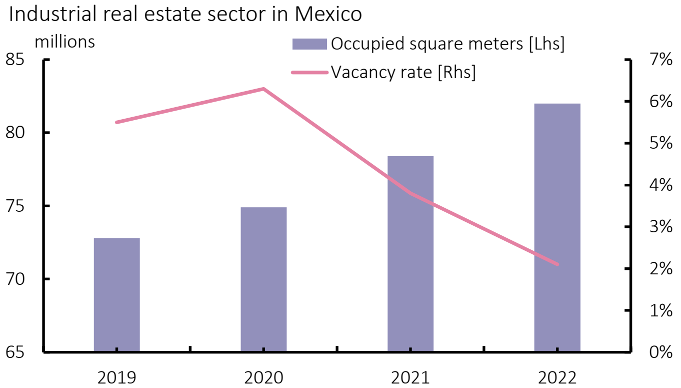
Exhibit 6: Participation in IMMEX programme



Source: INEGI and AXA IM Research, June 2023

The industrial real estate sector, however, is displaying remarkable signs of growth and activity. Occupancy in industrial real estate has witnessed a steady increase in recent years, reaching a noteworthy 82mn square meters. As a result, the vacancy rate declined to just 2% in 2022, considerably lower than its 6% peak in 2020 (Exhibit 7).

Exhibit 7: Industrial sector



Source: CBRE Group and AXA IM Research, June 2023

Furthermore, although still below pre-pandemic levels, the value of industrial real estate has been experiencing substantial growth in the past year, compared to the value of residential real estate, which has remained stagnant. This suggests a unique and dynamic development within the industrial sector.

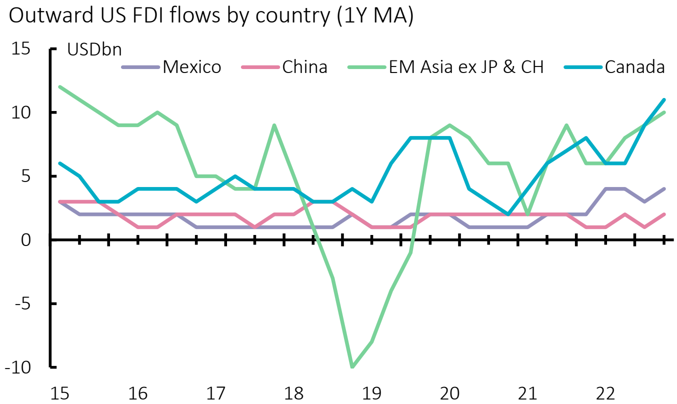
Central Bank of Mexico poll data also offers some corroborating evidence. In a July 2022 survey, companies were asked whether they had observed an upswing in product demand or an influx of foreign investment due to nearshoring. Some 16% of respondents answered positively, but the number jumped to 26.3% for companies already integrated into international supply chains. We think this data, coupled with evidence from the industrial real estate sector, suggest nearshoring is ramping up in Mexico, though not yet sufficiently to be reflected in macroeconomic data.

No longer in the dragon's shadow

The lack of large-scale nearshoring in Mexico, despite inherent benefits, stands in contrast to trends elsewhere. Emerging market Asian countries neighboring China are capitalizing on its diminishing dominance in global manufacturing. The proportion of US imports from emerging Asia, excluding China, has seen a notable rise, up by 3ppt to reach 15% since 2018 (compared to Mexico's 1ppt). The disparity is more pronounced when examining the origin of US manufacturing imports. The share of imports from Asia, ex-China, has seen substantial growth of 4ppt, compared to Mexico's stagnant share.

FDI data further substantiates the notion that Asian countries are benefiting from a relocation of supply chains. Emerging markets in Asia are attracting greater FDI inflows from the US compared to Mexico (as indeed is the developed Canadian economy to the north). So, while Mexico receives a higher FDI influx from the US than China at present, the disparity with the rest of Asia (and Canada) remains stark (Exhibit 8).

Exhibit 8: American investment abroad



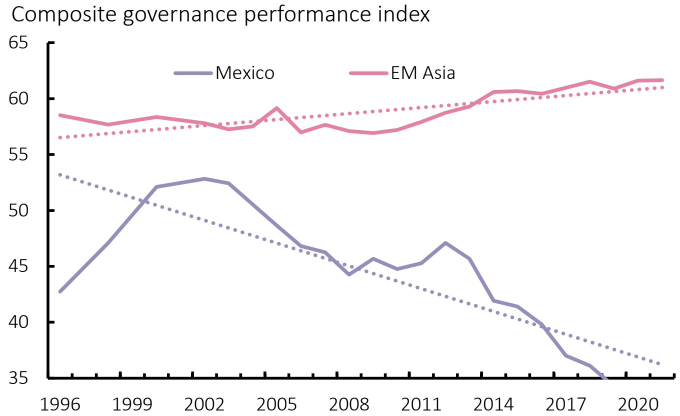
Source: Refinitiv Datastream and AXA IM Research, June 2023

Governance and education matters

Asia's ability to attract foreign investment is at least partly a result of addressing key structural factors. Strong governance and skilled workforces are instrumental in attracting and retaining foreign capital. Investors are drawn to countries with sound governance practices. Transparent and accountable institutions, efficient regulatory frameworks, and effective dispute resolution mechanisms instill confidence in investors, minimizing risks and uncertainties associated with their ventures. Furthermore, countries with well-defined and enforced property rights systems offer a secure foundation, ensuring that investments are safeguarded against arbitrary expropriation.

The World Bank provides a set of governance indicators that describe six dimensions of governance: Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law and Control of Corruption. In 1996, Mexico scored higher than Asian countries in the Government Effectiveness component (62.3 versus 58.9 out of 100). By 2019, Mexico's score had dropped to 45.7 while emerging Asia's soared to 74.6. The picture becomes even more striking when considering all other dimensions of governance. Taken together, these governance indices show that the gap between Mexico and emerging Asia has widened over time (Exhibit 9).

Exhibit 9: Divergent paths on governance issues[1]



Source: World Bank and AXA IM Research, June 2023

In addition to governance challenges, Mexico's education system also presents drawbacks that hinder its ability to attract manufacturing investment. Despite achieving near universal enrollment in primary and secondary education, the quality of education in Mexico remains relatively poor compared to its emerging market Asian competitors. The country's performance in the Program for International Student Assessment (PISA) conducted by the Organization for Economic Co-operation and Development (OECD) reflects this concerning reality. In 2018, Mexico underperformed in all three components of the PISA test, and the scores remained stagnant compared to those achieved in 2000. This is particularly problematic for attracting manufacturing investment where a skilled workforce is essential. This compares to remarkable progress in education across Asia.

Fledgling signs of nearshoring, but barriers remain

While Mexico possesses favorable conditions, macro-level indicators, such as US imports by origin and foreign direct investment (FDI) inflows, do not provide conclusive evidence of significant nearshoring taking place in Mexico. However, there are some positive signs at the micro-level, such as growth in the industrial real estate sector, which may suggest nearshoring is beginning to take hold.

By contrast, Asian countries have been more successful in attracting supply chains that are moving away from China. Structural issues, including governance and education, appear to be contributing to this disparity. Countries with solid governance practices attract more foreign investment and Asia has demonstrated improvements in governance indicators over time, while Mexico has, if anything, regressed. Similarly, Mexico has been unsuccessful in improving the quality of its education system, which has undermined its ability to develop a highly skilled workforce capable of attracting investment.

To fully benefit from nearshoring and attract foreign investment, Mexico needs to address these structural issues urgently. Improving governance practices and enhancing the quality of education are crucial steps towards positioning Mexico as an attractive destination. However, time is of the essence as the window of opportunity to attract foreign investment through nearshoring may close if these challenges are not promptly addressed.

For the time being, investors may wish to consider potential opportunities in sectors like industrial real estate and manufacturing companies.

Additionally, it is advisable for investors to closely observe the forthcoming Presidential election in Mexico, set for July 2024. A new administration could potentially implement the necessary reforms to attract nearshoring, foster economic growth, and unlock associated investment potential.

[1] The index measures the average percentile rank of countries based on five dimensions of governance. The percentile rank indicates a country's position relative to all other countries in the world, ranging from 0 (lowest rank) to 100 (highest rank) for each dimension. The index provides an overview of countries' overall governance performance by combining their percentile ranks across these dimensions.

The information has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. This analysis and conclusions are the expression of an opinion, based on available data at a specific date. Due to the subjective aspect of these analyses, the effective evolution of the economic variables and values of the financial markets could be significantly different for the projections, forecast, anticipations and hypothesis which are communicated in this material.