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GLOBAL ECONOMICS

LATAM INSIGHTS

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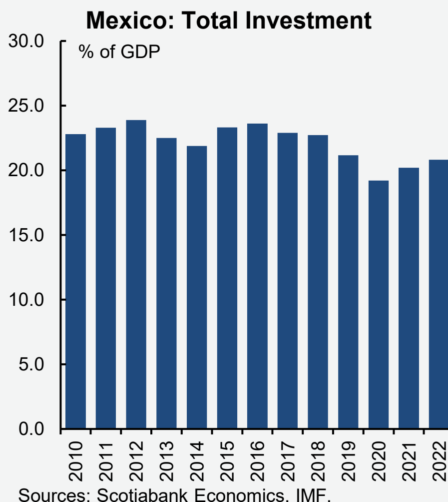
Mexico—Nearshoring Opportunity, and Its Hurdles

- **Mexico is faced with a strong opportunity for attracting investment due to the fragmentation of global supply chains.**
- **However, despite this opportunity, and an already observed large decline in China's share in US imports, Mexico seems to be missing out on investment.**
- **Our take is that even without improvements at country level policy, some regions and industries will continue to boom. The key question is whether this can turn into a macro level boom.**

Mexico is faced with a strong opportunity for attracting investment due to the fragmentation of global supply chains allowing it to tap investment aimed at satisfying US demand—particularly the productive capacity leaving China.

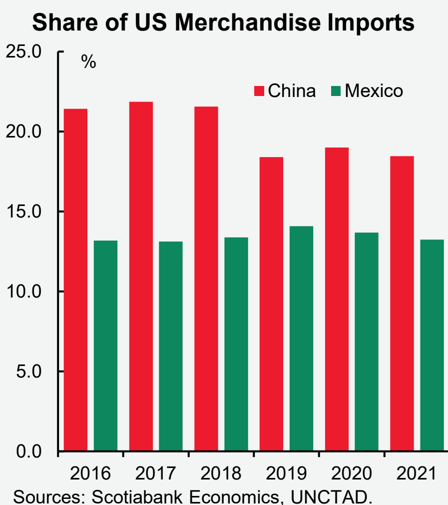
However, despite this opportunity, and an already observed large decline in China's share in US imports, Mexico seems to be missing out on investment (chart 1), recording depressed inflows not seen since China joined WTO in the early 2000s. Ironically, back in the early 2000s, the threat to Mexico came from China's entry into WTO as it risked eroding Mexico's manufacturing competitiveness. This time around, Mexico has the opportunity to capitalize on China's setbacks from a geopolitical perspective as well as global supply chains becoming more geographically proximate. Can Mexico seize this opportunity? So far, US import data do not show an increase in Mexico's share of the total, despite China's losses (chart 2).

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Scotiabank Economics, UNCTAD.

It's noteworthy that Mexico does not seem to be capturing an increasing share of global FDI flows (chart 3) despite its privileged geographical position and its nearshoring opportunities. One potential explanation is that companies look for a multitude production factors when deciding where to set up a plant (energy, skilled labour, cheap cost of capital, security, low taxes, etc.) and Mexico's business environment has been deteriorating/has stalled over the past few years (chart 4, measured by the World Bank's "Doing Business" report, flawed as it may be). In addition, some of the key characteristics of a manufacturing country are also areas where Mexico is lagging competitors:

- **The World Bank ranks Mexico 106 out of 190 economies in securing access to electricity for business**, with the time to connect to the grid representing one of the most challenging aspects (112 days on average, relative to an average of 67 days in LATAM and 75 days in the OECD high income), with its cost (281% of income per capita compared to 61% for the OECD average—this is largely the result of low per capita income) and the reliability of supply—where it also lags the OECD average (although Mexico scores better than the LATAM average)—also working against the appeal of investing in Mexico. The looming energy sector dispute between Mexico and Canada and the US under the USMCA framework highlights another key risk faced by Mexico's private sector when it comes to access to energy.
- **In the "paying taxes" category, Mexico is ranked 120th by the Doing Business index**, primarily due to a high corporate tax rate with an average contribution rate of 55.1% of profits, compared to 47% average in LATAM and 39.9% in OECD high income countries.
- **Dealing with construction permits is another challenge** (Mexico ranks 93 out of 190 economies), particularly due to their cost. Obtaining permits in Mexico costs 10.9% of warehouse value, compared to 3.6% in LATAM and 1.5% in the OECD high income countries on average.

We believe that these challenges, as well as others which include security costs, and a relatively high cost of capital, explain why investment in Mexico remains relatively low, despite the opportunities presented by the country's location and strong established 'clusters' in some industries. The opportunities are there, but work needs to be done to fully take advantage of them.

Currently, Mexico's private generators account for around ⅓ of generation capacity in the country, and about 50% of renewable generation capacity (table 1, CFE accounts for about 50% of renewable generation capacity, but it's practically all in hydroelectric power). It was good news that President Lopez Obrador announced five solar energy projects in Sonora to try to attract manufacturing to the north-west of the country—one of the regions where manufacturing remains highly competitive. More steps in this direction are needed.

The reality is that these aggregate numbers can be deceiving in relation to a complex reality. Some states are booming, while others are lagging far behind. The reality is that in many sectors, returns are based on micro, not macro numbers, and the true picture of Mexico's competitiveness is very nuanced by region and sector. Some states in the country (charts 5 and 6): Mexico City and the Estado de Mexico as corporate headquarters, alongside the Bajio and the North of the country, capture the lion's share of FDI. The North and the Bajio benefit from their proximity to the US market, as well as a long-standing manufacturing platform that has benefited from the creation of clusters, and in some cases even public-private partnerships that supply skilled labour, and logistical infrastructure. These clusters are well documented: aerospace in the Bajio region, automotive in the Bajio & North of the country, tech in the Bajio region, and medical devices in the North.

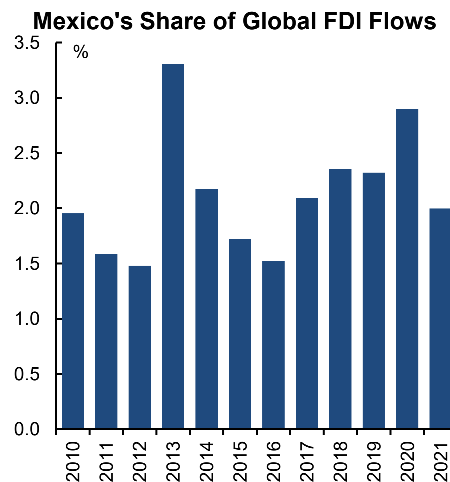
The Mexican Institute of Competitiveness (IMCO) compiles a state level index that measures a number of variables across states (Indice de Competitividad Estatal). This index looks at how states stack up across a number of metrics, including rule of law, access to labour, access to financial services, global connection infrastructure, innovation, etc. Not surprisingly, a number of the sub-indices correlate well with FDI receipts by state, with factors such as access to labour, innovation (correlated with quality of labour), and global connection infrastructure having a high correlation with each state's participation in FDI flows. **Our take is that even without improvements at country level policy, some regions and industries will continue to boom. The key question is whether this can turn into a macro level boom.**

Table 1: Mexico—Generation Mix by Operator and Energy Type (MW)

(%)	CFE	CFE-Private	Private	Pemex	Total
Hydro	13.8		0.6		**14.4**
Geothermal	1.1		0.0		**1.1**
Wind	0.1	0.7	7.3		**8.1**
Solar	0.0		6.9		**6.9**
Biomass			0.5		**0.5**
Nuclear	1.8				**1.8**
Efficient cogeneration			2.0	0.4	**2.4**
Regenerative braking					**0.0**
Combined cycle	12.5	18.3	9.1		**39.9**
Conventional thermal	11.9		1.1	0.5	**13.5**
Turbogas	3.3		0.9	0.1	**4.3**
Internal combustion	0.4		0.7		**1.1**
Coal	6.2				6.2
Total	**51.0**	**19.0**	**29.0**	**1.0**	**100.0**

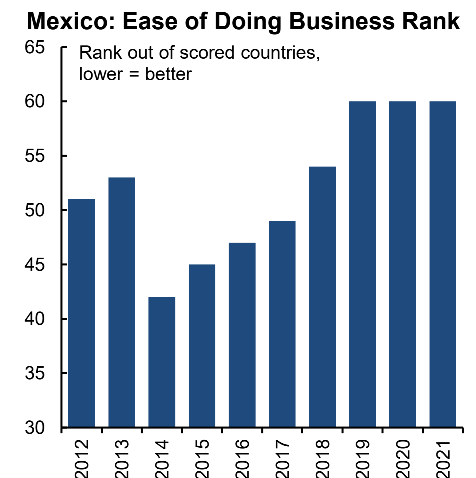
Sources: Scotiabank Economics, SENER.

Chart 3



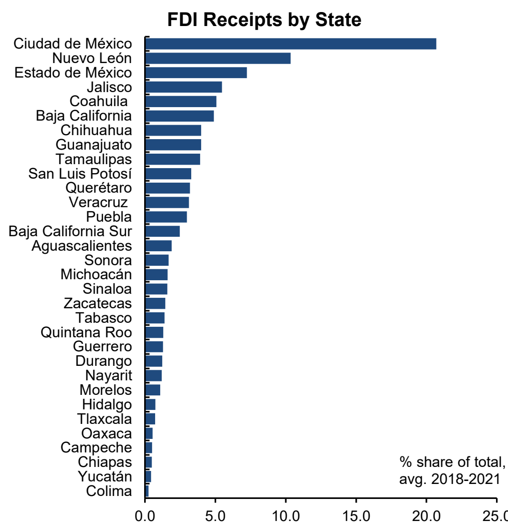
Sources: Scotiabank Economics, UNCTAD.

Chart 4



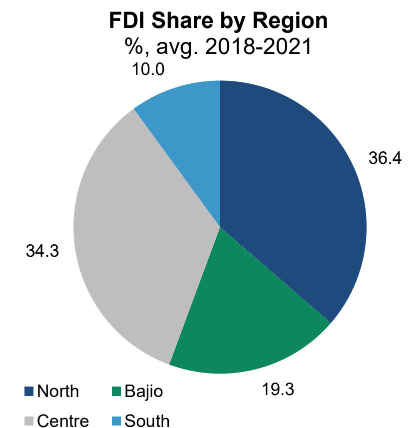
Sources: Scotiabank Economics, World Bank.

Chart 5



Sources: Scotiabank Economics, Ministry of Economy.

Chart 6



Sources: Scotiabank Economics, Ministry of Economy.

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