Nearshoring: Buzzword or Business Opportunity?

China is the most significant great power challenger the United States has faced in decades, and its growing presence in the western hemisphere tests the resilience of global value chains (GVCs). Although the U.S. remains the largest trading partner for Latin America and the Caribbean (LAC), China is in second place[1] and enjoys a growing relationship with Mexico, the U.S.'s most important trade partner in goods.[2] Chinese exports to Mexico totaled $79.48 billion in the first eight months of 2022, a 28% increase from the year prior.[3] On a regional level, trade and investment ties with China are growing too, swelling 26-fold in the last two decades,[4] while 21 LAC countries have joined China's Belt & Road Initiative in recent years.[5] As China further ingratiates itself with U.S. allies in LAC, and as U.S.-China tensions heat up, can the region provide a secure commercial framework that guarantees American companies access to reliable supply chains?

Nearshoring could be an opportunity to for the United States to bolster supply chains while addressing China's growing commercial influence in the region. More specifically, Mexico, Central America, the Caribbean, and Colombia are cited as ideal destinations given their Free Trade Agreements with and geographic proximity to the United States. However, poor infrastructure, an inconsistent commitment to rules-based trade, insecurity, and weak regional integration present challenges for business considering expanding operations in the area. These challenges undermine the region's potential as a nearshoring hub, fuel the skepticism of businesses looking to reconfigure their GVCs, and dampen perceptions of LAC as a region where businesses can thrive and where robust supply chains can take root.

The following sections examine each of these challenges in turn and explore solutions that could better enable LAC to serve as a nearshoring destination.

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Addressing Key Challenges

Reliable Infrastructure

First, reliable infrastructure across various sectors – including water and sanitation, energy, transportation, and telecommunications – are a prerequisite for companies seeking to relocate operations. Yet infrastructure is neglected in LAC and requires estimated investments of more than 3% of GDP each year through 2030, or more than $600 billion in Central America and Mexico and $19.6 billion in the Caribbean.[6] Mexico, which is the focus of most nearshoring discussions, invests less than 1% of GDP in infrastructure development, as opposed to the 5% recommended by the Mexican Chamber of the Construction Industry (CMIC),[7] and the 8% the government has invested in East Asia and the Pacific.[8] This means that firms lack the basic infrastructure needed to “set up shop” and to integrate their operations into GVCs. Indeed, LAC’s domestic and international transport costs are higher than in other regions due largely to limited, poor quality, and inadequately managed infrastructure.[9]

Commitment to Rules-based Trade

The inconsistent commitment to rules-based trade exhibited by regional leaders presents additional challenges. Although nearshoring trends are most visible in Mexico, the protectionist impulses of President Andrés Manuel López Obrador (AMLO) are shaking up the political and regulatory environment. Taking the energy sector as an example, in recent years AMLO has implemented policies favoring state-owned energy company, Petroleos Mexicanos (Pemex), over private companies, and rolled back 2013 energy reforms that enabled private companies to enter the sector for the first time in decades.[10,11] U.S. business activity remains strong, in large part because the United States-Mexico-Canada Agreement (USMCA) incentivizes it. But AMLO’s apparent indifference for the agreement could damage perceptions of the country as a trusted business partner and could encourage similar behavior in other countries. Already, Colombian President Gustavo Petro has been advocating for the nationalization of strategic industries such as oil, gas, and mining,[12] setting a tone that makes firms wary.[13]

Safety and Security

Safety and security are also critical to creating a stable, predictable environment for business operations. Mexico recorded 3,717 truck hijackings during the first half of 2022, up roughly 5% from the first half of 2021.[14] Overall, violent crimes accounted for 87.2% of the cargo lost to theft in the first half of 2022,[15] up from 84.7% in 2021. Investors and firms looking for new places to operate need to feel that their assets and employees are safe. Otherwise, this added strain can be perceived as a “war tax” for companies and small business owners. Reducing the risk of potential disruptions like theft, violence, or natural disasters can help to minimize standard operation costs and increase the potential for long-term profitability.

Regional Integration

Finally, poor regional integration further undermines LAC’s potential as a hub for nearshoring. LAC trades less than other regions, coming in at 11 percentage points below the global average in terms of the importance of trade for its economies.[16] Despite trade initiatives like Mercosur and the Pacific Alliance, regional commercial ties remain weak, which represents a drag on growth and deprives countries of the socioeconomic benefits of operating as a robust, integrated market.[17] These weak regional ties are rooted, in large part, in weak trade and investment policies that have driven up trade costs in LAC as compared to other regions, a discrepancy that makes the region less desirable as a trading partner and has generated a significant, still-expanding competitiveness gap.[18]

A Path Forward

Despite all the buzz about nearshoring, a relocation of global value chains to LAC has yet to meaningfully materialize.[19] Mexico has seen the most nearshoring activity to date, likely because the accountability established by the USMCA keeps business activity strong despite AMLO's apparent apathy toward international commerce.[20] Yet, improvements across the aforementioned areas can help position the region as a nearshoring hub.

Nearshoring is neatly aligned with the most pressing of U.S. interests, including national security, competition with China, and the need to improve the resiliency and redundancy of supply chains. But it is clear that improvements to the region's infrastructure, a more consistent commitment to rules-based trade, improved public security, and stronger regional integration will be fundamental. Fostering nearshoring will require patience. To expediate this process, companies should consider encouraging LAC governments to implement reforms in the areas mentioned. Moreover, the U.S. government should also significantly increase its efforts to partner with LAC governments to implement the changes needed to help the region be more attractive for businesses and to transform nearshoring from a buzzword into a real commercial opportunity.

Endnotes

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