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Mexico operational risk review

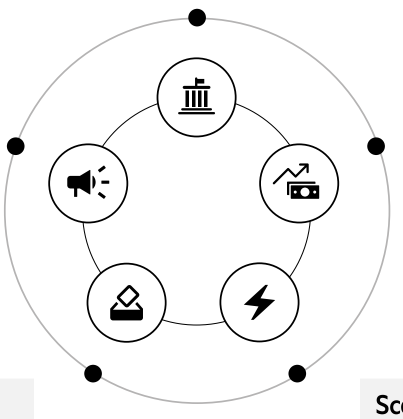
Five nearshoring risks in Mexico that businesses should be monitoring

Heightened geopolitical tensions have forced businesses operating in the US to rethink how they manage their supply chains and supplier relations. The pandemic expedited this trend, and plans to diversify trade and investment ties away from China through 'nearshoring' closer to US soil has highlighted Mexico as a potential alternative production hub.

There is scope for expansion, given the cheap cost of transport from Mexico into the US market. The 2020 US-Mexico-Canada Agreement trade deal, adds further impetus to nearshoring by raising regional content requirements from 62.5% to 75% in some sectors. However, the underlying operations in Mexico remain fairly difficult.

Using ratings and analysis found in our **Operational Risk** service, EIU has outlined five risk scenarios that US organisations should be watching in Mexico this year.

Scenario one: government introduces reforms that foster monopolistic practices



Scenario two: organised crime activity becomes costlier

Scenario three: energy dispute leads to trade row with the US

Scenario four: electoral reforms undermine the electoral system

Scenario five: perceived attacks on independent institutions increase anti-government protests

Risk intensity key

1-4	5-8	9-12	13-16	17-25

Risk score key

Probability: Very low (1) – Very high (5)
Impact: Very low (1) – Very high (5)
Intensity: Probability score x Impact score

Scenario one

The government introduces reforms that foster monopolistic practices in favour of state-owned companies, dealing a blow to private firms

25 **Probability:** High **Impact:** Very high

Limited competition in major sectors such as energy, telecommunications, transport and construction, has constrained market efficiency and competitiveness throughout most of Mexico's history. The administration of the previous president, Enrique Peña Nieto (2012-18), made some inroads in helping to improve the outlook for competition within the domestic market. However, the administration of current president, Andrés Manuel López Obrador, has taken a more nationalistic approach.

The government has suspended new oil auctions and favoured Pemex (the state oil and gas firm) over private companies to carry out investment projects. Businesses should monitor legislative proposals that seek to entrench monopolistic practices and create contingency plans should regulations change. Moreover, companies should consider engaging and managing relationships with policymakers to identify government priorities that affect market competition.

Scenario two

Organised crime activity becomes costlier for businesses to deal with

20 **Probability:** Very high **Impact:** High

Organised crime-related violence remains a major hindrance to the business environment. There are large variations in crime across Mexico's states, but estimates suggest that the total costs, including opportunity costs, amount to as much as 21% of GDP each year.

The government so far has not offered a comprehensive security strategy. The creation of a National Guard in 2019 was a promising step, but the force has been sidetracked in its mission by having to deploy some guardsmen to patrol the southern border in line with agreements with the US to reduce migration from Central America.

The influence of Mexico's organised crime groups is likely to remain significant, reinforcing the need for firms to ensure that they carry out thorough due diligence of

Mexican business partners. Companies should seek specific advice from experienced local private security firms to minimise security and operating risks, particularly if they are located in high-crime areas or along major drug-trafficking routes.

Scenario three

Energy policy dispute leads to trade and investment row with the US

16 **Probability:** High **Impact:** High

Mexico and the US are embroiled in a dispute over Mexico's controversial electricity reforms, which have led to the US asking for a consultation in the context of possible violations of the USMCA. The main point of contention is a series of amendments to Mexico's electricity law passed in 2021, which explicitly favour the Comisión Federal de Electricidad (the state-owned electricity company) for providing electricity at the expense of private firms, many of which are foreign-owned. If the consultation does not lead to a resolution, the row could escalate into a panel dispute, which, if the ruling favours the US, could lead to retaliatory or compensatory measures by the US.

Although the dispute is not likely to undermine the two countries' economic relationship, it could lead to Mexico becoming less attractive to investors and possibly have knock-on effects outside the energy sector. This scenario may in turn undermine some of the potential advantages that the country has with respect to nearshoring, as US companies may prefer to relocate elsewhere.

Scenario four

Electoral reforms proposed by the president pass, undermining the electoral system and institutional quality

12 **Probability:** Moderate **Impact:** High

In April 2022 the president proposed a series of measures to reform Mexico's electoral system. The measures aim to replace the National Electoral Institute with an electoral body whose members will be elected by voters rather than selected on the basis of experience and merit. Mr López Obrador also seeks to reduce the number of legislators in the Chamber of Deputies (the lower house) from 500 to 300 and the number of senators in the Senate (the upper house) from 128 to 96, eliminating proportional representation seats.

If the reforms were to pass (not our core forecast), Morena's position in Congress is likely to strengthen while making it difficult for smaller parties to have representation in the legislature. Businesses should monitor the status of the proposed reforms closely and prepare for a deterioration of institutional quality should the reforms pass.

Scenario five

Perceived attacks on independent institutions increase anti-government protests, severely disrupting business

12 **Probability:** Moderate **Impact:** High

The López Obrador administration has implemented a number of controversial decisions that appear aimed at restricting the independence of entities and sectors such as academia, the media and, most recently, the National Electoral Institute (INE).

There is a risk that bolder decisions in this vein during the last couple of years of Mr Lopez Obrador's presidency will prompt widespread protests, resulting in the disruption of business activities and property damage. Businesses should closely monitor proposals announced by the government to undertake reforms that focus on independent bodies, as well as responses from opposition groups, to implement mitigating strategies in a timely fashion.