China Economic Update March 2024

Reports of US supply chain realignment from China to Mexico are overblown

NAB Group Economics

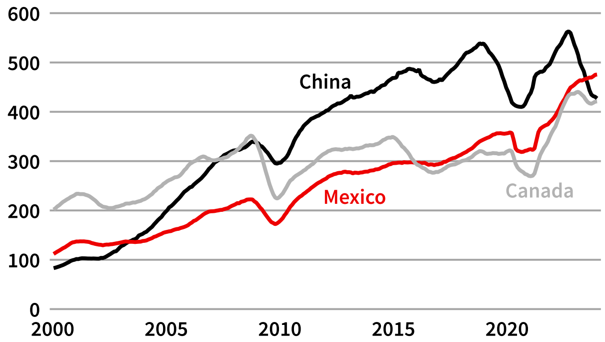
US trade data generated a lot of headlines in early February, with the Census Bureau reporting that Mexico overtook China to be the leading source of imports in 2023. In taking these data at face value, many commentators implied this this result pointed to a substantial shift in US supply chains away from China. However, we argue that this is unlikely to be the case, and that absent from major trade policy measures, any major realignment will be a slow process.

Are US consumers swapping China for Mexico?

China's rapid industrialisation and accession to the World Trade Organization led to a surge in exports from the early 2000s onwards, including to the United States. On a twelve-month rolling sum basis, US dollar imports from China reached similar levels to Canada by early 2007, before becoming the clear number one source in early 2009. While the value of US imports from China declined sharply in the wake of the US-China trade war, this trend reversed during the COVID-19 pandemic, as demand for key goods such as electronics, furniture and medical supplies surged.

US imports by country

Mexico overtook China to be the largest source of US imports in mid-23

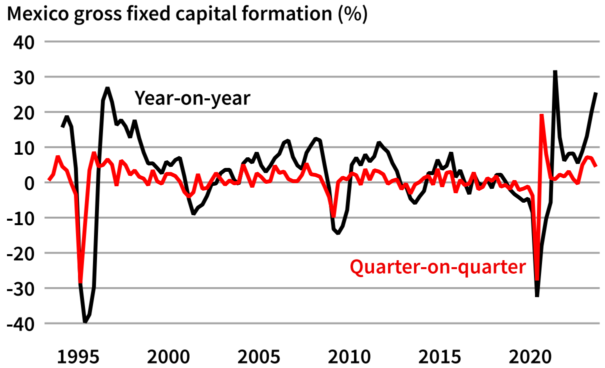


However, this trend couldn't last. The rolling sum of imports peaked in September 2022 at US$563 billion and has subsequently declined – down to US$427 billion in December 2023. A range of factors contributed to this trend, including the shift in consumption patterns away from goods and towards services (as consumption normalised following the pandemic) as well as the impact of tighter monetary policy impacting demand in the US.

It is also worth noting that the majority of tariffs imposed by the Trump Administration remain in place, impacting the competitiveness of Chinese products in the US market when compared with other manufacturers. China's share of total US imports fell below 14% in 2023, compared with a peak of almost 22% in the twelve months to March 2018.

Investment in Mexico

Sizeable ramp up in Mexican capital formation since COVID-19 pandemic



The decline in imports from China coincided with a comparatively modest increase in the value of imports from Mexico, with the twelve-month rolling sum totalling US$476 billion in December 2023, with Mexico's imports exceeding China's from July 2023 onwards. This shift was attributed by some observers to the growth in Mexico's manufacturing capacity, along with a realignment of global supply chains – particularly the near-shoring (with multinationals bringing production closer to its point of consumption) and friend-shoring (moving production to countries with a closer political or diplomatic relationship). While a degree of the shifting import patterns may be explained by this trend, we would argue that this is likely to be a bit simplistic – in part because

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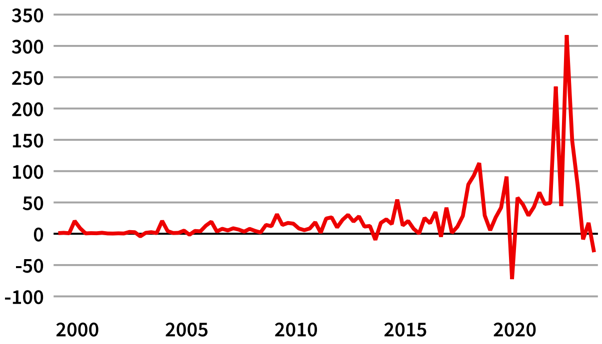
Data sources: Macrobond, NAB Economics

major shifts in supply chains tend to occur over decades rather than years.

It is worth noting that there has been a sizeable increase in investment in Mexico's manufacturing sector, particularly from 2021 onwards. That said, a key contributor to this investment has been China – with foreign direct investment into Mexico surging across 2021 and 2022 (albeit official Mexican data shows a pull back in the first three quarters of 2023). There has also been significant Chinese investment in other Latin American countries.

Foreign investment in Mexico

China's foreign direct investment has supported manufacturing growth



Considering supply chains using national trade data is also simplistic. Frequently there are sizeable discrepancies between what individual countries report for their bilateral trade data for a broad range of reasons, including freight and insurance costs and goods being transited via ports in third countries (with inconsistent treatment by statistical agencies in different countries).

The latter may be a factor in this case – China's exports to Mexico rose substantially in recent years – with exports in 2023 around 82% higher than 2020 levels (compared with a 31% increase for the rest of the world). This could include semi-finished manufactured items or components for final assembly – where the majority of value-added in the production process remains in China.

It is important to note that US regulations do not exempt trans-shipments (goods shipped from China through Mexico without any additional manufacturing) from existing tariffs. Goods with Mexican processing fit under the commitments of the United States-Mexico-Canada Agreement (the successor to NAFTA).

There may be many benefits for Chinese firms to realign exports ultimately destined for the United States via Mexico – including tax incentives to expand Mexican manufacturing capacity as well as the potential to bypass the Trump era tariffs by completing some manufacturing processes in Mexico. In addition, Chinese manufacturers may be able to route goods to the US through other countries as well.

It is also worth noting that the data suggesting that Mexico has overtaken China may not be accurate, due to the exclusion of lower value imports. Census Bureau data excludes imports below a threshold. This means that sales from fast fashion firms like Shein, low-cost marketplace Temu or even goods from Amazon that are drop-ship items made in China, the majority of which are believed to fall below the threshold, are likely excluded from the trade data.

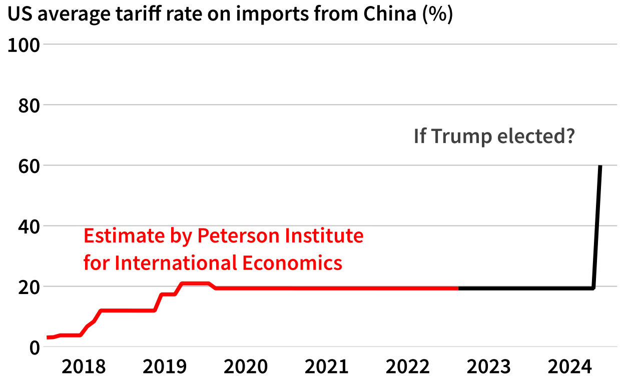
Conclusions

The vulnerability of global supply chains that were exposed by the COVID-19 pandemic, along with the fallout from the earlier US-China trade war and the restrictions on high technology computer chips imposed by the Biden Administration mean that the likelihood of significant changes to these supply chains over coming decades is relatively high – with Mexico an economy with potential to benefit from its close proximity to the United States – however we believe the recent reporting of a substantial shift in US trade away from China and towards Mexico is overblown.

The upcoming US Presidential election in November 2024 could have a significant impact on supply chains. During the current campaign, former US President Donald Trump, the presumptive Republican nominee, has proposed a flat 60% tariff on all Chinese imports. While such a policy would have a negative impact on US consumers, it would also be a major negative for China's manufacturers, driving a more rapid shift in the shape of global trade.

US trade policy

A second Trump presidency could accelerate supply chain realignment



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