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Nearshoring and Potential Trade Triangulation

The proliferation of more restrictive tariff policies along with emerging geopolitical events is producing a reconfiguration of global supply chains with the relocation of plants and investments to countries with geographical advantages and more market-friendly environments. This relocation process, called nearshoring or friendshoring, is happening already in North America and is greatly benefiting the area thanks to the advantages provided by the trilateral trade agreement among the U.S., Mexico and Canada. Mexico is becoming the main destination of nearshoring in North America.

Nearshoring is certainly producing benefits, but it is also generating inconveniences, as it attracts producers from other regions to Mexico with the purpose of accessing the U.S. market—particularly Asian producers subject to higher U.S. tariffs and restrictions. This is triggering concerns in the U.S. about the possibility of triangulation of China's imports to the U.S. via Mexico. By analyzing data on the volume of Mexico's imports from China and Mexico's exports of manufacturing products to the U.S., we can gain some insight about this potential trade triangulation. Our examination does not rule out the possibility that some products exported to the U.S. from Mexico are being generated outside Mexico.

Nearshoring and Potential Trade Triangulation

BY ALFREDO COUTINO

The proliferation of more restrictive tariff policies along with emerging geopolitical events is producing a reconfiguration of global supply chains with the relocation of plants and investments to countries with geographical advantages and more market-friendly environments. This relocation process, called nearshoring or friendshoring, is happening already in North America and is greatly benefiting the area thanks to the advantages provided by the trilateral trade agreement among the U.S., Mexico and Canada. Mexico is becoming the main destination of nearshoring in North America.

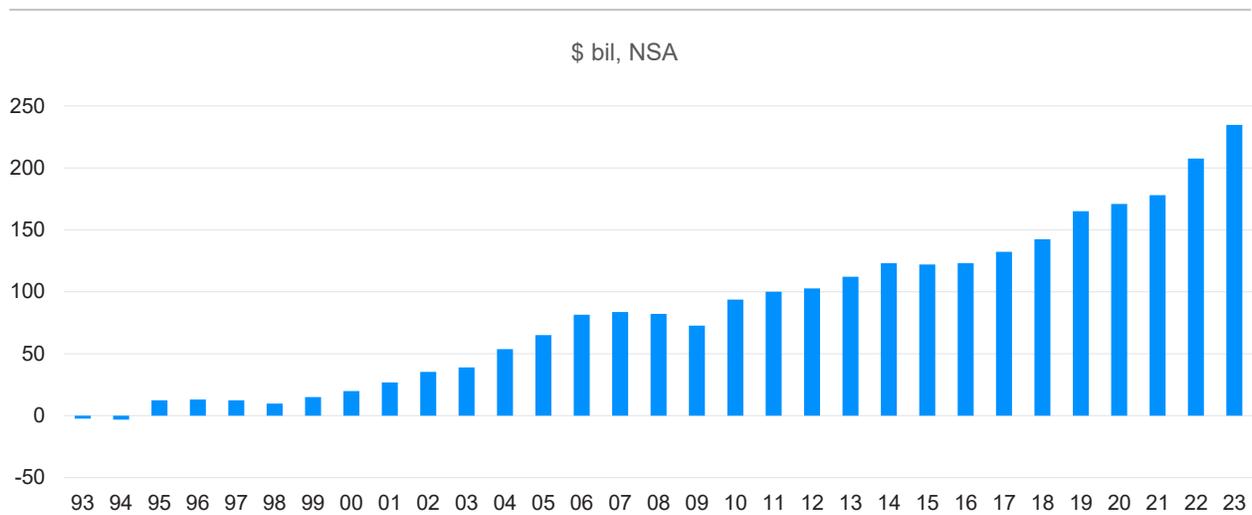
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Overview

Mexico has strengthened its trade and investment links with the U.S. thanks to the privileged status granted by the North American Free Trade Agreement since 1994. More recently, the country has been benefiting not only as a result of the U.S. tariff policy implemented against China but also because of the ongoing relocation of global supply chains, a phenomenon fueled by the pandemic and geopolitical events. Mexico recently displaced China as the main trade provider to the U.S. market. However, Mexico has not been exempted from trade frictions, as lately the U.S. does not perceive Mexico's friendly neighbor status as strong.

In the three-decade life of the trilateral trade agreement that involves Mexico, the U.S. and Canada, the value of Mexican exports has increased by more than tenfold, and Mexico's trade balance with the U.S. has improved significantly, from a deficit of \$2.4 billion in 1993 to a stratospheric surplus of \$234.7 billion in 2023. U.S. direct investment pouring into Mexico has multiplied from \$3.5 billion in 1993 to \$20 billion in 2023; this is not only in terms of new investments but also reinvestments, an indication of the degree of U.S. corporations' confidence in Mexico (see Chart 1).

Chart 1: Mexico Trade Balance With the U.S.



Sources: Central Bank of Mexico, Moody's Analytics

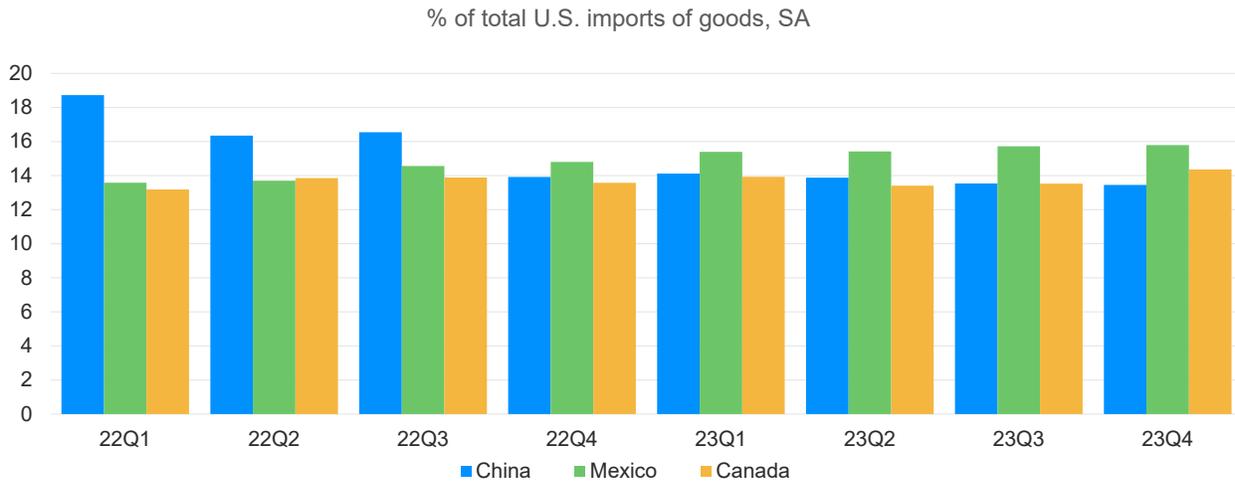
However, with the arrival of U.S. President Donald Trump to office in 2017 and as a result of his policy of bringing jobs back to the U.S., the trilateral trade agreement faced headwinds, and China's exports to the U.S. were penalized with higher tariffs. Fortunately, the trilateral agreement was renegotiated, and the United States-Mexico-Canada Agreement entered into force in mid-2020. Mexico's trade with the U.S. did not suffer during the negotiation period as the country's surplus with its northern neighbor continued to swell. Since 2021, trade tariffs on China have been ratified and extended under U.S. President Joe Biden. As a result, China lost its status as the main trade partner for goods to the U.S. market. The proportion of Chinese imports to the U.S. fell significantly in the past two years from almost 19% at the start of 2022 to only 13.5% at the end of 2023.¹ Meanwhile, U.S. imports from Mexico gained space and increased to around 16% at the end of 2023 from 13.5% at the start of 2022, making Mexico the main provider of products to the U.S. market and pushing China to second place at the end of 2022. Canada then pushed China to third place in the last quarter of 2023 (see Chart 2).

Mexico has become a net beneficiary of the U.S. tariff policy toward China, as indicated by its market gain in the past few years. It also benefited from the prolonged disruption in supply chains caused by the pandemic response, which forced U.S. companies to find closer and more reliable providers. Mexico, being part of the three-decade-long trilateral trade agreement, fully qualified to benefit from the relocation of some U.S. plants and investments. Also, given Mexico's geographical closeness to the largest market in the world, the country also attracted plants and investments from China and other Asian countries. As a result, foreign direct investment into Mexico accelerated after the pandemic, and prospects continue to improve as other corporations express interest in investing in Mexico.

Nearshoring is also introducing some inconveniences to U.S.-Mexico trade relations. Some Asian companies are interested in moving to or expanding their production plants in Mexico to take advantage of the USMCA trilateral trade agreement by complying with the agreement's regional content requirements and consequently accessing the U.S. market under preferential tariffs. Bilateral trade frictions have always existed,

¹ Bureau of Economic Analysis. "U.S. International Trade in Goods"

Chart 2: U.S. Main Import Providers



Sources: Bureau of Economic Analysis, Moody's Analytics

but they have increased in the past few years mainly as a result of measures taken by Mexico's government to limit private competition in key sectors of the economy such as oil and electricity, which adversely affect some U.S. firms and Canadian investors. These issues could limit the benefits of nearshoring in the longer term.

Meanwhile, nearshoring is a reality for Mexico; however, to take full advantage of this process, Mexico must improve the business climate and provide the infrastructure required by global players.

Nearshoring: The positives and negatives

Benefits

Nearshoring can be defined as the process of relocating production plants and investments from one country or region to another one closer to an important market with the purposes of ensuring the supply of inputs and products and reducing production costs. Nearshoring is usually accompanied by friendshoring, a relocation process that includes the selection of a place that provides a friendly environment for doing business and a political democracy that respects property rights.

The arrival of investments and plants to Mexico is essentially a nearshoring process triggered by three factors. First, the proliferation of protectionist policies has sought to shield local producers from unfair trade practices through the imposition of import tariffs. Second, the disruption in supply chains introduced by the COVID-19 pandemic contributed to an extended paralysis in production and distribution processes given the shutdown of international borders and transportation. Third, geopolitical events (including the Russia-Ukraine war and China-Taiwan frictions) added disruptions in the supply and distribution of commodities and manufacturing inputs. Production and consumption markets were forced to seek closer providers to reduce the risk of logistics disruption.

The benefits of nearshoring are diverse for both the promoter and the receiver of the relocation. It strengthens the trade partnership and integration of supply chains, increases the flow of investment and trade, stimulates

the transfer of technology and consequently productivity, and promotes economic growth and labor. In the case of U.S.-Mexico nearshoring, both countries greatly benefit. U.S. corporations relocate to Mexico production plants that have operated overseas and mainly in China to ensure the supply of inputs from a very close partner just across the border, improving logistics and reducing costs. On the other side, Mexico receives increasing flows of direct investments, new technology, the possibility to create more and better-paid employment, and increased trade with its main trading partner and the largest market in the world.

In 2023 the flow of foreign direct investment into Mexico increased about 30% from the year before, discounting the merger and acquisition of two corporations operating in Mexico. Certainly, the U.S. is the largest contributor of FDI to Mexico. This was particularly the case in 2023, when the U.S. represented around 45% of Mexico's total FDI. Looking at the amount of FDI in 2023, one cannot find direct evidence of the contribution provided by nearshoring in terms of new investments coming from abroad. This is because an important part of the FDI associated with nearshoring is recorded as reinvestments made by foreign corporations already operating in Mexico, which implies that those firms are using profits to expand their plants and capacity in the country. Thus, while reinvestments represented only 40% of total FDI in 2021, they increased their participation to 74% in 2023.

A number of announcements by foreign companies regarding their plans to invest in Mexico confirm the reality of this nearshoring trend. Mexico's Ministry of Finance estimates that such announcements accounted for around \$74 billion of FDI through October 2023,² including investments in energy, railroads, and transportation and communication. An update from announcements made through the first three months of 2024 accounts for another \$31.5 billion.³ The automotive sector is a key player in expressions of interest to expand in Mexico by companies such as Tesla, BMW, Ford and GM along with Asian manufacturers including BYD and KIA.

The main trade-off for Mexico is that it must commit to creating and improving the infrastructure required by these global players to ensure that the nearshoring and its benefits materialize. Improved roads, ports, airports, and expanded basic infrastructure for water and electricity (particularly from renewable energy) are needed as well as improved and expedited business processes.

Inconveniences

While Mexico reaps many benefits from nearshoring, the U.S. also sees gains mainly in terms of ensured supplies of inputs and products from its next-door neighbor at cheaper costs of production and transportation. However, nearshoring is also attracting the relocation of non-U.S. plants and investments to Mexico, particularly from countries facing nonpreferential treatment by the U.S. China and some other Asian countries that face tariff restrictions from the U.S. view relocation to Mexico as a way to access the U.S. market under the preferential treatment granted by the USMCA. This could be possible if a Chinese manufacturer relocates or opens a production plant in Mexican territory and complies with the established regional content requirements, known as the rule of origin or ROO, in the trilateral agreement.

Asian automakers already exist in Mexico. However, the U.S. trade policy on tariffs for Chinese products seems to be a factor accelerating the relocation of Chinese manufacturers to Mexico. An example of this is China's BYD, which began selling electric cars in Mexico in 2023 and announced intentions to build a manu-

² Secretaría de Hacienda y Crédito Público "[Comunicado No.68](#)"

³ Secretaría de Economía "[Comunicado de Prensa](#)", 15 de Marzo, 2024.

facturing plant there, even though BYD has said it will focus only on the domestic market.⁴ Mexican media also has reported about Tesla's intentions to open a plant in the northern state of Nuevo Leon, with an estimated investment of \$10 billion, and KIA's expansion, which will account for \$6 billion. Whether these plants materialize or not, they are already being taken into account by Mexican authorities, particularly the Ministry of Economics.

Meanwhile, on the U.S. side, there is increased demand to enforce the trade policy to protect domestic producers and to investigate potential unfair trade practices in the auto and steel industries involving Mexico. Regarding China's threat to America's auto industry via Mexico,⁵ the most recent example is the Alliance for American Manufacturing raising the alarm over China's plant expansions in Mexico and their access to the U.S. market by taking advantage of more favorable tariffs under the USMCA. A second example is the U.S. claim about a potential triangulation of steel and aluminum products via Mexico.⁶

Suspensions are increasing about Mexico being used as a back door to redirect Chinese imports into the U.S. A recent press release from Xeneta, a platform specializing in ocean freight rate benchmarking and market intelligence, reported a "massive increase in container shipping imports from China into Mexico,"⁷ raising suspicion that some of those Chinese imports could end up in the U.S. as importers try to avoid U.S. tariffs.

Searching for signs of triangulation

Mexico's imports from China have maintained a relatively stable proportion of around 19% of the total in the past four years, though they doubled from \$5.5 billion in 2016 to \$10 billion in 2023. The expansion began in 2021, when imports from China grew 37%. Growth moderated to 17% in 2022 and contracted 4% in 2023. In terms of current-dollar value, the data do not show evidence of a steady Chinese import penetration in Mexico. There is a counterargument, however, that the data reflect the influence of prices. For example, if import prices declined significantly, then the volume of Chinese imports could have increased. The number of containers arriving in Mexico from China is an additional piece of information that supports the argument of a massive arrival of Chinese imports into Mexico. According to Xeneta's report, the number of containers expanded at an annual rate of 60% in January 2024, growing from 73,000 units to 117,000 units. Certainly, there has been a significant expansion in the past two years, with the number of containers increasing 3.5% in 2022 and 35% in 2023. Therefore, the analysis must focus on volume of trade, which is defined as trade in constant prices, rather than on current-dollar value.

As a first attempt to search for more solid evidence, we perform a two-step data analysis about the volume of imports from China to Mexico and the volume of Mexico's exports of manufacturing products to the U.S. This analysis will help us to gain some insights about the possibility of a triangulation of Chinese imports into the U.S. that are wrapped as Mexican exports. The first step will allow us to determine if there are signs of a Chinese import penetration to Mexico in the past few years, and the second will help us to see the degree of correlation between the volume of Mexico's manufacturing exports to the U.S. and the country's manufacturing capacity and employment. If the volume of Mexico's manufacturing exports has expanded in an environment of unchanged capacity utilization and employment, that would be an indication that the extra volume exported comes from somewhere else. One source may be an improvement in productivity,

4 Yahoo Finance, "[BYD not planning to come to the U.S.](#)", February 27, 2024.

5 American Manufacturing Org. [On a Collision Course](#).

6 USTR, [Press Release](#), September 29, 2023.

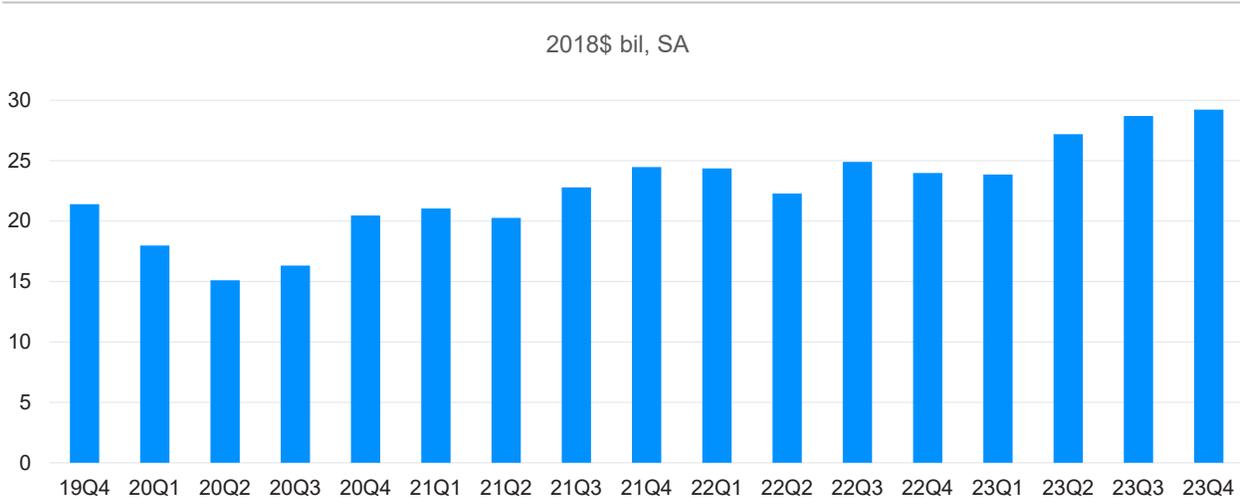
7 Xeneta, [Press Release](#), March 15, 2024.

in this case defined as the increase in output using the same number of inputs. If that is the case, then data should not show a decrease in employment. In other words, if employment has decreased and the use of capacity remains the same, then someone is producing the extra volume exported to the U.S. The same applies to the case of capacity utilization.

Has the volume of Chinese imports to Mexico expanded?

After plunging in the first half of 2020 because of the disruptions after the COVID-19 outbreak, the volume of total imports from China recovered to the pre-pandemic level by the third quarter of 2021 and remained relatively stable in 2022. Since then, import volume from China has expanded. It grew 22% in the second quarter of 2023 and averaged around 20% annual growth for the last three quarters of the year. For all of 2023, volume surged 14% over the 2022 level (see Chart 3), while the value of imports contracted 4%. A trend of increased Chinese imports appears to be extending into 2024 as indicated by the significant increase in the number of containers reported by Xeneta, and because the value of imports from China expanded 12% annually in January amid a 1% decrease in the total value of Mexico's imports. It is important to remark that most of Mexico's imports from China are nonoil products, with manufacturing imports being an important contributor.

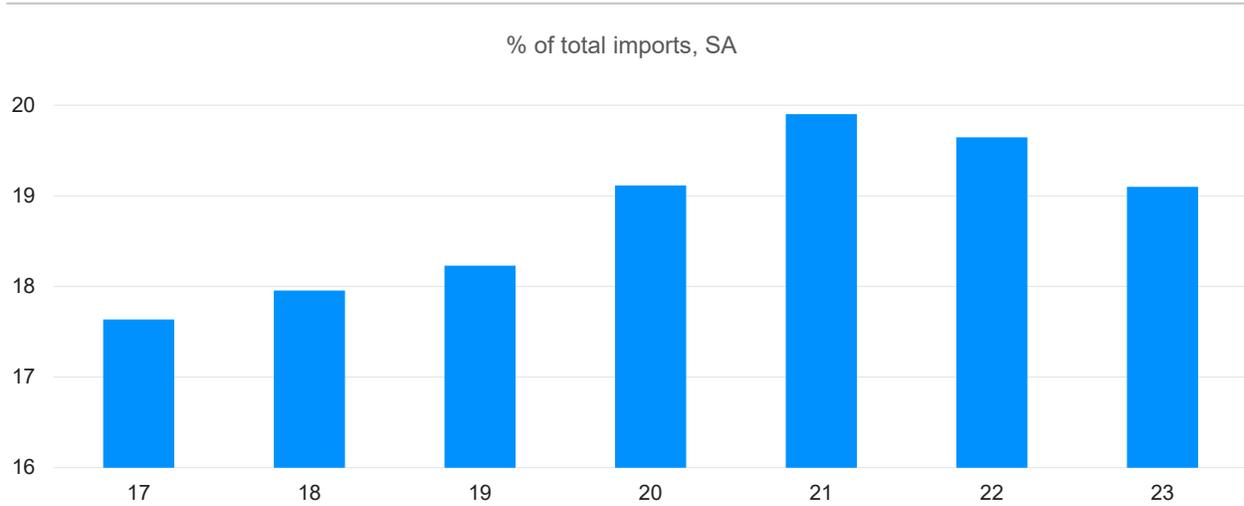
Chart 3: Mexico's Volume of Imports From China



Sources: Central Bank of Mexico, Moody's Analytics

So far, the data show evidence that the volume of imports from China expanded in 2023, even though the value decreased as mentioned before. One explanation lies in the decrease of import prices resulting from the strength of the Mexican peso during the year. In this case, Mexico bought cheaper products from China thanks to the strong peso. Another potential explanation could be that China sold its products at discounted prices to Mexico. In this case, China wanted to gain a market in Mexico. The main conclusion here is that the volume of imports from China has certainly expanded and increased its participation in Mexico's total imports by 1.5 percentage points from 2017 when U.S. President Trump took office. This could be explained as a deliberate Chinese policy to diversify its trade markets given the U.S. restrictions imposed on imports from China (see Chart 4).

Chart 4: Mexico's Volume of Imports From China



Sources: Central Bank of Mexico, Moody's Analytics

Has the volume of Mexico's manufacturing exports to the U.S. expanded?

The U.S. is the main market for Mexican exports with the neighboring country a destination for more than 80% of Mexico's total sales abroad. Manufacturing exports represent almost 90% of Mexico's total exports, and manufacturing exports to the U.S. market represent 75% of total exports. This makes manufacturing exports the main channel for Mexico to increase its export penetration in the U.S. Thus, our focus is to see if data indicate a gain in market participation for Mexico's manufacturing exports to the U.S. In the past two years, Mexico's manufacturing exports gained 1.1 percentage points as a proportion of total exports, and manufacturing exports to the U.S. gained 1.7 percentage points in the total. This is an indication that Mexico has exported more volume of manufacturing products to the U.S. in the past two years (see Chart 5).

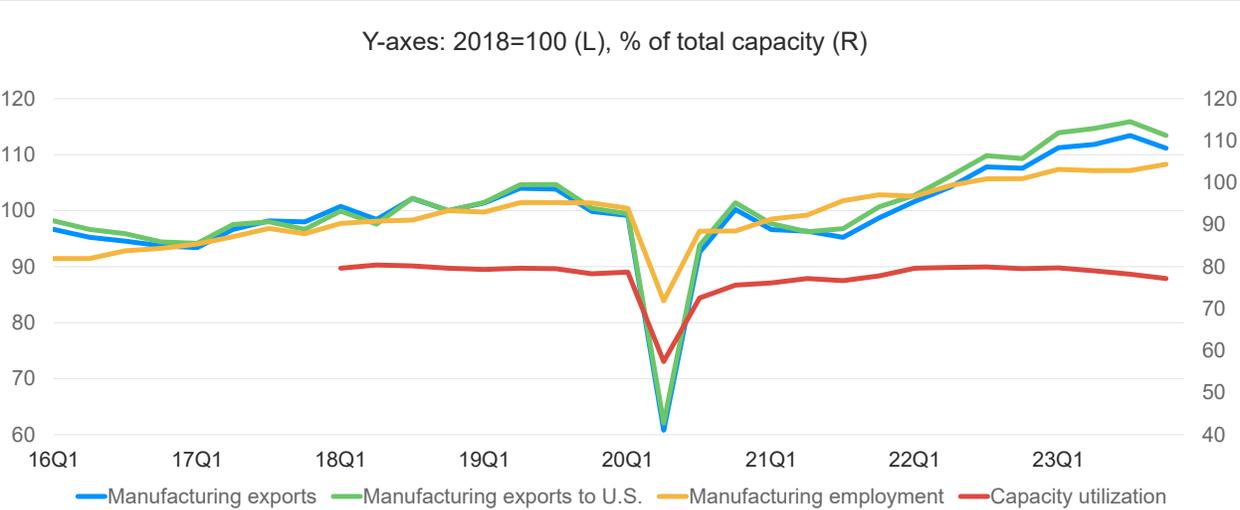
Chart 5: Mexico's Volume of Exports of Goods



Sources: Central Bank of Mexico, Moody's Analytics

If that extra volume of manufacturing exports is explained by more employment and increased capacity utilization, then there is no doubt that Mexico has increased its domestic capacity to produce more exports. By including employment in manufacturing production in the analysis, we see that jobs increased 2.4% from the end of 2022 to the end of 2023. Thus, the industry has certainly occupied more workers in the past year, which in principle could explain the increase in production and consequently in the volume of products exported. Moreover, capacity utilization by manufacturers decreased 3% in the same period. This raises two questions: Why are more workers now using less capacity? And, in the absence of an increase in productivity, would not more workers use more capacity instead of less (see Chart 6)?

Chart 6: Exports, Employment and Capacity Utilization



Sources: INEGI, Central Bank of Mexico, Moody's Analytics

The insights gained only leave the door open to the possibility that the increase in the volume of manufacturing production, without utilizing more capacity, could be partly explained by products generated outside of Mexico.

About the Author

Alfredo Coutino is a director at Moody's Analytics. Dr. Coutino is responsible for analysis, modeling and forecasting for Latin America. Based in the King of Prussia PA office, he is in charge of real-time coverage of Latin America for Economic View. He is a regular presenter at our annual Macroeconomic Outlook Conference. He has been a speaker at United Nations conferences and at the American Economic Association and has published papers on applied econometrics with Nobel laureate Lawrence Klein. Dr. Coutino received his PhD in economics from the University of Madrid after completing doctoral studies at Temple University.

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