US TRADE TENSIONS IMPACT ON MEXICO

WORKING PAPER

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US | TRADE TENSIONS

CHINA | IMPACT ON MEXICO

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INTRODUCTION

The Mexican economy is immersed in an increasingly complex context. The world leading economies have a tendency to slowdown, and there are no effective instruments to deal with the issue. In addition, there is a weakened commitment regarding trade openness, due to an increasingly tense environment.

This document on the impact of the commercial disagreement between the United States and China shows a concrete example of the opportunities for a competitive Mexico.

The government of President Andrés Manuel López Obrador must prepare for a more volatile environment. Yet, the strategy should not be only defensive, the opportunity should be taken to launch a competitive offensive that allows the country to grow and to gain market share.

This document illustrates an opportunity that can only be seized by Mexico: replace China in the United States and the United States in China.
TRADE TENSIONS BETWEEN CHINA AND THE UNITED STATES: IMPACT ON MEXICO

An opportunity for Mexico to reassert its position as a credible competitor in both leading economies

For the mid- or long-term, no country in the world—and much less Mexico—benefits from a strained environment in which there is no adherence to international trade rules. However, for the short-term, a strained trade environment produces adjustments to the supply chains, which could benefit competitors of those economies that are currently in conflict. Mexico, the second supplier of the United States only behind China, could reassert its position as a credible competitor of the Asian economy in the US. Likewise, in the context of trade friction, or even just the threat of a conflict, Mexico could strengthen its trade positioning in China by replacing part of the US offering.
The trade policy in the United States: Mexico and China on opposite poles

China was the United States' main trade partner in 2018, accounting for 15.7 percent of the total US trade. It is the top supplier of the US economy, with a 21.1 percent share of all US imports, up from a share of less than 3 percent 30 years ago. However, China buys only 7 percent of that country's exports. This difference resulted in a trade deficit of close to 415 billion dollars in 2018.

During the first quarter of 2019, Mexico surpassed Canada and China to become the top trade partner of the US, with 15 percent of the total US trade. China's share was down to 13.1 percent during the same period in 2019. The US allocated 6.4 percent of its exports to China during the first quarter of 2019, a number that is 1.6 percentage points below the same period in 2018.

In terms of imports, during the first quarter of 2019, 17.7 percent of US imports came from China, down from the 20.5 percent registered in 2018. The 2.8 percentage point's variation in the demand for US imports equals 16.76 billion dollars, which is more than the total exports from Vietnam, the seventh largest US supplier, during the first quarter of 2019. Mexico grew its share as a US supplier, reaffirming its position as the second largest supplier worldwide, with a 14.5 percent share of the total US imports.
In 2017, the US purchased 19 percent of the Chinese worldwide exports, making it its top market. During that same year, the US was the fourth supplier in China, accounting for 8.4 percent of its imports.

In terms of exports from the US, Canada is its top market in the world (17.7 percent), Mexico the second (15.7), and China holds the third place. China's export market share was down from 8.4 in 2017 to 7.2 percent in 2018. During the first three months of 2019, its share dropped to 6.4 percent. Losing 2 percentage points of the total US exports in two years comes to 8.2 billion dollars, similar to the total US exports to Hong Kong during the first quarter of 2019.
Its relationship with its top three trade partners has become a recurring electoral issue in the US. Once in office, Donald Trump’s administration opted for renegotiating the North American Free Trade Agreement (NAFTA). The renegotiation implied subscribing the USMCA (United States-Mexico-Canada Agreement), which is still pending approval. All parties involved should view this Agreement as a platform to not only increase trade in North America but also to enable all three economies to be successful in Asia, particularly in China.

China-US trade frictions originated in a political aversion to trade deficit and in the perception of antitrust practices and violations to industrial property. The United States has employed several measures to counter Chinese practices that are viewed as harmful: multiple antidumping notifications and the imposition of tariffs under sections 232 and 301 of its trade law. China has responded to these measures, which it considers arbitrary, by imposing retaliatory tariffs.
## Review of trade friction between the US and China

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<td>Tariffs imposed on steel and aluminum imports, from any country</td>
<td>Beginning of antidumping program for collecting sorghum imported from the US, valued at one billion dollars</td>
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<td><strong>May 25, 2018</strong></td>
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<td>Fine for 1.3 billion dollars imposed on ZTE, a Chinese telecommunications company</td>
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<td><strong>June 15, 2018</strong></td>
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<td><strong>May 10, 2019</strong></td>
<td><strong>June 1, 2019</strong></td>
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<td>Tariffs increased from 10 to 25 percent to Chinese products whose imports to the US were valued at 200 billion dollars in 2017</td>
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Review of meetings between the United State and China

Meetings

November 30 and December 1st, 2018
Meeting in Buenos Aires between presidents Donald Trump and Xi Jinping; agreement is reached to extend term to rise tariff from 10 to 25 percent

January 7-9, 2019
Meetings between Liu He, the Chinese Vice Minister, and US officials to address and ease frictions

February 14-15, 2019
Meetings between Xi Jinping, Liu He, Robert Lighthizer (USTR), and Steven Mnuchin (Treasury) in Beijing

February 21-24, 2019
Meetings between Liu He, Liao Min, Robert Lighthizer (USTR), and Steven Mnuchin (Treasury) in Washington; agreement is reached to not increase tariffs to 25 percent for 200 billion dollars in Chinese imports on March 1st

March 28-29, 2019
Meetings between Liu He, Robert Lightizer, and Steven Mnuchin in Beijing; meetings were “constructive” according to Mnuchin

April 3-5, 2019
Meetings between Liu He, Robert Lighthizer, and Steven Mnuchin in Washington; China recognizes consensus has been reached, but no agreement yet

May 5, 2019
Trump commits to imposing 25 percent tariffs on 325 billion dollars in Chinese imports that were not subject to tariffs and to increase from 10 to 25 percent the tariff on Chinese imports

Source: Drafted by author with data from Bloomberg and JP Morgan

The US has a trade deficit with the whole world, but more markedly with China. The deficit is concentrated in manufactures; it has a surplus in raw materials.

China is a manufacturing powerhouse and the US excels in raw materials and transport equipment

2018 bilateral trade balance (US-China) by group of products, in billions of dollars

Source: Drafted by author with data from USITC
**OPPORTUNITIES FOR MEXICO**

Regardless of the trade standoff, and whether it get worse or is resolved, Mexico needs to position itself as the export platform from North America to the world. Current frictions serve as an additional reason to do so, in three fronts: i) as a replacement for China in the US, ii) as a replacement for the US in China, and iii) as a transformer of Chinese inputs in Mexico.

1.1  *Mexico as a replacement of Chinese imports in the US*

The US has imposed tariffs for 265 billion dollars on 3,681 Chinese products. The main goods impacted include electrical machinery (77 percent) and non-electrical machinery (63 percent).

*China exports affected by tariffs*
By product category in billions of dollars

![Image showing China exports affected by tariffs]

*Source: Drafted by author with data from the UN Comtrade*

The set of products subject to tariffs of between 10 and 25 percent represent an opportunity for Mexico to export at the preferential zero percent tariff granted by either NAFTA or USMCA. Given the threat of potential trade tensions, the opportunity subsists even if the conflict were to be resolved.
To identify some of the product categories in which Mexico could be highly competitive, the following product parameters were considered:

i) China is either the first or second supplier for the US;

ii) Mexico is among the top 5 suppliers for the US; and

iii) US imports exceed 2 billion dollars.

From this analysis, we obtained a list of 48 products, which represent a total of 103 billion dollars:

**Competitive opportunity resulting from the Mexican conflict in the US market**
*By goods category, in billions of dollars*

<table>
<thead>
<tr>
<th>Category</th>
<th>Products</th>
</tr>
</thead>
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<tr>
<td>Electrical machinery</td>
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</tr>
<tr>
<td>Non-electrical machinery</td>
<td>17</td>
</tr>
<tr>
<td>Wood, paper, etc.</td>
<td>5</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>3</td>
</tr>
<tr>
<td>Manufactures, not elsewhere specified</td>
<td>3</td>
</tr>
<tr>
<td>Chemicals</td>
<td>2</td>
</tr>
<tr>
<td>Minerals and metals</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Drafted by author with data from UN Comtrade

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1 2017 UN Comtrade data. We employed 2017 data because that was the last tariff-free year for both countries, which serves as a point of reference to either compare against changes in the following years (at least 2018 and 2019) when the tariff was imposed or active.
Considering this, there are five products that offer the highest potential for Mexico. Aside from meeting with the above criteria, these Chinese products can be readily replaced with Mexican products. Mexico qualified as a substitute provider for these products when US imports from Mexico represent more than half, and less than 150 percent, of Chinese imports. Finally, only products for which US imports from Mexico exceeded one billion dollars in 2017 were considered.

Examples of products for which Mexico could replace China in the US

*In billions of dollars*

![Bar chart showing imports from rest of the world, China, and Mexico for various products.]

*Source: Drafted by author with data from UN Comtrade*

1.1.1 **Opportunities leveraged by Mexico in 2018**

US tariffs on China in 2018 granted Mexico new trade opportunities as a supplier of the largest economy in the world. Under these circumstances, certain Mexican export goods have already grown in detriment of Chinese products.
To show how these export opportunities have been capitalized, we analyzed US imports in those tariff lines for which the US imposed duties against China. For the 3,681 Chinese products on which a tariff was imposed, total US imports grew at an annual 9.1 percent rate in 2018. China increased its exports at a higher rate than the average global growth for these products, for a 9.8 percent increase in 2018. Mexico boosted its exports to the US for such products by 11.5 percent, which is 1.7 percentage points more than the growth of Chinese exports to the US market.

Out of the products with tariffs against China, Mexican exports of fish and fish products increased 41.1 percent, exceeding 15 billion dollars in 2018. Also relevant is the 18.7 percent increase in non-electrical machinery, with exports totaling more than 60 billion dollars.

**México grew 11.5 percent its exports to the US of taxed products, more than China and the rest of the world**

*Annual growth in exports in 2018, by product groups*

*Source: Drafted by author with data from the US ITC*
In order to limit the sample and focus the analysis on products in which Mexico significantly improved its position as a supplier to the US, the following criteria was considered:

i. China was among the top five suppliers in 2017;
ii. China’s market share was lower in 2018 than in 2017;
iii. Mexico’s market share was higher in 2018 than in 2017

Of the 3,681 products, 546 met with the parameters described above. For 168 of these products, Mexico’s gain in market share was higher than China’s loss. In 20 products, Mexico replaced China as the main supplier to the US economy. The following graph shows the eight most important products in terms of Mexican exports to the US in 2018, in which Mexico replaced China and became the supplier of choice.

**Capitalized opportunities, Mexico replaced China as the top supplier for the US in 20 of the Asian giant’s products on which a tariff was imposed**

*Market share of total US exports*

Source: Drafted by author with data from US ITC
Finally, we analyzed products that comply with the same parameters used in section 1.1 in order to verify the evolution of such products over the course of 2018. Eighteen product categories were identified in which Mexico increased its US market share, arranged according to the growth in market share for Mexico.

**Capitalized opportunities, main gains in market share for Mexico as a US supplier in significant products**

*Variation in market share for US imports in 2018 compared to 2017, in percentage points*

<table>
<thead>
<tr>
<th>Product Category</th>
<th>China's share difference</th>
<th>Mexico's share difference</th>
</tr>
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<tbody>
<tr>
<td>Certain iron or steel parts</td>
<td>-1.26</td>
<td>6.52</td>
</tr>
<tr>
<td>Time recording apparatus</td>
<td>-1.18</td>
<td>4.91</td>
</tr>
<tr>
<td>Brakes &amp; servo-brakes (auto parts)</td>
<td>-1.29</td>
<td>2.30</td>
</tr>
<tr>
<td>Automatic data processing machines</td>
<td>-1.55</td>
<td>1.71</td>
</tr>
<tr>
<td>Navigational instruments (aeronautical)</td>
<td>-3.19</td>
<td>1.42</td>
</tr>
<tr>
<td>Switches &lt; 1000V</td>
<td>-1.55</td>
<td>1.27</td>
</tr>
<tr>
<td>Electric motors &lt;37.5W</td>
<td>-0.22</td>
<td>1.22</td>
</tr>
<tr>
<td>Pumps for piston engines</td>
<td>-0.22</td>
<td>1.12</td>
</tr>
<tr>
<td>Machine parts for handling minerals</td>
<td>-0.01</td>
<td>1.05</td>
</tr>
<tr>
<td>Pumps, parts thereof</td>
<td>-2.55</td>
<td>1.04</td>
</tr>
</tbody>
</table>

*Source: Drafted by author with data from US ITC*
1.1.2 Measures Mexico needs to implement in order to attract Foreign Direct Investment

Although Mexico has in fact been leveraging trade frictions between China and the US since 2018, results for the mid-term depend greatly on Mexico’s ability to attract foreign direct investment (FDI) in a strategic and active manner, and on the support granted to producers who have the capacity to export to China.

In order for Mexico to become the export platform for North America, it is imperative that it can attract foreign direct investment. Its privileged geographic location is one of its most relevant competitive advantages, in addition to its extensive network of trade agreements and competitive production costs. With this, and with precursor sectors such as energy, telecommunications, and modern transportation, our economy could become an essential link in the formation of productive value chains, many of them driven by foreign capital which at times comes from regions other than North America.

Current uncertainty surrounding the ratification of USMCA constitutes an obstacle for attracting FDI. Likewise, the lack of respect for the rule of law and certain decisions made by the federal government, such as the cancellation of the new international airport known as NAICM, damage the perception of Mexico as an attractive destination for foreign direct investment. On May 7th, 2019, AT Kearney announced that Mexico had fallen eight places on the Foreign Direct Investment Confidence Index, ranking 25th out of 25 countries. The ratification of USMCA could play a determining role in attracting FDI, particularly if it occurs while tensions between the US and China persist.

Current trade frictions present an opportunity for attracting capital to Mexico. These opportunities are already coming to fruition in cases such as Fuling Global, a Chinese plastics company that has made the decision to open a facility in Monterrey\(^2\) in an

attempt to address the trade dispute between China and the US. The CEO himself recognized that 85 percent of the company’s revenues come from exports to the US. For this reason alone, the simple threat of tariffs resulted in the company’s decision to redesign its logistics strategy, favoring Mexico’s interests, where it will now produce a majority of the paper straws it will export to the US.

The current international trade environment, which is plagued by uncertainty, should be an additional reason to underpin internal competitiveness in Mexico in terms of offering certitude and promoting the energy, communications, and transportation markets.

1.2 Mexico could also replace US exports to the Chinese market

As retaliation in the trade standoff, China has imposed tariffs on 4,199 US imports. In terms of value, the four most relevant product groups are: minerals and metals, manufactures, transport equipment, and chemicals.

**Value of US imports affected by Chinese tariffs**
*By product category in billions of dollars*

<table>
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<th>Minerals and metals; 178.6</th>
<th>Manufactures, not elsewhere specified; 163.8</th>
<th>Chemicals; 146.6</th>
<th>Non-electrical machinery; 100.6</th>
<th>Wood, paper, etc.; 90.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transport equipment; 158.5</td>
<td>Oilseeds, fats &amp; oils; 141.5</td>
<td>Electrical machinery; 66.8</td>
<td>Leather; 30.1</td>
<td>Fish; 9.8</td>
</tr>
</tbody>
</table>

*Source: Drafted by author with data from UN Comtrade*
Mexico is at an gainful position to leverage trade restrictions imposed on the US by China—or even just the threat of restrictions—and strengthen its own position in that market. Currently, Mexico is poorly ranked as the 31st supplier for China (0.6 percent). Potential for growth is considerable given that exports from Mexico to China only represent 5.2 percent of US exports to that country.

The Chinese economy has a much more diverse supplier base than the US; South Korea, as the main exporter to China, accounts for less than 10 percent of the Chinese market share, and the top six suppliers, as a whole, account for 50 percent. In terms of the products it demands, China is known for importing raw materials. Accordingly, the opportunity for Mexico to replace US products in China is more restricted than the opportunity it has to replace Chinese exports in the US.

It is important to mention that in parallel to imposing trade tariffs to the US, China attempted to diversify its supply base and limit inflationary effects by reducing its most favored nation tariffs. Starting in November 2018, China lowered its average most favored nation tariffs from 9.8 to 7.5 percent, and there is a chance that it could lower them even further in the coming months, partly because of negotiations with the US.

However, because of the tariffs that have been announced, Mexico could replace US exports in China of at least 465 products, for a total of 5.66 billion dollars. The vast majority of these are manufactured goods. In the primary sector, we have identified 86 agricultural products, which, as a whole, open up an opportunity for Mexico valued at 218 million dollars. The following graph shows the commercial value of Chinese imports from the US, by group.
Among the non-agricultural products, ten meet with the following criteria:\(^3\):

i) The US is one of the top five exporters of the product to the Chinese market;

ii) Total Mexican exports to the world exceed total Chinese imports of the product. Therefore, exports from the US to China are also lower than total Mexican exports to the world.

iii) Mexico exports to the world more than 1 billion dollars; and

iv) The US exported more than 10 million dollars to China.

\(^3\) 2017 UN Comtrade
The following graph shows the value of Chinese imports from the US for these products.

**Opportunity for Mexican industrial exports to the Chinese market**

*Millions of dollars*

![Graph showing import values for different products.](source: Drafted by author with data from UN Comtrade)

Among agricultural products, 12 out of the 86 meet the following criteria:

i) The US is one of the top five exporters of the product to the Chinese market;

ii) Total Mexican exports to the world exceed total Chinese imports of the product.

iii) Mexico exports to the world more than 100 million dollars; and

iv) The US exports more than 2 million dollars to China.
The following graph shows the value of Chinese imports from the US for the 12 products that meet the criteria described in the paragraph above.

**Opportunity for agricultural exports from Mexico to the Chinese market**

*Millions of dollars*

1.3 *Mexico as a transformer of Chinese inputs for export to the US*

The tariffs the US imposes, or threatens to impose, on Chinese exports also create an incentive for Mexico to import Chinese inputs, transform them, and then export them to the US, even if they don’t meet Nafta or USMCA rules of origin. Chinese products would benefit since they would be able to enter Mexico at a much lower cost by paying the most favored nation tariff—or even no tariff under IMMEX programs—instead of the prohibitive US tariff.
In 2017, the US imported 2,342 intermediate goods from China subject to punitive tariffs with a value of 89 billion dollars. The majority of these inputs are non-electrical machinery (27 percent), minerals and metals (17 percent), electrical machinery (16 percent), and chemicals (16 percent).

**Intermediate goods imported from China that Mexico could transform and export**

*By category, as percentages*

Source: Drafted by author with data from UN Comtrade
Lack of Stability in Trade Friction

Regardless of the diversity of paths trade frictions between China and the US could take, just the threat of potential conflicts creates an incentive for Mexico to position itself in both markets. This is somewhat of a paradox given that 30 years ago China designed its export policy in terms that would enable it to replace Mexico in the US. Now, the future of trade in North America is in part dependent on Mexico becoming the region's export platform to the whole world, including China. Trade frictions constitute a good excuse to do it, as long as governments ensure the competitive integration of North America.