World Economy Brief

August 28, 2024 | Vol. 14 No. 31 | ISSN 2233-9140

Global Supply Chain Restructuring Initiated by the US: Mexico's Response and Adaptation

Sungwoo Hong PhD, Head of Africa, Middle East, and Latin America Team, Center for Emerging Economy Studies (swhong@kiep.go.kr)

I. Introduction

International shocks, such as the COVID-19 pandemic, the US-China conflict, and the Russia-Ukraine war, have disrupted global supply chains and heightened uncertainty, forcing countries to adjust their foreign policies. In particular, Mexico, which shares a border with the US, has recently drawn significant attention due to various US-led initiatives aimed at reorganizing supply chains, including the USMCA and the Inflation Reduction Act (IRA).

With the implementation of the North American Free Trade Agreement (NAFTA) and its modernized version, the USMCA, the Mexican economy has become significantly integrated with the US and Canadian economies. Building on this economic foundation, the US IRA, which came into effect in August 2022, has attracted the interest of electric vehicle manufacturers to Mexico. In other words, Mexico, being geographically close to the U.S. and having a relatively low-cost labor force, has emerged as the prime candidate for nearshoring operations aimed at entering the North American market.

In this context, Mexico warrants attention as the optimal candidate for nearshoring in US-led efforts to reorganize global supply chains. Furthermore, Mexico holds significant strategic value in securing a stable supply chain for key raw materials, such as critical minerals, and serving as a gateway for expansion into North, Central, and South America.

II. Mexico's Response to Global Supply Chain Shifts

As mentioned, Mexico is attracting significant attention as a nearshoring destination for multinational companies planning to expand into the United States amid supply chain reorganization.

Reflecting this interest, foreign direct investment in Mexico's manufacturing sector has seen remarkable recovery since the COVID-19 pandemic. According to the Mexican Ministry of Economy, in 2020, when the COVID-19 pandemic broke out, foreign direct investment (FDI) in Mexico's manufacturing sector dropped by 29.1% year-on-year to $11.28 billion. Since then, FDI has increased annually, rising by 9.5% year-on-year in 2022. In the first quarter of 2023 alone, FDI in the manufacturing sector reached $9.93 billion, representing 72.4% of the total FDI in the manufacturing sector for the entire year of 2022.

Amid the recent supply chain reorganization, Mexico appears to be in the process of developing specific strategies and policies. The direction of these policies seems to focus on strengthening the construction of a global value chain centered on Mexico's high value-added domestic industries, while actively attracting foreign investment in technology-intensive sectors to further integrate into new value chains.

A typical example is the mining sector. Mexico, rich in various mineral resources and critical minerals like lithium, is seeking to respond to the recent reorganization of supply chains by strengthening value chain development in this high-demand sector, aiming to increase domestic value-added contributions and establish itself as a key player in the global supply chain.

The revision of Mexico's Mining Law (Ley Minera) in April 2022 was likely driven by this intention. The key changes in the bill are as follows: the Ministry of Energy establishes a state-owned company called LitioMX (Litio para México), which will begin operations within 180 days of the law's enactment, after which it is given the authority to explore, mine, and utilize lithium reserves in Mexico, as well as manage and control the lithium value chain. Additionally, the law specifies that LitioMX must fulfill various roles related to lithium.

This policy direction has been reinforced by the implementation of the US IRA, which came into effect in August 2022. Following the revision of the Mining Law in April 2022, President Obrador signed another law in February 2023 transferring responsibility for lithium reserves to the Ministry of Energy and designating part of the Mexican state of Sonora as a protected area for lithium mining. At the signing of the law, President Obrador stated, "Mexico is the owner of this strategic mineral and will use it for the benefit of the Mexican people," while emphasizing that Russia, China, the United States, and others will not exploit lithium.

In fact, both the revised Mining Law of April 2022 and the new law of February 2023 lack specific details. The revised mining law does not clearly address how to handle existing concessions for lithium exploration and mining, while the law signed by President Obrador in February 2023 omits specific details on how mining activities will be prohibited in designated protected areas for lithium mining. Nevertheless, Mexico is responding to global changes in supply chain reorganization with a clear strategic direction.

This approach can be understood as an effort to further expand domestic value by minimizing the involvement of foreign capital in the mining sector – which has high domestic value and global demand – while strengthening national control. The intention behind this is to further enhance Mexico's forward linkages in the global value chain.

In contrast, Mexico's low value-added industries are pursuing a strategy of integrating into new global value chains by increasing foreign value-added contributions. The Decree, a tax incentive law to promote nearshoring, announced by the Mexican government in October 2023, can be understood in this context. The law aims to provide tax breaks to export companies in 10 sectors, including semiconductors, electronic components, batteries, medical devices, pharmaceuticals, and agricultural machinery, across any region in Mexico, provided they achieve a certain percentage of their sales through exports.

The aforementioned Mexican tax credit laws are primarily focused on technology-intensive industries, where Mexico is comparatively disadvantaged and does not hold a significant position in the global value chain. Therefore, instead of policies aimed at increasing Mexico's value added, a more effective short-term strategy may be to attract multinational companies to Mexico and offer incentives for these companies to export. This approach would help Mexico integrate into global value chains it previously struggled to access, thereby strengthening its backward linkages. The introduction of tax credits to promote nearshoring should be understood within this context.

In particular, the semiconductor, battery, and electric vehicle sectors are seeking to strengthen backward linkages through nearshoring. The semiconductor supply chain is centered in Asia, while the battery supply chain is especially significant in the context of supply chain reorganization, given China's considerable influence over key materials. As the US restructures semiconductor, battery, and electric vehicle supply chains around North America and its allies, Mexico is positioning itself to join a supply chain it had not previously been a part of.

At the North American Trilateral Summit held in January 2023, it was announced that the semiconductor supply chain would be reorganized around North America to reduce dependence on Asia. It was also reported that incentives for establishing semiconductor production facilities along the US-Mexico border had been discussed during the bilateral meeting between the US and Mexico. As a follow-up to the summit, the three North American countries held the first North America Semiconductor Conference (NASC) in May 2023 to explore the creation of a contiguous region for semiconductor development and production across North America, and to build an ecosystem that leverages the strengths of all three countries to enhance global competitiveness.

Mexico's response and strategy under the recent supply chain reorganization are clear: actively attracting foreign direct investment while strengthening national control over key minerals such as lithium. From a global value chain perspective, the former represents a strategy to integrate Mexico into new global value chains in which it has not previously participated, while the latter seeks to reinforce Mexico's role in the global value chains it has traditionally been a part of.

In other words, the new global value chains that Mexico is seeking to join are in technology-intensive industries where Mexico currently has very low added value, such as semiconductors, batteries, and electric vehicles. Mexico is actively attracting foreign direct investment in these sectors to strengthen backward linkages and is demonstrating a strong commitment to becoming a key player in the North American-centered supply chain. Simultaneously, in sectors where Mexico has traditionally had high added value, such as mining, the country is pursuing a strategy of nationalization or increased state intervention to enhance forward linkages in the global value chain. Low forward linkages, particularly in Mexico-US trade, remain a challenge for Mexico. Given the significant volume of trade between the two countries, Mexico's strategy to strengthen forward linkages in traditional industries is likely to persist, at least in the short term.

III. Policy Implications

Mexico's active nearshoring strategy will naturally encourage Korean companies to participate in the North American-centered supply chain in sectors such as semiconductors, batteries, and electric vehicles. Meanwhile, in industries where the state has traditionally played a significant role, such as mining, efforts are expected to focus on improving forward linkages in the global value chain by strengthening state-led supply chains. As a result, cooperation with Mexico has become increasingly important.

In this process, South Korea must aim to play a key role as a participant in the North America-centered value chain through trade with Mexico, while simultaneously increasing its market share in the United States, Canada, and Mexico, and securing a stable supply of critical raw materials.

Recently, with Chinese companies actively entering Mexico's automobile-related industry, a new situation is emerging, raising concerns that Korean companies' market share and competitiveness in Mexico may decline in the future. This could reduce South Korea's added value in Korea-Mexico trade, potentially weakening Korea’s position in the North America-centered global value chain. In this context, economic cooperation with Mexico has become more crucial than ever.

To enhance Korea’s added value and contribution to the North America-centered value chain, attention should be given to infrastructure investment in Mexico and cooperation in the transportation-related service sector. As Mexico is increasingly recognized as an ideal location for nearshoring, the importance of service sectors such as freight transportation and logistics will likely grow, alongside traditional infrastructure needs such as industrial water supply, communications, and roads. With the expansion of industrial complexes driven by the influx of multinational companies into the manufacturing sector, demand for infrastructure construction will naturally rise. This process could create opportunities for investment and cooperation in sectors such as water pipelines, communications, and roads.

Additionally, Mexico, leveraging its geographical proximity to the United States, has a strong incentive to improve its underdeveloped infrastructure, such as roads and railways. Given its strategy to integrate into technology-intensive supply chains, such as for semiconductors and batteries, stable and efficient transportation is of critical importance. The concentration of foreign direct investment in manufacturing near the US border further supports this view. Therefore, continuous attention should be given to the transportation service sector, which can enhance transportation efficiency alongside traditional construction infrastructure, while seeking opportunities for cooperation between the two countries.

Facing various global crises, including the COVID-19 pandemic and US-China conflict, the world is striving to secure stable supply chains and build industrial structures that are not overly dependent on a small number of countries. Korea is also working to reduce its heavy reliance on China and diversify its export and import routes. Similarly, Mexico, which depends heavily on the North American economy, may have an incentive to pursue such changes from a long-term perspective. Mexico is expected to explore policies that diversify its export markets, which are currently concentrated in the US and Canada, to include countries in Central and South America. Therefore, Mexico should be considered a strategic bridgehead for expanding into Central and South America. In this context, Korea should view trade with Mexico not only as a gateway to North America and a way to increase its market share in Mexico, but also as a means to boost Korea's added value in Central and South American countries and integrate into the regional value chain.