

Zai Jian Zhongguo, Bienvenidos a México: The Trend of Production Moving from China to Mexico – Regulatory and Practical Considerations

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In recent years, a wide array of trade actions pursued by the United States, foreign and domestic policies of the United States and China, reputational risks, and supply chain breakdowns are driving a trend of more and more manufacturing moving from Asia to Mexico. The Biden Administration has made no secret of its desire to encourage U.S. manufacturers and their component suppliers to move production from China to Mexico.^[i]

Trade Actions By the United States

The U.S. regulatory factors behind this trend include:

1. Free Trade Agreement: Entry into force in 2020 of the United States-Mexico-Canada Agreement (USMCA),^[ii] which increased the regional value content requirements for a wide range of products;
2. Special import duties: The aggressive imposition by the United States of Section 301,^[iii] as well as, traditional antidumping and countervailing duties on many Chinese products;
3. Export restrictions: The addition of many additional Chinese entities to the U.S. lists subject to national security related export restrictions, and the resulting due diligence challenges concerning Chinese companies' involvement in military programs or ownership or control by listed entities;
4. Forced labor ban: The issuance of further U.S. import prohibitions^[iv] and other sanctions^[v] on products with content originating from the Xinjiang region, stemming from U.S. policies targeting forced labor and treatment of the Uighur population; and
5. Extraterritorial application of U.S. export controls: The introduction of the new foreign direct product rules,^[vi] which have hampered the ability of semiconductor manufacturers in third

countries to supply many parties in China.

Industry-Specific Impact

For a broad range of industries, the result of these USMCA incentives, combined with the more restrictive rules for China, has been a push to relocate quite a bit of production to Mexico that would otherwise occur in China or elsewhere in Asia.

Automotive Industry Implications

We expect the automotive industry in particular to move production increasingly to Mexico. As early as 2020, following the entry into force of USMCA, Asian automotive component suppliers began expanding production in Mexico. For example, some suppliers now mine copper in Mexico that is then used to increase regional value content in the local production of components. Moreover, the COVID disruptions of automotive component manufacturing in Wuhan, which is known as the Detroit of China, have pushed more manufacturers out, often to Mexico.

Fashion Industry Implications

The apparel sector may have seemed a less likely candidate for such relocation because it is generally subject to the yarn-forward rule of origin. That rule requires the spinning and extruding of yarn and subsequent phases of production to occur in a USMCA territory in order for the resulting garment to enter the United States, Mexico, or Canada duty free. Even in this sector, however, USMCA made a number of exceptions that have resulted in an incentive to move some apparel production to Mexico. The single transformation rule allows foreign origin fabric and yarns to be used for certain specific products as long as the cutting of the fabric or knitting to shape, and all subsequent processes, are performed in the USMCA territory.

There are also USMCA provisions that allow the use of certain non-USMCA fiber, fabric, and yarns that are determined to be in short supply. In addition, there are quota provisions that allow USMCA duty-free treatment for specified quantities of non-originating fabric or yarn that has undergone significant processing in a USMCA territory. And there is also a special U.S./Mexico assembly provision that allows duty-free treatment upon import into the United States under HTSUS subheading 9802.00.90 for goods that are assembled in Mexico from fabric that was wholly formed and cut in the United States.

Moreover, the focus on the use of forced labor in China has pushed several apparel companies to stop sourcing cotton from China. For this reason, we also foresee further apparel sector manufacturing moving to Mexico from Asia.

U.S. and China Foreign and Domestic Policies Continue to Drive Relocation

In addition to the U.S. regulatory factors driving this trend of relocation from China to Mexico, both U.S. and China foreign and domestic policies bolster the trend. After the election of 2020, some observers wondered if there might be a meaningful reset of U.S.-China relations and an accompanying thaw in the U.S. restrictions on China. But that has certainly not happened. The change in U.S. Administration in January 2021 did not produce any material relaxation of the above import and export restrictions on China. Moreover, there is no reason to believe that much will change in the coming months and years.

The policies driving this relocation trend are not one-sided. China's failure to join the United States and its European and other allies in firmly opposing the Russian invasion of Ukraine has only added to the strains in U.S.-China relations. Some manufacturers are even choosing the China-Mexico relocation based on political risk from a potential conflict involving Taiwan that could result in U.S. sanctions and Chinese counter-sanctions. To these legal and regulatory factors, one must also add the singular Chinese response to the COVID pandemic. China continues to try to adhere to a zero-COVID policy, which has become extraordinarily difficult in the face of the wildly contagious Omicron variants. Lockdowns and supply chain disruptions in China have been in the headlines for weeks and look to remain so for the foreseeable future.

Reputational Risks

In this new era of environmental, social and governance (ESG) awareness, company boards are also weighing the reputational risks of continuing business in China. Apart from the import prohibitions and sanctions related to forced labor, some manufacturers are leaving China due to the reputational risk of being accused of indirect association with forced labor.

Supply Chain Breakdown

The increasing breakdown of supply chains is also contributing to the relocation trend. The backlog in global shipping has quadrupled shipping costs. Inflation in transportation costs and continuing disruptions to shipping are driving companies to nearshore their production.

Results of the Relocation

The trend is reflected in Mexico's economic statistics. The Mexican Secretariat of Economy reported that the country had a total of \$32.9 billion in foreign direct investment in 2019, and that this declined to \$29.1 billion in 2020 during the pandemic. For the first two quarters of 2021, however, the Secretariat reported \$18.43 billion in FDI, a significant return to growth. The International Monetary Fund estimates that total Mexican GDP will be \$1.37 trillion during 2022, a solid increase from the pre-pandemic level of \$1.26 trillion in 2019. It remains to be seen how large Mexico's manufacturing sector will become, but we see an opportunity for continued significant growth.

Interestingly, although this trend means less *Chinese-manufactured* content in the affected products, it does not necessarily mean less Chinese *ownership* of manufacturing. Chinese firms have been well represented among those increasing their investments in Mexico in response to the higher RVC requirements of USMCA. Indeed, around a third of the electronics manufacturing investment in Mexico is currently coming from Asian countries, much from China, but also from Japan and South Korea.

Limitations on the Manufacturing Migration

Our knowledge of the regulations and USMCA rules, however, suggest to us that there will be some limitations on how far this trend can go, especially as it concerns Chinese companies expanding in Mexico, for the following reasons:

1. 5G: Chinese companies and their affiliates seeking to move electronics manufacturing to Mexico will still need to avoid 5G and other areas of manufacturing that would serve parties in China like Huawei that are barred under the foreign direct product rule;

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2. **Xinjiang:** Chinese companies that have links to Xinjiang will remain subject to U.S. import restrictions to the extent they are subject to Customs and Border Protection prohibitions, or if their Mexican production would need to rely upon raw materials or components from Xinjiang; and
 3. **Listed Entities:** Although the Bureau of Industry and Security generally views a Mexican company manufacturing in Mexico as Mexican (notwithstanding ultimate Chinese ownership), the BIS prohibitions under the Part 744 Entity List,^[vii] the Military End User rule,^[viii] and the Xinjiang sanctions reach more broadly, which calls for careful due diligence by U.S. companies who would furnish technology to, or import products from, such Chinese-owned facilities in Mexico.

The above factors will limit the number of high-tech Chinese companies that can benefit from shifting production to Mexico, and even outside high tech, it will limit the opportunities for companies dependent upon Xinjiang.

Caution will need to be exercised not only by Chinese companies looking to expand manufacturing in Mexico, but also other companies (in Asia or elsewhere) looking to expand there, because they must still avoid Chinese sourcing (e.g., from Xinjiang) that would trigger a U.S. import prohibition, observe the foreign direct product restrictions if selling their Mexican production to China, adhere to the deemed export rules when posting personnel (e.g., from China) to Mexico, and last but not least, carefully apply the labyrinthine USMCA rules of origin when determining if their manufacturing flows will result in an end product that satisfies the applicable USMCA rules of origin and can enter the U.S., Canada, or Mexico duty free.

Members of our international trade team are well versed in the regulations and practical considerations affecting these supply chain decisions and are available to assist if you are considering a move to Mexico.

FOOTNOTES

^[i] See, e.g., Brookings, *Supply Chain: USMCA Forward: Building a more competitive, inclusive, and sustainable North American economy* (February 2022), available at <https://www.brookings.edu/essay/usmca-forward-building-a-more-competitive-inclusive-and-sustainable-north-american-economy-supply-chain/>.

^[ii] See also United States-Mexico-Canada Agreement Implementation, 19 U.S.C. Ch. 29 (2020).

^[iii] See Section 301 of the U.S. Trade Act of 1974, 19 U.S.C. § 2411 (2018).

^[iv] See Uyghur Forced Labor Prevention Act, Pub. L. 117-78 (2021); and Section 307 of the Tariff Act of 1930, 19 U.S.C. §1307.

^[v] See designations under Executive Order 13818, which builds upon and implements the Global Magnitsky Human Rights Accountability Act.

^[vi] See 15 C.F.R. § 734.9.

^[vii] See 15 C.F.R. § Part 744, Supplement No. 4.

[viii] See 15 C.F.R. § 744.21

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National Law Review, Volumess XII, Number 136

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