

North American supply chains

Will reshoring actually happen?

A report by The Economist Intelligence Unit



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North American supply chains: will reshoring actually happen?

Since the onset of the coronavirus (Covid-19) pandemic in early 2020, policymakers and businesses have shown great interest in strengthening the resilience of global supply chains. In the US, this has translated into discussions about the prospect of reshoring current overseas production—or, more realistically, rooting supply chains within North America at large.

Such conversations had already started pre-pandemic, as the US-China trade war simmered amid growing concerns about the centrality of China (and Asia more generally) in supply-chain networks. Reshoring discussions gained further traction when a revamped North American-Free Trade Agreement (NAFTA) took effect in mid-2020, in the form of the US-Mexico-Canada Agreement (USMCA), and reached a high point after the inauguration of Joe Biden as US president in January 2021. Unlike his predecessor, Donald Trump, Mr Biden has emphasised the importance of strong internal North American relations. He has also made supply-chain security a top priority and, by March 2021, had agreed with his counterparts in Canada and Mexico to collaborate on addressing this issue.

The optimism around these discussions does not reflect the reality on the ground, however, and The Economist Intelligence Unit does not expect a significant relocation of supply chains out of Asia, at least in the medium term.

- Supply-chain diversification is on the cards, particularly within Asia, but any movements to North America will remain an exception to the rule.
- Companies and investors will remain deterred by North America's relative lack of competitiveness. Of particular relevance will be Asia's more successful mitigation of coronavirus disruptions to production and trade (although a resurgence in infections will be a constant threat), as well as Asia's established, reliable, low-cost manufacturing capabilities.
- Lingering protectionism and cross-border tensions within North America will also complicate options for arbitrating production costs throughout the region.
- These factors will discourage the types of investment required to transform North America into a viable, self-sustaining supply-chain ecosystem. This will be particularly true of foreign investment, which will continue to favour Asia's low-cost production hubs. Asia's share of global exports will continue to rise in 2021-25, reflecting the sustained importance of the region in global supply-chain networks, while North America's share will remain unchanged.

The case for North America

The recent enthusiasm around developing a North American alternative to Asia-based supply chains is understandable. The pandemic revealed the vulnerability of far-flung supply networks, as lockdowns and other containment measures obstructed the movement of goods across borders. Meanwhile, US-China tensions—which escalated under Mr Trump and will not disappear under Mr Biden—turned supply chains into geopolitical instruments and highlighted the dangers of depending on a rival state for the provision of critical and strategically sensitive goods.

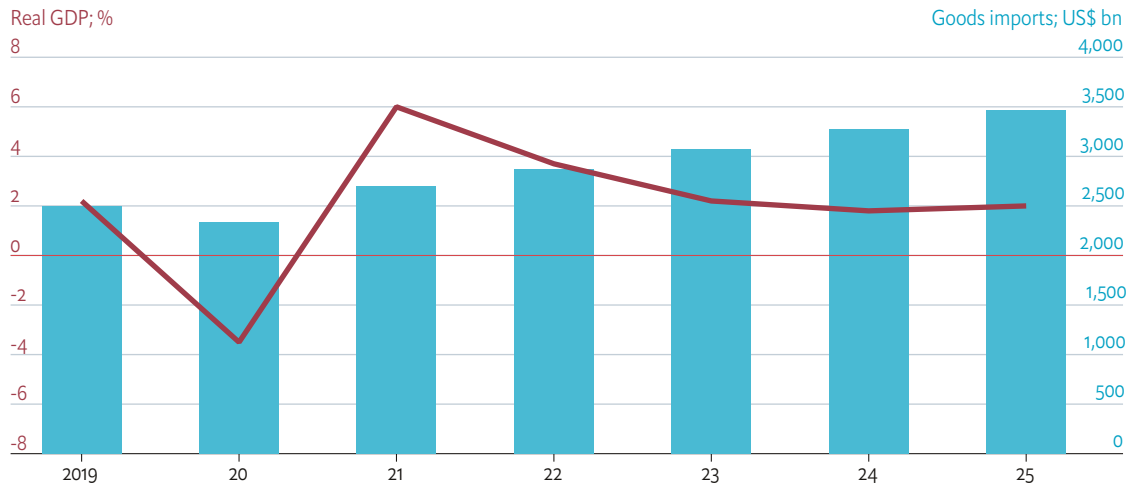
NORTH AMERICAN SUPPLY CHAINS

WILL RESHORING ACTUALLY HAPPEN?

For the US, the most logical solution would seem to be to look to its North American neighbours. North America benefits from nearly three decades of economic integration, following the implementation of NAFTA in 1994. The US, Mexico and Canada have become each other's primary trade partners—although China is in the mix as well—and compose one of the world's largest free-trade areas (FTAs) by GDP. Proximity is, naturally, a distinct advantage, with much shorter transportation times than those from Asian suppliers. USMCA also introduces procedures and structures—such as a new trilateral Competitiveness Committee—that are well placed to guide the development of effective intra-regional value chains.

The US's rapid economic recovery reinforces the case for North American co-operation. We expect the US economy to return to its pre-coronavirus (2019) size in the second half of 2021, with real GDP growth jumping to 6% this year and averaging 3% annually until 2025. Imports will also rise during this period, reflecting the release of pent-up demand but also Mr Biden's large-scale economic recovery plan, which we expect to total around US\$2trn once passed by Congress. The infrastructure elements of the package will provide a boon for manufacturers, particularly in green technologies, telecommunications and building materials. General Motors, a US auto manufacturer, has already announced investments of more than US\$1bn in one of its Mexican plants to produce electric vehicles.

US economic recovery fuels steady import growth*

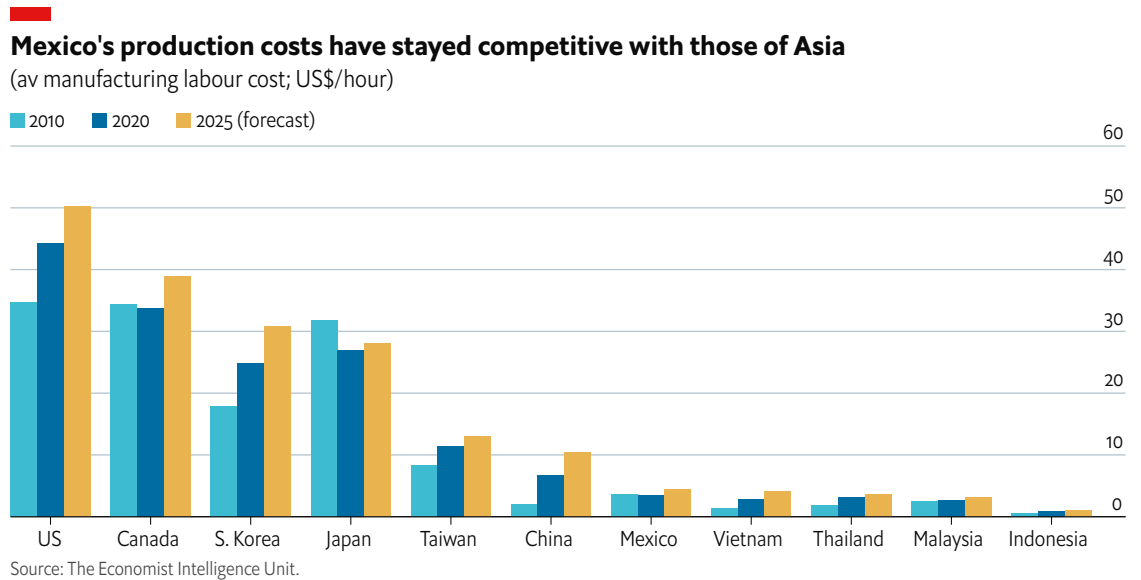


*Data for 2021-25 are forecasts.
Source: The Economist Intelligence Unit.

The final element of the equation is Mexico. The country plays an essential role in boosting the credibility of North America's reshoring potential. Production costs are far lower than in the US and Canada and have remained stable as China's wage levels have grown sharply in the past decade. While Mexican wages will rise in the medium term, in part owing to USMCA requirements, we expect them to stay competitive, even compared with low-cost production hubs in South-east Asia.

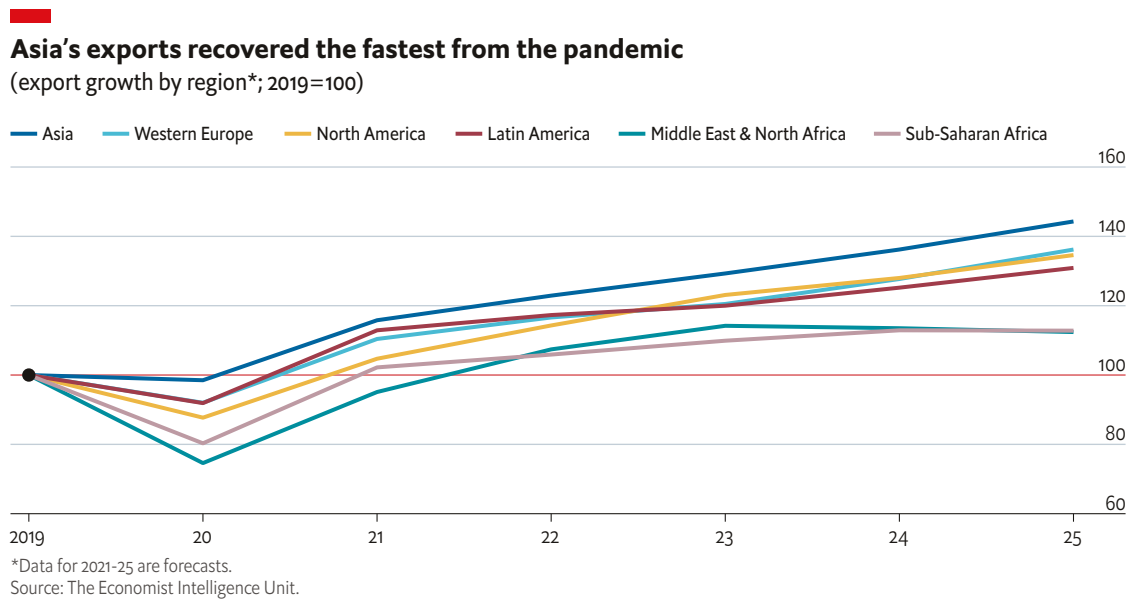
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WILL RESHORING ACTUALLY HAPPEN?



Competitiveness will remain a broad concern

Despite these advantages, we expect businesses to remain sceptical towards North America as a viable production substitute for Asia. Several factors underpin this forecast. For one, Asia's supply chains have proven highly resilient during the pandemic. Asian exports recovered faster than those of any other region in 2020, even exceeding pre-pandemic levels by early 2021. This resulted from generally successful coronavirus-mitigation measures, which allowed Asian factories to continue to operate while the rest of the world was entering lockdown (although a recent pandemic resurgence in Asia could challenge this advantage). North America has held up poorly by comparison. The US-Canada border remains closed to non-essential traffic as a coronavirus precaution; Canada's prime minister, Justin Trudeau, has stressed the need to maintain these restrictions until his country's vaccination



NORTH AMERICAN SUPPLY CHAINS WILL RESHORING ACTUALLY HAPPEN?

targets are met. Alongside Peru, Mexico has by far the world's worst coronavirus fatality rate, a symptom of its inadequate pandemic response.

Another issue is comparative advantage. Mexico, whose low manufacturing costs position it best to serve as North America's "factory", has longstanding production capacity in a variety of goods that Asia also produces—such as automobiles, vehicle parts and certain consumer electronics. However, in relation to some other goods, Mexico is on a much weaker footing. One example is semiconductors, which, amid the current global shortage, has become a priority area for Mr Biden. Taiwan and South Korea hold around 80% of the world's semiconductor production capacity, leaving little industrial foundation in Mexico on which to build. Chip production is highly capital- and skills-intensive, meaning that transferring this production to Mexico would be neither cheap, easy or quick. Established chipmakers are also often wary of expanding into foreign markets, owing to concerns over intellectual-property rights, which would make such a move even more complicated.

Protectionism and cross-border tensions will persist post-Trump

Businesses will also be put off by concerns about protectionism in North America. Mr Biden has gone to great lengths to signal that the US "is back" as an international partner, eschewing his predecessor's "America First" strategy. However, it remains unclear how Mr Biden will reconcile this approach with his goal of revitalising US manufacturing output and jobs. For instance, Mr Biden has yet to exempt Canada from his new "Buy American" rules, which increase restrictions on US government procurement purchases and created a dedicated Made in America Office. His administration has also

North America's fragmented business climate

(Score out of 10)

	Political effectiveness	Private enterprise policy	FDI policy	Foreign trade & exchange controls	Labour market	Infrastructure	Technological readiness	Overall
Canada	9.4	9.0	9.1	10.0	7.2	8.8	8.6	8.44
US	8.1	9.5	8.7	9.1	8.1	8.3	9.4	8.26
Taiwan	7.8	7.5	8.2	8.7	6.9	8.0	9.4	7.97
Japan	8.1	7.5	6.4	8.7	6.8	8.3	9.4	7.60
S. Korea	8.4	7.8	6.4	8.2	6.3	7.8	9.4	7.60
Malaysia	6.5	6.3	7.3	8.2	6.8	6.8	8.0	7.35
Thailand	5.5	6.3	6.9	8.2	6.5	5.8	6.9	6.79
China	4.9	5.3	6.0	6.4	6.1	7.3	8.9	6.54
Mexico	4.2	5.0	6.9	9.6	6.2	5.8	5.8	6.50
Vietnam	4.9	4.8	6.0	8.2	6.3	4.5	5.8	6.22
Indonesia	4.5	5.3	5.5	7.3	5.8	5.3	5.5	6.10

Note. Scores cover 2021-25 forecast period.

Source: The Economist Intelligence Unit, Business Environment Rankings.

NORTH AMERICAN SUPPLY CHAINS

WILL RESHORING ACTUALLY HAPPEN?

announced that it may double tariffs on Canadian lumber and will sue Canada for allegedly failing to open up its dairy market as per USMCA requirements. This has added to existing tensions generated by Mr Biden’s cancellation of the cross-border Keystone XL pipeline and his reluctance to intervene in the ongoing Enbridge pipeline dispute.

Protectionism plays a particularly strong role in Mexican policy. Since entering office in 2018, Mexico’s president, Andrés Manuel López Obrador, has pursued a highly nationalist and statist agenda. He has worked to roll back the country’s landmark energy reforms, which opened the sector to private participation, and has cancelled high-profile foreign-investment projects via controversial public referendums. His infrastructure-spending plans have been more ideologically driven than pragmatic. He has also expressed little interest in foreign affairs and has been slow to build relations with the Biden administration.

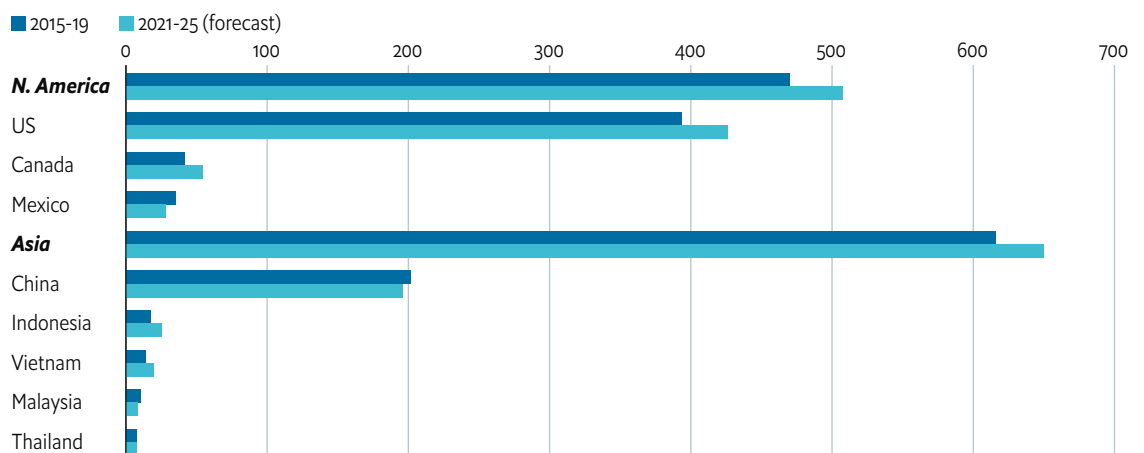
These policies will chill investor confidence during Mr López Obrador’s term, which ends in late 2024, adding to longstanding concerns about corruption and violence. Mexico scores well below the US and Canada in our Business Environment Rankings, which cover a forecast period of 2021-25. Mexico also performs unfavourably compared with China and several South-east Asian economies, including in political effectiveness, private enterprise policy and infrastructure quality.

Managing expectations

All of these factors will discourage the transformative investments required to fulfil North America’s reshoring potential. Our forecasts for foreign direct investment (FDI) and trade flows reflect this. We expect FDI to continue to grow in Asia over the medium term, particularly in countries that offer low-cost alternatives to China, such as Indonesia and Vietnam. FDI to North America will also increase, but this will be driven by inflows to the US and Canada. Mexico will be the only country in the region where the average annual foreign-capital inflow in 2021-25 will be lower than that during the five-year period that preceded the pandemic. The US government, in particular, is likely to use a range of policies to incentivise (and, in a limited number of cases, require) manufacturing to be carried out

Foreign investors will favour Asia’s low-cost production hubs

(av annual FDI inflows; US\$ bn)



Source: The Economist Intelligence Unit.

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WILL RESHORING ACTUALLY HAPPEN?

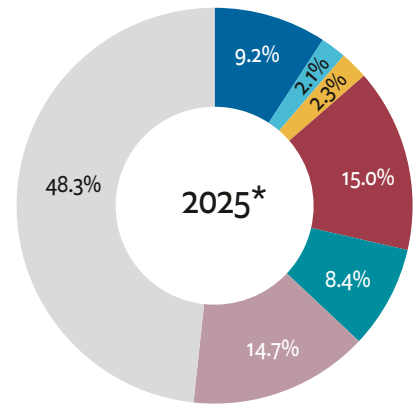
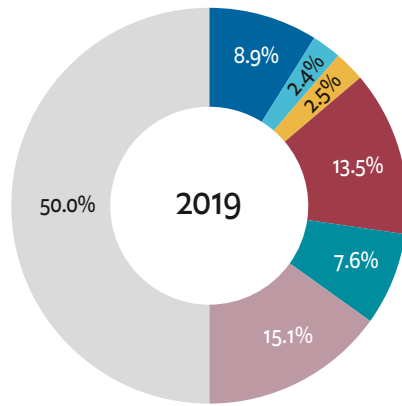
locally. However, this is unlikely to lead to radical changes in how companies source materials and produce goods.

We also expect North America's share of global exports (by value) to go unchanged between 2019 and 2025, remaining at 14%. A slight increase in the share of US exports will be countered by decreases in the shares for Canada and Mexico. Asia's share of global exports will rise by 2 percentage points, to 38%, with increases for both China and South-east Asia, highlighting Asia's durable significance in global supply chains. These projections reflect the difficulties of translating lofty policy rhetoric into actual change. Even as the US, Mexico and Canada deepen their economic integration, businesses and investors will continue to favour the convenience, reliability and cost-effectiveness of Asia.

Asia's share of global exports set to increase

(good exports; US\$ bn)

■ US ■ Canada ■ Mexico ■ China ■ ASEAN ■ Other Asia ■ Other world



*Data for 2025 are forecasts.

Source: The Economist Intelligence Unit.

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