

Pulse of China



How will US tariffs impact the economy and businesses around the world? What should businesses do in response? How does China feature in all this?

US Tariffs: Impact, Solutions and Opportunities

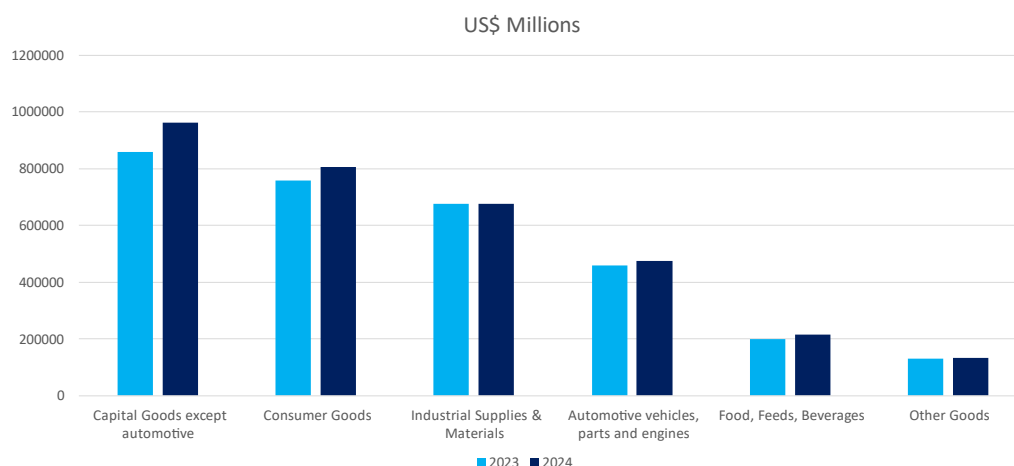
After threatening them ever since he took office, POTUS has finally rolled out his tariff plan.

Now, while there is a good possibility that political, trade or legal considerations may cause these tariffs to change or be reversed in their entirety, our perspective here is an entirely economic and business related one. How will the tariffs impact the US and global economies, how will businesses be affected and what should they do? Also, given that we focus a lot on China and the business opportunities there, we'll take the liberty of suggesting how international businesses can make China a part of their plan for mitigating the impact of tariffs and how Chinese businesses should look at international markets to accomplish the same end.

US Imports – what and from where?

To start with, let's take a look at the major categories of US imports over the last couple of years. At a very broad end-use category level, capital goods dominate and industrial supplies come in third. This is important because, while consumer goods imports are a direct reflection of consumer demand, capital goods and industrial supplies are required to produce goods for consumers. We'll come back to this a little bit later when we try and understand what happens when companies try to meet consumer demand with locally manufactured goods (which is ostensibly the point of the tariffs in the first place).

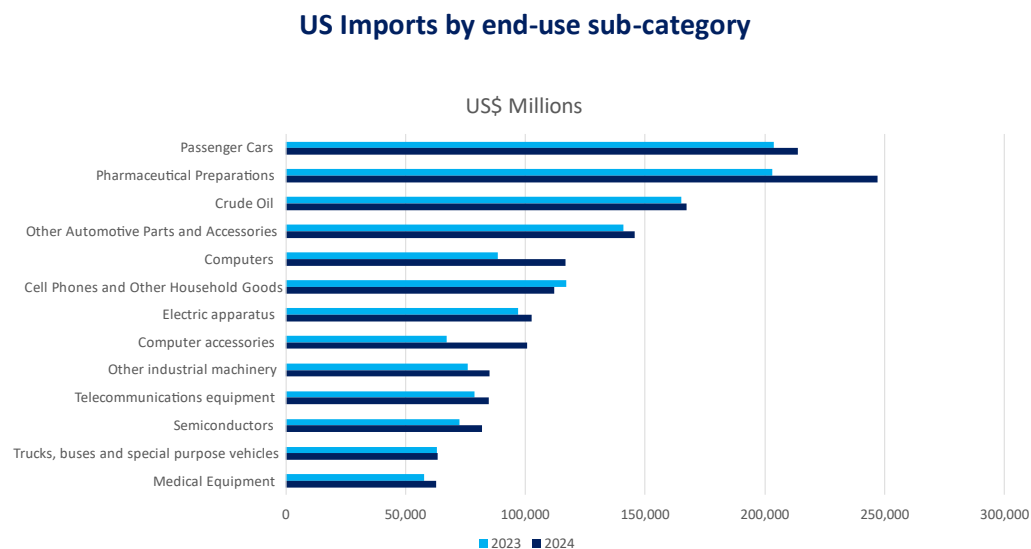
US Imports by end-use category and commodity



Source: U.S Bureau of Economic Analysis (bea.gov)

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Drilling down into more specific product categories, when we look at the top 10 we find a lot of consumer driven categories in the list. Crude oil comes in at 3, but the rest of the top 5 are all, arguably, things that consumers buy and companies could try and find ways to manufacture on US soil to circumvent the tariffs. Right? Well, let's see in a minute, shall we?



Source: U.S Bureau of Economic Analysis (bea.gov)

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What will happen to prices and demand once the tariffs take effect?

The image below captures the highly publicised formula for calculating the level of tariffs by country. While the formula itself is laughable, it contains within itself two elements that can help us understand what is likely to happen.

1. ϵ - price elasticity of import demand set by the USTR at 4. This means that an increase in price of 10% would cause a reduction in demand of 40%
2. Φ – elasticity of import prices with respect to tariffs set by the USTR at 0.25. This means an increase in tariffs by 20 percentage points will have only a 5 percentage point impact on price

We don't know how accurate or reliable USTR estimates will be when tariffs and price changes happen in such large increments. It is likely that a ratio of 4:1 on price elasticity is valid when price is changing in single digit percentage points. When it goes up by 20% will 80% of demand vanish? It does seem unlikely to happen across the board, but in categories which are seen as entirely or nearly non-essential this could happen. In fact, if consumers need to spend more on essentials, the drop in demand for non-essentials could be even more than 4x the price increases. What is essential or non-essential? We'll revisit that in a couple of paragraphs.

The second assumption in the formula is that prices will only increase by a quarter of the quantum of tariff increases. So if the US imposes a 34% tariff on imports for China, the supply chain will somehow absorb 25.5 percentage points of that tariff and the consumer will only pay an incremental 8.5%. This again, seems highly unlikely. It may happen in some categories where the prospect of losing a large market is daunting and there are very fat margins which can be reduced to retain volume, but it will not be true for the vast majority of imports, especially commodities and industrial goods.

Reciprocal tariff calculation

$$\Delta\tau_i = \frac{X_i - m_i}{\varepsilon * \varphi * m_i}$$

Δ = Delta, represents change in math.

τ_i = Tau, used to represent tariff in this instance, with i being import rate.

X_i = Defined as total exports to country from U.S.

m_i = Defined as total imports from country to U.S.

ε = Epsilon, used to represent price elasticity of import demand. The USTR set this at 4.

φ = Phi, used to represent the elasticity of import prices with respect to tariffs. The USTR set this at 0.25.

$$\text{Change in tariff import rate} = \frac{\text{exports} - \text{imports}}{4 * 0.25 * \text{imports}}$$

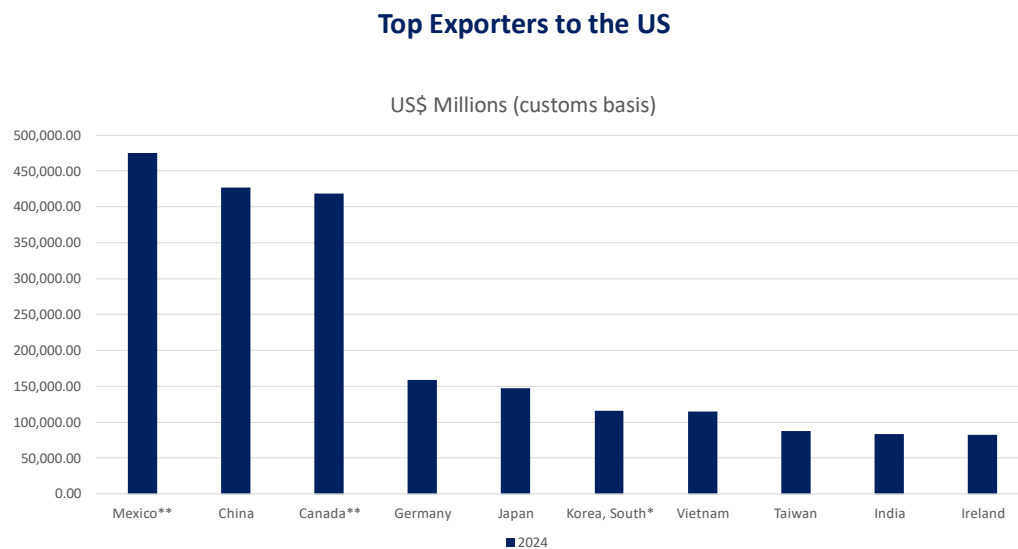
Since 4 multiplied by 0.25 is equal to 1, the formula is:

$$\text{Change in tariff import rate} = \frac{\text{exports} - \text{imports}}{\text{imports}}$$

It seems inevitable, therefore, that consumer demand in the US will contract sharply. In the very short term, companies will scramble to reexamine their business model and margins, find economies in the supply chain, take a haircut on margins and try and reduce their cost structures and price to customers to some extent. Nonetheless, prices will increase by a significant percentage and demand will drop for a large number of non-essential categories. What is non-essential? A category by itself may not be non-essential, but for consumers, buying a replacement product in that category may become non-essential. Computers, cars, running shoes, cellphones, clothes and categories of this nature may see a bigger impact than pharmaceuticals and food, for instance.

Who gets hurt when demand contracts?

Well, the seemingly obvious answer to that is the countries, or rather, businesses located in the countries on whose exports tariffs are being imposed, which is shown below.



Source: U.S Bureau of Economic Analysis (bea.gov)

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What are the businesses located in Mexico, China and these other countries? Sure, there are some Mexican and Chinese companies selling consumer products directly, but what about the American car brands manufacturing in Mexico? What about Apple and Nike who, while they're shifting manufacturing to Vietnam (also in the top 10 exporters to the US, by the way) are currently doing a lot of their production in China?

Interestingly, because there were already tariffs in place on Chinese imports (particularly in the automobile sector) Chinese companies may be less impacted than the American brands that manufacture in China. What can Nike, Apple, GM and other companies do when they find that their costs, therefore prices to consumers, increase in the US, thereby triggering a contraction in demand?

The desired response, of course, is to set up manufacturing in the US, avoid the tariffs and enjoy a clear playing field with less international competition.

The reality is that setting up a factory even for a simple product like running shoes and apparel will take at least a year or two, while doing so for a complex product like computers could take two or more.

The second reality is that the whole reason for manufacturing moving out of the US in the first place was the high cost of labour in the US. That won't change any time soon.

The third reality, way back in the first couple of charts that we saw, is that we live in an interconnected world. If you want to make computers, cell phones or cars in the US and not be impacted by tariffs, there's a lot of other things that need to be made in the US first. Computer chips, automobile components, more steel – if those are being imported then there isn't a realistic opportunity to bring down the price to consumers of the finished product. Building factories for computers is a walk in the park compared to building one for making chips. Increasing steel capacity requires a very long lead time and may still require importing iron ore if there are limits on local mining capacity or natural resources.

Given that the term of any given government / President is 4 years, will companies feel comfortable about investing in building capacity on US soil when that could take 2-3 years? What if they do all that, start manufacturing in the US and the next President drops or significantly reduces tariffs?

What should companies do?

Companies are, in many ways, independent of countries. A global business can no longer tie itself exclusively to being a citizen of its country of origin, no matter how much pride is involved in that provenance. We've seen that with MNCs shifting their tax headquarters to a place with favorable terms. Viewed dispassionately from that perspective, there is really only one strategy to counter this situation – reduce dependence on the US market and US consumer demand and diversify revenue across more international markets.

That applies to both legacy US brands (Nike, Apple, Ford and so forth) as well as brands from Mexico, China and others around the world. The Nikes and Apples of the world should double down on selling to consumers in Asia, Africa, Europe and South America. US brands who, in the last few years, have pulled back from making marketing investments in China, for instance, should rethink the importance of China as a market going forward. Bear in mind that many of these brands manufacture in China already, so they have less to worry about in terms of tariffs and taxes in China than they do in the US. It's not just China, of course – but it does still represent a significant opportunity and one of the more stable economies in the world to focus on.

What about Chinese brands? They should do exactly the same thing. Look at ways to bolster domestic demand and also look at other international markets than the US. Major companies like Huawei, Xiaomi, BYD and the like have been doing this anyway, as a result of various barriers to their business in the US, so they're relatively insulated from these shocks. Others should follow that model and not be too dependent on the US as a market.

That applies not just to companies making consumer products but to others as well, and in a broader sense even to governmental and semi-governmental export boards. We will very likely see a reshaping of international trade if the US tariffs stay in place as they are for the duration of this presidency.

Summary

1. Even if businesses selling consumer goods in the US and all of their supply chain partners make their best effort and shave costs and margins, prices to consumers in the US will rise sharply. This will lead to a contraction of demand in the US, especially for non-essential goods.
2. The contraction of demand will lead to a fall in revenue for most businesses selling consumer goods in the US, many of which are US brands who are either manufacturing overseas or are heavily dependent on a global supply chain for their manufacturing.
3. Moving production to the US will not be a quick solution and will still not yield the ability to avoid the increase of prices to consumers.
4. The only feasible solution for the vast majority of businesses around the world, both US and international brands, is to diversify revenue across more markets and reduce dependence on the US consumer market. China, as one of the largest and most stable economies in the world, will continue to be a crucial market and companies who have deprioritized it in their post-COVID plans may need to rethink and refocus on this as well as other markets outside the US.

We've provided in this article a brief outline of some of the key impacts of the new US tariffs and potential strategy for companies to deal with them. Naturally this can only be a brief overview. We'd be delighted to have more detailed discussions and particularly, help you think about your China or Asia strategy. Drop us a line at enquiries@searchlightchina.com if you'd like to talk further.

About Searchlight Consulting

Set up in early 2020, Searchlight is a boutique management consulting firm headquartered in Shanghai. We focus on helping brands understand and prioritize their opportunities and overcome their barriers to growth. We do this by working closely with our client teams over an extended period, facilitating their process of decision-making, building capability by guiding and training their teams, and also helping with organization redesign if necessary.

Our team of 14 associates covers a wide range of specialist areas – business management, brand management, marketing, communication, media, HR, CRM, sales management, technology. Each of us has at least 20 years of work experience, a large part of that in China

We coach and assist client teams to make quality decisions for the business. We also assist in the design of organizational processes and financial models, especially building internal and external capabilities for strategy implementation.

We've worked with both international and local brands, startups, and public listed companies - J&J, Hollister Medical and Pandora as well as SUNNER Foods (a listed food processing company that has become one of the fastest growing B2C brands in China) and startups like Little Ondine, LeBunna and Youxin coffee. For more about us visit www.searchlightchina.com