

Futility of applying bilateral tariffs in a global economy increasingly apparent, as large firms side-step intended impact and small firms endure steady beating



European Chamber
中国欧盟商会

Larger firms have options to avoid the US-China 'border'

Many European companies have accepted the lasting nature of the US-China trade war and have effectively side-stepped the steep tariffs at the US-China trade 'border' through such strategies as rejigging their supply chains and leveraging their global corporate networks. Unlike unilaterally imposed tariffs on all imports irrespective of origin, bilateral tariffs are proving relatively simple for larger firms to avoid, albeit not without cost. Pre-trade war supply chains were set up to be as efficient as possible, so making any changes to them is costly, however this strategy is still far cheaper than the 25 per cent tariffs that would otherwise be faced. Some multinationals with a global footprint have simply rerouted the origins and destinations of US- or China-bound goods to avoid the 'border', rendering the bilateral tariffs ineffective.

Smaller firms at the mercy of supply and demand elasticity

Meanwhile smaller European firms are generally experiencing one of several different effects, largely based on the relative elasticity of supply and/or demand. There is an advantage to producing extremely high-quality goods, as is common for European firms, in that they are often irreplaceable to customers who are unwilling to accept anything less. This puts some in a position, when exporting from China to the US, that allows them to keep prices the same, passing the tariff cost along to Americans downstream.

The disadvantage to producing such high-quality goods has an equal and opposite reaction: in scenarios where European firms in China only have suppliers in the US that can produce what they need, American firms can pass the cost along in China.

European companies importing highly elastic goods into China have the option of dodging tariffs simply by changing supplier, while exporters to the US that face global competition must either eat the cost of US tariffs or lose market share.

The tariff's intended goals are not materialising, SMEs pay the highest price

The reality of the situation is that larger firms are forced to pick up marginal costs for outmanoeuvring the tariffs, while smaller European and American firms end up either passing costs along, eating costs themselves, or changing suppliers (if this option is even available). Is this meeting the intended goal of driving investors—particularly larger companies—from the Chinese market back to the US? Clearly not.

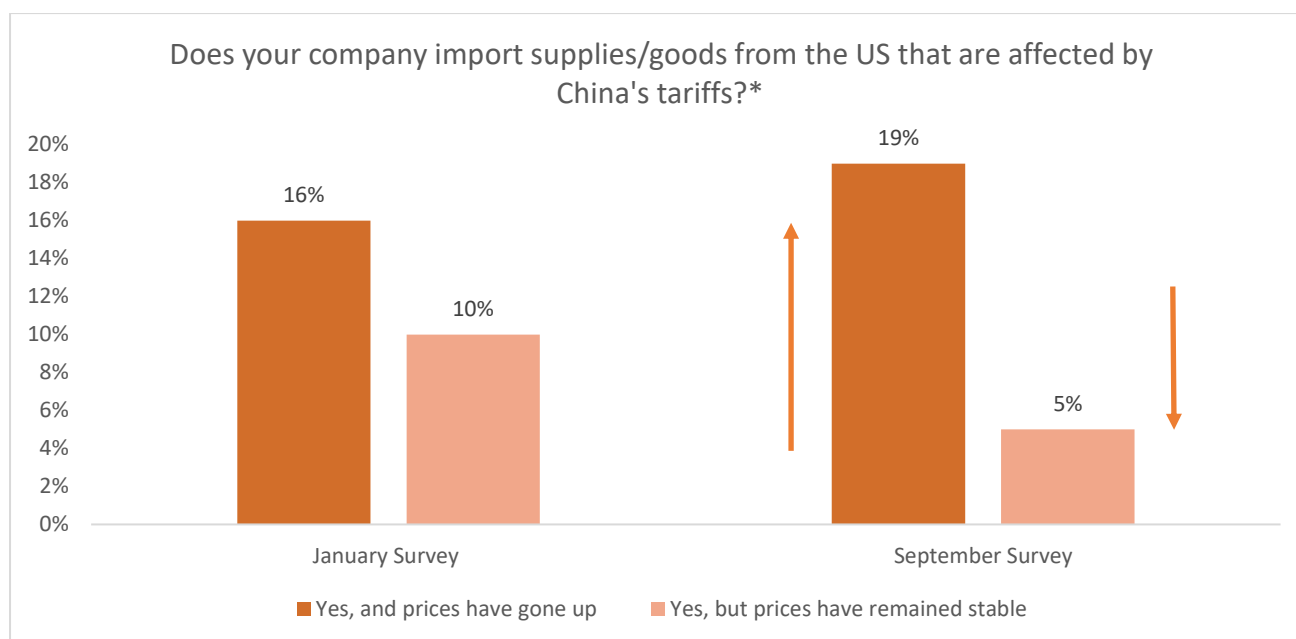
Many companies are moving relevant production out of China (mostly to Southeast Asia and India), and just as many are increasing their investments into China to onshore their supply chains to hedge against future uncertainty. The only way the US-China trade war could be considered a success is if its goal was to disrupt global supply chains at a modest cost to large corporations, while delivering a steady beating to unlucky China- and US-based SMEs on the wrong side of a supply chain.

"That European companies in China have effectively negated tariff effects in a relatively short space of time only serves to highlight the futility of bilateral tariffs in a global marketplace," said Joerg Wuttke, president of the European Union Chamber of the Commerce in China. "China certainly needs timely and wide-ranging reforms, and the right amount of strategic pressure can help move things in the right direction, but repetitive swings of the tariff hammer have proven anything but strategic."

Survey Results and Analysis

Background: From 12th– 20th September 2019, the European Union Chamber of Commerce in China surveyed its member companies to better determine how they are being affected by the ongoing US-China trade war. The survey was a follow-up to questions asked in a dedicated survey in September 2018, with further questions included in the annual European Business in China Business Confidence Survey 2019, which collected responses in January 2019. A total of 174 responses were collected in September 2019, in comparison to the 585 collected during the annual Business Confidence Survey.

More US suppliers are passing tariff costs along to China-based customers

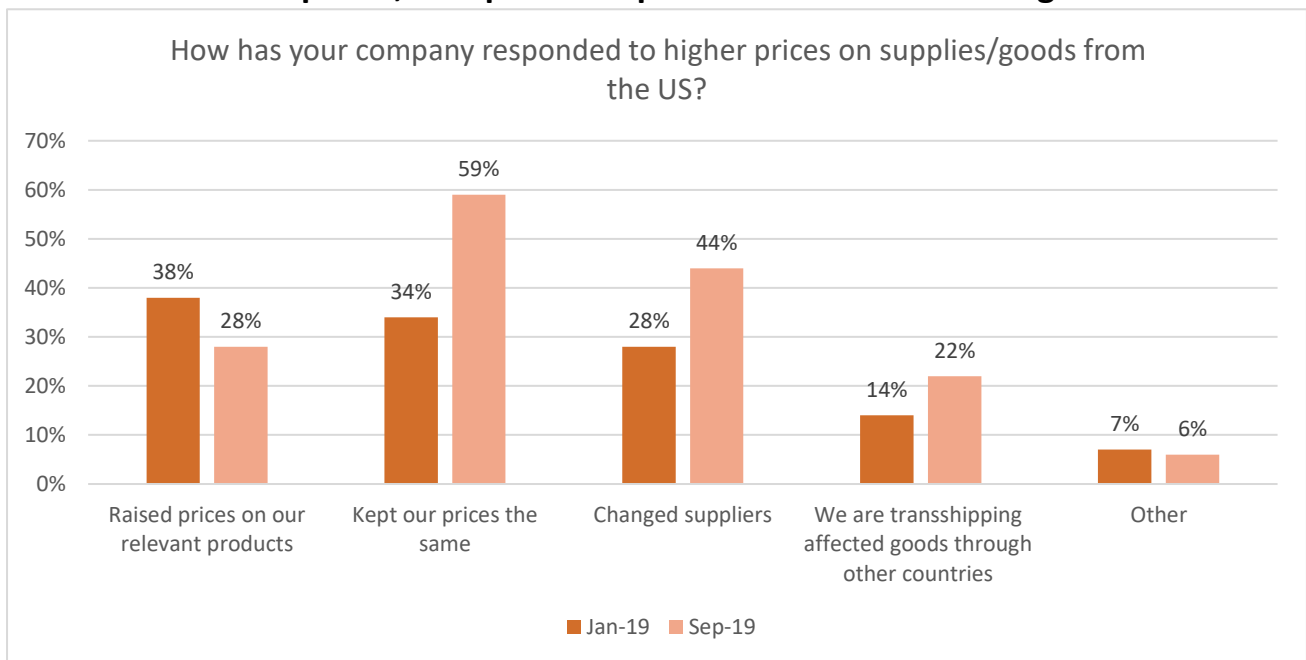


*Removed "No" responses, which were 74% and 76% of total respondents in January and September respectively

The proportion of US-based companies that are passing price increases along compared to those eating the costs of the tariffs has shifted considerably from about 60/40 to 80/20.

This increased gap indicates that many of the US-based suppliers that previously felt that they could cut into margins to avoid passing price increases along to China-based customers have changed their strategy in recent months and allowed prices to rise, likely due to higher tariff rates and the challenge of managing price cuts in a protracted trade war.

In response, European companies have shifted strategies



*Asked only if response to previous question "Does your company import supplies/goods from the US that are affected by China's tariffs?" was "Yes"

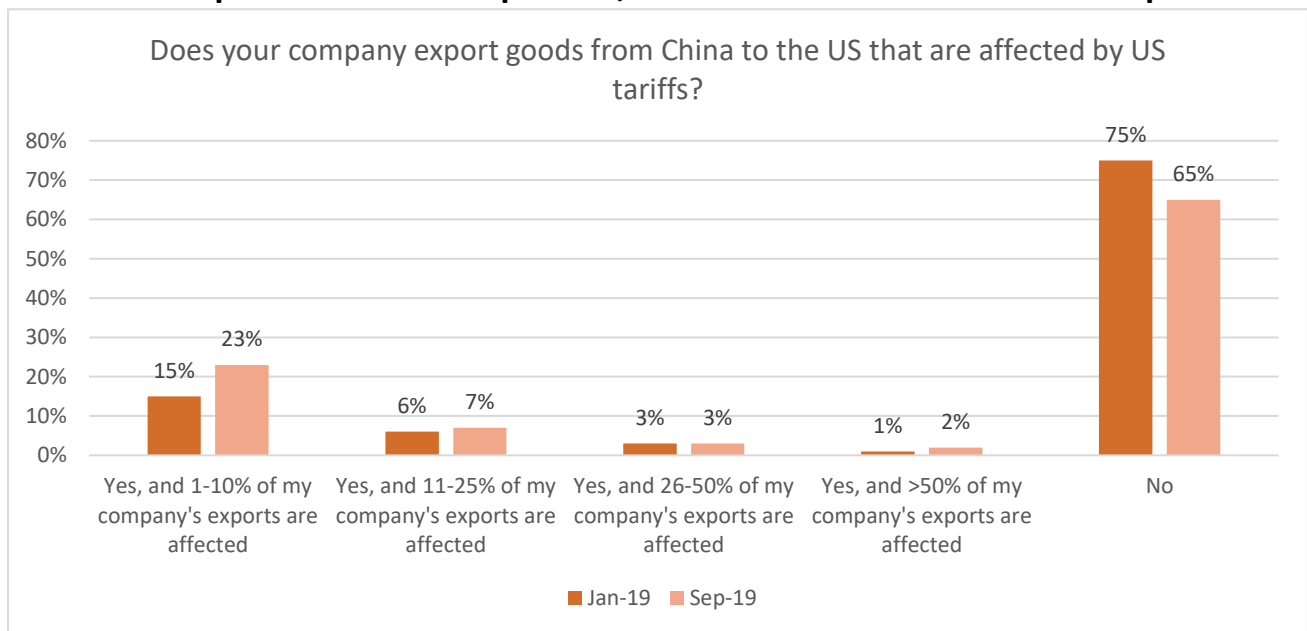
After displaying an even split in January, there are now twice as many respondents keeping their prices the same in response to higher prices as there are companies passing the costs along. This is explained by two main scenarios.

First, many companies can now keep their prices the same because of the significant increase in respondents that have changed suppliers or are finding other ways around the US-China 'border', thus negating the need to either raise prices or cut into margins. Similarly, a large number of European multinational companies have subsidiaries across many different markets, which can be brought into play to substitute production of commodities that would otherwise cross the US-China 'border', allowing them to completely avoid the tariffs.

Second, a certain share of those keeping their prices the same (i.e. not passing them along to customers) must do so because of the presence of alternative suppliers of their products from other markets. For example, a China-based European producer of a common medical device that relies on supplies that come from the US exclusively might have competitors in Japan. The goods coming from Japan would avoid the tariffs and be able to maintain their normal, competitive price, while the China-based producer would have to choose between raising prices (and losing market share) or keeping prices the same (and maintaining market share). Smaller producers are particularly hit by this trend, as they often lack the global production alternatives of MNCs to source production from alternative subsidiaries.

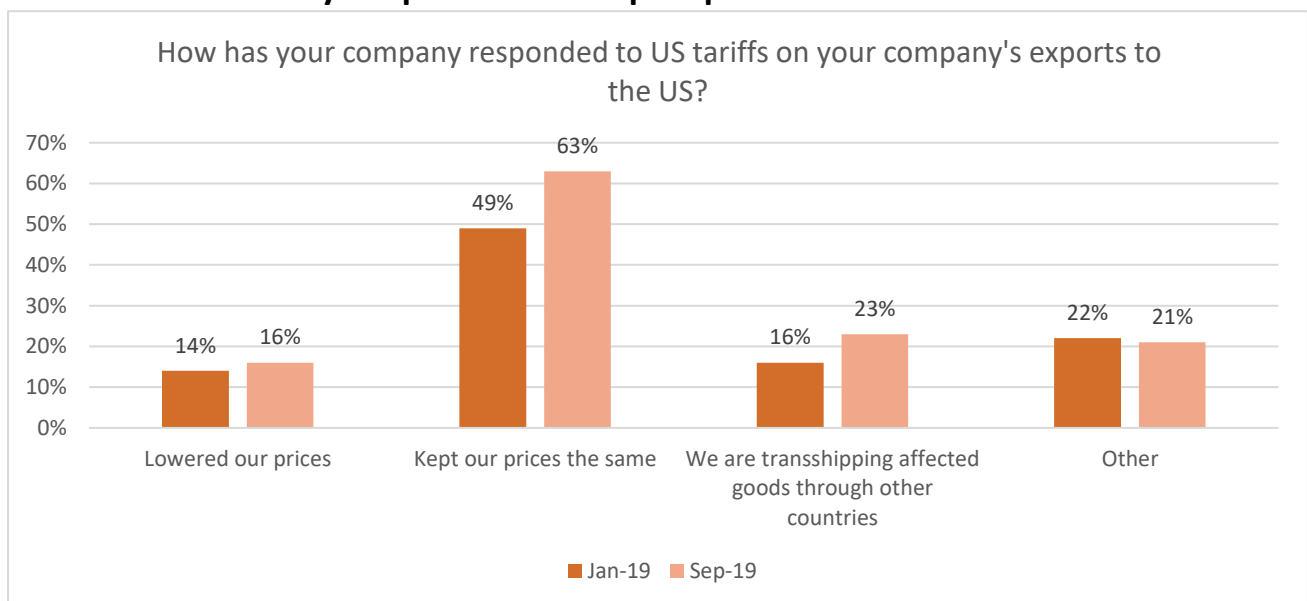
European companies have clearly adapted to survive in an extended trade war rather than hunker down in the hope that it will run its course, but the smaller companies that cannot leverage global supply chains to avoid the costs are continuing to take a steady beating.

As the scope of tariffs has expanded, so has the number of affected exporters



The number of European companies in China that export to the US and are affected by American tariffs climbed significantly from 25 per cent to 35 per cent. The bulk of new companies hit by new tariffs seem to be less exposed, however, with the majority seeing only one to 10 per cent of exports affected. However, for those seeing higher proportions of exports affected, this could become a life-or-death situation.

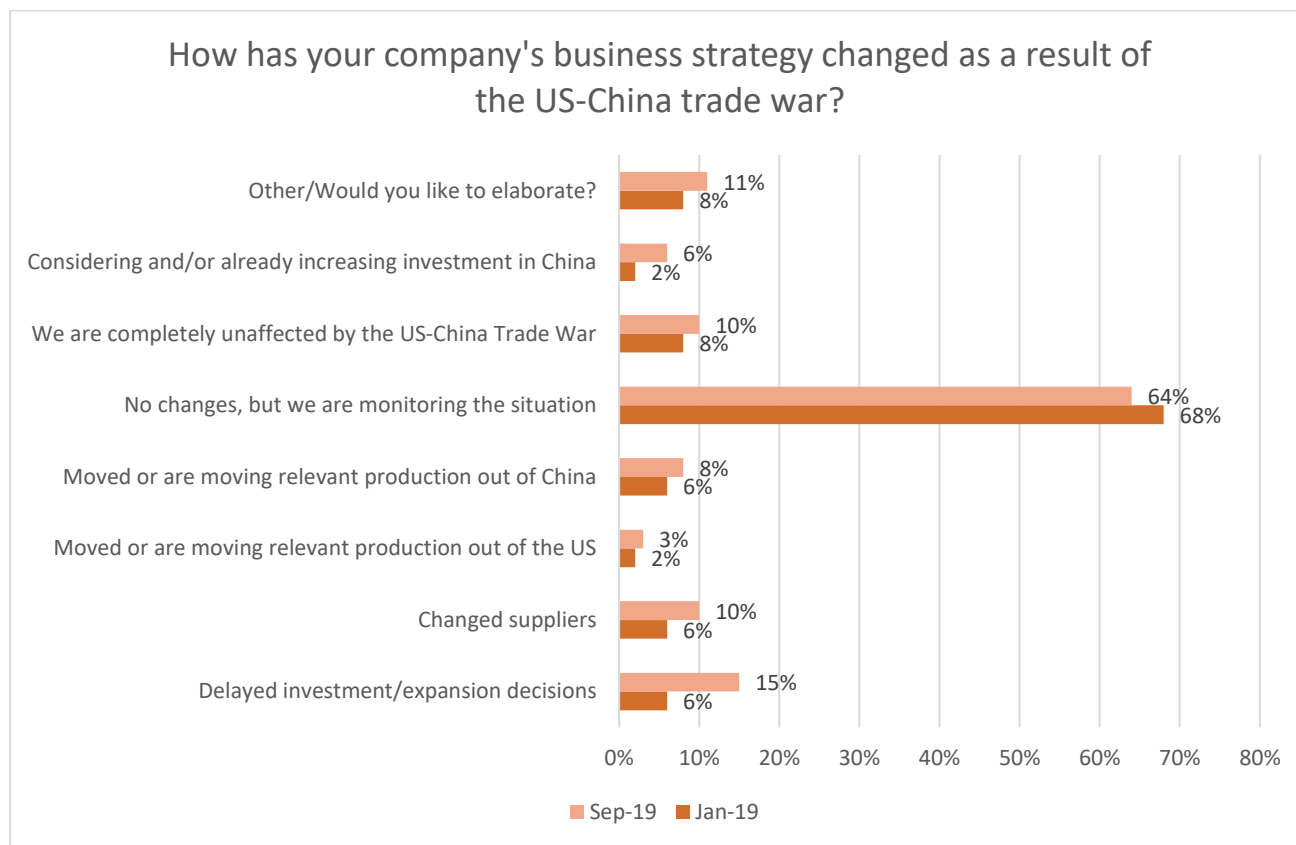
Four times as many keep US-bound export prices the same as eat the tariff costs



*Asked only if response to previous question "Does your company export supplies/goods from China to the US that are affected by US tariffs?" was "Yes"

A significantly higher number of European companies are now keeping their prices the same, despite the tariffs at the US border that will increase the cost of their products. This suggests either acceptance that they cannot offset the 25 per cent tariff rates, or demonstrates their confidence that downstream purchasers cannot, or will not, accept another product from a different source. The increased number of firms that are transshipping has risen considerably, and many of the "other" respondents indicated that they are adjusting

supply chains to service the US market from the EU or other third-markets. Companies appear to be making decisions based on the assumption that this will be a long-term issue.



More European companies have made strategic changes in response to the trade war compared to the European Chamber's previous survey. While small numbers have shifted investments out of China, roughly the same number are increasing their investment into China, essentially adopting the strategy of further onshoring to avoid tariffs altogether. This calls into question the efficacy of the tariffs used by the US, which have failed to achieve their goal of driving investment out of China.

Some of the individual responses to this question also shed additional light on the economic outlook:

- Several have simply shifted production of impacted goods to sister companies in Mexico to service both the US and China markets.
- One expressed the concern that their company is too reliant on China for suppliers, saying, "Our current dependency on Chinese suppliers might get very dangerous."
- Another noted that the effects of the trade war were indirect; that the overall demand on their products is driven by quickly-growing Chinese companies, which are now reducing their purchases as growth slows and they adopt a more sober outlook on the future.
- Two consultancies said that they were shifting services away from providing advice to Chinese companies looking to do mergers and initial public offerings abroad, which are less feasible in the US these days, towards providing service offerings that help companies cope with trade-war impacts.